Regulatory and Supervisory Independence: Is There a Case for Independent Monetary Authorities in Brazil

John William Anderson Jr.
REGULATORY AND SUPERVISORY INDEPENDENCE: IS THERE A CASE FOR INDEPENDENT MONETARY AUTHORITIES IN BRAZIL?

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"I wish to assert a much more fundamental role for institutions in societies; they are the underlying determinant of the long-run performance of economies."1

—Douglas North

I. INTRODUCTION

Despite its importance, the issue of financial sector regulatory and supervisory independence ("RSI") has received only marginal attention in literature and practice. The present work attempts to fill this gap by revisiting the theoretical approach justifying RSI and by conducting a case study on the Brazilian institutional framework.

The object of this paper assumes greater relevance in light of the current political and economic perspectives in Brazil. In May 2003, an amendment to article 192 of Brazil's Federal Constitution of 1988 regulating the Brazilian Financial System was approved by the Brazilian Congress.2 With the approval of this amendment, considerable changes are

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expected in the regulation of Brazil's financial system. Prior to being amended, the original constitutional provision established that the Brazilian Financial System, including banking, securities, insurance and re-insurance sectors, would be regulated by a single complementary law, which required a qualified quorum or an absolute majority of each of Brazil's legislative houses for approval. The constitutional amendment now allows the financial system to be regulated by more than one complementary law. Considering the complexity of issues in regulating the financial system, this amendment allows for more rapid legislative production on the subject. Thus, debates in connection with the effectiveness and soundness of the current regulatory and supervisory framework of Brazilian monetary authorities have regained importance.

In addition, it is uncertain how monetary policy and banking supervision in Brazil will be conducted within the administration of President Luís Inácio Lula da Silva. Certain challenges face the Brazilian monetary authorities in attempting to achieve monetary stability after the country's recent financial crisis in 1998 and 1999. These challenges include the reduction of inflation, the pursuit of economic growth, the control of currency value within the generalized global financial meltdown, and the guarantee of sound banking regulation and supervision. RSI can play an important role in the pursuit of such goals.

In the first part of this article, the theoretical background of RSI will be revisited and analyzed. Section one limits the scope of this work and establishes the different aspects of banking regulation and supervision. Section two addresses the main theoretical justifications for institutional RSI i.e., regulatory capture, time inconsistency, and the relationship between institutions and economic growth. Section three outlines the institutional framework of RSI. In the second part of this article, the degree of the Brazilian monetary authorities' RSI is assessed. Section four describes the institutional framework of Brazil's financial system, evaluates the degree of RSI within the Brazilian monetary authorities, and outlines proposals for improvements. The final part presents concluding remarks.

II. ESTABLISHING A THEORETICAL FRAMEWORK

A. DEFINING THE SCOPE – BANKING REGULATION AND SUPERVISION

1. Banking Regulation and Supervision – Definitions and Rationales

To limit the scope of this work and establish precise definitions of banking regulation and banking supervision, the boundaries of regulation and supervision must be set. In the present work, the term “regulation” should be understood as the normative intervention of the state in the economic activities of particulars, including the concession of public services and the direct regulation of economic activities. Similarly, the term “supervision” encompasses the activities of the state in connection with the enforcement of its normative activity. Supervision is often seen as an ancillary activity of regulation; it is directly related to the oversight of the
performance of certain activities by particulars and to the compliance of rules enacted by regulatory bodies.

Establishing definitions and rationales for banking regulation, however, is a difficult task. As noted by Mathias Dewatripont and Jean Tirole, "[t]here is no consensus in academe on why banks should be regulated, and whether they should be regulated at all." As a result, a vast amount of literature exists on many features of banking regulation, and consensus is rare.

Though current banking activities exceed the scope of traditional banking activity (deposit-taking and lending), most of the rationales for banking regulation are still based upon the traditional business of banks. Thus, the proposed definition for "banking regulation" is the set of rules in the form of legislation enacted by a parliament, administrative rules enacted by competent governmental authorities, and rules issued by international organizations and self-regulatory organizations that discipline the above-described banking activity and the institutions that perform such activity. "Banking supervision" refers to the oversight of banking activity and of the institutions performing such activity, as well as the enforcement of related rules.

Various rationales for banking regulation and supervision exist, including rationales arising from the traditional justifications for regulation, such as public interest, overcoming market deficiencies, and guarantee-
ing competition.\textsuperscript{8} Also, differing rationales exist for more specific features of the banking industry, including prudential,\textsuperscript{9} systemic,\textsuperscript{10} and monetary policy concerns.\textsuperscript{11}

The rationale of the Economic School, which concerns correcting externalities of the market or dealing with transaction costs, can be applied to banking regulation. Charles Goodhart and his co-authors point out that economies of scale can be secured by regulation and supervision in the banking industry.\textsuperscript{12} Regulation and supervision are pursued to obtain an efficient monitoring process of investment contracts and deposits, especially in determining the values of such contracts and deposits. Rosa Maria Lastra also recognizes the existence of information deficiencies as the main market imperfection that justifies banking regulation. The author outlines some natural monopoly features in the banking industry, as well as externalities caused by bank failures.\textsuperscript{13} Information deficiencies are acute in the banking industry because loans are made on a fixed-nominal value basis, and "[t]he non-marketability of the asset portfolio creates uncertainty, making it difficult to assess the creditworthiness of the banks and to distinguish the riskiness [sic] between strategies."\textsuperscript{14}

Guaranteeing competition is also defended as a rationale for banking regulation. Salomão Filho\textsuperscript{15} classifies the banking sector as one of those sectors in which regulation preserves competition in an environment that is propitious to undermine competition.\textsuperscript{16} The barriers of entry for new banks created by the authorization requirements of banking regulation are an example of factors that undermine competition in the industry.\textsuperscript{17} Likewise, Carlos Baptista Lobo suggests the idea of barriers of entry and even a potential natural oligopoly in the industry, mainly generated by the accrued reputation of existing banks.\textsuperscript{18} Predatory pricing and compulsory negotiations would be possible anti-competitive behaviors in the industry, facilitated by the high level of concentration in the sector (especially in recent years due to the failures of medium and small-sized

\textsuperscript{9} See Lastra, supra note 4, at 163; Goodhart \textit{et al.}, supra note 9, at 8-9.
\textsuperscript{11} See Calixto Salomão Filho, Regulação e Concorrência: estudos e pareceres 31-32 (2002).
\textsuperscript{12} Carlos Baptista Lobo, Concorrência Bancária 155 (2001).
banks) and the barriers to entry. In addition to the above-mentioned justifications, banking regulation rationales are also based upon the specific characteristics of the banking industry and banking activities. Most of the specific justifications for banking regulation arise from the main banking activities of deposit taking and lending. Lastra highlights the complexities arising from asset-liability mismatch as some of the main concerns of banking regulation.

The relevant literature differentiates between prudential and systemic rationales for banking regulation. Prudential regulation refers to "the safety and soundness of financial institutions vis-à-vis consumer protection." Goodhart and his co-authors make a case for prudential regulation because bank consumers would not be "in a position to judge the safety and soundness of financial institutions" in view of the difficulties of evaluation arising from the nature of banks' assets and liabilities. Dewatripont and Tirole make a similar case for banking (prudential) regulation by focusing their justifications on the protection of small depositors, who are unsophisticated and lack the necessary skills to monitor and evaluate the "intricacies of balance and off-balance sheet activities."

In addition to consumer protection, systemic concerns are at the core of banking regulation, as banks in particular are subject to causing and incurring systemic risk. According to Goodhart and his co-authors, "banks are subject to runs, which have contagion effects, and which can throw solvent banks into insolvency both because a large proportion of their assets are not easily marketable and, probably to a lesser extent, because the panic drives down the current value of marketable assets."

19. Salomão Filho, supra note 17, at 34-36.
20. See Lastra, supra note 4, at 81-82 ("[B]anks suffer a particularly acute maturity mismatch between short-term liquid liabilities [deposits] and longer term, comparatively, illiquid, non-marketable or, at least, non-marketed assets [loans, the marketability and evaluation of which are complex].").
21. See Goodhart et al., supra note 9, at 5.
22. Id.
23. Dewatripont & Tirole, supra note 3, at 31-32. Note that the authors advocate a different regulatory package for sophisticated clients and investors.
24. See Goodhart et al., supra note 9, at 5 (systemizing the case for prudential regulation to be necessary "where: (1) there is a fiduciary role of the institution; (2) consumers are unable to judge the safety and soundness of institutions with which they are dealing; (3) the value of contracts to the consumer is determined by the subsequent behavior of the institution, and [such institution] may become riskier because of a change in behavior after a long-term contract has been taken out by customers; and (4) there is a potential claim on a compensation or deposit insurance fund"). Banks are prone to have the above-described characteristics. First, banks assume a fiduciary role upon the management of the financial resources of third parties. Next, the complexity of bank's balance and off-balance sheet transaction and the evaluation of the assets of banks have already been addressed. Last, the role of the compensation of deposit insurance mechanisms is interesting to be observed. As demonstrated below, banks are usually offered protection mechanisms for failures to protect depositors and to avoid systemic risk. These mechanisms are apt to create a moral hazard scenario, which may encourage banks to engage in riskier activities.
25. Id. at 8-9. A bank's assets are mainly loans and are evaluated on the basis of information that the bank holds. In the instance of information deficiency, a sec-
For these authors, "[s]ystemic regulation is necessary when the social costs of the failure of a financial institution (particularly a bank) exceed the private cost and such potential social costs are not incorporated in the decision making of the firm."26 Lastra points to the systemic aspect as the main justification for banking regulation. Although acknowledging that "the safety and soundness of the financial system" and "the economic neutrality in the allocation of credit" are important justifications for regulation, its "ultimate goal is to safeguard confidence in the banking system."27

Again, the specific features of banking activities draw the scenario for systemic concerns. First, banks are subject to bank runs. Lastra reasons that banks runs are caused "because of the relative illiquidity of loans—they cannot be sold quickly without a loss in value—and because deposits can be withdrawn on demand or on short notice."28 Upon a lack of confidence in the financial system, the first-come, first-serve nature of bank deposits creates the incentive for a bank run. And because banks are prone to runs, maintaining public confidence in the banking system is crucial to banking regulation. Moreover, there is a risk of contagion in the banking system, and the collapse (illiquidity and insolvency) of one institution may cause the collapse of others, especially if doubts exist as to the soundness of a given financial system.

In the worst-case scenario, contagion and a lack of confidence in the financial system may generate a banking crisis. According to Mojmir Mrak, a banking crisis occurs "when actual or potential pressure on banks and/or their incapability of regular renewal of financial sources results in either their inability to meet their obligations or state intervention in form of financial help to the banks."29 Note that financial help would be given to banks with the aim of preventing their illiquidity or possible insolvency. The Slovenian author highlights that a banking crisis that involves a high number of banks has the potential of evolving into a crisis for the whole financial sector, including the securities markets.30

The systemic concerns of the banking system also have an international dimension. In the past few decades, the world witnessed the phenomenon of financial globalization,31 in which financial markets grew internationally and "financial innovation and new technologies have eroded geographic barriers."32 Several authors have considered the effects of
globalization on the international financial system, and many present a critical view, especially with respect to developing countries.\textsuperscript{33} The growing interdependence of financial markets and the consequent contagion risk of banking and financial crises creates the need for international coordination of banking regulatory and supervisory activities. The prudential regulation standards developed by the Basel Committee of Banking Supervision are an example of a response to such needs.

