

An Overview on the Positive Effects of the Implementation of the Basle Accord and the Strengthening of the Brazilian Banking System

The purpose of this research is to verify the strengthening of the Brazilian Banking System as from the implementation of the Basle Committee's International Convergence of Capital Measurement and Capital Standards (commonly known as Basle Accord) in the Brazilian banking system.

Hence, it is important to review some basic concepts regarding the Basle Accord, as well as the Brazilian banking system before reviewing the impact of the accord on this system.

BASLE ACCORD

In July 1988, the Basel Committee¹ on Banking Supervision issued the Basel Accord. The Basel Accord can be considered as a milestone for bank capital regulation. It established a basic framework for risk-based capital standards (credit risk) in order to improve these standards in many countries. The reason for this action is based in the World necessity of improving the liquidity standards of the financial institutions.

¹ The Committee is comprised by banking supervision authorities and was created by the Presidents of the Central Banks of the countries participating in the G-10 Group (i.e., supervision authorities and Central Banks of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, The Netherlands, Sweden, Swiss, United Kingdom and United States of America). Although they are twelve, they are still called group of 10. The Committee uses to meet in the headquarters of the Bank for International Settlements located in Basle, Swiss.

It required international banks from the G-10 to hold a minimum total capital equal to 8% risk-based capital ratio (risk-weighted assets), being at least half of this met by Tier 1 capital² and the remainder Tier 2 capital³.

Risk-based capital ratios were defined as the sum of the risk-adjusted assets on and off balance sheet. On-balance sheet assets were assigned to one of four risk levels (0%, 20%, 50% and 100%) and then weighted by the level's weight. Off-balance sheet contingent contracts, such as letters of credit, loan commitments and derivative instruments, which are traded over the counter, needed to be first converted to a credit equivalent and then multiplied by the appropriate risk weight.

Over time, the Accord has been well-tuned to account for financial innovation and some of the risks it did not consider initially. However, new concerns have been raised out because banks could easily reach into "cosmetic" adjustments to boost their reported adjusted ratios without enhancing their soundness.

Evidence of shortcomings, as well as the existence of studies carried out not only by the G-10 group (in 1996) and the opinions of Bank for International Settlements (BIS), International Monetary Fund (IMF) and the World Bank leded

² Equity capital (including common shareholder's equity, non-cumulative perpetual preferred stock and minority shareholdings in consolidated subsidiaries) and disclosed reserves.

³ It may include: hybrid debt capital instruments, preferred stock not qualified as Tier 1 Capital (in case of unpaid dividends cumulated or the stock has a limited life), term subordinated debt, general loan-loss reserves and net unrealized appreciation.

to the conclusion that the standards established by the Basle Accord should be improved.

In 1996, the Basle Accord was amended to require banks to set aside capital to cover the risk of losses arising from movements in market prices. For the first time, banks were allowed to use their own systems to measure their market risks. This amendment also defined a Tier 3 capital to cover market risks, and allowed banks to count subordinated debt (with an original maturity of at least two years) in this tier.

The main novelty of this amendment relates to the fact that it allows banks to use, as an alternative to the standard approach, their internal models to determine the required capital charge for market risk.

The standard approach defines the risk charges associated with each position and specifies how these charges are to be aggregated into an overall market risk capital charge. The internal models approach, in contrast, allows a bank to use its model to estimate the value-at-risk (VaR) in its trading account, that is, the maximum loss that the portfolio is likely to experience over a given holding period with a certain probability⁴. The market risk capital requirement is then set based on the VaR estimate.

⁴ A 10-day, 99th percentile VaR estimate equal to \$100 means the bank would expect to lose more than \$100 on only one out of 100 10-day periods.

Although these changes were implemented, the business of banking, risk-management practices, supervisory approaches, and financial markets each have undergone significant transformation since then. In June 1999 the Committee released a proposal to replace the 1988 Accord with a more risk-sensitive framework, on which more than 200 comments were received.

Reflecting those comments and the results of ongoing dialogue with the industry and supervisors worldwide, the Basle Committee presented in June 1999 a primary release for public comment of its new proposal. In July 10, 2002, it proposed a more concrete proposal, seeking public comments. By December 20, 2002, all comments received were considered for the new proposal to be addressed for public comments until the end of the second quarter of 2003. The Basle Committee intends to finalize the new accord by the fourth quarter of 2003, allowing the implementation of the new framework in each country at year-end 2006.

