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To: Members of the Executive Board

From: The Secretary

Subject: **Basel Core Principles for Effective Banking Supervision—Compliance by Brazil**

Attached for the information of the Executive Directors is an assessment of compliance by Brazil with the Basel Core Principles for Effective Banking Supervision, which was originally issued as an IMF/MAE and World Bank technical assistance mission report in July 2000.

Questions may be referred to Mr. Ize (ext. 36533) and Mr. Moore (ext. 38631).

Att: (1)

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Basel Core Principles for Effective Banking Supervision
Compliance by Brazil

July 2000

INTERNATIONAL MONETARY FUND
MONETARY AND EXCHANGE AFFAIRS DEPARTMENT

THE WORLD BANK
FINANCIAL SECTOR VICE PRESIDENCY

ACRONYMS

BCB	Central Bank of Brazil
CAR	Capital Adequacy Ratio
CVM	Securities Commission
COSIF	Chart of Accounts for Institutions of the National Financial System
EWS	Early Warning System
FGC	Deposit Guarantee Fund
GCI	Global Consolidated Inspection
IBRACON	Brazilian Institute of Accountants
NMC	National Monetary Council
PROER	Program of Incentives for Restructuring and Strengthening of the National Financial System
PROES	Program for the Reduction of the State Public Sector Banks
SISBACEN	Central Bank Information System

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I. Executive Summary

This assessment of Brazil's implementation of the Core Principles for Effective Banking Supervision was undertaken by a team from the International Monetary Fund (IMF) and the World Bank (WB), using the methodology recommended by the Basel Committee on Banking Supervision.[1] The assessment was carried out on the basis of a review of the legal and regulatory framework and intensive discussions with representatives from Central Bank of Brazil (BCB) and management and staff of three private banks in São Paulo, an international auditing firm and a bank-rating agency. The BCB was especially well prepared for the assessment and the team received excellent cooperation from all those it met. The documents examined included the BCB's self-assessment of compliance with the Core Principles and implementation of core banking laws (4595/64, 6024/74, 2321/87 and 9447/97). The in-country work for the assessment was during January 10–21, 2000.

The assessment team concludes that the BCB, as the sole supervisor of banks, has a competent and professional staff and works within an adequate legal and regulatory framework for the supervision of banks and affiliated entities. The primary tool for on-site supervision is the Global Consolidated Inspection (GCI), which includes (i) examination of financial and nonfinancial activities on a consolidated basis; (ii) assessment of the controlled subsidiaries and affiliates—local and foreign, including those in offshore financial centers; and (iii) inspecting branches abroad. Within banking groups, commercial banking is the dominant regulated financial activity. Arrangements for collaboration and information exchange between the BCB and other functional regulators for insurance, securities and other financial activities seem to work well.

The BCB's performance is especially observable through its management over the financial system during a period of significant economic adjustment characterized by high interest rates and substantial market volatility. The BCB's authority in the resolution of troubled and/or failing banks is clear and has been demonstrated in practice. Noted are the strengthening efforts that have occurred in the past several years in the area of regulations and the conduct of on-site inspections of banks.

Though the BCB demonstrates a strong core competency in banking supervision, its overall effectiveness is hindered by a lack of adequate staffing and budgetary resources for on-going supervision, which includes both the areas of on-site inspections and off-site surveillance. In 1999, the banking supervision department completed 25 full scope inspections of Brazilian private banks, which is off sharply from the 64 inspections completed in 1998. In terms of the amount of assets in banks that underwent inspection, institutions representing R$100 billion were inspected in 1999, down from R$168 billion in

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[1] The mission was jointly led by Mr. Michael Moore (IMF/MAE) and Mr. Vincent Polizatto (World Bank) and included Messrs. Alain Vedrenne-Lacombe and Juan Ortiz (both World Bank).

1998. The slower pace of inspections reflects a decline in the complement of staff due to a spate of early retirements prompted by the change to Brazil's social security system. Largely, those departing have not been replaced through new hiring. The BCB's capacity to fulfill the mandate of supervision will depend on the preparedness of its staff. Beyond staffing, BCB needs to restore the effectiveness of its offsite monitoring systems, which are outdated and lack relevance as a tool of banking supervision.

New challenges to the already strained resources will come from full-scope inspections of the federal banks. Inspections of Banco do Brasil and Caixa Economica Federal, which combined represent 35 percent of Brazil's banking system, are set for the second half of 2000 and the first half of 2001, respectively. As federally owned banks, these two banks had not received the same level of supervision as that for private banks. Consequently, their size, and complexity will pose a staffing and resource commitment larger than any one inspection for private banks. Some relief will come with the addition of 150 new staff members planned for 2000.

The BCB has adequate legal powers to require information from banks and, in practice, collects vast amounts of financial data through use of the COSIF—the mandated chart of accounts for financial institutions. However, the quality is not satisfactory, which adversely affects the overall integrity of the information system and by extension the off-site surveillance program. Moreover, the off-site surveillance systems have fallen out of date and no longer fulfill an appropriate on-going supervisory purpose. A comprehensive review of information collection processes is needed to rationalize the approach for collecting the information.

Summary findings

The Basel Core Principles are grouped into seven major categories as follows: (i) preconditions for effective banking supervision, (ii) licensing and structure, (iii) prudential regulations and requirements, (iv) methods of on-going supervision, (v) information requirements, (vi) formal powers of supervisors, and (vii) cross-border banking. In addition to the summary assessment, a discussion of each principle is presented in Section IV.

Preconditions for effective banking supervision (CP 1). The general legal and accounting framework in which banking and banking supervision take place is adequate, with deficiencies noted in the area of bankruptcy law and inadequate protection of the rights of creditors. In this regard progress is noted in addressing some of the shortcomings, as new legislation in 1997 followed by other resolutions have improved the legal framework for security arrangements for automobiles and mortgages. Accounting principles for financial reporting are generally in line with international accounting standards and provide meaningful information to market participants. The banking environment is generally market-based, as banks are subject to the disciplines of the market and allowed to fail. The BCB has demonstrated a willingness to close banks that have become insolvent.

The BCB by law is an autonomous agency with its own legal identity and assets, but hierarchically is attached to the Ministry of Finance and subservient to the decisions and instructions of the National Monetary Council (NMC). The BCB's board members serve without a fixed minimum term and may be removed at any time by the President of the Republic. In practice, however, the BCB operates with considerable operational and political independence from the Ministry of Finance. A recent demonstration of that independence is the decision to bring the large federal banks, which previously benefited from preferential supervisory and regulatory treatment, under the same standards and scrutiny as private financial institutions.

The BCB and its supervisory staff demonstrate a high level of professionalism and integrity and receive high marks within the banking industry, having established credibility in resolving past banking crises and in continuing the pace of reform designed to guard against future crises.

The BCB's bank supervision capacity has been affected by inadequate resources. Financial and staffing constraints have affected the BCB's ability to attract and retain staff and to hire qualified individuals at mid-career. Further constraints limit the bank supervision function's ability to employ outside experts to deal with special situations and to provide regular training opportunities for supervisory staff. Of particular concern, staff and budget constraints are limiting the frequency with which inspections are conducted and the ability of bank supervisors to travel to inspection locations outside the cities in which they are based. In view of concerns over the adequacy of human and budgetary resources for the banking supervision function, the assessment team considered CP 1.2—independence of the bank supervision function—to be materially noncompliant.

With regard to legal protection for banking supervisors, Law 8112/94 establishes that civil servants are not liable for actions while discharging their duties in good faith; however, the protection in practice is weak as the BCB's senior supervisors are financially exposed to lawsuits of weak legal merit. Legal actions can take many years to reach conclusion, which combined with the cost of legal representation will in time have a chilling effect on the bank supervision processes. In view of these considerations, the assessment team considers CP 1.5 to be materially noncompliant.

Licensing and structure (CPs 2–5). These Principles focus on the definition of banking activities and the proper use of the name "bank" as well as supervisory means to protecting sound ownership and structure of banks. A shortcoming in the legislation and regulation is that there is no restriction on the use of the term of "bank" in the context of a commercial company.

Prudential regulations and requirements (CPs 6–15). Brazilian financial institutions must maintain a minimum level of capital with respect to their risk-weighted assets and other commitments (CP 6). The Brazilian requirement is in line with the Basel Capital Accord model, but demands a higher 11 percent capital for credit risk, with add on capital charges for counter-party risk for swaps and market risk related to foreign exchange exposure and interest rate risk. The BCB has issued a new regulation for the grading of loans and the determination of the provisions for loan losses (CPs 7 and 8). The new system employs nine loan grades that consider traditional negative grades used by bank supervisors (e.g., substandard, doubtful and loss), as well as several positive grades of pass loans. The new regulation incorporates stricter criteria on the classification of rescheduled loans.

Internal control requirements have been strengthened substantially and CP 14 is viewed to be largely compliant. The BCB strengthened internal control requirements with the end1998 issuance of Resolution 2554/98, which gave financial institutions one year to implement requirements, which now are in force. During the one year implementation period, financial institutions had to meet specific monitorable performance benchmarks. The country is compliant with CP 15 regarding money laundering.

Methods of on-going supervision (CPs 16–20). This group of principles relates to the supervisory methods that should be applied, both on-site and off-site and the necessity to evaluate these methods qualitatively and on an on-going basis. The group includes the necessity of supervising financial institutions on a consolidated basis. Significant deficiencies are noted with respect to CPs 16 and 18, which were viewed by the assessment team to be materially noncompliant. The off-site monitoring systems (CP 16) are seriously out of date and lack necessary relevance as a surveillance tool. Equally disconcerting is that because of shortages of qualified staff, the frequency for global consolidated inspections is not adequate for all institutions. Instead the BCB must give priority to those institutions that pose higher systemic risk leaving others without adequate on-site inspections. Last, the federally owned banks largely have been excluded from the BCB's supervision efforts. Another factor in off-site monitoring, are the deficiencies in reporting (CP 18), which have affected the integrity and reliability of the information systems.

Accounting and financial statement requirements (CP 21) are considered largely compliant. The accounting and regulatory framework for information collection is adequate. However, shortcomings are noted with regard to accuracy of reported information. Renewed effort is needed to ensure that the BCB provides clear guidance on information to be collected and that management and external auditors to financial institutions are held to account when lapses in reporting are identified. Weaknesses in regulatory reporting have affected the integrity of the BCB's information systems, which in turn has contributed to deficiencies noted in the off-site monitoring (both, CPs 16 and 18) as noted above.

Formal powers of supervisors, including remedial measures and exit policies for banks (CP 22) is compliant. The legal framework grants the BCB sufficient and comprehensive powers for prompt corrective action, through either rehabilitation procedures or closure and liquidation. In addition, supervisors have at their disposal a broad range of powers that are available to impose graduated remedial actions.

Cross-border banking (CPs 23–25). Cooperation between home and host country supervisors and the exchange of relevant supervisory information to ensure appropriate consolidated supervision on a global basis is materially compliant. At present, the international network of Brazilian banks covers a limited number of countries. The BCB has developed a satisfactory process for exchange of information with relevant foreign supervisors on both a formal and an informal basis. Some weakness is noted with the ability of BCB supervisors to review on-site activities at material foreign affiliates of Brazilian banks because of budgetary constraints on foreign travel.