Finally, some authors identify concerns with monetary policy as a justification for banking regulation. Lastra highlights the special function of demand deposits as a major component of the money supply.\textsuperscript{34} Eduardo Salomão Neto reaffirms the money-multiplying factor arising from financial intermediation (deposit taking and lending) as the main justification for banking regulation.\textsuperscript{35}

2. A General Scheme of Banking Regulation and Supervision

In light of these rationales, banking regulation generally addresses: (1) authorization and licensing requirements; (2) capital adequacy requirements; (3) lending activity – terms, conditions and limitations; (4) deposit activity – terms, conditions and limitations; (5) off-sheet balance sheet activities, including securities underwriting, securitization, derivative transactions, stand-by guarantees, and foreign exchange activities; (6) illiquidity, insolvency and related liquidation and intervention procedures; and (7) deposit insurance, financial assistance, and other protection schemes.\textsuperscript{36} In addition, a general scheme of banking supervision would include “licensing [(referring to authorization and capital adequacy requirements)], supervision \textit{strictu sensu} [(also referred to as prudential supervision)], and sanctioning and crisis management,” which includes intervention, bankruptcy, and insolvency procedures, as well as deposit insurance schemes and monetary authorities’ role as lender of last resort.\textsuperscript{37}

The specific needs of banking regulation, namely prudential and systemic concerns, are addressed in those regulation and supervision schemes. Licensing and authorization, as well as capital adequacy requirements, guarantee that financial institutions have sufficient capitalization and acceptable standards of risk management in order to endeavor

\textsuperscript{34} LASTER, supra note 4, at 75.
\textsuperscript{35} Salomão Neto, supra note 11, at 22.
\textsuperscript{36} It is not our intention to design an exhaustive scheme of banking regulation. Banking regulation, broadly defined, would also include provisions with respect to disclosure, money laundry, corporate governance, and other particularities of the industry. The purpose here is to address banking regulation upon the justifications established and to limit the scope of the present work for purposes of studying regulatory and supervisory independence of monetary authorities.
\textsuperscript{37} LASTER, supra note 4, at 108-44 (serving as the design model for banking supervision).
deposit taking and lending activities. The stability of such institutions (systemic concerns) and the consequent consumer protection (prudential concerns) is clearly aimed.

Similarly, provisions addressing insolvency, bankruptcy, and intervention procedures purport to protect consumers and safeguard the stability of the financial system as a whole. Due to the complex valuation of bank assets and the going concern value that such assets exceed their liquidation value, banks are subject to intervention and differentiated liquidation procedures. Among other goals, such procedures are designed to maintain the value of bank assets during liquidation or insolvency procedures and possibly to sanitize unhealthy portfolios, thus avoiding bank runs and contagion. Finally, deposit insurance mechanisms, the lender of last resort for monetary authorities, and other bailout mechanisms, such as crisis management, address systemic concerns.

According to Brian Levy and Pablo Spiller, a regulatory design is composed of regulatory governance and regulatory incentives. The authors define regulatory governance as "the mechanisms that societies use to constrain regulatory discretion and to resolve conflicts that arise in relation to these constraints." Regulatory incentives refer to the material aspect of regulation. This paper concentrates on a particular aspect of regulatory governance, i.e., the case for regulatory and supervisory independence of monetary authorities.

B. THE CASE FOR REGULATORY AND SUPERVISORY INDEPENDENCE ("RSI")

1. Introduction

One of the important debates concerning regulatory governance refers to the independence of the regulatory and supervisory bodies, or, as described by the applicable administrative law literature, administrative decentralization. The debate was largely influenced by the institutional model of independent regulatory commissions of the United States, which in turn has influenced regulatory designs all over the world.

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39. Id. at 205.
40. LASTRA, supra note 4, at 10. For purposes of describing central bank independence, the author defines independence as follows: "Independence indicates the absence of political interference and implies the widest possible room for manoeuvre in the conduct of the policies [or competences] delegated to the central bank."
42. See id. at 6, 9-10. The U.S. model has three distinctive phases. The first wave of regulation occurred in the end of the nineteenth century and in the beginning of the twentieth century and was mainly focused on the antitrust agencies, which were created to deal with problems caused by natural monopolies. The second wave, contemporaneous to the "New Deal," was characterized by the creation of
As outlined by Steven Ramirez, the general policy arguments for independent agencies are guarantees of: (1) professionalism and expertise in connection with regulatory policy; (2) a stable and consistent basis for regulatory continuity; (3) constant regulatory adaptation to changing conditions; and (4) the elimination of political influence of special interests.\textsuperscript{43}

The creation of independent agencies or commissions has generated debates on their political and legal legitimacy within a democratic regime. For example, legislative delegation to independent agencies challenges the traditional concept of separation of powers and poses the question of how a governmental body that was not elected through traditional processes is able to enact rules. The same debate exists in connection with the enforcement and adjudicative powers of such agencies. Despite these debates, however, there is a consensus in literature and in different jurisdictions about the legitimacy of such independent agencies, provided that adequate mechanisms are in place to guarantee the accountability of such agencies and control their actions by executive, legislative or judiciary branches.\textsuperscript{44}

For example, the U.S. Supreme Court held that the Congress may delegate legislative powers without offending the constitutional requirement that Congress hold the legislative power of the federal government, as long as it provides intelligible principles to guide any agency in exercising delegated power. In addition, the U.S. Constitution limits the structural independence of such administrative agencies and provides that the President may remove officers of agencies upon a showing of good cause, pursuant to court interpretations. Finally, many of the acts of independent agencies and their budgets are subject to the control of Congress, and the judiciary may also review agency decisions.\textsuperscript{45}

Similarly, Brazilian independent agencies,\textsuperscript{46} created within the Plano Diretor de Reforma do Aparelho do Estado (Brasilia, 1995) and by the independent agencies in several sectors with legislative, adjudicative, and executive functions. The third wave can be placed after the eighties within the deregulation environment of that country. The Brazilian regulatory model has a clear inspiration in such regulatory evolution.


\textsuperscript{44} See Tojal, supra note 41; see also Paulo Todescan Lessa Mattos, Agências reguladoras e democracia: participação pública e desenvolvimento, in REGULAÇÃO E DESENVOLVIMENTO 182-230 (Calixto Salomão Filho ed., 2002).

\textsuperscript{45} See Ramirez, supra note 43, at 513-16, 525-26 (describing the U.S. accountability mechanisms and legitimacy debate).

\textsuperscript{46} The independent agencies are a legal figure entitled autorquias—"[a]n autonomous service, created by law, with legal personality and own financial resources, that perform activities of the public administration that require, for a better result, a decentralized administrative and financial management." Decreto-Law No. 200 of Feb. 25, 1997 [Decreto-Lei No. 200 de 25 de Fevereiro de 1997] (Braz.). In other words, autorquias are legal figures of the Brazilian legal system (legal entities under a public law regime) that allow decentralized administration of certain sectors. They are characterized by having autonomy in managing their financial resources and are controlled but not subordinated to the Central Administration. See C.A.B. Mello, CURSO DE DIREITO ADMINISTRATIVO 145-68 (15th ed. 2003), for a thorough analysis.
process of privatization of several economic sectors, have been subject to similar critics. Professor E. Grau clearly expressed his opinion towards the unconstitutionality of such independent agencies, noting that these regulatory bodies are characterized by: (1) the absence of hierarchic sub-

ordination; (2) independence or autonomy in the administrative, financial, patrimonial, technical, and human resources management fields; and (3) a fixed mandate and stability of its officers. The latter characteristic is incompatible with the constitutional regime of the autarquias: the officers, by definition, are subject to discretionary presidential control for appointment and dismissal purposes.

On the other hand, acknowledging the shift in legal paradigms with the advent of the so-called “regulatory law” arising from the changes in the behavior and role of the state during the past centuries, Tojal defends the legitimacy and constitutionality of Brazilian independent agencies upon a broader control of the normative activity by the judiciary power. Adopting a different approach, Paulo Mattos defends the legitimacy and constitutionality of the agencies upon the existence and successful implementation of instruments of public participation in the decision-making process of these bodies, such as public consultations, public meetings, and formal accusations by the public and interested parties.

In sum, RSI has been widely accepted within the new paradigm of regulatory law, provided that adequate control and accountability mechanisms are put in place. In the next section, two main theoretical streams that support RSI in the banking sector will be addressed.

2. The Capture Problem

The concept of capture is part of the deregulation trend in economic literature and arises as one of the main criticisms against regulation. In a seminal work, George Stigler suggests that “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.” Rather than pursing public interest, economists argue that regulated industries would be able to drive regulation towards its special interests. Stigler develops the capture problem upon the analysis of the legislative machinery and the costs involved in the legislative process, such as “votes and resources.” The author concludes that certain industries sufficient in size to bear such costs would succeed in having their interests contemplated by regulation.

47. See Law No. 8,031 of Apr. 10, 1990 [Lei No. 8,031 de 10 de abril de 1990] (Braz.).
49. Id.
50. Id. at 16-23.
53. Id. at 12.
In light of its characteristics, the banking industry is considered prone to capture problems. Ramirez asserts that bank regulation “naturally is more inclined to succumb to these influences because these are ‘money’ industries.”54 Writing about central bank independence in the context of conducting monetary policy, Alan Blinder highlights the risk that central banks may follow the interest of the market rather than pursue adequate policies.55

Professor Jeffrey Worsham concluded that organized interests can “reign supreme” in the banking industry in light of the following reasons.56 Banks can benefit disproportionately because regulation can “deliver concentrated benefits in exchange for diffuse or deferred costs.”57 In turn, banking regulation generally does not attract the attention of the general public, which facilitates the capture by specific interests (the author makes an exception for financial crises scenarios, and acknowledges that this capture factor may be transitorily annulled).58 Ramirez uses empirical evidence to justify his assertions by explaining that the U.S. savings and loan crisis of the 1980s—the costs of which amounted to one trillion U.S. dollars—was caused by “political distortions of regulatory policy” that had “their origins in severe failures by Congress as well as the primary thrift regulator, the FHLBB [Federal Home Loan Bank Board], to resist the political influence of the savings and loan industry.”59

Liliana Rojas-Suarez recognizes that regulatory capture problems occurred in the banking crisis in Ecuador in 1996 (though officially declared in 1998), in which “many areas of policymaking became subordinated to the situation in the banking system.”60 Financial conglomerates with considerable political power “prevented the strict application of any sound restructuring program,” and the lack of independence of the local Central Bank to declare the failure of an institution “subordinated its monetary policy to the liquidity needs of banks.”61 The author states that regulatory capture was “the main constraint that prevented an appropriate res-

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57. Id. at 557. The author exemplifies his statement upon the costs of relaxing banking soundness regulation, which are deferred and diffused. Bank profits are highly benefited by such relaxation.
58. Id. at 557-59.
59. Id. at 565-66. The FHLBB adopted new accounting standards called “Regulatory Accounting Principles.” According to Ramirez, “[t]his accounting approach allowed losses to be transformed into assets by allowing thrifts to spread certain losses over a period of up to forty years,” and “[t]his masked the worsening financial condition of the industry and allowed institutions that should have been shut down to remain in business.” Id. at 568.
61. Id.
olution of the 1996 crisis."\textsuperscript{62}

The above authors agree that banks have a considerable degree of influence over bank regulators. This influence is caused by the high concentration of the industry, the availability of resources to bear the costs of regulatory capture, and the public interests derived from the main rationales for banking regulation, namely prudential and systemic concerns. Upon the creation of favorable bailout, deposit insurance mechanisms, and relaxed capital adequacy requirements, regulators and supervisors will tend to observe the interests of the banking industry because the failure and insolvency of banks is likely to cause severe harms to the public interest and, ultimately, result in a banking crisis situation. It is widely accepted that highly profitable banks are unlikely to fail unless extremely risky and careless behavior is encouraged.\textsuperscript{63}

Thus, it is here advocated that regulators and supervisors should be insulated from the industry's capture, and the rationales of banking regulation and supervision should not be traded for the special interests of banks. As a result of broad delegation of authority to a singular agency with a high degree of independence, RSI is pointed to as an institutional solution for concealing the capture problem.