The proposal consists in three pillars: minimum capital requirements, supervisory review process and market discipline, in order to make the framework more flexible and risk sensitive by placing more emphasis on bank's own internal control and management, the supervisory review process, and market discipline.

This is because the 1988 Accord provided only one way for measuring the appropriate capital of internationally banks. Notwithstanding, each bank is

different from another and the best way to manage and mitigate risks differs from bank to bank. With this new framework, banks will be allowed to measure both credit and operational risks using simple to complex/advanced methodologies, making the system more flexible and reaching the best structure that fits their level of sophistication and risk profile.

The first Pillar: minimum capital requirement

The first pillar sets out minimum capital requirements. The new framework maintains both the current definition of capital and the minimum requirement of 8% of capital to risk-weighted assets. However, to ensure that risks within the entire banking group are considered, the revised Accord will be extended on a consolidated basis to holding companies of banking groups.

One could say that the new Accord will require more elaborate risk measurement methods in order to calculate credit risk of banks. Moreover, the revised Accord proposes for the first time a measure for operational risk, while the market risk measure remains unchanged.

The second pillar: supervisory review process

This new framework will implicate a much more detailed and constant dialogue between supervisors and banks, as well as much more training and expertise of bank supervisors because the supervisory review process requires supervisors

to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks. Intervention will be allowed when necessary.

The revised Accord emphasizes the importance of bank management developing an internal capital assessment process and setting targets for capital capable to measure the bank's particular risk profile and control environment.

The third pillar: market discipline

The new Accord recommends that banks booster the disclosure of their risk policies and profiles and adequacy of their capital positions in order that market participants have a better and an effective understanding of bank's risk profiles and capital adequacies, including recognition of internal methodologies applied by banks to calculate credit risk, credit mitigation techniques and asset securitization.

A long way to go

Although the new Accord is a very good attempt to avoid bank failures and runs, one cannot assure that bank's failures will be totally avoided with the implementation of the new framework because there is not only a "lack of full understanding of the relative efficiencies in the processing and aggregating

information, but also a complete understanding of the optimal risk-sharing among the various claimholders in a general equilibrium framework⁵.”

Nevertheless, I believe that with the implementation of the new framework the increase in the transparency of the required disclosures and the optimization of the risk-ratio methods will proportionate lead market participants more flexible decisions.

AN OVERVIEW ON THE BRAZILIAN BANKING SYSTEM

Current figures

It is not the main purpose of this work to fully review the Brazilian banking system. However, it is important to mention its principal characteristics which may justify the successful implementation of the Basle Accord.

Brazil has a diversified banking system which includes commercial investment and multi-purpose banks (known as multiservice banks⁶), in addition to consumer finance, leasing, brokerage, dealer and credit companies. The system consists of

⁵ Joao A. C. Santos in Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature. Bank for International Settlements Working Papers No. 90, September 2000.

⁶ Multiservice banks are institutions licensed to carry out a number of different functions including commercial and investment banking, created pursuant to Brazilian Monetary Council Resolutions No. 1524 of September 21, 1988 and regulated by Resolution No. 1649 of January 25, 1989.

738 financial institutions⁷ among banks and hundreds of credit unions, brokers, dealers and consumer credit companies⁸.

Among these 738 financial institutions⁹, there were 644 authorized portfolios in the end of the year of 2001.

Operating Institutions

Considering the institutions and portfolios of the same kind

Type	Date	dec-98	jun-99	dec-99	jun-00	dec-00	jun-01	dec-01
	COMERCIAL	185	181	175	174	173	167	160
PORTFOLIOS	INVESTIMENT	128	123	126	126	123	120	121
	DEVELOPMENT	21	19	18	18	17	17	15
	REAL ESTATE CREDIT COMPANIES	86	83	77	75	73	75	74
INSTITUTIONS	COMSUMER CREDIT COMPANIES	187	184	182	178	176	170	169
	LEASING COMPANIES	100	103	103	108	109	107	105
	TOTAL	707	693	681	679	671	656	644

Source: CENTRAL BANK OF BRAZIL - COSIF - DEORF/COPEC

⁷ Financial institutions are defined as public or private companies that have as their main or ancillary activities the raising, brokering or investment of financial resources, whether their own or belonging to third parties, in Brazilian or foreign currency, as well as the safekeeping of third-party property (Article 17 of the Banking Law, defined below). The primary feature of financial activities is the public raising of funds for the purpose of extending credit. Financial institutions are classified in accordance with the transactions they are authorized to carry out. The main categories of financial institutions are as follows: (i) commercial banks; (ii) investment banks; (iii) multiservice banks; (iv) consumer credit companies; (v) securities brokerage firms; (vi) securities dealerships; (vii) leasing companies; (viii) development banks; and (ix) savings banks. Any person who carries out any of the activities referred to above may be considered tantamount to financial institutions. The performance of any of the activities exclusive to a financial institution without authorization from the Central Bank of Brazil is deemed a serious infringement of the banking law and could constitute a criminal violation.