Table 1. Compliance with the Basel Core Principles on Effective Banking Supervision

Core Principle	Grading					Remarks
	1	2	3	4	N/A	
1.1 Objectives	X					
1.2 Independence			X			Lack of resources constrain supervisory capacity
1.3 Legal framework	X					
1.4 Enforcement powers	X					
1.5 Legal protection			X			Weak legal protection for supervisors
1.6 Information sharing	X					
2. Permissible activities			X			Term "Bank" not reserved in law
3. Licensing criteria		X				No business plan requirement and criminal checks
4. Ownership	X					
5. Investment criteria	X					
6. Capital adequacy		X				Partial implementation of market risk requirement
7. Credit policies		X				Weakness in review of loan policies
8. Loan evaluation		X				Resolution for loan classification issued
9. Large exposures	X					
10. Connected lending	X					
11. Country risk					X	
12. Market risks		X				Specialized risk—staffing and training needs
13. Other risks		X				Prudential guidance and monitoring needed
14. Internal control		X				Partial implementation of new regulation
15. Money laundering		X				Regulations in place—lack full implementation
16. On-site and off-site			X			Off-site weak—need to increase GCI frequency
17. Bank management contact	X					
18. Off-site data			X			Data quality weaknesses, surveillance systems outdated
19. Validation of information		X				Weaknesses in audits and inspections procedures
20. Consolidated supervision	X					
21. Accounting		X				Weaknesses in regulatory reporting
22. Remedial measures	X					
23. Global consolidation		X				Resources prevent inspections of foreign affiliates
24. Host country supervision		X				Relationship with host-country affected by resources
25. Sup/foreign establishments		X				Need to strengthen ties with home-country supervisors

Explanations: The columns marked 1−2−3−4 indicate the degree of compliance: 1=compliant, 2=largely compliant, 3=materially noncompliant, 4=noncompliant and N/A = not applicable.

II. BACKGROUND

A. Structure of Banking Sector

With nearly 200 banks and assets of R$741 billion (US$414 billion) at the end-1999, Brazil's banking system is one of the largest among emerging market countries. The banking system is dominated by large publicly and privately-owned banks, with the ten largest banks holding about 70 percent of banking system assets. Foreign-controlled banks have come to hold a sizeable share of the market for both retail and wholesale financial services. At end-1999, foreign banks represented about one fifth of the banking system assets. Brazil has seen a decline in the number of banks as the result of a consolidation within the banking system, which has included the effective resolution of failed banks and the privatization of publicly-owned banks (mostly those owned by the state governments). At end-1999, there were 194 banks,[2] which is down from 243 at end-1994.

The banking system has shown relative resiliency despite a difficult economic environment especially between second half 1998 and first half 1999. These difficulties included the sharp depreciation of the exchange rate following the floating of the real in January 1999. Most banks are well capitalized, and though showing continued high nonperforming loan ratios, remain well provisioned.

As measured by the fifty largest banks, which combined account for more than 90 percent of the banking system, the average risk weighted capital adequacy ratio (CAR) was 15.2 percent. Nonperforming loans for the fifty largest banks were 10.3 percent of loans, with provisions representing a 124 percent of the NPL amount. Among the bank groupings, the federally-owned banks are weaker in terms of capitalization and asset quality. For the federally-owned banks, the average CAR was 12.0 percent, with NPLs representing 15.5 percent of loans and provision coverage of 105 percent.

Historically, loans have made up a relatively small portion of bank balance sheets because of the election by banks to invest in lower risk, high-yielding securities and inter-bank lending. Because of relatively high default costs, financial institutions need to maintain a substantial interest rate spread over the cost of funds. High default costs in part result from inefficiencies in the judiciary system, which has shown inadequate enforcement of creditors' rights. In 1997, the BCB introduced a centralized data base system for the collection of information on borrowers. The system is accessible by all banks and tracks loans above R$20,000.

[2] The reference to banks is for commercial and multiple banks, and savings and loans.

B. Macroeconomic Environment

Overall macroeconomic performance in 1999 has been favorable as the economy grew by 0.8 percent, against an initially projected decline of 3.8 percent, and inflation in consumer prices was contained to under 9 percent during the year (against an initial forecast of about 17 percent). The trade account improved to a deficit of US$1.2 billion from US$6.6 billion in 1998. The current account deficit declined to US$24.4 billion (4.4 percent of GDP) from US$33.6 billion (4.3 percent of GDP) in 1998. Following the large outflow early in the year in the runup to, and immediate aftermath of, the January floating of the real, the overall balance of payments remained near equilibrium for the rest of the year. Net international reserves (excluding the IMF and bilateral support package agreed to in 1998) stood at US$23.9 billion at end-December 1999.

Brazil made a substantial fiscal adjustment in 1999, with the primary balance shifting into a surplus equivalent to 3.1 percent of GDP from near equilibrium in 1998. The improvement reflected both a significant increase in the tax ratio, and a strong effort to contain expenditures. Progress was also made in structural fiscal reforms, in particular of the social security system for private sector workers. For monetary policy, the BCB continues to operate under an inflation-targeting framework introduced in June 1999. The rate of inflation in consumer prices exceeded the central target for end-1999 by less than 1 percentage point, but remained well within the band of 2 percent on either side of the target set by the authorities.

In 2000, economic activity to date and prospects for the rest of this year are expected to build on momentum achieved in the last quarter of 1999, which was propelled by a strong pickup in exports, improved household and business confidence, large foreign direct investment and continuing substitution of domestic production for imports. In the absence of serious external shocks, the rate of growth of real GDP is expected to be at around 4 percent. Inflation in consumer prices—which had accelerated in the last quarter of 1999, reflecting a weakening of the exchange rate since midyear and some supply shocks—is decelerating again, lending some confidence that the 12-month rate of inflation will be below that of 1999. The deceleration of inflation owes much to the cautious monetary policy followed by the BCB in recent months, which—along with improved confidence in the external and fiscal performance—has contributed to strengthening the exchange rate.

The strength of exports and continued moderation of imports in real terms has contributed to favorable prospects for the external accounts. The trade balance has been running surplus in recent months and is expected to post a surplus of around US$4 billion for the year as a whole. The current account deficit is projected to decline to around US$23 billion (3.5 percent of GDP) in 2000, which—as in 1999—should be more than financed by net FDI. The rest of the capital account is expected to show a significant surplus, leading to significant accumulation of net international reserves in the course of the year, which would leave gross reserves at year-end at around US$31.9 billion (nearly 6 months of imports and over 50 percent of short-term debt on a residual maturity basis).

III. Main Findings

This assessment of the effectiveness of banking supervision focuses primarily on the legal and regulatory framework and the official institutions involved in the supervision of financial institutions. The BCB by delegation from the National Monetary Council (NMC) has the primary responsibility for prudential supervision of banking groups. A team of four experts from the IMF and the WB has conducted the assessment based on an examination of key documents and discussions with BCB's supervision and regulation departments. In addition, discussions were held with management and staff of three private banks in São Paulo, an international auditing firm and bank-rating agency. The assessment team enjoyed the full cooperation of its counterparts and received all of the information that it required.

The documents examined included the BCB's self-assessment of compliance with the Core Principles that the BCB completed using the methodology prescribed by the Basel Committee. The core laws reviewed were Laws 4595/64, 6024/74, 2321/87 and 9447/97. Law 4595/64 underpins the framework for Brazil's national financial system, creating the NMC and the BCB. The NMC has ultimate responsibility for regulating the incorporation, operation and supervision of financial institutions, as well as the application of the penalties. Largely, this responsibility is executed through the BCB, which has been empowered by the NMC to inspect and authorize financial institution.

Additional powers are provided to the BCB in law 6024/74, which deals with intervention and extra-judicial liquidation for financial institutions, and law 2321/87, which allows for temporary administration for financial institutions with weak management. Both the 6024/74 and 2321/87 laws were further strengthened by law 9447/97, which gave the BCB the power to (1) demand that shareholders infuse new capital, (2) force the transfer of shareholder control; and (3) reorganize a financial group including forcing a merger, consolidation or the spin-off of a subsidiary.

A. Preconditions

Infrastructure

It is not feasible in the context of this assessment to thoroughly evaluate the adequacy of the legal and judicial infrastructure needed for successful compliance with the Core Principles. Thus the assessment of these preconditions rests primarily on the views of the authorities and private sector officials interviewed by the assessment team. The legal framework in which banking and financial markets function needs to provide an environment that fosters honoring and enforcing financial contracts. It is composed of legislation on contracts, enforcement of contracts, the functioning of collateral or other security arrangements, loan collection mechanisms and the bankruptcy resolution process.

In Brazil, high costs associated with loan defaults and high administrative expenses are held out as an important causal factor for the large interest rate spreads that exist between the interest rates charged to borrowers and that paid by banks to funds providers. Though

Brazil's legal system recognizes specific creditor rights, the system falls short in enforcement. Deficiencies in enforcement reflect the heavy congestion in the courts and the ease with which delays can be introduced on the part of debtors, who generally remain in control of assets during the protracted litigation. Caseloads of judges are excessive, leading to delays in the resolution of claims anywhere from one to ten years.

An additional effort to strengthen the credit culture is reflected in the BCB's introduction of a centralized debtor information system—the Risk Central Data Base—in 1997. The BCB requires that all financial institutions report to the Risk Central Data Base information on all credit relationship exceeding R$20 thousand. Several banks have now incorporated information from the Risk Central into credit scoring models on borrowers. The Risk Center Data Base will be modified to incorporate the loan grading information pursuant to Resolution 2682/99, which requires banks to classify their loans according to nine quality grades. The Risk Center supplements information provided through the privately-owned Seraza, which is a consortium-owned credit bureau. To date, privately-owned credit bureaus have been slow to develop, reflecting in part the view by financial institutions as to the proprietary nature of information on borrowers.

The NMC has delegated to the BCB the responsibility for establishing the accounting and auditing framework for financial institutions. Through regulation, the BCB defines processes to be used for asset valuation and income recognition. In establishing the accounting requirements, the BCB has specifically included a requirement for consolidated financial statements. Related regulations are issued by the Securities Commission (Comissão de Valores Mobiliários, CVM), which establishes the standard for reporting requirements for listed companies, except financial institutions. For non-financial companies, the Brazilian Institute of Accountants (IBRACON)[3] interprets generally accepted accounting principles, however IBRACON's statements do not have the force of law. There is also an officially constituted Brazilian Institute of Independent Auditors, which works on national auditing standards to be used generally for every company.

Financial institutions are required to file comprehensive regulatory reports through the BCB's financial reporting system (COSIF) each month end that include a balance sheet, income statement and off-balance sheet information. Under BCB requirements, audited financial statements are required twice a year—June 30 and December 31—along with notes and a formal opinion expressed by outside auditors. Because of continuing data quality issues *among Brazilian financial institutions generally, the BCB must devote considerable effort to* verification of COSIF information through transaction testing. Resolutions in place impose consistent valuation requirements on financial institutions. A new regulation for loan classification was approved at end-1999 that incorporates stricter criteria on the classification of rescheduled loans. Previously, banks were allowed too much discretion in the

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[3] Instituto Brasileiro de Contadores.

classification of renegotiated loans, which resulted in the understatement of problem assets and the overstatement of income.