3. \textit{Time Inconsistency, Central Bank Independence, and Monetary and Financial Stability}

This section addresses the protection of RSI from undue political or governmental influence. In particular, this section develops the argument laid out by Marc Quintyn and Michael Taylor that "RSI is important for financial stability for the same reasons that central bank independence is important for monetary stability."\textsuperscript{64}

There is a great consensus in existing economic, legal, and political literature towards central bank independence ("CBI").\textsuperscript{65} In a famous lecture, Blinder presented an interesting definition of CBI stating, "To me, central bank independence means two things: first, that the central bank has freedom to decide how to pursue its goals and, second, that its decisions are very hard for any other branch of government to reverse."\textsuperscript{66}

\begin{itemize}
\item \textsuperscript{62} Id.
\item \textsuperscript{63} The existence of deposit insurance mechanisms, for example, as a regulatory mechanism to prevent systemic risks and failures, is considered by vast literature to create a moral hazard scenario and therefore encourage riskier bank behavior and consequently, the possibility of higher profits.
\item \textsuperscript{65} See id; \textsc{Blinder}, supra note 55, at 53-76; \textsc{Lastra}, supra note 4, at 10-69; \textsc{Independent Central Banks and Economic Performance} (Sylvester C.W. Eijffinger ed., 1997); \textsc{Geoffrey P. Miller}, \textit{An Interest-Group Theory of Central Bank Independence}, 27 J. Legal Stud. 433, 433-53 (1998); \textsc{Charles Goodhart}, \textit{Central Bank Independence} (London School of Economics, Financial Markets Group, Special Paper No. 57, 1993), \textit{available at} http://fmg.lse.ac.uk/pdfs/sp0057.pdf.
\item \textsuperscript{66} \textsc{Blinder}, supra note 55, at 54.
\end{itemize}
CBI is advocated mainly in monetary policy conduct, such as the pursuit of anti-inflationary policies by central banks and monetary authorities. The basic underlying justification for CBI is that politicians may often be heavily tempted to use monetary expansions to meet the financial needs of a given country inconsideration of the short-term benefits, which tend to be more popular with electors. In contrast, independent central bankers would consider long-term goals and seek the maintenance of price stability.

Conclusions about the benefits of CBI are grounded upon extensive economic literature. Goodhart identifies the origin of such reasoning in the Phillip's curve, which was developed by Bill Phillips, and points out the criticisms made by Milton Friedman to Phillips's findings.

Initially, Philips indicated that "an optimal combination, or trade-off, between inflation and unemployment" could be reached by governments or monetary authorities. In response, Friedman concluded there is no trade-off in the medium and longer terms between "inflation on the one hand, and output, growth and unemployment on the other." After unsuccessful attempts by governments to reach an acceptable trade-off between inflation and unemployment, it became clear that politicians would be tempted to achieve more popular short-time goals rather than committing themselves to a long-term low inflation target. Those conclusions were systemized in economic literature as the "time inconsistency" problem, which was developed by Finn Kydland and Edward Prescott in 1977. Inconsistency arises when the best plan made for a future period is no longer optimal at the time that period actually starts. Policy-makers elaborate policies pursuant to the current conditions, and such policies may not be optimal in the long run.

In 1983, R.J. Barro and D.B. Gordon developed this argument in connection with monetary policy and price stability. The authors pointed out that monetary authorities in a discretionary regime create inflation shocks ex-post, and people tend to adjust their expectations to such inflationary surprises. The potential for creating such ex-post inflation shocks generate higher average rates of inflation and monetary growth, as well as higher inflation costs. Barro and Gordon concluded the best solution for the time inconsistency problem is to introduce fixed rules in monetary policy rather than leaving the task to the discretion of political authorities. If a good enforceability mechanism is in place, either by a superior

67. See id. at 53-76.
68. Goodhart, supra note 65, at 2.
69. Id.
70. Id. at 2-3.
authority or by a reputation threat, monetary authorities will forgo "the short-term benefits from inflation shocks in order to secure the gain from low average inflation over the long-term." 73

Once rules determining price stability are preferable rather than discretion, handing authority over to an independent central bank is a way to formulate "a credible and binding commitment to price stability." 74 It is important to note the consensus in the literature concerning price stability and lower inflation rates as a value and a goal that must be pursued by monetary authorities.

Similarly, RSI has been advocated as a complementary feature of CBI, as it purports to guarantee financial stability, which is a twin goal of monetary stability. 75 In this regard, Lastra argues that "independence to pursue stable money should be accompanied by independence to pursue sound banking (...), because a sound banking system is a necessary condition for maintaining monetary stability." 76

Financial stability is strongly pursued in light of the financial sector crises of the 1990s, wherein the lack of independence of monetary authorities from political influence was blamed for deepening such crises. Quintyn and Taylor acknowledge that the experiences of certain countries demonstrate how inadequate arrangements to ensure the independence of the regulatory agencies contributed to financial instability and banking crises. 77

Young Shim recognizes the problems caused by the lack of independence ("government controlled banking system with lax regulation and supervision") of the financial authorities in Korea as one of the main causes of the Korean banking crisis. 78 Quintyn and Taylor also highlight the case of Japan, where "the lack of independence of the financial supervision function within the ministry of finance is also widely believed to have contributed to the emergence of financial sector weaknesses." 79

The same observations are made with respect to Indonesia where "intrusive interventions into the activities of the Indonesian Bank Restructuring Agency (IBRA)" were made by the Financial Sector Action Committee in connection with the Venezuelan banking crisis of 1994. 80

According to the authors, "[p]rotection of weak regulations by politicians and forbearance as a result of political pressures (preventing the regulators from taking action against institutions that they were aware needed to be intervened) are the two most common types of undermining

73. Id. at 102.
74. See Lastra, supra note 4, at 15; see also Independent Central Banks and Economic Performance, supra note 65, at xiii.
75. See Quintyn & Taylor, supra note 64.
76. Lastra, supra note 4, at 160.
77. Quintyn & Taylor, supra note 64, at 3-6.
79. Quintyn & Taylor, supra note 64, at 6.
80. Id. at 7.
the integrity of the supervisory function."^81

Once the case for regulatory independence is presented for purposes of achieving financial stability, useful analogies can be extracted from the theoretical background of CBI.^82

Time-inconsistency problems can be identified in the pursuit of financial stability, which would require the enactment of adequate regulations aimed at the soundness of the banking system. As described by Quintyn and Taylor, "[s]hort-term political objectives do not always coincide with this need for a clear and stable set of rules and regulations" and are not compatible with the pursuit of a long-term goal of financial stability.^83

Undue political influence would harm the credibility of a regulatory and supervisory system and possibly discourage investments in and the development of the banking system. In addition, the authors acknowledge that "[b]ank liquidations are typically politically unpopular since they can result in genuine hardship for depositors and other creditors."^84 Considering that depositors are voters, "[v]ote-maximizing politicians with shorter time horizons than supervisors may be concerned about the short-term costs of bank closure, whether fiscal, in terms of lost votes, or in terms of lost campaign contributions."^85 Thus, the supervisory activities could be compromised by undue political influence, as assistance packages are unduly granted and interventions delayed for the achievement of short-term and popular goals.^86

4. Institutions, Growth, and Credibility

Economic literature has outlined the relationship between legal and political regimes and institutions on the one side, and economic growth on the other. There is an agreement in literature that the strengthening of institutions in developing countries is a necessary measure towards economic growth.^87 Economic literature considers that weak institutions affect growth because they generate unnecessary transaction and transformation costs.^88 "Institutions may be [considered] weak because rules simply are absent, rules are suboptimal, or useful rules are poorly enforced."^89 For example, Janine Aron attributes the lack of correlation between the central bank's constitutional autonomy and low inflation in developing countries to the weakness of the judiciary in enforcing such

81. Id. at 6.
82. See id. at 10-13.
83. Id. at 11.
84. Id.
85. Id.
86. GOODHART ET. AL., supra note 9, at 120 (recognizing that bank regulators without political independence "may not be able to sell banking properties [of an insolvent institution] through arm’s length transactions.").
88. NORTH, supra note 1. See Aron, supra note 87, at 104.
89. Aron, supra note 87, at 104.
Discussions concerning the relationship between institutions and growth are complex and involve the definitions of a variety of concepts. A consensus has not been reached on the definitions of institutions or economic growth. For example, institutions may be comprised of informal and formal sets of rules. Economic literature presents several indicators of the measures of such relationships. In this respect, several factors have been established to qualify the degree of influence of institutions in a country’s growth, such as political stability, ethnic diversity, religious or colonial heritage, and past growth.70

It is important to note that the institutions comprising financial regulation and supervision of a country are taken into consideration in studies with respect to the relationship between institutions and growth. Aron exemplifies the relationship between institutions and central bank independence,71 and José Tavares highlights certain connecting factors of banking regulation and supervision with economic growth in Portugal.72

There are two main applications of the institutions/growth relationship to financial regulation and supervision, and both derive from the notion of capital and financing to development73 or of the level of investment as a determinant factor of growth.74 Pursuant to the first application, strong institutions in connection with banking regulation and supervision guarantee an efficient allocation of resources (savings) arising from the activity of financial intermediaries. Tavares points out that “one of the preeminent economic institutions, secure property and contract rights, is seen as key for banks and financial institutions to work properly; whereas,] [w]eak contract enforcement creates incentives for default by debtors and decreases willingness to lend.”75 In other words, sound investor or consumer protections upon the enactment of sound prudential regulation, including authorization requirements, capital adequacy requirements, regulation of banking transactions, and intervention and liquidation procedures, are an institutional requirement for growth. Within this context, RSI of monetary authorities can be advocated as an instrument of growth to the extent that it allows sound prudential regulation and avoids inadequate political and industry influence.

70. Id.
72. Aron, supra note 87, at 104.
74. Id. at 28.
75. Aron, supra note 87, at 100.
76. Tavares, supra note 93, at 28.
The second application refers to the systemic aspect of banking regulation and supervision, and to the relation of efficient investment to growth. Within a scenario of financial globalization and the consequent capital flows amongst nations, efficient designs of financial regulation and supervision will grant a given country the necessary credibility for receiving cross-border investments and will allow such a country to benefit from the economic growth arising there from. To the extent that financial stability is achieved by means of RSI of monetary authorities (since the presence of strong institutions signals to the international community of the commitment of a given country to financial stability), RSI can again be considered an institutional arrangement that supports growth.

5. Final Considerations

The purpose of this chapter is not to make a panacea in connection with RSI, and critics in connection with the subject are acknowledged. Quintyn and Taylor highlight the argument developed by Edward Kane, who argues that "the incentives faced by regulators differ from those faced by conservative central bankers" and "regulatory forbearance [would] arise . . . from self-interested actions of regulators rather than those of politicians" due to their incentive structure. In addition, the authors argue that RSI gives supervisors the "coercive power of the state against private citizens" (non-existent in CBI), and independence to such bodies could be dangerous and against democratic values. As further demonstrated herein, these arguments are outplayed by adequate accountability mechanisms, appropriate incentive structures, and institutional mechanisms.

With respect to developing countries, critics argue that granting legal independence to institutions may be a wrong alternative. In the context of CBI, Christos Hadjiemmanuil argues that "[g]iven the distance between legal arrangements and practical application, which is particularly pronounced in countries lacking a tradition of good governance, legal independence may become a dead letter, concealing, rather than minimizing, the politicization of monetary policy." Drawing an analogy to RSI, the merits of the arrangement are considerably hindered in a country with weak institutions and credibility, as stated in section 2.4 above, and with personnel lacking appropriate regulatory expertise.

In sum, despite RSI's critics, the theoretical background outlined above supports a strong case for this institutional arrangement. The next sec-

97. Quintyn & Taylor, supra note 64, at 10 (citing Edward J. Kane, Principal-Agent Problems in S&L Salvage, 45 J. Fin. 755 (1995)).
98. Id. at 12-13.
99. Id. at 13.
tion will address the institutional and legal framework that guarantees RSI.