⁸ Source: The Central Bank of Brazil, December 31, 2001.

⁹ Note that the Central Bank of Brazil considered each of the multiservice banks authorized portfolios in order to reach this amount.

Regarding just the banking subgroup, in the end of 2001 there were 182 banks, among them 153 were multiservice banks, 28 commercial banks (including the foreign branches in Brazil of foreign banks). During 2001, two multiservice banks were authorized to operate in Brazil by the Central Bank of Brazil (“Central Bank”), two leasing companies were transformed into multiservice banks and the authorization to operate in Brazil for 13 banks were cancelled by the Central Bank, for a wide range of motives. Furthermore, the Central Bank approved the change of corporate objectives of 61 institutions among which 27 remained financial institutions meanwhile 34 were transformed in non-financial institutions¹⁰.

On the other hand, in the end of 2001, there were 15 development banks, 169 consumer credit companies (credit and investment companies and credit, financing and investment companies), 74 real estate credit companies and 105 leasing companies

It is worth noting that the number of the Brazilian banks with participation abroad has decreased from the end of 2000 to the end of the year 2001, as shown below:

Year	No. of Banks with Investment Abroad	%	No. of Agencies Abroad	%	No. of Offices Abroad	%	No. of Participations Abroad	%
2000	61		84		26		155	
2001	55	(9.8)	89	6.0	25	(4.0)	151	(2.6)

Source: THE CENTRAL BANK OF BRAZIL - COSIF - DEORF/COPEC

¹⁰ Source: The Central Bank of Brazil, December 31, 2001.

In the end of the year 2001, the foreign participation in the total net worth of the banking system reached the levels of 30.72%. The force of this power may be explained by the globalization of the financial market world-wide and the participation of the foreign banks in the privatization of several public banks and the acquisition of a large range of undercapitalized banks with several huge financial and capital requirement problems.

From 76 foreign banking institutions (commercial, investment and foreign branches) located in Brazil, 29 (38%) are European originated and 15 (20%) from United States of America and/or Canada.

Within 1996 and 2001, the number of banks with foreign control raised to 70 from 40 (75%) and the banks with foreign equity participation decreased from 29 to 14 (-52%). However, not only their amounts of average assets increased, but also the industry as a whole:

Type of Institutions	1996		1997		1998		1999		2000		2001	
	No. Of Banks	Average Assets ¹¹	No. Of Banks	Average Assets	No. Of Banks	Average Assets	No. Of Banks	Average Assets	No. Of Banks	Average Assets	No. Of Banks	Average Assets
DOMESTIC PRIVATE BANKS	130	1,512	119	1,597	105	1,822	96	1,939	93	2,539	82	3,341
BANKS WITH FOREIGN CONTROL	40	1,314	45	1,775	58	2,135	67	2,567	69	3,264	70	3,941
BANKS WITH FOREIGN PARTICIPATION	29	1,040	26	2,750	17	2,724	12	3,833	13	4,241	14	4,884
DOMESTIC PUBLIC BANKS ¹²	32	9,106	27	12,210	23	13,416	19	16,104	17	17,706	16	19,446
Total Average	231	2,471	217	3,092	203	3,301	194	3,660	192	4,258	182	5,107

¹¹ Simple average. Calculated by the sum of each amount of assets of each institution, in each segment, divided by the number of institutions that comprise each segment.

¹² Public banks mean banks owned/controlled by the government.

Type of Institutions	1996		1997		1998		1999		2000		2001	
	No. Of Banks	Average Net Worth ¹³	No. Of Banks	Average Net Worth	No. Of Banks	Average Net Worth	No. Of Banks	Average Net Worth	No. Of Banks	Average Net Worth	No. Of Banks	Average Net Worth
DOMESTIC PRIVATE BANKS	130	175	119	174	105	264	96	291	93	352	82	505
BANKS WITH FOREIGN CONTROL	40	114	45	145	58	249	67	293	69	332	70	438
BANKS WITH FOREIGN PARTICIPATION	29	123	26	258	17	304	12	532	13	412	14	675
DOMESTIC PUBLIC BANKS	32	488	27	604	23	618	19	1,013	17	914	16	1,146
Total Average	231	201	217	231	203	303	194	377	192	330	182	549

Source: THE CENTRAL BANK OF BRAZIL - COSIF - DEORF/COPEC

The average amounts of every segment increased significantly, mainly for the banks controlled by foreign entities and for the banks with foreign participation in their capital. With regard to public banks, it is worth mentioning that their amounts decreased due to the privatization and restructuring programs settled within these years.