Resolution of problem banks and the public safety net

The BCB established the PROER and PROES programs in order to restructure and strengthen the banking system beginning in 1995.[4] Among the larger private banks resolved (under PROER) were Banco Economico (intervened 8/95, assets R$5.4 billion), Banco Nacional (intervened 11/95, assets R$11.7 billion) and Banco Bamerindus (intervened 3/97, assets R$13.5 billion). Several state banks have been sold (under PROES) to existing private banks, including the state banks of Rio de Janeiro, Minas Gerais and Bahia. Scheduled for the second quarter 2000, is the privatization of the huge Banespa, which formerly was owned by the State of Sao Paulo. Banespa, with assets of R$27 billion (US$15 billion) is the sixth largest commercial bank by assets.

To deal more effectively with bank failures, a bank-owned private deposit insurance fund (the Credit Guarantee Fund)[5] was established in January 1996 to protect depositors up to R$20 thousand per depositor. By law, the deposit insurance scheme does not receive government backing. All banks, including foreign and those publicly owned, are required to participate through a monthly assessment rate of 0.030 percent of total deposits. Thus far, the fund has been limited to paying off depositors as a means of resolving bank failures. Although in general bank failures have been dealt with promptly, the public safety net remains an area where some strengthening is needed.

B. Core Principles Assessment

The assessment of fulfillment of the Core Principles is not, and is not intended to be, an exact science. Banking systems differ from one country to the next, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the Core Principles are seen as minimum standards.

This assessment of compliance with each Principle has been made on a qualitative basis using the methodology prescribed by Basel Committee. A five-part assessment system has been used: compliant; largely compliant; materially noncompliant; noncompliant; and not applicable. To achieve a "compliant" assessment with a Principle, all "essential" criteria

[4] PROER, Program of Incentives for Restructuring and Strengthening of the National Financial System (announced November 1995) and PROES, Program for the Reduction of the State Public Sector Banks (announced February 1997), established three types of support for the privatization or restructuring of state-owned banks.

[5] The Fundo Garantidor de Credito (FGC).

generally must be met without any significant deficiencies.[6] A "largely compliant" assessment is given if only minor shortcomings are observed and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that Principle. A "materially noncompliant assessment" is given when the shortcoming are sufficient to raise doubts about the authority's ability to achieve compliance, but substantive progress had been made. A "noncompliant" assessment is given when no substantive progress towards compliance has been achieved, or if insufficient information was available to allow a reliable determination that substantive progress had been made towards compliance. An assessment of "Not applicable" is rendered for a Principle deemed by the assessors to not have relevance.

As indicated in the following section, the assessment concluded that of the thirty principles (there are 25 core principles, but CP 1 is comprised of six sub-principles), Brazil is in full compliance with 11 principles, and largely compliant with a further 13 principles. For all but one of the principles considered to be largely compliant, an effort to achieve full compliance was underway. There were five principles assessed as largely noncompliant, for three of these efforts to comply were underway and for the other two—legal protection for supervisors and the term "bank" not reserved in law—an effort was not underway to become compliant. No principles were considered to be noncompliant. The principle pertaining to country risk was determined to be not applicable as Brazilian bank exposures to this risk type is minimal. In most cases, the BCB through its completion of a self-assessment using the Core Principles Methodology identified those areas where important deficiencies existed and some corrective measures are underway.

In a related development, the assessment team welcomes the BCB's plan to undergo a detailed diagnostic study by external consultants that will review the organizational structure and all operational areas within the BCB related to the bank supervision function. The range of areas to be covered by the diagnostic include on-site inspection methods, the off-site monitoring function—including modifications to information collection/technology processes; the number and allocation of bank supervision staff among regional offices and Brasilia; and training for staff.

Exceptions to compliance with the Basel Core Principles stem from weaknesses in resources affecting BCB supervisory capacity (CP 1(1)), the adequacy of legal protection for supervisors (CP 1(5)) and control over the name bank (CP 2). On-site and off-site supervision (CP 16) reflect again deficiencies in staffing resources for on-going supervision. Deficiencies in off-site data (CP 18) affect the integrity of BCB information systems. Detailed assessments are contained in Section IV, but in summary the extent of compliance is as follows:

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[6] The "essential" and "additional" criteria are defined in the Basel Committee's methodology.

Materially noncompliant—efforts to achieve full compliance not underway

Principle 1 (5) (Suitable legal framework—legal protection of supervisors). Legal actions brought against BCB officials can take several years to wind through the judicial system before reaching resolution. The protracted period before resolution combined with the cost of legal representation will in time have a chilling effect on the bank supervision processes. Because of a lack of appropriate safeguards, lawsuits of weak legal merit can cause financial and professional harm to supervisors.

Principle 2 (Permissible activities and use of "bank"). Brazilian law does not restrict the use of term "bank;" hence, companies not supervised by the BCB could use the word "bank" in their name. Because of the absence of restrictions that apply to nonfinancial companies that ensure that the use of the word "bank" is regulated CP 2 is materially noncompliant.

Materially noncompliant—efforts to achieve compliance underway

Principle 1 (2) (Suitable legal framework—operational independence and resources). The banking supervision function lacks sufficient budgetary and staff resources to perform its core functions. Budget restrictions imposed on the BCB reduce its ability to appropriately oversee the banking system. To a lesser extent, there is a potential independence issue for the BCB though in practice it operates with considerable autonomy from political influence.

Principle 16 (On-site and off-site supervision). The off-site monitoring systems are seriously out of date and lack necessary relevance as a surveillance tool. The overall assessment of materially noncompliant is based on the need to develop the off-site monitoring system, provide comprehensive written conclusions to each bank and to introduce a formalized bank rating system. Of equal concern is the frequency of global consolidated inspections is inadequate for all institutions; instead priority is given to those institutions that pose higher systemic risk. Last, the large federally-owned banks have been excluded from in depth inspections. Suggestions to correct these weaknesses are under active discussion within the bank supervision department.

Principle 18 (Off-site data). The BCB has adequate legal powers to require information from banks and, in practice, collects vast amounts of data in COSIF. However, the effectiveness of the information collection and the surveillance monitoring systems is troubled by inaccurate reporting that has affected the integrity and reliability of the reporting system. Moreover, surveillance systems have fallen out of date and no longer fulfill an appropriate on-going supervisory purpose.

Largely compliant—efforts to achieve full compliance not underway

Principle 12 (Market risks). Through the use of specialized teams to review policies and procedures in place for risk management, operational controls and accounting practices, the BCB's oversight of market risk is effective. However, prudential oversight of market risk requires highly specialized skills, which are in very short supply among present BCB on-site inspections personnel. Hence full compliance is not achieved. Flexibility in hiring restrictions is needed to allow the BCB to recruit mid-career professionals for specialized risk areas.

Largely compliant—efforts to achieve full compliance underway

Principle 3 (Licensing criteria). Specific licensing regulations identify requirements for beginning capitalization and information on sources of capital—Resolution 2099/94—fit and proper standards for owners and managers—Resolution 2645/99—and definitions for management responsibilities and internal controls—Resolution 2554/98. To the extent that licensing and informational requirements are not met, the BCB can reject applications. BCB authorizes financial institutions based on clear and appropriate criteria, weaknesses are minor.

Principle 6 (Capital adequacy). High capital requirements have been established and strengthened when the economic and financial environment was considered more volatile. Supervisory powers are clearly defined and give enough authority to the BCB to enforce capital requirements. The qualification from an assessment of compliant refers to only partial implementation of a capital regulation that considers market risk, which will soon go into full force.

Principle 7 (Credit policies). The assessment is largely compliant, with some weaknesses noted regarding reviews of written, board-approved loan policies and the need to communicate in writing appropriate recommendations to the bank management when policies are absent, deficient or not followed.

Principle 8 (Loan loss classification and provisioning). The assessment is largely compliant, which considers the recent issuance of Resolution 2682/99, which requires that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions.

Principle 13 (Other risks). The overall assessment of largely compliant is based on marginal effectiveness in the current environment given the existing preference by banks to hold liquid assets and the existing high reserve requirement. However, both these conditions will evolve in coming quarters that will cause the overall liquidity profile of Brazilian financial institutions to decline. Consequently, prompt actions are needed to prepare for the change through the issuance and implementation of supervisory guidance.

Principle 14 (Internal Control and Audit). A new regulation for internal controls that was issued in 1998 and allowed a phased implementation over one year is now in full force. CP 14 falls short of full compliance because the regulation became fully effective only in January 2000. Very few institutions have an audit committee and control culture still has to be promoted in the industry as a whole.

Principle 15 (Money Laundering). The BCB created a new department, DECIF, in 1999 with the purpose to monitor and control financial crime. The legal framework now in place is consistent with the FATF 40 recommendations. The full compliance would require that on-site inspections are conducted in order to ensure that policies and procedures are in place that enable financial institutions to detect and report all suspicious transactions. The unit has only recently been created, consequently not enough time has passed to evaluate overall effectiveness.

Principle 19 (Validation of supervisory information). The BCB strengthened its on-site inspection efforts following the identification of significant weaknesses in the work of auditors of several large banks that failed. The BCB did not achieve full compliance because of deficiencies in the accuracy and reliability of regulatory information and some deficiencies with the auditing profession overall. The BCB, in the on-site inspection process, places considerable emphasis on validating the accuracy of reported information, especially with regard to prudential returns and information for the credit risk bureau. However, more needs to be accomplished to formalize inspection procedures in all areas of inspection.

Principle 21 (Accounting standard). The accounting framework and regulatory requirements are sufficiently adequate to ensure that financial institutions maintain records so that financial information is provided in a consistent and timely manner. The overall assessment of largely compliant is based on an adequate and enforceable accounting framework. Weaknesses, nevertheless, remain regarding the quality of regulatory reporting, which reflects adversely on accounting practices.

Principle 23 (Global consolidated supervision). The international network of Brazilian banks covers a limited number of countries. The BCB has developed a sufficient exchange of information with relevant foreign supervisors on both a formal and an informal basis. Some weakness is noted with the ability of BCB supervisors to review on-site activities at material foreign affiliates of Brazilian banks because of budgetary constraints on foreign travel.

Principle 24 (Cooperation with host country supervisors). The BCB has exchanged and shared information with host country supervisors. However, due to budgetary constraints, it has curtailed on-site inspections of the foreign affiliates of Brazilian Banks. The overall assessment of largely compliant is based on effective cooperation and information sharing with host country supervisors, but a closer working relationship has been affected by budget constraints that limit travel.

Principle 25 (Equal treatment of foreign banks). The BCB applies the same supervisory standard to foreign-owned or controlled banks as that used for domestic banks, as well as takes into account whether the home country supervisor practices consolidated supervision. However, the BCB falls short of full compliance because of budgetary pressures, which have slowed the assessment of home country supervisors, as well as travel to countries whose banks have a material Brazilian presence to meet with home country supervisors.

Compliant

Principle 1 (1) (Clear responsibilities for agencies involved in bank supervision).

Principle 1 (3) (Suitable legal framework—licensing and supervision).