C. THE INSTITUTIONAL FRAMEWORK OF REGULATORY AND SUPERVISORY INDEPENDENCE

1. Introduction

This chapter will analyze the legal and institutional arrangements that guarantee RSI of monetary authorities. Literature refers to institutional independence as “the status of the agency as an institution separate from the executive and legislative branches.”\(^{101}\) Although it is recognized that governments, through the executive or legislative branches, have the ultimate power to restructure the agency, institutional arrangements are necessary for the officers of agencies or monetary authorities to have “the widest possible room for manoeuvre” in regulating and supervising the banking industry.\(^{102}\)

Thus, legal arrangements are an important factor of RSI. Independence should be recognized in the constitution, in applicable laws, or by contract (statutory independence), so that the government is bound by the rule. The purpose is not, however, to make a panacea out of institutional arrangements. As noted by Ramirez, the legal structure of an agency is only part of the agency’s political independence, as ultimately, the political branches (the legislative branch, in particular) have the power to restructure the agency or limit its independence.\(^{103}\) Therefore, independence will depend “not only upon the agency’s structure, but also upon the strength of presidential and congressional commitment to its independence.”\(^{104}\)

2. Institutional Dimension of Independence

a. Appointment, Dismissal and Terms of Office

Clear rules in connection with appointment and dismissal avoid discretionary governmental influence in the regulatory and supervisory body and grant officers a reasonable degree of freedom in conducting the agency’s functions. For purposes of CBI, Lastra argues that the appointment of governors of monetary authorities should be pluralistic, which implies the participation of bodies or economic agents in addition to the government.\(^{105}\) A pluralistic appointment would divide the sources of possible influence within the authority. Clear rules of dismissal are also an important aspect of institutional independence and should be based upon an officer’s competence and probity,\(^{106}\) rather than upon the deci-

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101. Quintyn & Taylor, supra note 64, at 20.
102. See Lastra, supra note 4, at 10.
104. Id. at 518.
106. Id. at 31 (defending that the grounds for dismissal, as adjudicated by an independent court of justice, should include the following: criminal offence or serious misconduct, permanent incapability, and serious lack of fulfillment of obligations).
sions they reach.\textsuperscript{107} As explained below, revision of decisions should be part of accountability arrangements and should be carried out by an independent branch, such as the judiciary. Finally, agencies should have a sufficiently long term of office to safeguard independence and prevent undue political influence under short-term perspectives.\textsuperscript{108}

b. Other Personnel Concerns – Suitability, Salary, and Restrictions

Lastra\textsuperscript{109} and Quintyn and Taylor\textsuperscript{110} advocate the position that officers of regulatory and supervisory bodies should have skills compatible with banking regulation and supervision. This correlates with a main rationale behind independent agencies, which is to provide adequate regulation and supervision to a complex industry, the development of which is constant due to changes in the economy, technology, and in the international scenario. Skilled professionals should be selected based on legal requirements for academic and professional qualifications, as well as evidence of previous experience within the industry and with the tasks that a given position requires.

Measures should also be taken in order to grant officers professional independence, both from the industry and from the government. A guarantee of an adequate salary is an institutional arrangement that fulfills such a purpose, as it attracts skilled and qualified professionals to the regulatory body and hinders the incentive for additional compensation or bribery practices from the industry-side. Additional measures that encourage independence can be achieved with restrictions to the officers of regulatory agencies. During their terms of office, such officers should not perform activities that are incompatible with their regulatory and supervisory tasks, which might generate conflicts of interest between the goals of sound banking regulation and supervision, the industry’s interest, and even governmental goals.\textsuperscript{111}

Similarly, conflicts of interest can be avoided by restricting officers of regulatory and supervisory bodies after they leave office to avoid capture-related problems and electoral-related conflicts of interest. Lastra argues that “[c]entral bank officials should...be limited in their ability to pursue private employment in credit and financial institutions” and “ineligible to become government officials” for a reasonable period following their term of office.\textsuperscript{112} This would be an incentive for officers not to attend to industry’s interests or short-term and popular goals in detriment of long-term sound banking regulation and supervision. Nevertheless, arrangements have to be put in place so that those officers are guaranteed an adequate wage during such restrictive period.

\textsuperscript{107} See Quintyn & Taylor, supra note 64, at 20.
\textsuperscript{108} Lastra, supra note 4, at 30.
\textsuperscript{109} Id. at 32.
\textsuperscript{110} Quintyn & Taylor, supra note 64, at 20.
\textsuperscript{111} See Lastra, supra note 4, at 34.
\textsuperscript{112} Id. at 35.
c. Governance Structure and Decisional Autonomy (RSI Stricto Sensu)

The design of the governance structure and decision-making procedures of agencies are crucial for the maintenance of independence and the achievement of a consistent regulatory and supervisory scheme. Quintyn and Taylor recommend multi-member commissions to guarantee a continuous decision-making process and avoid the influence of a single individual.\footnote{113} The authors also advocate thorough transparency and disclosure within the decision-making process, “making it possible for both the public and the industry to scrutinize regulatory decisions minimizing the risk of political interference.”\footnote{114} In addition, the agency in charge of banking regulation and supervision should have independence on the performance of its tasks or, in other words, regulatory and supervisory independence \textit{stricto sensu}.

Quintyn and Taylor suggest the following legal designs to safeguard supervisory independence: (1) legal protection to bank supervisors upon the execution of their supervisory task, so that supervisors cannot be threatened by lawsuits and other means for reasonable performance of their functions; (2) a transparent rules-based system of sanctions and interventions, in order to remove discretion in individual cases, and therefore, industry capture;\footnote{115} and (3) adequate and transparent administrative procedures in connection with sanctioning financial institutions (in particular, with adequate time limits for appeals).\footnote{116}

d. Budgetary or Financial Autonomy

Quintyn and Taylor define budgetary independence as “the role of the executive/legislature in the determination of the size of the agency’s budget and its use, including staffing of the agency and salary levels.”\footnote{117} In general, agencies can be funded by the government either from their supervisory ministry or directly from the budget or alternatively, from the regulated industry.

In the first case, agencies may be open to political interference of different sorts, including: (1) not having enough budget to conduct adequate wage policies; (2) the budget may be subject to cuts during periods of fiscal austerity; and (3) manipulation by politicians if the agency is pursuing ends that are contrary to political interests. If the money has to come from the government budget, the agency’s budget should be “proposed and justified by the agency, based on objective criteria related to develop-

\footnote{113} Quintyn & Taylor, supra note 64, at 20.  
\footnote{114} Id.  
\footnote{115} We acknowledge that supervisors should have some level of discretion in view of systemic concerns and available bailout mechanisms to failing banks. Nevertheless, such level of discretion should be based upon defined parameters to avoid capture by the industry.  
\footnote{116} Id. at 17-18.  
\footnote{117} Id. at 21.
ments in the markets."

In the second case in which resources are obtained from the regulated industry through such means as collection of fees upon the exercise of the supervisory activity, legal and accountability mechanisms should be in place so that fees are reasonably defined and budgetary dependence from the industry does not exist. That can be achieved with objective and transparent criteria for the collection of such fees.

3. Accountable Independence

As described above, the creation of independent agencies generates concerns of legitimacy within a democratic regime especially in view of the broad reach of supervisory powers. Also, there is a consensus in literature about the legitimacy of independent agencies, provided that adequate mechanisms are in place in order to guarantee their accountability. In general, an accountability system requires that the agency justify its policies and actions, and the agency must account for the decisions made in the execution of its responsibilities.

Several legal structures can be set out to achieve accountable independence. Page recognizes three models of “regulatory legitimacy” relevant for the establishment of regulatory accountability and control: (1) legislative mandate; (2) oversight; and (3) due process. The legislative mandate model sets forth that “agency action is deserving of support when it is authorized by the legislature.” This is the statutory form of accountability, which is provided by legislation itself in the form of objectives and principles to be followed by the regulatory and supervisory body. The imposition of goals and general duties opens the way for judicial revision of the agency’s actions. The oversight or “checks and balances” model is characterized by the “subjection of the regulator to adequate checks and balances.” It is derived from the constitutional and administrative law theory of checks and balances among the executive, legislative, and judicial powers. This model includes internal controls, ministerial controls, parliamentary controls, judicial controls, and stakeholders’ controls. Control by the executive (ministerial control) is a crucial feature of banking regulation. The applicable national treasury or finance ministry has its role in the formulation of monetary policy. Moreover, a degree of information exchange and cooperation with the main financial and monetary authorities is advisable. In the Brazilian independent agency design, for example, agencies are submitted to ministerial control depending

118. Id.
119. See Lastra, supra note 4, at 49.
121. See id. at 129.
122. Id.
123. See Quintyn & Taylor, supra note 64, at 30, (describing the “dialogue model,” which contemplates that regulators should do their best to be informed about the intentions, wishes, and opinions of the political leadership and to anticipate their
on the sector, and the executive has the power to indicate the directors of such agencies.

Both on a periodic and extraordinary basis, parliamentary control implies either direct control by the parliament, if the agency is not subject to the direct control of the executive, or reporting requirements directly to the parliament.\textsuperscript{124} The Financial Services Authorities ("FSA"), a U.K. mega-regulator, is accountable to ministers of the Parliament and has to submit an annual report to the scrutiny of the legislative body.\textsuperscript{125} The FSA is also required to make reports in connection with its activities, including an annual report of its operations to the Congress.\textsuperscript{126} In Brazil, the Senate may direct inquiries to the directors of certain agencies, including the independent agencies, the antitrust authority, and the central bank.

Some authors classify judicial control under the legislative mandate model, as it purports to control the lawfulness of the agency's acts and decisions in the fulfillment of its functions.\textsuperscript{127} It must be understood that judicial control is a crucial part of any accountability mechanism, especially if there are laws setting forth the limits, goals, and parameters for the rules and supervisory activities carried out by the agencies. With respect to the Brazilian regulatory system, Tojal advocates a thorough control of the agencies by the judiciary, including verification of the implementation of statutory goals and directives of agencies.\textsuperscript{128} Although accountability mechanisms available to the industry should be limited in order to discourage regulatory capture, stakeholders' control refers to the exercise of accountability by industry and consumers.\textsuperscript{129} Instruments of public participation in the decision-making process of regulatory agencies, including public consultations, public meetings, and formal accusations by the public and interested parties, are examples of stakeholders' control.\textsuperscript{130}

Internal controls can be an additional mechanism of accountability, particularly if the committee or persons performing this function are granted a considerable degree of independence from the directors of the agencies through, for example, a transparent dismissal procedure. Such controls may verify how the agency is conducting its financial affairs, the efficiency of allocation of resources, and the overall performance of the regulatory work. The FSA has a non-executive committee that performs such internal controls.\textsuperscript{131}

\textsuperscript{124} See Lastra, \textit{supra} note 4, at 54-55.
\textsuperscript{125} See Page, \textit{supra} note 120, at 133.
\textsuperscript{126} See Ramirez, \textit{supra} note 43, at 525-26.
\textsuperscript{127} See Lastra, \textit{supra} note 4, at 57.
\textsuperscript{128} Tojal, \textit{supra} note 41, at 22.
\textsuperscript{129} See Page, \textit{supra} note 120, at 135.
\textsuperscript{130} See Mattos, \textit{supra} note 44, at 204.
\textsuperscript{131} See Page, \textit{supra} note 120, at 131.
Finally, the due process models consist of the adoption of adequate and fair administrative procedures so that the agency can better serve the public interest and provide equal treatment to those subject to their regulatory and supervisory activity. Clear definitions and limitations of rule-making, disciplinary, and enforcement powers will provide an additional control over the regulatory and supervisory activities, and will grant those persons subject to regulation and supervision additional tools through administrative procedures to question and contest unlawful rules and supervision procedures.

It must be noted that arrangements for accountability must allow the agencies to exercise discretion in a reasonable way, as there is a risk that independence may be lost within the mechanisms of a strict accountability regime. As pointed out by Quintyn and Taylor, "[p]roperly designed independence arrangements **MUST INCLUDE** mechanisms for holding the agency accountable for the discharge of its functions **without creating opportunities for ad hoc interference with its operations.**"133

4. Regulatory and Supervisory Structure

The final aspect of institutional independence is the choice of regulatory structure, which should contemplate the mechanisms and arrangements described above to achieve accountable independence. Throughout the present work, the terms "agency," "regulatory and supervisory bodies," and "monetary authorities" refer to financial regulators and supervisors. The reason for such broad terminology is that there are existing debates in the literature over who should perform banking regulation and supervision. The two main debates concern the creation of a "mega-regulator," which would be an appropriate structure to regulate and supervise financial conglomerates, and the attribution of the regulatory and supervisory activities to an agency different than the central bank. These debates will be briefly addressed here, from the perspective of RSI.

Some qualifications are necessary before addressing the debates. Economic and legal literature presents a variety of optimal regulatory designs with differing degrees of independence and autonomy. Taking into consideration the popular Brazilian expression that "the paper accepts everything," optimal regulatory and supervisory designs must be analyzed with a degree of care. Also, it is doubtful that a pure design would be applicable to any given country. As pointed out by Goodhart and his colleagues, "[d]ifferences in institutional structure are the result of several factors: historical evolution, the structure of the financial system, political structures and traditions, and the size of the country and financial sector."134 Provided that the objectives of regulation are duly pursued, the optimal design will invariably be dependent upon the specific characteristics of a

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132. See id. at 137.
133. Quintyn & Taylor, supra note 64, at 29 (emphasis added).
134. Goodhart Et. Al., supra note 9, at 145.
given country, and any suggestions in this regard should be qualified in this way.