In December 2001, the total assets of the Brazilian banking system in *reais* amounted to the equivalent of USD 321.8 billion¹⁴, net worth to the equivalent of USD 29.7 billion and net profits of the equivalent to USD 1.5 billion. The respective currently amounts for September 2002 are: USD 391.5 billion (R\$ 1,291,948, 274,000), USD 32.2 billion (R\$ 106,375,882,000) and USD 2.1 billion (R\$ 6,988,515,000), representing an increase, respectively, of 21.66%, 8.42% and 40%.

¹³ Simple average. Calculated by the sum of each amount of assets of each institution, in each segment, divided by the number of institutions that comprise each segment.

¹⁴ Source: The Central Bank of Brazil. Exchange rate: 1 USD/R\$ 3.30.

Overview

In order to improve and strengthen the Brazilian banking system pursuant to the implementation of a centralized control system of the monetary policy and organization of legal framework for the development of modern financial institutions, the government released Law No. 4595 on December 12, 1964 (the “Banking Law”).

The Brazilian financial system comprises the Brazilian Monetary Council (“CMN”), the Central Bank, the Brazilian Securities Exchange Commission (“CVM”), the Private Insurance Superintendence (“Susep”), the Secretary of Supplementary Pension and public and private financial institutions.

Law 4595/64 created the CMN and Central Bank and played a very important role for boosting the Brazilian financial market because before there was a lack of effective instruments for the creation and implementation of monetary, credit and foreign exchange policies. It was hard for the government, at those days, to navigate any process for the Brazilian financial market and credibility and development of a financial system are important factors for the development of a country.

“Other important banking regulations in the regulatory framework include: (1) the Capital Markets Law,¹⁵ which provides for the regulation and development of the Brazilian capital markets; (2) the Liquidation Law,¹⁶ which provides for extrajudicial liquidation and intervention in financial institutions, as well as establishes the responsibilities and liabilities of their officers; (3) the Securities Law,¹⁷ which created CVM and set the general guidelines for the Brazilian securities market; (4) the Corporation Law,¹⁸ which governs the companies formed as *sociedades por ações* (corporations); (5) the White Collar Criminal Law,¹⁹ which defines the crimes against the Brazilian financial system; (6) the RAET Law,²⁰ which instituted the System of Special Temporary Administration (*Regime de Administração Especial Temporária – RAET*) which provides the rules and regulations for temporary administration of non-federal private and government-controlled financial institutions in distress; (7) the Joint Liability Law,²¹ which provides for joint liability of controlling shareholders of financial institutions undergoing extrajudicial liquidation, intervention and RAET; and (8) the Anti-Money Laundering Law,²² which provides for the implementation of an effective legal system to combat money laundering in Brazil. The CMN also issues rules made public by the Central Bank pursuant to resolutions (*Resoluções*) dealing with specific subjects under the Banking Law, which are in

¹⁵ Law 4728, of July 14, 1965, which regulated the stock exchange activities, created incentives for the issuance and acquisition of debentures and defined the investment banks objectives.

¹⁶ Law 6024 of March 13, 1974.

¹⁷ Law 6385 of December 7, 1976.

¹⁸ Law 6404 of December 15, 1976.

¹⁹ Law 7492 of June 16, 1986.

²⁰ Decree-law 2321 of February 25, 1987.

²¹ Law 9447 of March 14, 1997.

²² Law 9613 of March 3, 1998.

turn complemented by regulations issued periodically by the Central Bank (*Circulares and Cartas Circulares*). These *Circulares* and *Cartas Circulares* establish the technical details for implementation of the resolutions. The CVM likewise issues certain rulings (*Instruções*) and opinions (*Pareceres*) that affect banks performing investment banking and securities activities in Brazil”²³.

The main purposes of the reform of the Brazilian financial system at that time were the institutionalization of the monetary correction and specialization of the financial institutions.

Banks were diversified into market segments as they believe within this strategy they could be more profitable. Although, it was possible for all financial institutions of a same economic conglomerate work together, their accounting should not be consolidated.