Principle 1 (4) (Suitable legal framework—compliance with laws and safety and soundness).

Principle 1 (6) (Suitable legal framework—sharing information between supervisors).

Principle 4 (Ownership transfer).

Principle 5 (Criteria for investments).

Principle 9 (Large credit exposure limits).

Principle 10 (Connected party lending).

Principle 17 (Bank management contact).

Principle 20 (Consolidated supervision).

Principle 22 (Remedial measures and exit).

Not applicable

Principle 11 (Country risk). For Brazilian financial institutions, transfer and country risk is not material and not a supervisory issue that merits specific policies and procedures for controlling exposures or determining provisioning levels. In this regard the assessment team considered the principle not applicable.

C. Recommendations

The most acute problem is a general scarcity of qualified people and budget to carryout the bank supervision function. This constraint in turn is a contributing factor to other weaknesses identified by the assessment team. The BCB is well aware of the need to hire and train staff and is in the process of hiring 150 additional entry-level personnel. Still a weakness affecting the BCB's capacity in banking supervision is that civil service legislation prevents the hiring of staff at a mid-career level, which affects its ability to bring in personnel for highly specialized supervision areas. Whether the staffing will need to be augmented further will be determined in the course of the diagnostic review that will be underway shortly.

Resource deficiencies are also implicated in the areas of on-site inspections and off-site monitoring. Special emphasis is needed for the off-site surveillance to make it more relevant to the ongoing banking supervision program.

Areas that may require modifications to the legal framework include the problem of inadequate legal protection of bank supervisors for their official acts and the need to restrict the use of the term "bank."

Other aspects regarding the legal framework needing attention are deficiencies associated with the weak rights of creditors and the problem of delays in resolving creditor claims.

In the next section—Principle-By-Principle Assessment—other suggestions are provided to enhance compliance with the Basel Core Principles. In this regard, the BCB's attention is directed especially to the discussion of those principles considered to be either materially noncompliant or largely compliant. In both instances, identified shortcomings are described.

IV. Principle-by-Principle Assessment

This section analyses Brazil's compliance with the core principles with regard to the supervision of banks by the BCB. The assessment takes account of the additional criteria.

Principle 1: Objectives, autonomy, powers, and resources

An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their on-going supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection of supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 1 (1): *An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.*

Description: Law 4595/64 underpins the framework for Brazil's national financial system, creating the NMC and the BCB. By law, the NMC has ultimate responsibility for regulating the incorporation, operation and supervision of financial institutions, as well as the application of the penalties. Largely, this responsibility is executed through the BCB, which has the duty to carryout the requirements of the NMC, in matters of inspecting and authorizing financial institution.

In addition to examining the books and records of financial institutions, law 4595/64 gives the BCB clear authority to review the books and records of individuals and legal entities that own financial institutions. Moreover, the BCB is empowered to apply penalties for violation of law and regulation, including the issuance of warnings, imposition of fines, suspension of individuals from the exercise of their positions, temporary or permanent disqualification of management in financial institutions and the cancellation of authorization of financial institutions.

Additional powers are provided to the BCB in law 6024/74, which deals with intervention and extra-judicial liquidation, and law 2321/87, which allows for temporary administration for institutions with weak management. Both the 6024/74 and 2321/87 laws were further strengthened by law 9447/97, which gave the BCB the power to (1) demand that shareholders infuse new capital, (2) force the transfer of shareholder control; and (3) reorganize a financial group including forcing a merger, consolidation or the spin-off of a subsidiary.[7]

Assessment: Compliant. Essential Criteria and Additional Criteria of Principle 1(1) are met. Laws and a supporting body of regulation provide a stable framework for establishing prudential standards for financial institutions. The BCB is the sole supervisor of banks. Its authority in the resolution of troubled financial institutions is clear and has been demonstrated in practice. There is evidence of a process of reviewing and updating banking laws as necessary, as well as the revision and development of necessary regulation. The BCB's performance of its responsibilities is especially observable through its management over the financial system during a period of significant economic adjustment characterized by high interest rates and substantial market volatility. Reports on the condition of the banking sector are publicly available.

***Principle 1 (2)**: Each such agency should possess operational independence and adequate resources.*

Description: The NMC is comprised of the Minister of Finance who serves as Chairman, the President of the BCB, and the Minister of Planning and Budget. Among the NMC's many powers are those which enable it to authorize the issue of paper money, approve the monetary budgets prepared by the BCB, to estimate overall money and credit requirements, to establish exchange policy and guidelines, and control the activities of the Stock Exchange. The Council also regulates the incorporation, operation and supervision of financial institutions and establishes prudential rules and norms within which they are expected to operate. The NMC can also require the BCB to refuse authorization for the

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[7] Law 9447/97 especially improved the process for facilitating bank failure resolutions, by giving the BCB the authority to transfer assets and liabilities to other institutions; reorganize a financial group in order to preserve continuity of business operations; and, assign the management of assets to other institutions.

operation of new financial institutions as a matter of general convenience. Law 4595/64 establishes the BCB as a federal autonomous government entity with its own legal identity and assets. It is the duty of the BCB to comply and cause compliance with current legislation and the rules issued by the NMC. The President of the Republic appoints the board members of the BCB, who must receive confirmation of the Senate. Board members serve at the pleasure of the President of the Republic.

The NMC also determines the technical and administrative structure of the BCB, approves its internal regulations and makes decisions about its budget and accounting system. A 1996 decision by the Supreme Court, however, ruled that BCB employees are civil servants subject to Law 8112/94; consequently, the NMC no longer has the authority to determine the number of personnel nor their remuneration.

Assessment: Materially noncompliant—efforts to achieve compliance underway. In practice, there is no significant evidence of government or industry interference in the operational independence of the BCB to supervise financial institutions. Recent efforts have now brought the large federal banks, which previously benefited from preferential supervisory and regulatory treatment, under the same standards and scrutiny as private financial institutions. The BCB and its supervisory staff demonstrate a high level of professionalism and integrity. The banking supervisory function receives high marks within the banking industry, having established credibility in resolving past banking crises and in continuing the pace of reform designed to guard against and prevent future crises.

The BCB in practice operates with considerable autonomy from political influence, however, the operational independence could be compromised by the existing structure. The BCB is hierarchically attached to the Ministry of Finance and subservient to the decisions and instructions of the NMC. BCB board members serve without a fixed minimum term and may be removed at any time by the President of the Republic. Consequently, there is a potential that elected officials could influence the independence of the BCB and its banking supervision function.

Because of a large federal deficit, strict controls have been imposed on all government agencies, including the BCB. The Supreme Court decision that BCB employees are civil servants for whom salaries have been frozen for several years has imposed a severe constraint that restricts the ability of the banking supervision function to attract and retain qualified staff and to hire qualified individuals at mid-career. Moreover, the BCB is restricted from employing outside experts on a temporary basis to deal with special situations and to provide regular training opportunities for supervisory staff. Of particular concern, staff and budget constraints are limiting the frequency with which inspections are conducted and the ability of bank supervisors to travel to inspection locations outside the cities in which they are based. The pace of inspections has been slowed by a decline in staff that was prompted by the changes to the social security system.

Constraints on new hiring have lead to a shortfall (estimated by bank supervision at about 200 persons, of which 160 vacancies are in the regional offices) in meeting necessary staffing requirements to effectively conduct banking supervision in Brazil.[8]

The overall assessment of materially noncompliant is based on the absence of sufficient budgetary and human resources and potential for an independence issue for the BCB that would affect financial institution supervision.

Principle 1 (3): *A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their on-going supervision.*

Description: The response to principle 1(1) above discusses important aspects to Brazil's legal framework necessary for banking supervision. Laws 4595/64, 6024/74, 2321/87 and 9447/97 gives the BCB ample powers in the granting and withdrawing of authorization of financial institutions in Brazil. Specific regulations for licensing and on-going supervision are in place, including the ability to require information from banks in the form and frequency necessary. The law gives the NMC and the BCB sufficient flexibility to set prudential rules administratively without the need to make revisions to the law.

Assessment: Compliant. Principle 1(3) is complied with as the necessary legal framework is in place.

Principle 1 (4): *A suitable legal framework for banking supervision is also necessary with regard to powers to address compliance with laws as well as safety and soundness concerns.*

Description: Article 9 of Law 4595/64 grants exclusive powers to the BCB to supervise financial institutions.[9] Decision regarding the frequency for on-site inspections is left to the banking supervision function. Presently, institutions are selected based on a priority of whether they have evidence of problems and/or on size. As the staffing level is presently fixed because of fiscal constraints, selection of institutions for on-site inspections will continue to be prioritized by risk.

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[8] A diagnostic study is being conducted by international consultants to assess bank supervision staffing and training needs.

[9] The concept of financial institution includes banks, leasing companies, other financial institutions, stock exchange brokers, and *"Consorcios."* In addition, at least two types of institutions (factoring and credit card companies) are not considered financial institutions under the Brazilian legislation, thus not subject to licensing and supervision unless they belong to a bank group.

Supervisors are granted appropriate flexibility to take action to correct unsafe or unsound banking practices. To form their judgement, the supervisors have full access to bank records and the working papers of the external auditors; as well, the BCB can require information from controlling shareholders (without regard to whether the shareholder is a corporation or individual).

The legal and regulatory framework grants considerable powers to the BCB to force corrective action (Decree-Law 2321/87, Law 6024/74, Law 9447/97, and Resolution 1065), which may include liquidation to deal with banks that contravene prudential regulations and to cope with problem banks (see Principle 22). A specific department within the BCB (DECIF) deals with the disciplinary measures, which could also be applicable to the senior managers, the controlling shareholders, and the external auditors.

Assessment: Compliant. The current legal framework empowers the BCB with extensive powers to address compliance with laws and regulations and safety and soundness issues.

Principle 1 (5): *A suitable legal framework for banking supervision is also necessary with regard to legal protection of supervisors.*

Description: The Federal Civil Servants Law (Law 8112/94) establishes that civil servants are not liable for actions while discharging their duties in good faith and gives them the right to legal assistance. Nonetheless, inadequacies in the functioning of the judicial system have exposed the BCB's senior supervisors to lawsuits of weak legal merit. In principle legal representation is available from the BCB; however, staff shortages within the legal department limit effectiveness. Consequently, those supervisors subject to legal action are compelled to hire their own counsel at considerable personal costs.

Assessment: Materially noncompliant—efforts to achieve full compliance not underway. Presently, the status of legal protection does not appear to influence the supervisory staff in the proper fulfillment of their duties. Nevertheless, legal actions against BCB officials can easily take several years to wind through the judicial system before reaching resolution. The protracted period before resolution combined with the cost of legal representation will in time have a chilling effect on the bank supervision processes.

The overall assessment of materially noncompliant is based on deficiencies in legal protection of supervisors from lawsuits of weak legal merit demonstrating a lack of appropriate safeguards, which cause financial and professional harm to supervisors.