The case for a "mega-regulator" or an integrated financial authority, defined as a regulatory and supervisory body regulating and supervising the banking, securities and insurance sectors, is advocated in view of the growing existence of financial conglomerates and the constant diversification of the activities of banks, which are not confined to the traditional banking business. From the perspective of RSI, authors agree that such an agency could benefit from the existing independence of regulatory bodies of the different sectors. On the other hand, strict and powerful mechanisms of accountability would have to be in place because such a body would encompass overwhelming adjudicative and legislative powers.

Changing a system of separate regulatory and supervisory bodies for different financial sectors into an integrated system is not an easy task. Many costs are involved in the process, including the dismissal and allocation of personnel and the recording and transmission of "regulatory memory." In addition, such change of regime is considerable in the regulatory culture of any country. The implementation of an integrated regulator in Brazil, for example, would face both obstacles, and it would be hardly feasible. Therefore, in light of the purpose of this article, i.e., to evaluate RSI of Brazilian monetary authorities, the analysis of the "mega-regulator" structure will be limited.

On the other hand, the debate on the separation of regulatory and supervisory functions from central banks can bring some interesting ideas and suggestions to the Brazilian regulatory model, especially because the Brazilian legal system contemplates the existence of independent agencies as described above.

Arguments exist for and against the separation of regulatory and supervisory functions from central banks. The main argument for separation is the potential conflict of interest between banking supervision

135. Id. at 147. The authors present a useful definition of financial conglomerates based on the De Swaan Report of the Tripartite Group of Bank, Securities and Insurance Regulators (The Supervision of Financial Conglomerates): "any group of companies under common control whose exclusive or predominant activities consist of providing services in at least two different financial sectors (banking, securities, insurance)." Id.

136. As set forth by Goodhart and his co-authors, "[t]he creation of a single regulator would involve a loss of potentially valuable information simply because a single approach was adopted. In effect, there is merit in having a degree of competition and diversity in regulation so that lessons can be learned from the experience of different approaches." Id. at 154.

and monetary policy. Determining interest rates in connection with the injection or withdrawal of reserves is a clear example of such conflict. Monetary authorities will likely pursue higher rates for such purposes as achieving price stability, maintaining an exchange rate peg, or reducing monetary growth. Meanwhile, regulatory authorities are concerned with the adverse effects of higher rates upon bad debts, profitability, capital adequacy, and the solvency of the banking system. Therefore, the regulatory concern within a central bank would jeopardize the pursuit by such authority of adequate monetary policies.

Joseph Norton adds that separation is also a useful tool to guard the reputation and credibility of a central bank because the bank is not made liable for banking failures or crises. In addition, he argues that the increasingly diverse nature of financial institutions prevents the central bank from administering adequate supervision. Nevertheless, he recognizes that the lack of experienced financial personnel in developing countries hinders the weight of this argument, and useful synergies are gained "by placing banking supervision under the central bank's responsibility."141

The three main arguments against separation are those relating to the central bank's lender of last resort function, those involving the system of payments, and those advancing the need for consistency between monetary policy and banking supervision. The first two arguments derive from the simple notion that whoever pays for a risk taken by third parties should be able to monitor the behavior of the persons taking such risk. If the central bank is the one performing the lender of last resort function by paying for the rescue of illiquid and insolvent authorities and guaranteeing liquidity risks within the payment system, then regulation and supervision of the behavior of banks and of the participation in the payment system are justified and necessary. Norton suggests that "[t]he separation of the central bank from the banking supervisory functions is an effective separation of the lender of last resort from the information it needs to exercise its duties." The final argument, in connection with the consistency between monetary policy and banking supervision, concludes that monetary stability and financial stability are two sides of the same coin. Therefore, the authority elaborating monetary policy should have a "comprehensive and intimate understanding of the workings of the banking system." Concentrating the roles in one body would be an optimal method of achieving such a result.

139. See Norton, supra note 137, at 10-11.  
140. Id. at 10.  
141. Id. at 11.  
142. Id.  
143. See Goodhart & Schoenmaker, supra note 137, for a thorough analysis.  
144. Norton, supra note 137, at 11.  
145. See Quintyn & Taylor, supra note 64, at 24.  
146. Norton, supra note 137, at 12.
Thus, it is possible to say that separation and concentration are feasible regulatory designs, and their implementation will depend on the regulatory culture of a given country. Nevertheless, given the traditional roles of the central bank and the systemic concerns arising from financial globalization, the study of both arrangements makes it clear that a degree of interaction and transparency among the authority elaborating monetary policy, the body exercising the functions of lender of last resort, the body guaranteeing liquidity in the payment system, and the regulatory and supervisory agency of the financial sector is vital and indispensable.

Discussions regarding separation and concentration have interesting implications in relation to RSI. Quintyn and Taylor argue that concentration favors RSI because CBI has found wide recognition in the last decades, and "supervisors could 'piggyback' and enjoy (or build up) the same degree of autonomy and prestige."147 By the same token, separation is highly advisable when the central bank of a given country does not enjoy an adequate degree of independence. In addition, some countries provide for special independence regimes for regulatory and supervisory agencies, mainly in connection with public utilities. In this case separation would cause banking supervisors and regulators to "piggyback" similar degrees of independence.

III. EVALUATING BRAZILIAN MONETARY AUTHORITIES

A. BRAZILIAN MONETARY AUTHORITIES AND RSI

1. Introduction

The present section purports to evaluate the level of RSI of Brazilian monetary authorities. The first part outlines the history of monetary authorities in Brazil and will demonstrate a certain degree of political and industry influence in monetary and banking affairs, even in the first monetary authorities of the country. The second section addresses the current legal and institutional framework of Brazilian monetary authorities and evaluates its degree of institutional RSI. The third section addresses the material commitment of Brazilian political authorities to RSI of monetary authorities and to sound banking regulation and supervision, especially after the implementation of the Real Plan (as defined below). The last section discusses the case for institutional RSI of Brazilian monetary authorities and presents suggestions to improve institutional RSI within the Brazilian banking sector.

2. Brazilian Monetary Authorities – A Story of Influences

a. The Path Towards a Central Bank

The monetary history of Brazil begins with the opening of the ports and the liberalization of trade phenomena observed after the Portuguese royal family moved to then Portuguese Brazil following Napoleon’s inva-
The first Bank of Brazil (Banco do Brasil) was created by royal decree. The bank performed the basic functions of financing the government and performing currency exchange functions, which were vital for commerce at the time. The official bank had a short life, as it became insolvent when King John VI returned to Portugal, taking with him all of the gold deposited in the bank. This event sets the benchmark for undue political influence in the monetary authorities of Brazil. Even after independence, following administrations attempted to use a state bank for financing purposes. As described by Saddi, funds were easily transferred from the Bank of Brazil to the Treasury, and the relationship of such bodies was characterized by a "thick fog of complicity."  

Nevertheless, the Bank of Brazil, even when controlled by the private sector, played an important role in connection with determining the value of the currency and organizing public finance. After the proclamation of the Republic in 1889, Brazil faced several monetary problems including devaluation of the currency, inflation, and a lack of control of financial intermediation. These situations culminated in the merger of the Bank of the Republic of the United States of Brazil (Banco da República dos Estados Unidos do Brasil) and the Bank of Brazil. This merger generated a new entity known as the Bank of the Republic of Brazil (Banco da República do Brasil), which was ultimately granted a monopoly in issuing currency. This entity was liquidated in 1900, thus characterizing the first period of Brazil’s monetary history with budgetary unbalances, inflationary actions, and currency devaluation because of undue political influence.

In the following years, certain legislative attempts to implement further monetary controls within the Bank of Brazil were made. Nevertheless, the first centralized monetary authority was created through Decree Law No. 7,293 of February 2, 1945. The Superintendence of Currency and Credit (Superintendência da Moeda e do Crédito – SUMOC) was intended to control the payment system and the money market to prepare the country for the organization of a central bank.

After the implementation of SUMOC, Brazil experimented with a dual system of monetary authorities or bodies, as certain attributions were still shared with Bank of Brazil. On one hand, SUMOC’s responsibilities included: (1) setting commercial bank reserve requirements and discount rates; (2) setting interest rates; (3) supervising the operation of commercial banks; (4) carrying out open market operations (purchase and sale of securities issued by the National Treasury); (5) defining the foreign ex-

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149. Saddi, supra note 148, at 173.
150. See id.; Caldeira, supra note 148.
152. See id. at 175-76 (concerning the Caixa de Emissão de Redescontos do Banco do Brasil and the Caixa de Mobilização Bancária do Ministério da Fazenda).
change policy; and (6) representing Brazil before international institutions.\footnote{153} On the other hand, the Bank of Brazil continued to act as the government's bank by offering unlimited overdraft protection to the government.\footnote{154} Jairo Saddi points out that SUMOC never had normative competence over issues of monetary policy or credit policy because it was not responsible for monetary stability.\footnote{155} Certain crucial functions for the purpose of monetary stability, such as the management of the compensation system, financial agency of the federal government (acting as depositary of its revenues), payment and financing of the budgetary deficits of the National Treasury, and lender of last resort, were performed by the Bank of Brazil.

The relative confusion of roles in the conduction of monetary and credit policies in an environment of fiscal disorientation, budgetary unbalance, and a high level of inflation, composed a background favorable to the creation of centralized monetary authorities with well-defined roles in respect to the control of monetary and financial policies. Such a scenario culminated in the creation of the Central Bank of Brazil and contributed to the design of the main features that still characterize Brazil's monetary authority.

b. The Creation of the Central Bank of Brazil

Within the military regime, the National Monetary Council (\textit{Conselho Monetário Nacional – CMN}) and the Central Bank of Brazil (\textit{Banco Central do Brasil - BACEN}) were created through Law No. 4,595 of December 31, 1964. BACEN was granted a monopoly in issuing the national currency and was deemed the supervisory authority of monetary and banking policies. The CMN was designed as a superior authority, a collegiate organ encompassing the main normative functions of the financial sector.

The CMN was initially composed of nine members, three of which were the Treasury Minister, the president of the Bank of Brazil, and the president of the National Bank of Economic Development (\textit{Banco Nacional de Desenvolvimento Econômico}).\footnote{156} The other six members were mandated a fixed term of seven years. The Central Bank was organized as an autarquia,\footnote{157} subject to the control of the Treasury Ministry, and the president was appointed by the CMN.

There is a consensus that BACEN was granted a considerable degree of
independence at the time of its creation.\textsuperscript{158} This independence was gradually undermined by the "government's commitment to growth at all costs during the military dictatorship."\textsuperscript{159} Originally designed to strengthen the central bank and prevent interference from the government, even the CMN, was "completely disfigured during the military dictatorship."\textsuperscript{160} As set forth by Camilla Gomes Nogueira Cortez, "[c]onstant increases in the government's representation in the Council and the extension of its scope ended up extinguishing its original neutrality."\textsuperscript{161} The causes for such policy changes were derived from the initial concern in 1964 over solving problems with the balance of payments and consequent access to international credit. In light of these concerns, the existing monetary system was reformed in order to correct monetary imperfections and attract foreign capital. Such changes were abandoned after the improvement of the international environment.

Finally, it must be noted that the Bank of Brazil continued to play an important role as a monetary authority. In fact, Brazil experimented another dual period, during which the Bank of Brazil acted as an agent of the government in connection with the government's development and credit policies. According to Saddi, the Bank of Brazil had more powers than the new central bank, encompassing functions such as the financial and credit agent of the National Treasury, collector of federal taxes and revenues, and maker of payments in connection with the federal budget.\textsuperscript{162}

The Bank of Brazil only ceased to be a monetary authority upon the enactment of Decree No. 2,283 of February 27, 1986 and Decree No. 2,284 of March 10, 1986. The most important measure of such decrees was the extinction of the movement account (\textit{conta movimento}), through which the Bank of Brazil could withdraw funds from BACEN to bear expenses of the government. This account enabled the Bank of Brazil to perform issuance of currency for purposes of government financing and was used to inject money into the country's economy.

In view of the above, it should be noted that Brazilian monetary authorities have been subject to political influence even after the creation of the central bank. The creation of the Real Plan and consequent economic stabilization during the nineties generated a different situation in which a commitment towards independent institutions was observed by the administration.