In 1988, the Central Bank of Brazil released the Accounting Plan of the Financial System Institutions (“Cosif”), pursuant to which the financial institutions pertaining to a same economic conglomerate could therefore consolidate their accountings.

“On September 21, 1988, the CMN issued Resolution 1524, allowing banks to carry out different financial activities such as commercial banking, investment banking, real estate credit, consumer credit and leasing through one legal entity,

²³ Mendes, Antonio and Balduccini, Bruno, in Banking Regulation in Brazil and Treatment of Foreign Banks, 2000.

by having different licenses (*carteiras*). These entities were named *Bancos Múltiplos* or multiservice banks. Financial groups were also permitted to consolidate their activities in just one multiservice bank by merging all companies into one. Prior to the creation of multiservice banks, each specific financial activity had to be conducted through separate legal entities: for example, consumer credit through a consumer credit company, underwriting through investment banks and property financing through real estate credit companies”²⁴.

Until 1962, there were no restrictions for the entrance of foreign banks into Brazil. However, with the issuance of Law No. 4131 on September 3, 1962, the foreign investment in financial institutions was limited to 1/3 of the shares with voting power and 50% of the total capital of financial institutions. Prior approval by the Central Bank or approval by Executive Power decree was necessary.

Moreover, with the Constitutional Reform of 1988, the entrance of new foreign investment into the Brazilian Financial System was forbidden²⁵, until a new Supplementary Law is issued in that regard.

In order to strengthen the financial system and avoid any of the negative effects of the economic stability on the role played by the banks in Brazil, in August 1995, the President of the Republic approved Income Ministry’s Opinion No. 331, pursuant to which, in summary, foreign banks could enter the Brazilian financial

²⁴ Mendes, Antonio and Balduccini, Bruno, in Banking Regulation in Brazil and Treatment of Foreign Banks, 2000.

²⁵ Article 52 of the Constitutional Transitory Provisions Act.

system (by acquiring existing banks and other financial institutions) since the acquirer could prove that there was a prior Government interest on the acquisition and increase of participation of foreign individuals and legal entities in financial institutions in Brazil.

According to this opinion, the increase in the foreign investment participation in the financial market in Brazil would financially reinforce the market by bringing external resources into Brazil, improving the reserves, as well as by the improvements in the products and services and consequent decrease in products and services prices offered by the institutions.

As from the approval of this opinion, there was an increase in the number of foreign banks branches in Brazil and most recently the increase of foreign investment in banks in Brazil (not only an increase in the number of banks with foreign participation, but also the increase of their participation in the average assets and net worth of the same, as shown above).

Control of financial institutions – Basle Accord

As Brazil was one of the 100 countries that adhered the Basle Accord, the CMN issued Resolution 2099 on August 18, 1994, which deals with the rules for the opening, operation, transfer and reorganization of financial institutions, revoked all the incentives for the establishment of multiservice banks, unified the

development and investment portfolios of banks and created leasing portfolios. Moreover, Resolution 2099/94 established the minimum capital requirements and net worth for the financial institutions and the institutions authorized by the Central Bank to operate.

As from that date, the adjusted net worth of any financial institution should be calculated proportionally to the risk-adjusted ratio of the assets.

Until November 17, 1995, the minimum capital requirements of foreign institutions were different. On that date, the CMN issued Resolution 2212 that revoked these differences and on July 26, 1996, the CMN issued Resolution 2302 which established that foreign institutions should use the same method used by Brazilian financial institutions so far.

It is worth noting that on June 26, 1997, Resolution 2399 raised the capital and the minimum requirement to 10% of capital to risk-weighted assets (risk-based capital ratio) from 8%. This Resolution was revoked by Resolution 2788, on December 1, 2000 and the risk-based capital ratio was increased to 11% pursuant to Resolution 2692 of February 25, 2000. Presently, although the risk-based capital ratio is 11% for banks, 20% for credit cooperatives and 13% for cooperative banks, in June 2002, the Brazilian financial system presented a risk-based capital ratio higher than 16%.

Any other provisions were adopted in order to strengthen the Brazilian financial systems as regards minimum capital requirements and risk-weight controls.

The Central Bank regulates the requirements for: (1) authorization for operation; (2) minimum limits of paid-in capital and net worth; (3) installation and operation of branches in Brazil; and (4) the risk-based capital ratio.

