MULTILATERAL INVESTMENT FUND

I. BASIC INFORMATION

Country/Region:	Regional		
Program Name/Number:	Peer Led Effort to Strengthen Bank Regulation and Supervision by improving Compliance with Basel Core Principles (RG-M1070)		
Team:	Miguel Aldaz (MIF/PPU), team leader; Luis Giorgio (RE3/FI3); Alberto Bucardo (COF/CME); and Carla Bueso (MIF/DEU)		
Date of Request:	June 2005		
Beneficiaries:	Less developed Bank Supervision Agencies in LAC		
Executing Agency:	Association of Supervisors of Banks of the Americas (ASBA)		
Financing Plan:	MIF Facility I	US$	425,000
	ASBA	US$	695,000
		US$	1,120,000
Tentative Dates:	EVP: November 2005		

II. BACKGROUND AND PROBLEM STATEMENT

2.01 **Background[1].** The new global international banking regulations, after years of debate and argument, are very close to implementation. The new recommendations in capital sufficiency assessment or Basel II were released by the Basel Committee in June 2004[2] with the goals of strengthening the stability of the financial system by promoting the adequate capitalization of banks and encouraging improvements in risk management. Now bankers and regulators around the world are putting these new complex rules into effect. Elaborated under the auspices of the Bank for International Settlement (BIS), Basel II is intended to make financial regulation more flexible and effective with more sophisticated rules that require banks to allocate capital in line with a broader range of operational and credit risks. Banks will be able to measure these risks either using standard models, or by developing their own methodologies – if they can convince regulators that they are assessing risk adequately. These measure and assessment capacities by banks and regulators will allow financial intermediaries to better control risks and, in doing this, allocate capital more efficiently and price loans more consistently from a risk-return perspective, becoming one of the most relevant key drivers in determining a bank and a country financial competitiveness within nowadays more than ever integrated global market.

2.02 Latin American banks and regulators are now grappling with these difficult issues. The Latin American banking sector is being confronted and its competitiveness is at stake. Basel II, with its new concepts and requirements, clearly present a critical challenge to LAC banking industry and its regulators. Some countries are more advanced along the road to Basel II than others, with the region's largest and most sophisticated markets such as Brazil, Chile or Mexico making the most progress. Nonetheless, the efforts of LAC's financial industry and regulators are being severely undermined by the delay in implementing the "Core Principles for an Effective Banking

[1] Latin Banking Guide & Directory 2003, 2004 and 2005. LatinFinance Magazine numbers 149, 159 and 169.
2 "International Convergence of Capital Measurement and Capital Standards: a Revised Framework".

Supervision", released in 1997 by the Basel Committee and keystones of the 1998 Basel Accord (the first Basel), the global benchmark measure of banks' financial health.

2.03 **Problem Statement.** Bilateral reviews and diagnostics carried out by the International Monetary Fund and the World Bank have demonstrated that bank supervisors in LAC have a pending implementation agenda of the sound practices reflected in the Core Principles. LAC's bank supervisors have reached compliance degrees that are, in the best-case scenario, half of those corresponding to the industrialized nations[3]. This insufficient regulatory and supervisory environment hinders the competitive improvement chances of the region and deters economic growth by holding back credit expansion. In an integrated global financial market in which banks and countries compete internationally, LAC is finding itself in an increasingly more disadvantageous situation that is mostly impacting local banks (vs. international banks) and the smaller countries.

2.04 This project will greatly benefit from and complement the numerous country diagnostics that other institutions have undertaken but not acted upon. These diagnostics showed that Core Principles' implementation in LAC presents serious weaknesses in critical areas such as:

(i) Insufficient capacity to enforce regulation: An adequate level of operative independence and sufficient resources for the bank supervisory agency are essential to secure an effective supervisory framework. This has to be complemented with a clear legal framework wherein the bank supervisor is legally protected. This is not the case in the Americas and the advances made in this process need to be properly assessed and disseminated within the region.