\textsuperscript{158} See Roberto de Oliveira Campos, \textit{A Lanterna na Popa} – Memórias (4th ed. 2001); Saddi, supra note 148, at 180-83; Cortez, supra note 100, at 5.

\textsuperscript{159} Cortez, supra note 100, at 5 (stating "[t]he first attempt to reduce the [BACEN]'s autonomy occurred in early 1967, when President Arthur da Costa e Silva replaced [BACEN]'s governor, Denis Chagas Nogueira, by Rui Aguiar da Silva Lerma, in spite of the fact that his term of office had not expired. As a result, under the government of Costa e Silva, the National Monetary Council and the [BACEN] became institutions that fully backed the government's expansionist policies.").

\textsuperscript{160} Id. at 6.

\textsuperscript{161} Id.

\textsuperscript{162} Saddi, supra note 148, at 182.
Currently, the CMN and BACEN are the monetary authorities in Brazil and both bodies enact what was defined here as banking regulation. BACEN is the organ responsible for banking supervision. The next section will address the current institutional and legal framework and the regulatory and supervisory competences of such bodies in order to evaluate the degree of RSI of such institutions.

3. CMN and BACEN – Institutional Framework

Article 192 of the Federal Constitution of 1988 provides the general framework of the so-called Brazilian Financial System. The article states that a complementary law shall set forth the regulation of the financial system. Because no complementary law was enacted for such a purpose to the present date, Law No. 4,595/64 currently regulates the financial system in Brazil in addition to creating the CMN and BACEN. Originally enacted as an ordinary law, it was granted the status of complementary law by a phenomenon known as “constitutional reception.”

In accordance with article 8 of Law No. 9,069 of June 29, 1995, the CMN is a collegiate organ composed of the following members: (1) Treasury Ministry (Ministro de Estado da Fazenda), who will be the president of the CMN; (2) the Ministry of Planning, Budget and Management (Ministro de Estado do Planejamento, Orçamento e Gestão); and (3) the president of BACEN. Pursuant to article 3 of Law No. 4,595/64, the policy goals of the CMN are described as follows: (1) to adapt the volume of the means of payment to the needs of the national economy and its development; (2) to regulate the internal value of the currency, preventing or correcting inflation or deflation outbreaks of internal or external origin, economic depressions, and other disruptions in the economic equilibrium; (3) to regulate the external value of the currency and the balance of payments of the country; (4) to orient the application of the resources of private and public financial institutions; (5) to improve institutions and financial instruments for purposes of providing more efficiency to the payment system; (6) to oversee the liquidity and solvency of financial institutions; and (7) to coordinate the monetary, credit, budgetary, fiscal, and external and internal public debt policies.

163. In the Brazilian legislative system, a complementary law requires a qualified quorum for its approval (absolute majority). See BRAZ. CONST. art. 69 (Federal Constitution of 1988).

164. In addition to the CMN and BACEN, other authorities can be identified in the Brazilian Financial System such as the Brazilian Securities and Exchange Commission, the Brazilian Development Bank, and the organs in charge of regulation and supervision of insurance and re-insurance activities. This work will focus on the activities of the CMN and the Central Bank; the organs responsible for banking regulation and supervision.

165. Upon the promulgation of a new constitution, the laws and rules of the existing legal system are amended or interpreted in a manner to be consistent with the new constitutional rules. As the existing law in connection with the financial system at the time of the promulgation of the constitution, No. 4,595/64 was granted the status of a complementary law.
The goals and policies of the CMN reveal its broad authority in connection with monetary and credit policies. For purposes of the present work, this analysis will focus on the goals and activities of the CMN in regard to banking regulation and supervision.

With respect to supervisory and regulatory functions, the following exclusive competences of the CMN are worth mentioning: (1) regulating credit transactions; (2) regulating the incorporation, functioning, and supervision of all entities that perform activities described under Law No. 4,595/64, as well as the applicable sanctions and penalties; (3) limiting when necessary interest rates, discounts, commissions, and any other form of consideration of transactions and financial or banking services, including the services rendered by BACEN; (4) determining the maximum percentage of resources that financial institutions are allowed to lend to a single client or corporate group; (5) regulating indexes and other technical conditions about patrimonial relationships to be observed by financial institutions; (6) enacting general accounting and statistic rules to be observed by financial institutions; (7) determining minimum capital adequacy requirements to be adopted by financial institutions; and (8) regulating the limits, terms, and other conditions of discount and loan transactions of private and public financial institutions.

The description of the policies and competences of the CMN leads to the conclusion that it is not only the organ responsible for formulating the monetary policy in Brazil, but also the main body in charge of banking regulation in the country.

On the other hand, the enforcement of banking regulation and the supervision of the banking activities and financial institution are granted to the central bank.

Articles 10 and 11 of Law No. 4,595/64 present an extensive list of the competences of BACEN. Several competences reflect the implementation of the general rules and policies enacted by the CMN. Relevant for the purposes here are the following competences: (1) establish reserve requirements and receive the corresponding compulsory deposits; (2) execute discount operations and grant loans to banking financial institutions; (3) exercise the control of credit; (4) supervise the financial institutions and enforce the applicable penalties; (5) grant authorization for the incorporation (including branches and subsidiaries), mergers, amalgamations, and other corporate transactions conducted by financial institutions, as well as authorizing the performance of certain specific activities such as foreign exchange transactions; (6) regulate the conditions for the appointment and performance of managing or advisory positions of private financial institutions, subject to the rules enacted by the CMN; (7) regulate the payment system; and (8) exercise "permanent" oversight of the financial and capital markets. As set forth above, BACEN re-

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166. Law No. 4,595/64, art. 4 [Lei No. 4,595/64, art. 4] (Braz.).
167. Id. art. 9 [Lei No. 4,595/64, art. 9].
168. Id. arts. 10-11 [Lei No. 4,595/64, artigos 10 e 11].
placed the SUMOC, and was characterized by article 8 of Law No. 4,595 as an *autarquia* with legal personality and financial resources. The relationship and subordination of BACEN to the CMN is stressed by article 9 of Law No. 4,595, which sets forth that BACEN shall observe and enforce the rules enacted by the CMN.

Pursuant to article 8 of Law No. 4,595/64, a president and eight other directors appointed by the President of Brazil manage BACEN.

A description of the competences and activities of BACEN reveals its supervisory role of banking activities and financial institutions, as well as a complete subordination to the rules enacted by the CMN. The next section addresses specific features of the CMN and BACEN that will allow the assessment of RSI of such institutions upon the parameters established in Part I of the present work.

4. **CMN and BACEN – Assessment of Institutional RSI**

a. The Relationship Between the CMN and BACEN

A brief analysis of the constitutional and legal provisions of the Brazilian financial system leads to the obvious conclusion that there is room for political influence in the Brazilian monetary authorities. The presence of two Ministries of State in the composition of the CMN highlights the strong presence of the government in the authority responsible for elaborating the main set of banking regulations for the country.

It is also clear that the CMN has a great influence over BACEN, the body responsible for banking supervision. Not only does the CMN limit the interest rates, discounts, commissions, and other forms of consideration obtained through services rendered by BACEN (one of the main sources of revenue of the institution), but it also approves the internal rules of BACEN and its accounts.¹⁶⁹

In view of the above, it is clear that there is a strong political influence on the authority in charge of formulating banking regulation. Pursuant to the theoretical background outlined above, this could make the CMN prone to time inconsistency and capture problems. The next sections focus on other independence factors of BACEN.

b. Appointment, Dismissal, and Terms of Office

Articles 52 and 84 of the Federal Constitution of 1988 regulate the appointment of the president of BACEN and its directors. By means of secret vote, the Senate must approve the President of Brazil’s nominations for president or members of the management board of BACEN.¹⁷⁰ Pursuant to article 1 of Decree No. 91,961 of November 19, 1985, BACEN shall be managed by a board composed of nine members, including the president of BACEN. The President of Brazil appoints the members

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¹⁶⁹. *Id.* art. 4 (XXVII) [Lei No. 4,595/64, art. 4 (XXVII)]. Article 4 of Law No. 4,595 sets forth that CMN has the competence to approve the accounts of BACEN.

¹⁷⁰. **BRAZ. CONST.** art. 52(III)(d).
from a pool of Brazilians with outstanding capabilities in economical and financial matters. With respect to dismissal procedures, the decree states that the directors and presidents of BACEN may be dismissed “ad nutum” or, stated differently, at the President’s discretion.

The pluralistic appointment of the governors of BACEN is in accordance with the applicable theory on RSI.\textsuperscript{171} The approval by the Senate of the President’s candidates also represents an important tool of accountability and control of such procedures. On the other hand, the dismissal procedures of the governing body of BACEN are not clear. The applicable legislation does not contemplate objective rules and standards for dismissing the directors, and the presidential discretion in dismissal represents a serious opening to undue political influence. This factor has a serious implication in connection with terms of office. Originally, Law No. 4,595/64 contemplated a six-year term, a mandate longer than the presidential mandate, that would allow the directors of BACEN a certain degree of independence from the executive branch. Currently, there is no specific term for the governors of BACEN, whose mandates are subject to presidential discretion.

c. Other Personnel Concerns – Suitability, Salary, and Restrictions

The suitability of the governors of BACEN is contemplated in article 1 of Decree No. 91,961/85, which states that the suitability of the governors of BACEN should be determined based on their “outstanding capacity in economical and financial matters.” More objective criteria is desirable, including specific academic titles and a defined period of professional expertise. Nevertheless, the approval of the presidential appointment by the Senate through public inquiry sessions and the pressures of external markets guarantee that adequate expertise requirements are maintained by the governors of the central bank.\textsuperscript{172}

Codified law establishes the salaries of the president and directors of BACEN. Within the federal administration, the president and the directors of BACEN, considered to be the Positions in Commission of Special Nature (\textit{Cargos em Comissão de Natureza Especial - NES}), are paid monthly in the amount of R $8,000.00 (U.S.$ 2,676.03\textsuperscript{173} or £1,701.56\textsuperscript{174}).\textsuperscript{175}

Considering the pattern of salaries paid within the banking industry, it is fair to say that the salaries paid to the governors of BACEN are not adequate, as they fail to attract skilled and qualified professionals and hinder the incentive for bribery practices from the industry side. In fact,

\textsuperscript{171} \textit{See supra} Part II.C.2.a.
\textsuperscript{172} Brazil has a tradition of appointing governors with great expertise, selected from the main economic schools of the country.
\textsuperscript{173} Conversion effected on August 25, 2003, at the following rate: 2,9895000 Real/Brazil = 1 U.S. dollar, available at \url{http://www.bcb.gov.br}.
\textsuperscript{174} Conversion effected on August 25, 2003, at the following rate: 4,7015600 Real/Brazil = 1 Sterling Pound, available at \url{http://www.bcb.gov.br}.
\textsuperscript{175} Law No. 10,470 of June 25, 2002 [Lei No. 10,470 de 25 de junho de 2002] (Braz.).
one of the great benefits of these positions is the possibility of occupying a well-paid position within the banking industry after the expiration of the terms of office. Governors of BACEN and even members of the CMN have historically occupied important positions within the banking industry after the expiration of their respective mandates.\footnote{See Veja Magazine, Edition 1801 (May 7, 2003), available at http://veja.abril.uol.com.br/070503/p_110.html. Pedro Malan, former Treasury Ministry of the Cardoso Administration, is currently employed as a vice-president of Unibanco, the third largest private bank of Brazil. Armínio Fraga, former president of BACEN, is working with a private investment consulting firm.}

The above assertion leads us to the analysis of the restrictions imposed on the governors of BACEN. Persons occupying Positions in Commission of Special Nature must not perform activities or render any services in the sector in which they have acted within the governmental body for a period of four months after the expiration of their mandates.\footnote{Provisional Measure (\textit{Medida Provisória}) No. 2,225-45 of Sept. 4, 2001, art. 6 (Braz.).} During this restrictive period, the governors of BACEN cannot be employed as managers, members of the board of directors, or establish an employment relationship with any individual or legal entity that they have maintained an official and relevant relationship with during the last six months before dismissal or expiration of mandate. The same prohibition applies to legal or administrative representation of such individuals or persons before organs of the federal administration. During this restrictive period, the officials shall be paid a salary in the same amount of their remuneration during the respective mandate.