Resolution 2607 of May 27, 1999 sets forth the minimum paid-in capital for financial institutions. The minimum paid-in capital ratios for banks are the following:

Paid-in Capital

Multiservice Bank

Each license requires the following minimum paid-in capital:

Licenses	Minimum Paid-in Capital
Commercial	R\$ 17.500.000,00
Investment or Development	R\$ 12.500.000,00
Real Estate Credit	R\$ 7.000.000,00
Consumer Credit	R\$ 7.000.000,00
Leasing	R\$ 7.000.000,00

Commercial Bank and Cooperative Bank

- Headquarters or principal office in Rio de Janeiro or Sao Paulo R\$ 17.500.000,00
- Headquarters or principal office in other states except Rio de Janeiro or Sao Paulo and with at least 90% of the branches out of the route Rio de Janeiro – Sao Paulo R\$ 12.250.000,00

Development Bank, Investment Bank and Savings Banks

- Headquarters or principal office in Rio de Janeiro or Sao Paulo R\$ 12.500.000,00
- Headquarters or principal office in other states except Rio de Janeiro or Sao Paulo and with at least 90% of the branches out of the route Rio de Janeiro – Sao Paulo R\$ 8.750.000,00

With regard to foreign exchange transactions, banks with appropriate authorization to deal so must add more R\$ 6.500.000,00 to their minimum paid-in capital.

Risk-based capital ratio

The risk-based capital ratio is calculated taking into consideration the Reference Net Worth (*Patrimônio de Referência*), which in turn is used to set forth the operational limits as the Net Worth and the patrimonial accounts as follows.

Tier I Capital

Tier I represents the company's core capital. According to Brazilian legislation, at least half of the required capital must consist of Tier I Capital while the balance may be composed of Tier II Capital. Any amount representing goodwill, however, may not be considered as Tier I Capital.

Tier I is represented by the corporate capital, capital reserves, revenue reserves and retained earnings or accumulated losses adjusted by the net difference between such earnings and losses.

For purposes of Tier I calculation, the following shall be deducted: reserves for revaluation, reserves for contingencies; special revenue reserves for undistributed mandatory dividends; amounts set aside for shares held in treasury; amounts payable on account of cumulative dividends attached to preferred shares; and amounts set aside for redemption of redeemable preferred shares.

Tier II Capital

Tier II Capital—or supplementary capital—includes asset revaluation reserves; reserves for contingencies; special revenue reserves for undistributed mandatory dividends; amounts payable due to cumulative dividends on preferred shares; amounts set aside for redemption of redeemable preferred shares; subordinated debt, and other quasi-equity instruments. Tier II Capital is capped so as not to exceed the Tier I Capital.

All assets must be weighted in accordance to the related risks and must be analyzed on a case by case basis.

As in the American banking system, the Brazilian financial institutions (except credits cooperatives and savings and loans associations) must contribute to a Credit Insurance Fund (“Fundo Garantidor de Créditos – FGC”). The contribution is 0.025% of the accounts balance object of the guarantee and the responsibility of the participants is limited to the amounts contributed to the FGC.

The FGC is a private legal entity without profit purpose, with the main function to manage the credit holders’ protection mechanism against financial institutions²⁶.

The fund will pay to each depositor the total amount of R\$ 20,000.00²⁷ in the event of intervention, extrajudicial liquidation and bankruptcy of the financial institution that is not under any of the Central Bank’s special temporary administration systems.

Central Bank is willing to transfer to FGC one of the attributions that it has today: the power to intervene into banks with liquidity problems.

Important changes were carried out throughout 1995, when Provisional Measure No. 1182 of November 18, 1995 was issued. This Provisional Measure was turned into Law No. 9447 of March 14, 1997 (the “Joint Liability Law”, as defined above), pursuant to which Central Bank was given powers to take actions in order to avoid liquidity problems in the financial system. Moreover, pursuant to the Joint Liability Law, direct or indirect controlling shareholders of financial

²⁶ CMN Resolution No. 2.197 of August 31, 1995. Bylaws and rules were established by CMN Resolution No. 2.211 of November 16, 1995.

²⁷ Equivalent to approximately USD 8,700.00 (Foreign exchange rate at 1 USD = R\$ 3.30).

institutions under intervention, extrajudicial liquidation or special temporary administration are jointly liable for their liabilities and may have their assets frozen at Central Bank's request.

Other important innovation of this Provisional Measure converted into Law 9447/97 is that independent auditors may be held liable too for the services rendered to the institutions under intervention, extrajudicial liquidation or special temporary administration. Pursuant to this rule, the independent auditors are obliged to inform the Central Bank of any eventually difficulties in the financial system, under the penalty to be held liable for that.

