Henrique Meirelles: Regulation and international standards in Brazil, the US, the EU and Switzerland

Speech by Mr Henrique Meirelles, Governor of the Central Bank of Brazil, at the First International Conference on Law & Economics, IBMEC São Paulo, in cooperation with the Foundation for Law and Economics at the University St Gallen, Switzerland, held in São Paulo, 2 April 2009.

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The world is experiencing the most severe economic and financial crisis in 80 years. What started as a deleveraging process in the US banking system has extended to a strong downturn not only in advanced economies, but also in the emerging world.

It is emblematic that we are here today in São Paulo discussing regulation at a time the issue is also being discussed at the meeting of heads of states of the G-20 in London. Much of the focus of the meeting relates to the redesign of the international financial system and its regulation, including possibly the outline of a sort of international financial regulator.

The current financial turmoil is ultimately a result of the failure of regulators, supervisors and policymakers in the advanced economies to prevent excessive risk-taking and leverage and to account for the interplay between regulated and non-regulated markets, partly due to their fragmented regulatory frameworks, partly due to legal restrictions on information and data sharing. Lax regulatory standards, coupled with poor risk management practices, deleterious incentives for risk-taking and deficient corporate governance structures in financial institutions are costing the global economy a high price.

Throughout the years, Brazil has adopted more cautious and broader regulatory standards than the international norm. Just to mention a few examples of what I am referring to, there are twenty-one different types of financial institutions under the regulation and supervision of the Central Bank, from universal banks to credit unions, all sharing common prudential and leverage rules. Furthermore, not only capital requirements are higher in Brazil than the Basel recommendation but also all capital requirements and controls are applied on a consolidated basis that includes non-financial subsidiaries in a banking group, so that most institutions are consolidated for supervision purposes. Finally, accounting standards adopted in Brazil require that all operations be kept on balance, with the respective risk requirements and provisions.

Risk management and internal controls regulations, as well as prudential loan loss provisioning requirements and large exposure limits have been in force for many years in Brazil. Additionally, having learned from past experience of international integration and fast contagion, the Central Bank makes careful evaluation of financial innovations and their impact on financial stability, so that the development of new products should be compatible with adequate prudential regulation. For instance, access to credit derivatives is limited and all over-the-counter derivatives that have a supervised entity as counterparty have to be registered and monitored.

The continuous review and update of the prudential regulatory framework is a priority for us. An example of a recent early prudential action occurred in June 2007, well before the recent financial turmoil aggravated: the Central Bank established a foreign exposure capital requirement for cross-border positions within international banking groups.

In a nutshell, the Brazilian approach insulated its financial institutions from the sort of problems that is affecting counterparties abroad. In fact, it is no coincidence that our financial system has shown resilience and has been largely unaffected during the current financial turmoil.

The overall assessment on the Brazilian regulation framework, which was sometimes criticized on the grounds of excessive carefulness, is currently praised in international forums. For instance, the fact that Brazilian regulators have access to information from the clearing systems of all operations in the financial market is a factor of admiration and reference worldwide.

Before closing, let me mention that I strongly welcome the recent enlargement towards emerging economies – including of course Brazil – of the Financial Stability Forum (FSF) and of the Basel Committee on Banking Supervision (BCBS). Emerging economies rapidly increasing weight in the global economy and global finances makes them an integral part of any viable solution to the current problems, as we are witnessing today in regard to their role in the G-20. The enlargement of forums in the area of regulation and financial sector supervision give more legitimacy to the discussion being held, with a view to design a new and more robust regulatory framework. I believe we need to have this new framework in place by 2010, as the current crisis is left behind, hopefully, and growth and stability are restored.

As part of the work program already laid down in the G-20, critical points in the reform include the need to make regulatory capital more neutral over-the-cycle, by integrating the macro prudential framework into the required capital of individual institutions; the need to reach, with prudential regulation and supervision, all quarters of the financial industry; and the need to enhance transparency of financial instruments and markets.

Thank you very much.