Principle 1 (6): *Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*

Description: There are formal agreements between the different domestic agencies participating in the regulation and supervision of the various types of financial entities. In addition, the BCB has powers to issue memoranda of understanding, or exchange information with supervisors of other countries. In practice, formal agreements have been signed with supervisors of Argentina, Japan, Spain, and Cayman Islands, and informal arrangements are in place with Netherlands, United Kingdom, and the United States. Agreements are pending with Italy, Panama, Paraguay, Peru, Portugal, and Venezuela. Supervisors are not prohibited from exchanging information for prudential supervisory purposes. Agreements and other arrangements appear adequate to ensure that the receiving party preserves appropriate confidentiality.

Assessment: Compliant. Supervisors have in place adequate procedures for sharing of supervisory information with domestic supervisory and regulatory agencies, as well as foreign supervisors regarding the risk activities of Brazilian banks abroad and the domestic activities of foreign banks.

The overall assessment of compliant is based on existence of appropriate framework for information sharing between supervisors and protection of the confidentiality of the information.

Principle 2: Permissible activities and use of "bank"

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

Description: The NMC through specific regulation has defined permissible activities for financial institutions supervised by the BCB. That regulation requires that the institution's name include a specific designation regarding their licensed activity. Financial institutions must use specific designation such as bank, credit union, savings and loans associations, leasing corporation, stockbroker, securities dealer, etc. clarify to the public their kind of business. Nevertheless, Brazilian law does not restrict the use of the term "bank" in the name of a company and there have been instances where the term "bank" has been used in the name of factoring companies, which are not supervised by the BCB.

Assessment: Materially noncompliant—efforts to achieve full compliance not underway. Brazilian law does not restrict the use of term "bank;" hence, companies not supervised by the BCB could use the word "bank" in their name.

The overall assessment of materially noncompliant is based on absence of restrictions that apply to non-financial companies that ensure that the use of the word "bank" is regulated.

Principle 3: Licensing criteria

The licensing authority must have the rights to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors *and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.*

Description: Under article 10 of law 4595/64, it is the BCB's exclusive duty to authorize financial institutions to operate in Brazil. Specific licensing regulations identify requirements for beginning capitalization and information on sources of capital—Resolution 2099/94—fit and proper standards for owners and managers—Resolution 2645/99—and definitions for management responsibilities and internal controls—Resolution 2554/98. Specific minimum capital levels depend upon the type of financial institution and the activities conducted.[10] Commercial banks are to maintain a minimum capital of R$17.5 million, whereas investment and development banks must maintain R$12.5 million. The minimum capital level increases progressively depending on the types of activities engaged in. For Multiple Banks engaged in the full range of activities available, the minimum capital requirement would be R$51 million.

Resolution 2099/94 also imposes an added requirement on the net worth of controlling shareholders. For companies, the total net worth less the amount of the investment in the financial institution must be 220 percent of the investment and for individuals, the personal net worth less the amount invested must be 120 percent of the value of the investment. To the extent that licensing and informational requirements are not met, the BCB can reject applications. Agreements are in place with the tax authority and insurance and securities regulators to conduct background reviews of owners and managers, as well there is a public notification requirement through a wide-circulation newspaper. A special procedure for the establishment of local offices by foreign banks requires the concurrence of the home supervisory authority.

Assessment: Largely compliant—efforts to achieve full compliance underway. The BCB authorizes financial institutions based on clear and appropriate criteria. Weaknesses in BCB processes are as follows:

- Business Plan. There is no requirement for the submission of a business plan as part of the authorization process. In the Brazil case the difficulties commonly experienced with the establishment of new banks have been mitigated by the substantially tightened restrictions on new authorizations. Nevertheless, the BCB should require that prospective owners provide a business plan that sets out the management's and owner's strategy for the next three to five years. The business plan should include an analysis of the market for both credit demand and other income opportunities, as well as information on funding sources. Projections for asset growth should be in line with the building of a stable funding base, which under most circumstances should be

[10] To encourage the establishment of banks outside of the states of São Paulo and Rio de Janeiro, the minimum capital requirement is reduced by 30 percent.

deposits. To the extent that the newly licensed bank is to rely on wholesale funding, there needs to be the strong expectation that the funding will be stable through periods of market volatility.

- Pre-opening Meetings and Inspection. Though officials in the authorization area of the BCB meet frequently with prospective bank owners and managers during the course of the application process, representatives of on-site supervision should also meet with management and board members to discuss important laws and regulations, as well as to become better acquainted with the management and owners. After the authorization is granted, but before the bank is opened, the BCB should check conformance with the resolutions for internal controls and information systems, as well as review general areas of preparedness to conduct a banking business.

- Criminal checks of owners and managers. Existing procedures require that the owners and managers stipulate that they have not been convicted of any crime; however, there is no verification procedure in place with law enforcement officials. The procedure for contacting the appropriate law enforcement agency should be similar to that already in place for contacting the tax authorities and regulatory agencies for insurance and securities.

Principle 4: Ownership transfer

Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Description: Banking law and relevant regulation define significant ownership, as well as specific application and notification requirements for changes in management. Requirements for capitalization, fit and proper standards for managers and information on sources of the equity capital continue to apply. The BCB has sufficient authority to reject applicants not meeting eligibility requirements.

The BCB imposes similar managerial and ownership requirements for transfer of controlling stake as it does for approving the creation of new banks. However, financial requirement for the creation of new banks are substantially higher than for the purchase of an existing banks, which by design was to encourage consolidation of the banking system and that new entrants into the financial sector acquire an existing bank rather than start a new one. (See response to Principle number 3).

Assessment: Compliant. Principle 4 is complied with as all essential and additional criteria are met. Necessary legislation and regulations for purposes of reviewing transfers of significant ownership or controlling stakes are in place and function satisfactorily.

Principle 5: Criteria for investments

Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Description: Law 4595/64 and relevant resolutions from the NMC grant explicit authority to the BCB to authorize the establishment and change of ownership of financial institutions, which includes the granting of authorization for one financial institution to acquire another. Requirements for capitalization, fit and proper standards for managers and information on sources of the equity capital continue to apply.

Under Resolution 2674/99, prior BCB authorization is required for establishment of a foreign branch or subsidiary, as well as any increase in ownership. Consolidation requirements may apply to companies controlled through common shareholders. Moreover, the same resolution imposes a consolidated supervision requirement, whereby the BCB can deny authorization for acquisitions where information access regarding the subsidiary is unduly restricted. Specific regulatory reporting to the BCB is required of foreign branches and subsidiaries.[11]

For investments in non-financial companies that are not consolidated for purposes of Resolution 2674/99, the investment is to be included as permanent assets, which are limited to 70 percent of net worth, declining to 60 percent in June 2002 and 50 percent by December 2002.

Assessment: Compliant. Criteria for Principle 5 are met. Necessary legislation and regulations are in place to establish and review requirements for acquisition or investments by banks. Moreover, Resolution 2674/99 imposes requirements that significantly limit affiliations or structures that impede consolidated supervision.

Principle 6: Capital adequacy

Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the banks undertake, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, the requirements must not be less than those established in the Basle Capital Accord.

Description: Resolutions 2099/94, 2399/97, 2606/99, and 2212/95 require banks and financial institutions licensed by the BCB to maintain a minimum net worth proportionate to risk weighted assets. Banks are to maintain a combined tier one and two capital of 11 percent

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[11] Subsidiaries are required to report, if the Brazilian financial institution owns more than 20 percent of the voting equity of the subsidiary.

for credit risk, with add on capital charges for other risks. Add on capital charges are 20 percent of the notional value for swaps and 50 percent of the gross aggregate foreign exchange position. A regulation is nearing completion (currently being tested by several banks with planned release in first quarter 2000) that will introduce a capital charge for interest rate risk of fixed and floating rate bonds. Afterward, the BCB will work on defining capital requirements for equity and operational risks.

Resolution 2543/98 defines tier one and tier two capital, in agreement with the Basel Committee Standards. Tier two capital includes subordinated debt and other hybrid instruments. The BCB is working on a new regulation that will clarify the definition and the specificity of these instruments vis-à-vis the bankruptcy law. Minimum levels of capital are defined for each category of bank and financial institution, based upon the type and the location of the activity (Resolution 2607/99). See description to Principle 3.

Balance sheet and off-balance sheet risks are considered under the present regulations and risk weights generally follow the Basel recommendations. The minimum capital requirement must be met continuously on a consolidated financial entity basis. Reporting of capital adequacy is monthly, except with regard to foreign currency exposures which is daily. The regulatory capital adequacy ratio is applied to each individual bank. For financial groups, the capital ratio is calculated at the consolidated level of financial activities.

Resolution 2674/99 will require the consolidation of (i) financial institutions and (ii) non-financial institutions for capital adequacy purposes. Insurance, credit card companies and factoring companies in Brazil are considered non-financial companies. In determining compliance with capital requirements for banks and their subsidiaries, the BCB will consider the regulatory capital both with the aggregation of the capital of the subsidiary and without.

Resolution 2099/94 provides the BCB extended powers, should the capital adequacy ratio fall below the minimum level. This includes:

- Summoning the bank's senior management to account to the BCB and require corrective action of any deficiency within five days.

- Requirement management/board of directors to present a corrective action plan within 15 days.

- The implementation of the plan should not exceed 6 months and include the designation of an external auditor who will report monthly to the BCB of the implementation of the plan.

- Should the bank not meet its obligations, the BCB can force liquidation.

Assessment: Largely compliant—efforts to achieve full compliance underway. High capital requirements have been established and strengthened when the economic and financial environment was considered more volatile. Supervisory powers are clearly defined and give enough authority to the BCB to enforce capital requirements. The qualification refers to only partial implementation of a capital regulation that considers market risk. Full implementation is pending the release of the resolution for market risk.

Principle 7: Credit policies

An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the on-going management of the loan and investment portfolios.

Description: The NMC has issued three regulations related to the granting of loans, making investments and the on-going management of the loan and investment portfolios. These include Resolution 2390/97, which created the centralized credit risk center, Resolution 2554/98, which addresses minimum internal control requirements for banks, and Resolution 2682/99, which requires banks to classify their loans according to nine grades using criteria established by the BCB. The latter replaces an earlier resolution that did not consider the treatment of renegotiated loans. Specific requirements are in place regarding the preparation of operating manuals, loan approval guidelines, exposure limits, credit monitoring, and internal control systems. In addition to the specific requirements laid down in these regulations, supervisory procedures and practices require that examiners evaluate banks' policies, practices and procedures relating to the granting of loans and making of investments and the on-going management of the loan and investment portfolios during their on-site inspections.

Assessment: Largely compliant—efforts to achieve full compliance underway. Through the on-site inspection process, bank supervisors assess the adequacy of management's decision regarding the granting of loans and the making of investments. Supervisors have complete access to information concerning the credit and investment portfolios of the bank and to the bank's lending and investment officers. Non-adherence to a bank's established policies and procedures, as well as inappropriate lending and investment practices, are singled out by the examiners for criticism and correction in their meetings with management. The examiners also classify loans and investments and validate the bank's own internal asset classification systems.