(ii) Key supervisory areas and risk management: Only 10% of LAC countries comply with principles related with the need for bank supervisors to: (a) set prudent and appropriate minimum capital adequacy requirements that reflect the risks banks undertake, and define the components of capital by their capacity to absorb losses; (b) verify that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves; (c) verify that banks have management information systems to identify concentrations within their portfolios, understand the inherent risks, and adopt appropriate measures within the regulatory limits established; and (d) verify that banks have the ability to monitor and manage their risks and hold sufficient capital against these risks;

(iii) National and international consolidated supervision: This is especially important for the monitoring of internationally active banks where prudential regulations have to consider all aspects of their businesses at their foreign branches, joint ventures and subsidiaries; and

(iv) Proper bank resolutions frameworks to allow the market's adequate operation and provide feedback to all deposit insurance efforts being made.

2.05 If this scenario were further complicated by the need of gradually adopting the new recommendations of Basel II, the region's perspectives to participate competitively in the international financial markets would be further pressed. Preliminary surveys show that at least two thirds of the countries in LAC are not in condition to implement the Basel II tenants by the end of 2006. This means that regulatory and supervisory LAC authorities must work quick and hard in understanding their immediate and mostly shared challenges. Thus, to improve and develop the region's financial markets competitiveness, this project proposes to resolve practical regulatory and supervisory issues by combining in a joint program the efforts and resources of LAC's banking supervisors. This will be accomplished through a continued and concerted peer regional effort that no other multilateral or academic institution is supporting, in which ASBA leading countries will provide access to their know-how to those supervisors in need of peer collaboration in designing and implementing sound regulation and supervision practices

[3] The IADB on its 2005 publication "Unlocking Credit" indicates than only 6 of the 25 Principles are implemented in the region.

according to international best practices adapted to the local needs and requirements. It is particularly critical that the supervisory authorities work collaboratively and support each other in their effort to comply with the Core Principles since expertise in implementing Basel reforms are concentrated among a very small number of institutions and difficult to access. Banks from more advanced countries have climbed the learning curve but are reticent to make public their information and share their lessons learned, and, at the same time, there are only a few banking regulators who have developed the specific know-how.

2.06 This project is highly complementary with the Bank's efforts in promoting LAC's financial markets competitiveness and stability, among others actions, by: (i) organizing regional forums for public institutions (supervisory agencies and public banks), and private banks (international and national banks) to share views and discuss policies on best practices to manage financial risk; and (ii) supporting the use of transparency rules and market discipline instruments in Policy Base Lending Programs that support financial reform and enhance competitiveness of LAC's economies. The present proposal facilitates the exchange of technical knowledge and lessons learned not available in the market to implement Basel Core Principles, by supporting activities among peer supervisory agencies and their association, the only LAC member institution of the Basel Committee. The IADB[4] has tentatively identified the "development of stable and effective financial systems that are in conditions to support robust economic performance, minimize vulnerability to crisis that imply reduced growth and expensive restructurings, and undermine confidence in financial systems" as the third pillar of its new financial markets strategy.

III. PROGRAM OBJECTIVES AND DESCRIPTION

3.01 **Objectives.** The general objective of this project is to contribute to LAC's financial markets competitiveness and stability. The specific objective is to facilitate the joint development and implementation of regional regulatory and supervisory best practices to support the growth, stability and competitive functioning of LAC financial markets under a new global risk-sensitive framework. These objectives will be accomplished through three components: (i) development of guidelines and best practices; (ii) technical cooperation; and (ii) specialized peer training.

3.02 Component I: Development of guidelines and best practices. Technical working groups will analyze priority topics and make recommendations to ASBA's Board of Directors for later implementation of best practices, on an optional basis, by supervisory authorities throughout the region. These recommendations will take into consideration the particularities of the region's financial markets. These groups would seek to identify the common issues that hinder an effective action of the supervisory frameworks in the region and propose, in close collaboration with those supervisory authorities with more experience in the topic, the best possible practices to resolve them. To do so, the working groups will analyze current practices on each of the subjects identified, develop discussion papers for the consideration at the peer level, as well as recommendations that would best address the identified concerns in the region.