EVOLUTION (1989 – 2000)

Conditions regarding the development of a particular financial system comprise the structural and nature aspects of its markets and relationships among its institutions and other economic agents and legal framework. It comprises also the credit lines and credit acquisition methods, services offered and customer segmentation, as well as monetary policies and types of certificates utilized within the transactions.

The structure of the Brazilian financial system was changed since 1964, even because of the creation of the multiservice banks, as well as the implementation and improvement of the principles and tools created by the Basle Accord.

It has been changing as from an inflationary scenario, extremely favorable to the business, into a more stable scenario with interest rates much lower than the ones used at that time.

In December of 1988, there were 104 commercial banks and 5 savings banks. From 104 commercial banks, 49 (47%) were private banks, 26 (25%) had foreign control and 29 (28%) were public banks.

With regard to the assets ownership, in December 1988, it was distributed as follows:

Year	Type of Banks	No. of Banks	% Increase	% of Assets	% Increase
1988	Domestic Private Banks	49	-	56.85	-
	Private Banks with Foreign Control	26	-	9.62	-
	Domestic Banks with Public Control	29	-	33.53 ²⁸	-
	Total	104	-	100.00	-
2000	Domestic Private Banks	104	112	42.56	(25)
	Private Banks with Foreign Control	71	173	33.11	244
	Domestic Banks with Public Control	16	(45)	24.33	(27)
	Total	191	84	100.00	-

Source: THE CENTRAL BANK OF BRAZIL - COSIF - DEORF/COPEC

²⁸ Of the total of 33.53%, 21.55% owned only by Banco do Brasil.

Of the 191 existing banks in December 2000, 64 (33.5%) have been operating since December 1988 and which survived the 1989-2000 period with important changes in the Brazilian financial and economic scenario.

The increase in the participation of the private banks with foreign control within the total of assets of the financial system could be explained by the acquisition by foreign individuals and legal entities of domestic private and public banks, as a result of the Government's 1994 *Plano Real*²⁹ as well as to the decrease on the participation of the government in the financial system.

On the other hand, within the 1989-2000 period, 115 banks were liquidated of which 15% were merged into other financial institutions, 15% were transformed into other type of financial institution, 45% of those banks were under intervention or liquidation processes and 25% had their permissions to operate cancelled.

In the end of the 1988-2000 period, the Brazilian banking system comprised a total of 191 banks, most of them multiservice banks, which allowed Central Bank to have a broader and integrated view of the quantity and type of institutions pertaining to a same economic-financial group, as well as the strategies adopted by this economic conglomerate.

²⁹ The Plano Real is a stabilization program implemented in July 1994, which aimed at curtailing inflation and building a foundation for sustained economic growth. It is designed to address persistent deficits in the Government's accounts, expansive credit policies and widespread, backward-looking indexation.

Despite the corporate scandals of the early 2000s, little growth of the developed economies, contraction of the securities markets worldwide and increase of the international investors' risk reverse factor, the financial systems (in the developed and in development countries) have been working well, since the adoption of the prudential and supervision practices accepted worldwide. Exception made to the banks of Japan and Argentina, which crisis may be attributed to the respective economic scenarios and the adoption of specific economic and market policies.

Because not only of the abovementioned factors but also of the implementation of the Brazilian Payments System (*Sistema de Pagamentos Brasileiro – SPB*)³⁰, certain stability of the Brazilian banking System must be noted.

Despite the local currency devaluation faced by Brazil right before and after the Presidential election of 2002, the shrinking in the volume of foreign investments and capital inflow into Brazil and the war against Iraq, by and far the numbers above showed a Brazilian financial system that remained solid because of (i) a continuous increase in the total of assets of the market; (ii) a decrease trend of operational costs; (iii) positive profits; and (iv) an adequate capitalization (risk-based assets ratio of 16%, in June 2002, higher than the 11% presently required) of banks. According to a recent study prepared by the Central Bank, in June

³⁰ Pursuant to an implementation of an electronic system the private financial entities systemic credit risk previously supported by the public sector was shifted to the private sector. In summary, rigid controls and supervision by the Central Bank on the banking reserves accounts that must be daily settled at a clearing house will intend to avoid or at least mitigate any kind of serious illiquidity problem of any Brazilian bank (negative balances in banks' reserve accounts are not allowed. These accounts are rigidly monitored by the Central Bank). In case of illiquidity by any bank, guarantees deposited with the clearing house will be exercised.

2002, from a range of 137 financial institutions randomly selected only four (4) (i.e., representing 2.9% of the total) would need capital infusion in order to accomplish with the 11% required risk-based asset ratio³¹.