The on-site inspections process is largely driven from the bottom-up at the transaction level and, therefore, tends to focus on problems that have been identified as exceptions, rather than on the systematic prevention of problems. While it is important to review and classify assets to determine that loan loss reserves are adequate and the bank is in a sound financial condition, it is also essential to conduct a more comprehensive and systematic review of policies employed by management for day-to-day operations. This review should determine that policies are in writing, that they have been adopted by the board of directors, that they are reasonable and complete, and that they have been communicated to management and are followed. In this regard, it is noted that many small banks still operate without the benefit of formal, board-approved written policies. Appropriate policies and the risk management systems to identify, measure, control and monitor risks are necessary to prevent problems from occurring and thus play an important role in ensuring financial system stability and health.

The overall assessment is largely compliant. Some weaknesses are noted regarding reviews of written, board-approved loan policies and the need to communicate in writing appropriate recommendations to the bank when policies are absent, deficient or not followed.

Principle 8: Loan loss classification and provisioning

Banking supervisors must be satisfied 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.

Description: Resolutions 2554/98 and 2682/99 issued by the NMC provide for the establishment of appropriate internal controls, the identification, classification, accounting, and review of problem credits and the establishment of minimum levels for provisioning. Resolution 2682/99, in particular, requires banks to grade their credits into nine categories according to increasing levels of risk. The Resolution requires the financial institution to make a qualitative judgment about a borrower's ability to repay using verifiable criteria that is consistently applied and considers both past performance and future prospects. Where more than one credit to a customer or economic group is outstanding, the most severe classification is used. Past due credits are automatically classified monthly according to the number of days past due. However, a more severe classification can be applied in the judgment of the financial institution.

Resolution 2682/99 also establishes the minimum scope and frequency for a bank's internal review of the portfolio. The frequency of review of individual credits depends in part on the size of the exposure. All exposures exceeding 5 percent of net worth must be reviewed at least semi-annually and exposures exceeding R$ 50,000 must be reviewed at least annually. Minimum provisions are required based on the loan rating and range from zero for the best loans (Level AA) to 100 percent for those most problematic (Level H). Per the Resolution, though there are minimum provisions, it is the responsibility of management to ensure that the level of the provisions is adequate. The Resolution also defines and establishes rules for renegotiated credits and requires the adoption of policies and procedures for classifying credits, documentation supporting internal credit review activities, valuation of collateral, and disclosure of selected information in the financial statements. Auditors must conduct a detailed review of the criteria adopted by the institution and determine that classifications and the amount of loan loss reserves are appropriate. In addition, examiners from the BCB can require changes in classifications and additional provisions that they may consider necessary.

Assessment: Largely compliant—efforts to achieve full compliance underway. The NMC resolutions establish reasonable rules for the periodic review by banks of individual exposures, asset classifications and provisioning. In addition, specialist credit inspection teams examine asset quality during the on-site inspection process to independently determine the quality of assets and the adequacy of loan loss reserves. The examiners also validate the banks' own systems of internal loan review, review banks' classification and provisioning policies and practices, assess loan approval and credit administration activities, collection efforts and on-going oversight of problem credits, and collateral valuation practices, and determine adherence to banks' established policies. All exposures are reviewed including loans and advances, off-balance sheet items, due from banks, investments, acquired assets, and other assets. Starting from March 2000, banks are required to classify their loans according to the new criteria contained in Resolution 2682/99. The recently issued Resolution requires a much more realistic assessment of asset quality based on a borrower's ability to repay and requires that loans are recognized as impaired when there is reason to believe that amounts due will not be collected in accordance with contractual terms. Collateral is required to be valued realistically at net realizable value. The recently issued Resolution also establishes the responsibility for auditors to review the quality of assets and the adequacy of provisions during their audits. Supervisors have the ability, and use this ability when required, to cause banks to improve their credit-granting standards, increase provisions and reserves, issue capital, and undertake such other actions as required when the level of problem assets is deemed to be of concern. In addition to on-site inspection activities, supervisors stay informed of banks' asset quality through monthly reports and the information contained in the credit risk center.

The assessment is largely compliant, which considers the recent issuance of Resolution 2682/99, which requires that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions. Consequently, the effectiveness of the new Resolution could not be observed and may yet require a period of adjustment for the implementation.

Principle 9: Large credit exposure limits

Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Description: Resolution 2474/98 prohibits financial institutions from extending loans or advances, or give guarantees to a single borrower or group of companies under common control which, in the aggregate, exceed 25 percent of adjusted net worth. In addition, financial institutions may not underwrite, or hold in their investment portfolios, securities of any one issuer, its subsidiaries or affiliates, exceeding 25 percent of adjusted net worth. A closely related group is defined in regulations related to prudential exposure limits and the requirements for consolidated reporting. Banks' management information systems must provide the means for banks to aggregate their borrowers as to group, industry or sector, and type of collateral so that concentrations may be monitored.

Assessment: Compliant. The exposure limit for a single borrower, issuer or a group of related borrowers or issuers is reasonable and monitored through the central risk center and the on-site inspection process. The definition for a closely related group reflects actual risks. In addition, portfolio concentrations are appropriately monitored. One improvement that can be made, however, is to establish an explicit rule for combining loans when the loan proceeds are used for the benefit of another party that is also borrowing.

The overall assessment of compliant is based on reasonable exposure limits, appropriate management information systems and effective monitoring and enforcement through the supervisory process.

Principle 10: Connected party lending

In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Description: Article 34 of Law 4595/64 prohibits financial institutions from lending or advancing funds to, or guaranteeing the obligation of, or underwriting the securities of: (i) its directors, and executive officers, managers, members of its fiscal council, their respective spouses and certain other relatives of such persons; (ii) any person or entity which holds more than 10 percent of its capital stock; (iii) any entity of which such financial institution holds more than 10 percent of the capital (except subject to prior approval of the BCB in certain circumstances); and (iv) any entity of which any of the persons mentioned in (i) above holds more than 10 percent of the total capital. Crimes against the financial sector are further dealt with by Law 7492/86, which addresses so called "white-collar" crimes.

Assessment: Compliant. The prohibition on credit to insiders and connected parties is strict and closely monitored through the supervisory process, both on-site and off-site. Management information systems are adequate to identify loans to insiders and connected parties. Non-compliance with the legislation is considered a criminal offense. Improvements can be made, however, by requiring executive officers to report their borrowings at other banks to their board of directors (such reports to be made a part of the minutes). In addition, supervisors can improve the monitoring of potential "sweetheart" arrangements and the use of due from bank accounts as compensating balances for personal loans at other banks. Strengthened monitoring is recommended to ensure that preferential credit is not granted on a reciprocal basis and that the bank's funds are not being used for personal benefit.

The overall assessment of compliant is based on the prohibition on credit to insiders and connected parties, the adequacy of management information systems, and the close monitoring and enforcement provided through the on-site supervisory process.

Principle 11: Country risk

Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate reserves against such risks.

Description: Through its on-site inspections, the BCB has determined that exposure to country and transfer risk by Brazilian financial institutions is not material. Consequently, there is no specific policy guidance that deals with the related activity. In discussions with BCB inspection teams, where country or transfer risk is identified, it is dealt with under policies and procedures applicable generally to credit exposures.

Assessment: Not applicable. For Brazilian financial institutions, transfer and country risk is not material and not a supervisory issue that merits specific policies and procedures for controlling exposures or determining provisioning levels.

Principle 12: Market risks

Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Description: Resolution 2554/98 requires financial institutions to implement internal control systems consistent with the type, complexity and risk of their operations, which include systems for operational controls and management information systems. Special responsibilities are attributed to the general manager and external auditors in this regard. The BCB is satisfied with the risk monitoring procedures and internally established exposure limits.

The BCB relies on specialized teams to review the treasury and trading activity functions, with emphasis on controls over market risk. The specialized teams review policies and procedures in place for risk management, operational controls and accounting practices. The teams coordinate with other specialist teams for information systems and management. Recently, the inspections staff has completed a comprehensive and practical manual for market risk to guide inspectors with the on-site inspection process.

In May 1999, the BCB introduced Resolution 2606/99, which mandates a specific capital charge for foreign exchange exposure risk. The regulation requires a progressive capital charge as the foreign exchange position increases above 20 percent of net worth whereby banks are to hold additional capital representing 50 percent of the exposure that exceeds 20 percent of capital. A second parameter for foreign exchange exposure imposes a maximum position limit of 60 percent of net worth. The capital regulation was refined further for market risk with the February 2000 issuance of Resolution 2699/00, which imposes a capital charge for interest rate risk based on a standardized measurement model.

Assessment: Largely compliant—efforts to achieve full compliance not underway. The BCB's oversight of market risk is effective. However, full implementation is constrained by weaknesses in staffing levels and capacity. Prudential oversight of market risk requires highly specialized skills, which are in very short supply among present BCB on-site inspections personnel. Resources are needed to train inspectors in specialty areas such as market risk models. Moreover, flexibility in hiring restrictions is needed to allow the BCB to recruit mid-career professionals for specialized areas. This need will become even more acute to the extent that the BCB allows financial institutions to use internal models. Moreover, the monitoring of market risk will need to receive the support of a strong off-site surveillance program.

The overall assessment of largely compliant is based on general effectiveness of the BCB's oversight of market risk, but given the specialization required to oversee this risk type, limitations in staffing and training are evident and prevent a determination of full compliance.

Principle 13: Other risks

Banking supervisors must be satisfied that banks have in place comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.

Description: Resolution 2554/98 requires that financial institutions define and implement internal control systems appropriate to their activities. Such internal controls must be effective and consistent with the nature, the complexity and the risk of operations. Senior management is responsible for defining and implementing an internal control structure, establishing related objective and procedures and verifying regularly the adequacy and comprehensiveness of procedures.

The BCB has not issued specific prudential guidance or regulation to control or monitor liquidity risk. Instead, high reserve requirements on deposits have been imposed for monetary policy purposes, which require the maintenance of high liquid assets. These high reserve requirements currently negate the need for prudential guidance for liquidity risk.

Operational risk is analyzed by specialist teams of inspectors. A new team with eight people in São Paulo review banks' management, which includes strategy, organization, efficiency and results, internal control, and compliance aspects. The team still has to develop a methodology and feels the need for additional specific training. Analyses are generally appreciated by banks, which have not yet developed management tools and databases, for most of them. The volatile environment, in which banks operate until now, was not conducive to defining comprehensive term strategies.

Assessment: Largely compliant—efforts to achieve full compliance underway. The BCB's oversight of other risks shows marginal effectiveness. The new internal control regulation and the development of new specialized inspection teams are welcomed. However, Brazilian financial institutions maintain a high degree of liquidity because of (i) incentives to hold liquid government securities, which offer a superior return with relative low risk, and (ii) the high reserve requirement on deposits. With further economic stabilization and a declining interest rate environment, financial institutions will need to rely more on loans for interest income and less on government securities. Moreover, efforts are underway to lower the legal reserve requirement. Consequently, prudential measures will be needed to control liquidity risk exposure, including consideration of monitoring requirements.

Staffing limitations again will be a factor in the BCB's capacity to carryout effective oversight of liquidity and other operational risks. In addition, the off-site surveillance function needs to be augmented to develop appropriate monitoring screens for liquidity risk and other operational risks.

The overall assessment of largely compliant is based on marginal effectiveness in the current environment given the existing preference by banks to hold liquid assets and the existing high reserve requirement. However, both these conditions will evolve in coming quarters that will cause the overall liquidity profile of Brazilian financial institutions to decline. Consequently, prompt actions are needed to prepare for the change through the issuance and implementation of supervisory guidance.