3.03 Component II: Technical cooperation among peer supervisory authorities. This component will address the major shortcomings detected in the countries' assessments performed by the International Monetary Fund, World Bank and others by allowing peer collaboration in implementing solutions, best practices, etc through technical cooperation among bank supervisors as well as on-the-job training activities. These activities will have two subcomponents:

(i) Horizontal cooperation. It contemplates the facilitation of technical assistance for the implementation of sound practices over periods not to exceed 20 days between bank supervisory agencies in the region. Its objective is to accelerate the implementation of sound practices that

[4] "Developing Financial Markets: The Challenges for the Decade. A Regional Financial Forum". June 13, 2005.

are not in pace with the average conditions in a member country. Countries like Canada, United States, Brazil, Mexico, Chile, Peru, Colombia, El Salvador, Jamaica, Trinidad and Tobago, and others may act as service providers in different areas of expertise. While countries such as Belize, Ecuador, Guyana, Nicaragua, Paraguay, and others[5] may be support recipients. This activity will be carried out by practitioners from the different supervisory agencies, whom will be identified and requested by ASBA to their respective authorities to provide pre-defined cooperation to a third associate member; and

(ii) Secondments. This component seeks to develop expertise on risk based bank analysis, consolidated supervision best practices, early warning systems implementation and problem bank resolution, design and implementation of strengthening programs and others, through the implementation of on-the-job-training secondments both at ASBA's Executive Secretariat as well as at leading banking supervisory agencies. These secondments should not last more than 30 days and their results would need to be evaluated by both home and host agencies. The program will be made available only to supervisors that have at least three years of field experience.

3.04 Component III: Specialized peer training. This component will support the implementation of the project's two other components and/or to disseminate the best practices/lessons learnt developed. The training events will increase the discussion and experience sharing among the participants through a more active participation of its attendees, keeping lecture periods to the minimum just to cover the essential tools to approach an issue. The success of the training program will depend on the quality of the instructors and facilitators identified and committed to it. Historically these resources have come from the Unites States supervisory agencies, the Financial Stability Institute, the Office of the Superintendent of Financial Institutions in Canada, the World Bank, the International Monetary Fund, and some private organizations. The project is designed to continue on this path and to make greater use of the IADB regional expertise.

3.05 **Description.** ASBA members are conscious of the challenges ahead and urgency to implement strategies that prioritize the compliance with Basel Core Principles. In order to prioritize activities and beneficiaries, ASBA will establish a Technical Committee in charge of the project's execution. Members of ASBA's Secretariat, ASBA's Board of Directors and IADB staff will make up the Technical Committee. The Technical Committee will define a selection criteria for the project's activities based on: (i) existing country assessments and ASBA surveys; (ii) beneficiary's institutional absorption capacity; (iii) size of the beneficiary's financial market and expected impact; (iv) urgency; and (v) replicability potential in other countries. The Technical Committee will define specific milestones, key drivers, indicators and expected outcomes for each specific activity approved.

3.06 The project's expected outcomes are: (i) Four technical working groups best practices implementation guidelines that will help guide the supervisors activities during their Core Principles compliance process (Component I); (ii) Ten horizontal cooperation exercises on issues related with this project's areas (Component II.i); (iii) Six employees trained through secondments in the areas identified as challenges in this project (Component II.ii); (iv) Nine specialized peer training events to reach 315 participants (Component III). Some of the most likely outcomes of the best practices implementation guidelines will be: (a) Quantitative Impact Studies (QIS) requirements issued by the Supervisory Agencies to a sample of selected banks as a tool to assess the bank capitalization rule changes in line with the new international standards; (b) analysis and interpretation of QIS results and preparation of reports that will guide the supervisory agencies development and implementation of transition strategies to the new capital

[5] Only MIF members' Bank Superintendencies will benefit from this project.

adequacy framework; and (c) issued roadmaps[6] to facilitate the understanding of the banks and financial entities of the goals pursued by the authorities.