Analyzing the appropriateness of the Brazilian salary arrangements is a sensitive task. In view of the current fiscal deficit faced by Brazil and all the efforts in connection with tax and pension reforms to correct such deficit, raising salaries within the public service is a very polemic issue. The restrictive period of CMN members and governors of BACEN is too short to prevent industry capture and thus, should be extended.\footnote{Lastra, supra note 4, at 35 (stating that members of the board of the Fed have to observe a restrictive period of two years after the expiration of their mandates).}

In addition, stricter and more detailed secrecy obligations to governors of BACEN after the expiration of their mandate would hinder the potential of industry or political capture.

d. Governance Structure and Decisional Autonomy

Because of the structure of the CMN, it is clear that the regulation-making activity of Brazilian monetary authorities is not free from political influence. Considering that the general rules and supervisory standards are set forth by the CMN, there is considerable political influence in the supervision activity of BACEN.

Nevertheless, within the limits established by the rules of CMN, BACEN has discretion and autonomy to perform banking supervision. The analysis of the competences of BACEN outlined in Law No. 4,595/64
corroborates this assertion. Because BACEN was granted the main set of supervisory powers, it has the supervisory independence *stricto sensu*.

In addition, Law No. 9,784 of January 29, 1999, Law No. 4,595/64, and other rules enacted by CMN provide detailed administrative procedures for supervising, sanctioning, liquidating, and performing interventions in financial institutions. Moreover, the Brazilian superior courts recognize the validity of these procedures. Thus, BACEN has considerable freedom to act within the boundaries of law without being subject to lawsuits or to annulment of its decisions and acts.

BACEN also has an adequately designed governance structure. The president and nine other members comprising a multi-member commission guarantee a continuous decision-making process and therefore avoid the influence of a single individual. Although such items are subject to the approval of the CMN, BACEN also has autonomy to elaborate its internal rules and accounting procedures.

e. Budgetary or Financial Autonomy

Revenues of BACEN derive from the following: (1) financial transactions and other investments of BACEN's resources; (2) foreign exchange transactions, purchase and sale of gold, and any other transactions in foreign currency; and (3) other occasional revenues, including penalties and interest charged upon default. In general terms, BACEN enjoys financial autonomy because its revenues are not derived from government grants or certain budgetary determinations.

The constraints placed upon BACEN with revenues and financial resources arise because of the relationship between BACEN and the National Treasury. As set forth by Decree-Law No. 2,376 of November 25, 1987, the profits of BACEN must be transferred to the National Treasury. Relevant literature argues that the transfer of profits to the Treasury is a consequence of the monopoly of issuing currency granted to the entity, and therefore, the transfer is recommended and acceptable.

Finally, it must be noted that Law No. 4,595/64 subjects BACEN's budget to the approval of the CMN. At the same time that this provision may constitute a useful tool for guaranteeing accountability, it creates a path for undue political influence in the institution.

f. Accountability Arrangements

The Brazilian legal system has a variety of accountability arrangements in place that guarantee that the CMN, and especially BACEN, are subject

179. See supra Part III.C.A.3.
180. See supra Part II.C.2.c.
181. Law No. 4,595/64, art. 16 [Lei No. 4,595/64] (Braz.).
182. See SADDI, supra note 148, at 224. BACEN also finances the Treasury through the purchase of Treasury Bonds, as allowed by article 164 of the Federal Constitution of 1988.
to different kinds of control. To begin with, Brazil adopts the principle of separation of powers between the executive, legislative, and judiciary branches under article 2 of the Federal Constitution; each Power exercises control over the others pursuant to the checks-and-balances doctrine.\footnote{Braz. Const. art. 2.} Acts of the Federal Administration, which include actions by the CMN and BACEN, are subject to the review and control of the legislative and judiciary branches.

For example, the two houses of the Brazilian Congress, the Senate and the Chamber of Deputies, may institute parliamentary inquiry commissions (comissões parlamentares de inquérito) with powers of investigation.\footnote{Id. art. 58, § 3.} As demonstrated below, such commissions have recently represented an important legislative control over the acts of the monetary authorities.

Furthermore, pursuant to article 70 of the Federal Constitution:

\begin{quote}
Control of accounts, finances, budget, operations and property of the Union and of the agencies of the direct and indirect administration, as to the lawfulness, legitimacy, economic efficiency, application of subsidies and waiver of revenues, shall be exercised by the National Congress, by means of external control and the internal control system of each Power.\footnote{Id. art. 70.}
\end{quote}

The external control by the Congress is carried out through the Federal Court of Accounts (Tribunal de Contas da União), which shall, among other things, “evaluate the accounts of the administrators and other persons responsible for public monies, assets and values of the direct and indirect administration.”\footnote{Id. art. 71, § 2.}

In addition, article 5, item XXXV, of the Federal Constitution sets forth that the “law shall not exclude any injury or threat to a right from the consideration of the Judicial Power.” Inserted among the fundamental rights of the Brazilian Constitution, this principle places the judiciary as a controller of last resort of unlawful acts of the legislative and executive powers.

Finally, BACEN, as an autarquia, is subject to the control of the Treasury Ministry. Although autarquias enjoy autonomy with respect to their revenues and assets, they are subject to the supervision of the applicable Ministry of State.\footnote{Decreto-Lei No. 200/67, art. 19 [Decreto-Lei No. 200/67, art. 19] (Braz.).} According to C.A.B. Mello, this control consists of verifying that the autarquias are fulfilling the goals stated by the law that determined its incorporation and harmonizing the entities with the global administration of the state.\footnote{Mello, supra note 46, at 149.}

In sum, the Brazilian legal system provides an efficient accountability framework. There is a consensus that both BACEN and CMN lack more
instruments of control by the general public, such as the public consultations and public meetings conducted by the Brazilian independent agencies. Nevertheless, the recent decades witnessed certain initiatives of BACEN that enhanced the disclosure of its activities to the general public, increasing its accountability towards society.

g. Conclusions on Institutional RSI

It is possible to conclude that the Brazilian monetary authorities lack institutional RSI. The presence of two government officials in the CMN undermine any possibilities of regulatory independence in the organ responsible for enacting banking regulation. In addition, the CMN is still in control of certain areas of BACEN and sets the limits for its supervisory activities.

As an autarquia, BACEN presents an institutional framework that promotes RSI. In fact, BACEN has a considerable degree of discretion in the performance of the supervisory activities. However, because the governors can be dismissed at the discretion of the president, the low amount of the governors’ salaries, and the short restrictive period after the expiration of the mandates of governors, a scenario is generated in which regulatory capture and political influence are likely to occur.

Despite this unfavorable conclusion regarding institutional RSI, there is a consensus that during the recent years and especially after the implementation of the Real Plan, the Brazilian government has demonstrated a material commitment to RSI of monetary authorities. As demonstrated below, this fact and other factors advocate the case for the implementation of institutional RSI in Brazilian monetary authorities.

5. The Real Plan, CMN and BACEN – Assessment of Material RSI

a. Preliminary Considerations

As set forth above, there is a consensus that within the administration of President Fernando Henrique Cardoso BACEN was granted the power to act as if it was independent, although not formally. 189

In fact, since its creation in 1964, BACEN has not had independence (except for a brief period during the Castelo Branco administration from 1964 to 1967), and has experienced different types of political and industry interference. 190

In addition to clear political influence, different forms of regulatory capture by the industry could be observed during the existence of BACEN. In particular, until the implementation of the Real Plan, different sorts of “moral hazard” situations existed. As mentioned above, the function of central banks as lenders of last resort creates a perverse form of industry capture, as bank owners are likely to engage in riskier activi-

190. See Part III.A.2.b.
ties and count on the bailout or other rescue packages provided by monetary authorities.

During the eighties, Brazil experimented a dispersion of monetary authority in light of the process of politic decentralization carried out after the end of the military regimes when the powers of state governors were increased. State governors pressured for a decentralization of fiscal resources and used state banks for the purposes of issuing quasi-currencies, challenging the authority of BACEN. Quasi-currency was created upon the issuance of state bonds and the granting of direct loans to state governments.191

History also demonstrates that every time a state bank faced financial difficulties, the bank received a rescue package from BACEN, and the monetary authority “relaxed” some of the conditions for the granting of such programs.192 The rescue package granted during the eighties, namely Credit Support Program (Programa de Apoio Creditício - PAC) and Financial and Economic Recovery Program (Programa de Recuperação Econômica e Financeira - Proref), conditioned the financial bailout on the adoption of several measures of deficit reduction and re-capitalization by the banks. Many of these conditions were not observed by state banks, but nevertheless, BACEN granted the aid packages. The extreme situation could be observed through Decree-Law No. 2,321 of February 25, 1987, which created the special intervention mechanism in financial institutions and the Special Temporary Management Regime (Regime de Administração Especial Temporária – Raet). Although this legal measure allowed BACEN to directly intervene in the management of state banks and to conduct the liquidation of such institutions, these banks were returned to the management of their shareholders after much of the costs of the “broken” banks were borne by BACEN itself. In a very inappropriate manner, BACEN was not only financing broken state financial institutions, but also financing the public debt of Brazilian states and state companies.193

Industry influence was also present in the private sector. Although moral hazard situations could not be specifically observed, there was a general belief that certain banks were “too big to fail” and would therefore receive assistance from the monetary authority in case of need.194 As demonstrated below, the implementation of the Real Plan and the consequent economic stabilization allowed BACEN to regain political power and establish a factual independence from political and industry interests.

192. See id. at 169.
193. Id. at 179.
194. Id. at 177.
b. The Real Plan and Factual Independence of BACEN

Up to the implementation of the Real Plan, the Brazilian economy was mainly characterized by hyperinflation. The inflation scenario was favorable to state and private banks that managed to control their fiscal deficits with inflationary financing, a technique consisting of granting long term financing to the public and placing liabilities in short-term deposits or bonds. Between 1990 and 1993, the banking sector generated inflationary revenues amounting to four percent of the GDP.\(^{195}\)

The Real Plan emerged in 1994 from the process of economic stabilization and liberalization in Brazil. Still in the administration of President Fernando Collor de Mello after 1990, Brazil was gradually experiencing certain measures of economic liberalization, including the removal of restrictions on capital flows, export barriers, and privatization. In view of the hyperinflation environment after the eighties, the main purpose of the plan was to reduce inflation rates to stabilize the economy. The plan included the creation of a new currency, the Real, that would be anchored to the U.S. dollar. A clear objective of pegging the Real to the U.S. dollar was to attack the fiscal component of inflation by subjecting the issuance of new money to the increase of the external reserves.\(^{196}\)

With economic stability arising from the Real Plan, the Executive gained bargaining power over state governors, and the authority of BACEN was reaffirmed. The end of high inflation weakened the finances of state governments, and in turn, they became more dependent on the federal government.\(^{197}\) This situation was guaranteed by certain legislative measures, such as the restriction of the capacity of state banks to grant loans to their shareholders\(^{198}\) and the enactment of laws establishing the liability of managers of public companies.\(^{199}\)

In light of this scenario, BACEN increased its independence from industry and other political interests. This was observed in the disciplinary measures taken by BACEN after the implementation of the Real Plan. BACEN intervened successfully in Banespa (Bank of the State of São Paulo) and in Banerj (Bank of the State of Rio de Janeiro) on December 30, 1994. Interventions also were conducted in the Bank of the States of Alagoas (January 23, 1995), Mato Grosso (February 6, 1995), and Rondônia (February 20, 1995).

Furthermore, the Incentive Program for the Reduction of the State Public Sector in the Banking Activity (Programa de Incentivo à Redução do Setor Público Estadual na Atividade Bancária – Proes), a new, stricter rescue package targeting state banks, was created. Pursuant to Provi-
sional Measure No. 1,514 of August 7, 1996, to obtain a full refinancing of their state debts, state governors should agree with one of the following measures in connection with their respective state banks: (1) privatization; (2) liquidation; or (3) transformation into a state development agency. If state governors wished to keep the control of their state banks, only fifty percent of the state debt would be refinanced. Due to the gravity of the banking crisis upon the stabilization of the currency, this was not a feasible alternative.