Principle 14: Internal control and audit

Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Description: Resolution 2554/98 which is now in effect requires that financial institutions define and implement internal controls that are adequate for their activities, their financial, operational and management information system, the nature and scale of their business, and that make them meet the legal and regulatory requirements. These include:

- defining responsibilities for specific activities to senior officials within the institution;
- segregation of duties to safeguard against conflicts of interest;

- identification of internal and external factors that could adversely affect completion of the objectives;

- consideration of those risks associated with individual activities; and,

- rationalization of risk exposures with internal and prudential limits and ensuring that any deviation will be promptly corrected.

Internal controls must be regularly revised and updated to include guarding against new risks. The responsibility belongs to senior management who must ensure the promotion of high standards for ethics and integrity, as well as promote an organizational culture that demonstrate and emphasize for all staff the importance of internal controls.

Internal audit is integral to the internal control system. It depends directly on the board or, if there is not one, on the senior management. Financial statements are audited on a half-yearly basis. Audit reports and work-papers must be retained and available to the BCB for 5 years.

At the BCB, a specialized team assesses internal controls in liaison with teams in charge of inspecting operational activities. The BCB can request additional controls when deficiencies are identified, as well as impose specific operational limits for an institution that fails to comply with applicable resolutions. Resolution 2645/99 allows the supervisor to remove board members and senior managers who would be not qualified.

Resolutions 2451/97 and 2486/98 require financial institutions to segregate custodian activities and third parties accounts management from their other activities, including investment funds, especially when they are linked to their institution. Each financial institution must designate a senior manager as the one to be held to account for instances of fraud, negligence, imprudence and otherwise improper activity in the management of such accounts, as well as for the supervision of related information provided to the public.

Assessment: Largely compliant—efforts to achieve full compliance underway. The new regulation for internal controls was issued in 1998, but financial institutions were given one year to fully implement specific requirements. The regulation became effective in January 2000, consequently, effectiveness of the regulation has not been reviewed in sufficient detail. Very few institutions have an audit committee and control culture still has to be promoted in the industry as a whole.

The overall assessment of largely compliant is based on the introduction of an important regulation for internal controls. However, effectiveness of the implementation of the regulation has yet to be reviewed because the regulation has only just become effective in January 2000. Weaknesses are further identified with Principles 18 and 21, respectively off-site information and accounting policies, which have related issues.

Principle 15: Money laundering

Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Description: Law 7492/86 defines crimes against the National Financial System and Law 9613/98 makes money-laundering a criminal activity. The latter law establishes a Financial Intelligence Unit (FIU) and the Council for the Control of Financial Activities (COAF) with the BCB as one of the members.

In 1999, the BCB created a new department, DECIF, which is in charge of monitoring foreign transactions, both for regulatory and financial crime purposes, and for receiving suspicious reports from banks.[12] The department has now 190 people and will increase to 230, which includes staff in nine regional BCB branches.

The circular 2852/98 requires financial institutions to maintain and update information files on their customers, and to keep these records for five years. Circular 2826/98 provides an extensive definition and list of transactions that must be reported. Information required by COAF includes:

- Banks must keep records on customer transaction activity and financial capacity; all suspicious transactions, or group of transactions, equal or above R$ 10,000 must be reported to the BCB. The reporting of false information is considered to be a crime, under the provisions of law 7492/86.

- Financial institutions, which are authorized to operate in the foreign exchange market, consortiums (consórcios), branches and subsidiaries of foreign financial institutions must report daily their transactions in foreign currency through SISBACEN[13] (Circular 2852/98); the BCB makes an automated selection of suspicious transactions the next day.

Communications related to economic crimes, which are made in good faith, do entail the institutions and entities, their board, administration and staff with a civil or administrative responsibility. The BCB sends only general information to COAF, but can provide more detailed data to the judicial authorities.

[12] To date the number of reports is about 3000 per year.

[13] The BCB's information system.

In each financial institution, a person in charge of implanting and monitoring anti-money laundering procedures must be nominated. A review was conducted in 1993 and a large number of ghost accounts were closed. DECIF will start soon conducting specific on-site inspection for money laundering. Sanctions are defined for board members which bank fails to comply with the law on financial crime.

Assessment: Largely compliant—efforts to achieve full compliance underway. The legal framework that is in place is consistent with the FATF 40 recommendations. The full implementation would require that on-site inspections are conducted in order to ensure that policies and procedures are in place that enable financial institutions to detect and report all suspicious transactions. The unit has only recently been created, consequently not enough time has passed to evaluate overall effectiveness.

Principle 16: On-site and off-site supervision

An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Description: Banking supervision embraces both on-site inspections and off-site monitoring. On-site inspections are conducted as often as budgetary and staffing resources permit, which is of a less than adequate frequency for all institutions. The schedule of inspections is determined in a half-yearly cycle in May and November that takes account the bank's importance to the system, the last inspection date, matters of concern raised in earlier inspection or through the off-site monitoring process, and information from other sources. To date, on-going supervision has primarily focused on privately-owned financial institutions, leaving the federal banks largely unsupervised.[14]

Starting mid-1997, the BCB has relied upon the Global Consolidated Inspection program as its primary approach for on-site supervision. The objectives of the on-site inspections are to evaluate the financial condition of the institution, its operational systems and policies, the reliability of information and internal controls, and other matters considered important. In planning the individual inspections, the lead inspector assembles a team drawn from both general and specialized inspection teams.

The BCB's specialized teams operate within the areas of management, credit, treasury, and management information systems. Inspections vary in length depending on the size and complexity of the institution and the staff resources employed. During the inspection, regular meetings are held with management and all senior executives and board members are interviewed. At the completion of the inspection, the overall conclusions are discussed with the management. However, at present, the inspection report is not provided to

[14] On-site inspections of federal banks, largely have been targeted reviews of asset quality or adequacy of financial reporting.

the bank. Only exceptions are communicated to the management in writing with a request, or if warranted, a demand, that they be corrected. Banks identified as warranting closer supervision are placed on a watch list and are subject to a special supervisory regime that includes more frequent inspections and vigorous corrective measures.

Off-site monitoring is based on the monthly accounting data provided by financial institutions to the BCB's SISBACEN—information system. Three systems were developed by the supervision area to organize the monthly reporting in order to provide information for off-site surveillance. These include: INDCON, a system that enabled supervisors to compile trends, ratios, peer groups, and relative rankings; SUPER, a system that identifies anomalies in reported data; and SENTINELA, which detects major variations in accounting statements. In addition, banking supervision uses the centralized credit risk center to review large exposures, loan classifications, delinquencies, and general credit trends. This system, which has been in operation for only two years, captures credit information for all exposures greater than R$ 20,000. In addition, inspectors review financial information and prepare analyses of their banks in-between on-site inspections.

Assessment: Materially noncompliant—efforts to achieve compliance are underway. The off-site monitoring systems are seriously out of date and lack necessary relevance as a surveillance tool. Following the collapse of several large banks in the mid-1990s, INDCON for example fell into disuse due to its inability to warn of the impending failures. Largely, this occurred because the information collected was of poor quality, leading to false results. A new effort is underway at the BCB to improve the surveillance processes, including the creation of a new off-site monitoring division that is working to develop new information tools. Systems are needed that evaluate growth trends, performance ratios, peer groups, and rankings to improve the on-going supervision, especially in-between on-site inspections.

As the result of failures in the detection of deteriorating banking conditions through the off-site monitoring of banks, on-site inspections were emphasized to review the condition of financial institutions and to introduce greater discipline in the reporting of accurate financial information. New regulations to augment on-going supervision are now in place and the on-site inspections now focus more on assessing risk, as well as compliance with laws, rules, and the regulations. The on-site inspections are effective and receive high marks from the industry. However, only an exception report is provided in writing to the bank. Given the wealth of very good information, conclusions, and judgements made in the report of inspection, much more of it should be shared with the supervised institution. In addition, the introduction of a bank rating system would be beneficial in further segmenting the banks within the watch category, thereby, permitting better targeting of corrective action and a means for monitoring the condition of the banking system as a whole.

The overall assessment of materially noncompliant is based on the need to develop the off-site monitoring system, provide comprehensive written conclusions to each bank and to introduce a formalized bank rating system. Of equal concern is the frequency of global consolidated inspections is inadequate for all institutions; instead priority is given to those institutions that pose higher systemic risk. Last, the federally-owned banks largely have been excluded from the BCB's supervision efforts. Suggestions to correct these weaknesses are under active discussion within the bank supervision department.

Principle 17: Bank management contact

Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

Description: As part of the new supervisory approach adopted by banking supervision, individual examiners are accountable for individual financial institutions. It is their responsibility to lead inspections, conduct off-site monitoring, and stay in regular contact with their institutions to ensure that they remain in, or are brought to, a sound financial condition. Regular contacts are made to discuss operational matters, including strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems, and other matters of importance. The new supervisory approach uses both global consolidated inspections and targeted inspections. The former is comprehensive in scope and includes the consolidated group and all of its members. The latter is targeted to areas of particular concern such as loans or investments.

Assessment: Compliant. The new supervisory approach establishes a meaningful relationship between supervisor and supervised institution wherein banking supervision is in frequent contact with senior management and the board of directors and is informed of any material adverse developments that may affect the financial condition, performance, or prospects of the institution. The quality of management is considered an important aspect of the supervisory process. The global consolidated inspections allow supervision to be informed of all risks that may affect the bank, including those stemming from elsewhere in the group.

The overall assessment of compliant is based on regular and meaningful contact and exchange of information between supervision and supervised institution and supervision's thorough understanding of the institution's operations.

Principle 18: Off-site data

Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

Description: Law 4595/64 provides the NMC and the BCB adequate authority to require information in a form and frequency deemed necessary. This authority is backed up by sufficient enforcement powers to assure accuracy and timeliness in reporting. In 1988, the BCB introduced the COSIF accounting framework for financial institutions, which standardized the creation of a uniform chart of accounts.[15] Reporting and publishing

[15] COSIF, the Chart of accounts for institutions of the national financial system.

requirements include monthly balance sheet, income statement and off-balance sheet information provided in both an unconsolidated bank only basis (Series 4010) and consolidated for the financial group (Series 4040).

Financial institutions use the BCB's information system—SISBACEN—to electronically file reports for foreign exchange exposure, liquidity and reserve requirement information, as well as monthly balance sheet, income statement and off-balance sheet information. In addition, publicly-traded financial institutions must publish consolidated financial statements on a quarterly basis with the CVM. For periods ending June 30 and December 31, banks must provide audited financial statements including explanatory notes. Present off-site surveillance consists of monitoring performance in three systems SUPER, INDCON, and SENTINELA.

Assessment: Materially noncompliant—efforts to achieve compliance underway. The BCB has adequate legal powers to require information from banks and, in practice, collects vast amounts of data in COSIF. However, the effectiveness of the information collection and the surveillance monitoring systems are troubled by inaccurate reporting that has affected the integrity and reliability of the reporting system. Moreover, the three surveillance systems have fallen out of date and no longer fulfill an appropriate on-going supervisory purpose. A comprehensive review of information collection processes is needed to rationalize the approach for collecting the information. Moreover, staffing constraints limit the effectiveness of the off-site surveillance function.