IV. COST AND FINANCING

4.01 The total cost of the project is $1,120,000. MIF will contribute 38% of this amount ($425,000), while the local counterpart will amount to 62% ($695,000). Local supervisory authorities will contribute, in the form of airfare and per diem for those participating in the different activities, part of ASBA contribution. The project will be executed over a period of 30 months. The disbursement period will be 36 months.

V. EXECUTING AGENCY AND EXECUTION STRUCTURE

5.01 The Association of Supervisors of Banks of the Americas (ASBA) consists of 34 bank supervisors from the Americas and the Caribbean. Its goals are to: (i) Promote and maintain close communication ties among supervisors; (ii) Constitute a high level forum for dealing with and exchanging ideas, technologies, techniques, experiences, and knowledge regarding bank supervision issues; (iii) Foster the development of research, systematic training programs, and technical cooperation services among members; (iv) Promote cooperative relationships with non-member bank supervisors as well as with other entities related to the Association's objectives; and (v) represent LAC countries' unique circumstances and requirements before international forums like the Basel Committee.

5.02 ASBA has the following advantages for the program's conducting: (i) *Project ownership and common vision*: ASBA is an organization supported by the region's supervisors with a clear mandate to support the development of bank supervision in the region. Thus, its "owners" appropriate any activity carried out within the organization as it responds to their demands and is aligned with their common vision to progressively achieve this goal; (ii) *Regional Scope and integration*: For any banking operation to be cost effective and safe, a predictable regulatory and supervisory framework is essential. The globalization of the financial sector needs of a regulatory and supervisory process that is increasingly homogeneous. ASBA has the advantage of bringing LAC's perspective and coordination capacity to help in this process, brings different perspectives that are representative of the region into the discussion of issues, and reaches within its resources to respond to the regional needs; (iii) *Versatility and adaptability* to simultaneously concentrate on several projects and deliver its services to 34 countries in the Americas, attempting a regional balance. It can further adapt to changing conditions through being close to its members and learn of their challenges and need first hand; (iv) *Cost effectiveness*: The Association's regional management produces an important return to the resources invested in comparison with projects bilaterally designed and implemented; and (v) *Management unity and consistency*: The unified management of a regional project by an organization like ASBA helps to closely coordinate tasks with the beneficiaries; quickly respond to changing conditions should they arise; and establish a strong evaluation process through a central reporting system.

5.03 In addition, ASBA brings the opportunity to greatly improve the dissemination of the project's outcomes by making them available to all 34 countries members of ASBA. Thus, the outcomes shall not only be part of a library of products that may help as a reference to the supervisors, but should be translated into practical implementation guidelines or practices. This project is integral in the sense that a particular initiative may involve technical working groups, technical cooperation and training to give it practical use.

[6] As of June 2005, only Chile has issued in LAC the needed roadmap to implement Basel II.

VI. MAJOR ISSUES

6.01 The Project Team will give special attention to the following issues during the analysis mission: (i) the level of commitment to the project's objectives by the region's supervisors; (ii) the capacity of ASBA's Executive Secretariat to manage the activities over the time-period proposed; (iii) the development of the project's evaluation guidelines; (iv) the development of a dissemination plan of the project's outcomes; (v) a more specific definition of the proposed activities and expected outcomes; and (vi) mechanisms to maximize the input and feedback to be received by the IADB Group during the execution of this project.

VII. ENVIRONMENTAL AND SOCIAL STRATEGY

7.1. No negative environmental or social impacts are expected from this operation.

VIII. ACTION PLAN

8.1. The following is a preliminary schedule for the project's approval process:

CESI	September 2005
CRG	October 2005
Donors Committee	November 2005