According to other studies prepared by the Central Bank in order to verify the stability of the Brazilian banking system, only in a scenario of interest rate and foreign exchange rate increase (devaluation of the local currency) and increase of the credit risk (all together) is that approximate 34% of the analyzed institutions would require infusion of capital of 14.2% more on the required net worth³².

CONCLUSION

As a whole, the Brazilian banking system has grown approximately 84% as from 1988 until 2000. The number of assets has increased almost 22% in the 2001-2002 period. Furthermore, the foreign capital has increased its participation in the total of assets of the market substantially.

Despite structural and operational changes in the system, the Brazilian banking sector remains solid. Most banks are reacting to the pressure created by the new low inflation environment by cutting overhead and diversifying services offered to their customers. This is one of the reasons of the new wave of banking

³¹ Relatório de Estabilidade Financeira, Central Bank of Brazil, November 2002, volum 1, No. 1, page 87.

³² Relatório de Estabilidade Financeira, Central Bank of Brazil, November 2002, volum 1, No. 1, page 88.

acquisition that has been carried out in Brazil. Government-owned banks have been the hardest hit by the changes. With significant labor costs and substantial defaults on the existing loan portfolios, they are experiencing difficulties in the adjustment process. Several of these have undergone extensive restructuring and privatization.

As a result of this process, the number of private banks with foreign control has increased but not more than their participation in the total of assets of the financial system. Furthermore, it is worth noting that among the institutions acquired by foreign entities within the 1988-2000 period, only 35% of the assets acquired belonged previously to privatized public banks. Hence, the increase of the foreign participation in the total of assets of the financial system was originated mainly by the decrease in the participation of the domestic investment in this system.

Within the 1995-2000 period, the participation of the 10 major banks in the existing total of assets of the Brazilian financial system was as follows:

	1995	1996	1997	1998	1999	2000
10 Major Banks	64.38%	60.10%	61.27%	62.68%	62.70%	64.10%

Source: COSIF – DEORF/COPEC

In the most recent years, the participation of the foreign capital in the total of assets of the financial market has decreased to 30.72%³³, and we still foresee a “nationalization” movement in the financial system because domestic financial conglomerates are buying banks such as BBA, Fiat and BBV which were previously controlled or had some kind of foreign control.

Bank	Date of Transfer of Control	Buyer	Purchase Price in R\$ (Millions)
BEG	December 2001	Itaú	665
Mercantil SP	January 2002	Bradesco	1,372
BEA	January 2002	Bradesco	183
Cidade	March 2002	Bradesco	549
BBA	November 2002	Itaú	3,300
FIAT	November 2002	Itaú	897
BBV	January 2003	Bradesco	2,630

Source: Austin Assis.

³³ Source: the Central Bank of Brazil (December, 2001).

Another characteristic of the system is that there is a movement of concentration of total of assets into the hands of the major 10 banks existing in Brazil:

No.	Bank	Total of Assets ³⁴	%
1	Banco do Brasil*	213.4	18.1
2	Bradesco* + BBV	156.8	13.3
3	Caixa	123.4	10.4
4	Itaú* + BBA + FIAT	123.3	10.4
5	Unibanco*	73.4	6.2
6	Santander do Brasil*	61.4	5.2
7	ABN AMRO Bank	43.6	3.7
8	BankBoston*	35.3	3.0
9	Citibank*	31.4	2.7
10	Safra*	26.5	2.2
Total		1,182.1	75.2

(*) Consolidated.

As from 1995, that there is an increase in the concentration of the total of assets within the 10 major banks, i.e., to 75.2% from 64.38% (increase of almost 17 percentage points), that means approximately 10.6% of the Brazilian Gross Development Product.

This concentration is the result of the change of the strategy adopted by the huge financial conglomerates in order to offer more modernized and specialized

³⁴ As of September, 2002 and in billions of reais - R\$. Source: Isto é, Edition No. 1738.

services for specific customers. It is the reflection of the power of the money and the necessity of it in order to accomplish with the capital and risk-weighted requirements established by the Basle Accord too. Although for antitrust purposes this concentration may be deemed to be perverse, as regards strength and credibility of the system, it may be considered positive, because it is unlikely that any of those 10 institutions with assets of those amounts may fail in the near future.

Based on the foregoing, even though the Brazilian banking system suffered great changes in its structure and adopted the new framework of the Basle Accord, it remained solid. Even more, I would say that it is stronger than ever.

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