

Paulo Sergio Cavalheiro: Regulation of capital and financial stability

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The final version of the Capital Accord, also known as Basel II, has just been released. The document maintains the basic framework initially proposed, that is, three pillars, the first one dealing with the calculations of the capital requirements per se, comprising market, credit and operational risks (this last being the real novelty), the second describing the supervisory review process and the third detailing the market discipline to be achieved via disclosure.

In Brazil, capital requirements were introduced by Resolution 2099, in August 94, which specified 8% of risk weighted assets as the minimum capital required. Following Resolution 2099, in October 94, Circular 2500 modified some values for minimum capital and net worth required for the establishment of banks, in accordance with the location and size of institution. The supervisory authority raised the minimum capital required to 10% of risk-weighted assets in June 97. In November 97, Circular 2784 again raised this value, this time to 11%, which is still the minimum ratio. The requirements set by the authority are in line with those prescribed by Basle, including the risk-weight approach to assess capital adequacy, with weights of 0%, 20%, 50% and 100%, the division of the constituents of capital in tiers 1 and 2 and capital required to cover exchange risk and interest rate risk.

Additional measures to strengthen prudential rules in Brazil included regulations issued in 1998 (internal controls), 1999 (credit risk classification) and 2000 (liquidity risk). As a result of the internal controls regulation (Resolution 2554), the board of directors is considered responsible for the smooth functioning of the internal control system, internal auditors must present semi-annual report on the quality and effectiveness of internal controls and supervision can restrict activities and operations where the internal controls are not satisfactory. Resolution 2682, on credit risk classification, introduced a forward-looking approach, specifying that loans must be classified not only according to their past due status, as it was previously done, but also based on the creditworthiness of borrower and on the nature of the transaction. Banks, according to Resolution 2.804 must follow specific liquidity management policies, such as: sound liquidity practices, the use of alternative scenarios and the application of stress tests (reviewed by supervisors).

Returning to the implementation of Basle II, supervision in Brazil is as yet undecided with respect to the date of implementation or the timetable to be followed, as this will depend very much on the intentions and readiness of the banks and on the existence of robust and consistent databases and models. The intention is to achieve implementation as closely as possible to the G10 schedule. Examples of tricky issues to be considered with care are: how to (or whether to) apply operational risk requirements for smaller institutions; how to carry out the validation of internal models for both market risk (we still do not allow banks to use them for capital purposes) and IRB; how to encourage more complex banks to adopt IRB.

There are, however, more pressing priorities for Brazilian supervision at present, such as the improvement of recently implemented processes of risk focused supervision, the consolidation of the New Credit Information System, the studies underway for the introduction of a supervisory rating system geared towards the determination of the adequate frequency and intensity of supervision for each particular financial institution/conglomerate and the definition of strategies for consolidated supervision and international co-operation.

The New Accord will be most likely implemented in Brazil in a gradual manner, the new rules co-existing for a while with the old ones. This will be the case, for example, of the smaller banks, to which will be applied either the simplified standardised approach, which does not depend on external credit assessment institutions, or the current approach. One possibility is the application of the current approach with slight modifications, such as a review of the present weights and the incorporation of some innovations from the standardised approach. For these less complex institutions, the capital requirement for operational risk might not be explicit, but only covered under Pillar II. At best, some

small banks might be required to allocate capital for operational risk through the basic indicator approach. In the case of larger institutions, they will be allowed, at first, to implement only the foundation IRB approach. For the advanced IRB approach more time will be necessary for the banks to improve database quality and for supervisors to improve their experience in validation. Also for operational risk, in the first moment, only the alternative standardised approach will be available. The advanced measurement approaches will have to wait a while longer.

No significant impact is expected in terms of capitalisation levels after Basle II. As previously explained, current capital requirements in Brazil are 11% and this buffer has allowed banks to face periods of high volatility with no major impact. Two important challenges expected in the implementation of Pillar I are the construction of adequate databases, either of pooled or individual data, and the incipient stage of operational risk management in the industry.

As for Pillar II, with the New Capital Accord, it will be necessary for institutions to further develop their own processes for the internal assessment of capital adequacy and for the supervisory authorities to increase their supervisory focus on such processes. Cross-border supervision is another issue where occasional problems are expected to occur. Although we already have a number of supervisory agreements (MOUs) in place with most supervisory authorities of home supervisors to banks of importance in Brazil, which will help smoothening such issues, a real sense of the problems and the need of effective co-operation will only be truly felt at the moment of validations, that is, after the whole process begins.

The legal and regulatory framework will, of course, have to undergo a number of modifications before the implementation of the New Accord. The greatest legal obstacle to the implementation of the New Accord is that, currently, Brazilian supervisors are not allowed to impose differentiated capital requirements for individual banks (at present, 11% must be applied across the board to all institutions). Changes of a smaller scale will also be needed in some regulations in order to allow for more effective supervisory discretion.

No significant problems are envisaged with respect to the implementation of Pillar III as far as quantitative disclosure is concerned, given that Brazilian banks already comply with a reasonable amount of quantitative disclosure requirements. However, Brazilian banks will have to improve a lot in terms of qualitative disclosure, which is something they are not particularly accustomed to do.

In terms of measuring economic capital, no doubt banks are usually more capable of correctly determining their own needs than the supervisor via regulatory capital. Nevertheless, for this to work properly, banks must develop the culture of using economic capital and employ appropriate internal models. In this sense, the use of IRB imposes a dramatic change in the supervisory approach. The judgemental capacity of supervisors will play an increasingly important role in examinations, which is why adequate training to carry out the validation of models and capital adequacy assessments will be of fundamental significance.

Supervisors still have a lot of work to be done in order to implement Basel II. We understand that it is important to disclose, as soon as possible, an overview of our implementation plans to the industry while we internally make all the studies necessary to support the numerous decisions to be made. The next steps include, for example, the evaluation of simpler alternatives for smaller institutions (non-bank and small banking institutions), the definition and disclosure of aspects of national discretion, the definition of eligibility criteria for IRB, and, finally, the release of an "Advanced regulation notice" - open to public/industry comments, and a Country Quantitative Impact Study considering revised aspects of national discretion.