Successful interventions also occurred in the private sector, including the intervention in Banco Nacional, Banco Bamerindus – purchased by HSBC, and Banco Econômico – purchased by Banco Excel and ultimately acquired by the Spanish Bank Bilbao Viscaya. The creation of the Program for the Restructuring and Strengthening of the National Financial System (Programa de Estímulo à Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional – Proer) also represented an improvement in the factual independence of BACEN from the industry’s interests. The difference between Proer and previous rescue programs was that Proer allowed the incorporation of insolvent financial institutions by healthy banks pursuant to the determination of BACEN.

The increasing number of interventions in public and private institutions was followed by the implementation of several legislative and regulatory measures aimed at increasing the discipline within Brazilian financial system and preventing banking crises. Such measures included: 1) the joint liability of controlling shareholders of financial institutions, upon the enactment of Provisional Measure No. 1,182 of November 11, 1995 (currently Law No. 9,447 of March 14, 1997); 2) mechanisms to prevent money laundering (Law No. 9,613 of March 3, 1998, as amended); 3) a deposit insurance fund (Fundo Garantidor de Crédito – FGC), pursuant to Resolution No. 2,212 of November 16, 1995; 4) the implementation of internationally accepted principles of banking regulation and supervision, such as methods of classification of credits, internal controls, and operational risks (CMN Resolutions No. 2,682 of December 22, 1999 and 2554 of September 29, 1998); and 5) restrictions for the use of liquidity credit lines from BACEN and emergency loans (Resolution No. 2,685 of January 16, 2000).

Finally, it must be noted that the current composition of the CMN is a result of the implementation of the Real Plan. Originally, the CMN was composed of the following members: Treasury Ministry; the president of Banco do Brasil S.A.; the president of Brazilian Development Bank.

200. See Lourdes et al., supra note 189, at 189. From the implementation of the Real Plan in 1994 to 1997, forty-three banks were submitted to intervention or liquidation, being eighty percent from the private sector. Due to an increase in the participation of foreign financial institutions and stricter disciplinary measures, a reduction of twenty percent in the number of financial institutions in Brazil could be observed between 1993 and 1999.

201. Provisional Measure (Medida Provisória) No. 1,179 of Nov. 11, 1995 (Braz.); CMN Res. No. 2,208 of Nov. 3, 1995 (Braz.).
In sum, although the statutory independence of BACEN was not assured by legislative delegation, Brazilian monetary authorities enjoyed a considerable and increasing degree of independence during the last decade, especially during the Cardoso administrations. From an initial situation of strong political influence from federal and state governments and industry capture, the country experienced a true evolution in terms of banking regulation and supervision. The data above demonstrates that BACEN has acted in a much more pervasive way with respect to banking supervision, acting against the interests of industry and state governors.

This result can be explained by the fact that the election of President Cardoso in 1994 was highly based on the successful implementation of the economic stabilization plan. The continuity of the economic stabilization plan was also a crucial factor for his re-election in 1998. Also, during this time there was a considerable change in the preferences of the Brazilian population and in the motivations of the institutions of the country, which got used to and were eager for financial and monetary stability. The questionable financial package granted by BACEN to the banks Marka and Fonte Cindam after the devaluation of the Real in 1999 resulted in a strong reaction from the public and a thorough scrutiny of the members of CMN and directors of BACEN by the Congress. This is evidence of the generalized commitment to financial and monetary stability, as well as evidence of the use and implementation of the accountability mechanisms available under the Brazilian legal system.

Therefore, recent years have demonstrated a very strong commitment by the federal government towards monetary and financial stability. The material independence of the monetary authorities and the implementation of sound banking regulation and supervision were essential instruments to the pursuit of such values.

This section ends with an interesting paradox: at the same time that Brazilian monetary authorities do not enjoy RSI under the current institutional framework, there is a strong commitment by the government towards RSI, as reflected in the banking regulation adopted (which pursues sound banking and international standards of banking regulation) and the supervision conducted. The next section presents the case for institutional RSI for Brazilian monetary authorities, as well as for an adequate regulatory design in connection therewith.

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6. A Case for Institutional RSI in Brazil

a. A Scenario Supporting a Case

Because of the institutional and factual features of the Brazilian regulatory and supervisory design, this work argues that there is a case for the implementation of institutional or statutory RSI in Brazilian monetary authorities. Although political influences and industry capture were highly present during the history of Brazilian monetary authorities, the implementation of the Real Plan changed the political, social, and economical background of Brazil. This opened the path for the implementation of RSI. The economic stability allowed BACEN to increase its disciplinary measures with financial institutions and enhanced its bargaining power towards state banks and governors. The commitment of the past administration to economic stability resulted in a “de facto” regulatory and supervisory independence of monetary authorities because of the pursuit of sound banking regulation and supervision in accordance with worldwide-accepted principles.

Similarly, the last decade was characterized by the evolution of social preferences and thinking towards financial stability, sound banking practices and rules, and adequate banking supervision. The impact on public opinion of the scandals generated by the doubtful rescue packages granted by BACEN after the devaluation of the Real in 1999 evidences this fact. The Brazilian Congress reacted to this situation by triggering available accountability mechanisms (“parliamentary inquiry commissions”). This is further evidence of the trend in Brazilian society towards RSI. Currently, the Brazilian society sustains a generalized belief in financial stability and international credibility, and financial crises like neighboring Argentina’s are not a feasible option.

Finally, uncertainties of monetary policy and banking supervision by the current administration must be highlighted. As mentioned above, in May 2003, the press indicated clear strategic divergences between members of the federal administration and BACEN personnel, especially in connection with inflation control and reduction of interest rates. Such divergences culminated in the dismissal of the monetary policy director of BACEN. Considering the current political scenario, it is not clear whether the informal commitment to RSI achieved during the Cardoso administration will be maintained.

In view of the proposed reforms to the Brazilian financial system, Brazil has the opportunity to include institutional RSI of monetary authorities in its legal framework. This inclusion would assure that the

203. BRAZ. CONST. art. 58, § 3.
governmental commitment to RSI is maintained and regulatory capture
and time-inconsistency problems are formally addressed. Such a measure
would enhance the country's credibility within the international scenario
and strengthen Brazilian institutions, therefore enhancing the pursuit of
economic growth. The following section addresses the proposal for in-
cluding institutional RSI within the Brazilian legal system.

b. A Proposal for RSI in Brazil

As set forth above, the approval of Amendment No. 40 to the Federal
Constitution allows the possibility for the enactment of different laws for
purposes of regulating the National Financial System. The only other rel-
vent legislative initiative concerning the same topic is Project of Law
No. 317 for 2003, elaborated by the Senate. This project contemplates
important elements of CBI such as statutory independence, a defined
mandate for the president and directors of BACEN, clear procedures for
the dismissal of governors of BACEN, and defined goals of monetary pol-
icy. While it contemplates the figure of the mega-regulator discussed in
section 3.4 above, it does not address RSI. Banking regulation is still
under the competence of the CMN, and the composition of the organ is
not fundamentally changed by the project.

Because the project does not contemplate RSI, it is herein proposed
that the regulatory and supervisory functions are removed from CMN
and BACEN, respectively, and granted to a different body organized as
an independent agency under Brazilian law (autarquia especial). This
proposal is backed by existing literature defending the separation of the
regulatory and supervisory functions from central banks or authorities in
charge of the formulation and implementation of monetary policy.206

In addition, the legal framework of the independent agencies guaran-
tee RSI by addressing the requirements outlined in Chapter 3. First,
those agencies are created with specific goals to reach.207 In the same
way access to telecommunication and electricity services can be a statu-
tory goal, financial stability and sound banking regulation and supervi-
sion can be established as mandatory targets in such a legal regime. In
addition, Brazilian independent agencies are granted (1) absence of hier-
archic subordination; (2) independence or autonomy in the administra-
tive, financial, patrimonial, technical, and human resources management
fields; and (3) a fix mandate and stability of its officers. Financial (or
budgetary) and decisional autonomy are therefore intrinsic to the legal
regime of such agencies.

207. See Law No. 9,427 of Dec. 26, 1996 [Lei No. 9,427 de 26 de dezembro de 1996] (Braz.) (which created the National Agency of Electric Energy (Agência Nacional de Energia Elétrica – ANEEL)); Law No. 9,472 of July 16, 1997 [Lei No. 9,472 de 16 de julho de 1997] (Braz.) (which created the National Agency of Telecommunication (Agência Nacional de Telecomunicações – ANATEL)).
Most personnel concerns are also addressed by the legal regime of the independent agencies. Independent agencies are managed by a collegiate organ. One of the members of the collegiate organ is the president.\textsuperscript{208} The concern of preventing the influence of a single individual is therefore addressed. Furthermore, suitability concerns are addressed in article 5 of Law No. 9,986/00, by requiring that the members of the collegiate organ must be Brazilians of good reputation with superior education and a high level of expertise in the field of functions that they will perform. Members of the collegiate organ are appointed by the President of Brazil, and approved by the Senate (as demonstrated above, the approval by the senate represents a useful accountability tool, and prevents undue political influence from the executive).

Article 6 of Law No. 9,986/00 provides a fixed mandate for directors of independent agencies to be set forth in the law of creation of a given agency. Pursuant to article 9 of Law No. 9,986/00, the mandate of directors of independent agencies can only be terminated upon renouncement, judicial determination, or through a disciplinary administrative proceeding. This clear dismissal criterion is a useful instrument for the establishment of RSI and addresses some of the concerns discussed in regard to the dismissal procedures of governors of BACEN.\textsuperscript{209} Article 8 of Law No. 9,986/00 also contemplates the four-month restrictive period for directors of independent agencies. After the expiration of their mandate, directors are not allowed to work in any type of function within the public service or in any private companies within the sector regulated and supervised by the independent agency. Salaries are also limited in the same manner as the salaries of BACEN governors. In this respect, the same considerations on the restrictive period and salaries of governors of BACEN apply.\textsuperscript{210}

The concentration of banking regulation and supervision in an independent agency would also represent an improvement of accountability mechanisms. In addition to the existing accountability framework, the framework of independent agencies contemplates instruments of public participation in the decision-making process of such bodies. These may be in the form of public consultations, public meetings, and formal accusations by the public and interested parties.

The present proposal purports to address a specific reasoning behind optimal regulatory structures. As described above, optimal regulatory and supervisory designs must be drawn pursuant to the specific characteristics of a given country, including political structures and traditions, the size of the country, and the financial sector. In addition, drastic measures and institutional changes may be burdensome for any given country and may even cause considerable losses for the regulatory regime, including

\textsuperscript{208} Law No. 9,986 of July 18, 2000, art. 4 [Lei No. 9,986 de 18 de julho de 2000, art. 4] (Braz.).

\textsuperscript{209} See Part III.A.4.b.

\textsuperscript{210} See Part III.A.4.c.
the loss of regulatory culture and memory. The use of a figure available in the Brazilian legal system would address these concerns because the regulatory, political, and economic traditions of Brazil would be respected.

Finally, some specific qualifications and requirements are necessary for purposes of coordinating the independent regulatory agency of banking regulation and supervision with the other monetary authorities of Brazil. Although the independent agency would be free from the existing political influence in the CMN and consequently in BACEN (in this case, there is no "piggyback" of RSI in relation to CBI), a degree of interaction between the agency and the authorities that elaborate on monetary policy, exercise the functions of lender of last resort, and guarantee liquidity in the payment system must be guaranteed.

It is therefore proposed that the president or another director of the independent agency occupy a seat, even without a right to vote in the CMN and in BACEN. With this arrangement, an adequate exchange of information could occur among the authorities, a reasonable degree of consistency between monetary policy and banking supervision could be achieved, and the function of the lender of last resort could be properly performed.

IV. CONCLUSION

In conclusion, the RSI of monetary authorities is herein supported and the implementation of the corresponding institutional arrangement is justified for purposes of avoiding regulatory capture and time inconsistency problems. In addition, the framework of RSI is an important factor for a country’s financial stability, and such an institutional arrangement may directly contribute to a country’s credibility and consequent economic growth.

As to the proposed case study, Brazilian monetary authorities do not enjoy institutional RSI. Nevertheless, the case for the implementation of RSI in Brazilian monetary authorities is advocated, taking into consideration the material commitment of the previous and current administrations of the country towards RSI and generalized social support of financial stability within the country. The separation of regulatory and supervisory functions from the CMN and BACEN into an independent agency is defended as the adequate institutional arrangement for this purpose.