The inadequacies are known and efforts are underway to improve data collection efforts and change approaches to off-site surveillance. Further attention is needed to ensure that senior managers and the external auditors of financial institutions do their part in ensuring the accuracy of the regulatory reporting. To the extent that submissions from financial institutions are not sufficiently accurate, corrective action against the institution—and external auditors as necessary—should be taken.

The overall assessment of materially noncompliant is based on: (i) deficiencies in the accuracy of reported information, which has impeded the development of a credible off-site surveillance function, (ii) surveillance systems are outdated, and (iii) staffing for the off-site function are currently inadequate.

Principle 19: Validation of supervisory information

Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Description: Following the failure of several large banks in the mid-1990s, BCB officials recognized that substantial reliance on off-site surveillance was misplaced without a strong on-site inspection program. Therefore, the BCB strengthened its on-site inspection efforts and in 1997 introduced the global consolidated inspection program that focused on the various risks within a financial institution on a fully consolidated basis. To enable the supervisors to carry out on-site inspections, financial institutions are obliged to make their corporate records and any other documents necessary available for inspection. This obligation also extends to the corporation or individual that controls the financial institution.

In the past, external auditors had been relied upon to provide independent confirmation of supervisory information. However, significant weaknesses were found in the work of auditors in a number of notable large bank failures. The NMC responded by issuing Resolutions 2267/96 and 2676/96 that establish requirements for auditors and stiff penalties for unprofessional practice leading to losses in banks. The auditors are still required to render their opinion on an audited institution's financial statements and the adequacy of accounting principles, compliance with accounting norms issued by the NMC, the quality and adequacy of internal controls, including electronic processing systems, and on compliance with regulations. Additionally, banks are now required to appoint a member of senior management to take responsibility for the effectiveness of internal and external audit activities.

Assessment: Largely compliant—efforts to achieve full compliance underway. Because of deficiencies in the accuracy and reliability of regulatory information and the auditing profession overall, the BCB concentrated more heavily on the on-site inspection of financial institutions, as well as strengthening requirements for internal controls and auditing practices. The BCB, in the on-site inspection process, places considerable emphasis on validating the accuracy of reported information, especially with regard to prudential returns and information for the credit risk bureau. However, more needs to be accomplished to formalize inspection procedures in all areas of inspection.

Recent resolutions are serving to improve the quality of audits. However, the performance of auditing firms remains uneven and requires continued attention. Although the examiners meet with auditors on a frequent basis, there remain difficulties in supervisors obtaining access to auditors' working papers. As needed, the supervisors can appoint external auditors to conduct supervisory tasks. The supervisors can also oppose the appointment of an external auditor that they consider lacks appropriate expertise or independence.

The overall assessment is largely compliant, which considers weaknesses in external audit activities and the need for banking supervision function to further formalize procedures in all areas of the on-site inspection program.

Principle 20: Consolidated supervision

An essential element of banking supervision is the ability of the supervisors to supervise the banking organization on a consolidated basis.

Description: Resolution 2674/99 requires the consolidation of: (i) financial institutions and (ii) nonfinancial institutions for purposes of consolidated supervision, including determination of capital adequacy. In determining compliance with capital requirements for banks and their subsidiaries, the BCB will consider the regulatory capital requirement both with the aggregation of the capital of the subsidiary and without. Insurance, credit card companies and factoring companies in Brazil are considered non-financial companies. The new resolution assures that the BCB has full access to books and records of subsidiaries and affiliates of banks. The BCB applies prudential and regulatory reporting requirements on financial institutions both at the levels of the consolidated entity and at the stand-alone regulated entity.

The BCB has signed agreements with the Securities Commission (CVM) in 1978 and the Insurance Superintendence (SUSEP) in 1988, on collaboration, information centralization and exchange, and inspection coordination. Since 1997, banking groups have been monitored and examined on a consolidated basis, in the context of the Global Consolidated Inspections Program, which includes: (i) reviewing all financial and non-financial activities; (ii) assessment of the controlled subsidiaries/affiliates—local and foreign, including those in offshore financial centers; and, (iii) inspecting branches abroad.

Assessment: Compliant. The supervisory framework imposes a consolidated supervision requirement for financial institutions on a consolidated basis.

Principle 21: Accounting standard

Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Description: The NMC delegates to the BCB the authority to establish accounting principles for financial institutions. Accounting practices were standardized through the 1988 creation of the COSIF, which is the uniform chart of accounts used by all financial institutions. The COSIF established detailed reporting requirements and procedures for filing financial information with the BCB. By regulation, a senior management official is accountable for monitoring compliance with norms and accounting as prescribe by the COSIF. Noncompliance with reporting requirement can subject the management official and the institution to penalties.

Comprehensive regulatory reports through COSIF are required for each month end that includes balance sheet, income statement and off-balance sheet information. Under BCB requirements, audited financial statements are required twice a year—June 30 and December 31—along with notes and a formal opinion expressed by outside auditors. Because of continuing data quality issues among Brazilian financial institutions generally, the BCB must devote considerable effort to verification of COSIF information through transaction testing. Resolutions in place impose consistent valuation requirements on financial institutions. A new regulation for loan classification was approved at end-1999 that incorporates stricter criteria on the classification of rescheduled loans. Previously, banks were allowed too much discretion in the classification of renegotiated loans, which resulted in the understatement of problem assets and the overstatement of income.

Following serious breaches in accounting practices, law 9447/97 prescribed new responsibilities on auditors for the accuracy and independence of reporting. The external auditors are now liable for materially incorrect information. Other specific requirements include:

- Auditors have a positive obligation to report to the BCB all facts affecting whether there is a risk that an institution is no longer able to function as a going concern.
- The scope of external audits at a minimum must include an examination of the adequacy of risk management, internal controls, information systems and compliance with regulatory reporting.
- The auditor must be rotated every four years.
- An individual director must be designated responsible for accounting and auditing practices.
- The BCB will review the independence of external accounting and auditing functions instead of the Securities Commission.

Assessment: <u>Largely compliant—efforts to achieve full compliance underway</u>. The accounting framework and legal requirements are sufficiently adequate to ensure that financial institutions maintain records so that accurate financial information is provided in a consistent and timely manner. The BCB controls the accounting standards for financial institutions and they are sufficiently conservative and conform to international standards. Laws and regulations prescribe that financial institutions publish audited accounts with explanatory notes on a semi-annual basis.

Following the failure of several large banks where accounting deficiencies were widespread, accounting practices have improved. However, weaknesses in regulatory reporting remain, which reflects negatively on the control environment and internal and external auditors. As part of the discipline building process, the external auditors need to held to account when there are serious faults are identified. Accounting deficiencies in turn affect the integrity of BCB information systems used to monitor the condition of individual banks as well as the banking system overall.

The overall assessment of largely compliant is based on an adequate and enforceable accounting framework. Weaknesses, nevertheless, remain regarding the quality of regulatory reporting, which reflects adversely on accounting practices.

Principle 22: Remedial measures and exit

Banking supervisors must have at their disposal adequate supervisory measures to bring about corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way.

Description: The BCB has a range of supervisory measures to impose corrective action by individuals and institutions that fail to perform in the best interests of owners, depositors, creditors and the public generally. Remedial measures range from informal instructions directing a particular response by management, to the severe action of intervention and if needed liquidation. The effect of the latter is the suspension of the institution's license and the arresting of control from shareholders, who are responsible—jointly with the controlling shareholder—for the acts performed or the omissions incurred during their office. Temporary special administration and extra-judicial liquidation allow the BCB to immediately force from office the managers and members of the audit committee and allow for the following preventive measures: (i) prevent managers from assuming any role of management of other financial institutions, (ii) impose restraints on the activities of the financial institution, and/or (iii) determine the substitution of the external auditor.

Law 6024/74 and Decree-Law 2321/87 deal with intervention and extra-judicial liquidation, and allow for temporary administration for institutions with weak management. Law 9447/97 grants the BCB power to for cause (i) demand that shareholders infuse new capital, (ii) force the transfer of shareholder control, or (iii) reorganize a financial group including forcing a merger, consolidation or the spin-off of a subsidiary.

The leveraging up of pressure includes fines, warnings and suspensions against board members and bank officials that are itemized in Resolution 1065 of the Monetary Council. Under the law, fines can range from R$25,000 to R$100,000.

Assessment: Compliant. The legal framework has placed at the disposition of the BCB strong measures to deal with troubled banks granting sufficient and comprehensive powers for prompt corrective action, through either rehabilitation procedures or closure and liquidation. In addition, supervisors have at their disposal a broad range of powers that, in principle, are available to impose timely and graduated remedial actions. In spite of this, an effective feature that is not available is the ability to prohibit the distribution of dividend to shareholders. In practice, the BCB has been willing to use its substantial supervisory powers under the law as demonstrated by the numerous interventions and subsequent closures of banks and other financial institutions that have taken place the last three years.

The BCB routinely requires that banks remedy deficiencies of various types that are identified in the course of on-site inspections. The supervisor in charge of each financial institution is responsible for the follow-up on the implementation of these corrective actions.

There is room to improve on the use of supervisory action against auditors, including the prospect of sanctions against external auditing firms for material inadequacies.

The overall assessment of compliant is based on the BCB having adequate enforcement powers and its preparedness to use them to achieve prompt corrective action.

Principle 23: Global consolidated supervision

Banking supervisors must practice global consolidated supervision, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banking organizations worldwide, primarily at their foreign branches and subsidiaries.

Description: Banks must receive BCB authorization before opening branches and subsidiaries abroad. Banking groups must consolidate their financial activities for prudential requirements—a preexisting requirement—and, beginning 2000, their financial and non-financial activities, on a worldwide basis.

The BCB has effective cooperation arrangements (formal and informal) in place with about ten countries. In the context of the Global Consolidated Inspection Program, the BCB supervision function has conducted inspections of the material foreign branches of Brazilian banks from 1995 to 1998. However, because of budgetary pressures, the BCB suspended inspections of foreign branches in 1999.

Regarding subsidiaries, the BCB is satisfied with the information obtained from foreign supervisors and plans to visit some of the foreign supervisory authorities in 2000. Concerning entities licensed in offshore centers, the BCB obtains full access to information where books and records are maintained in Brazil, but some difficulties arise regarding information maintained at the physical premises in certain so-called offshore jurisdictions. In case the information provided is not sufficient, the supervisor can require bank to record provisions against the non-disclosed assets.

Conversely, the BCB authorizes foreign supervisors to conduct on-site inspections of the local affiliates of foreign banks in Brazil. Of late, several of these inspections have been conducted jointly between the BCB and the foreign supervisor.

Assessment: Largely compliant—efforts to achieve full compliance underway. At present, the international network of Brazilian banks covers a limited number of countries. The BCB has developed a sufficient exchange of information with relevant foreign supervisors on both a formal and an informal basis. Some weakness is noted with the ability of BCB supervisors to review on-site activities at material foreign affiliates of Brazilian banks because of budgetary constraints on foreign travel.

Principle 24: Cooperation with host country supervisors

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Description: The recent Resolution 2674/99 requires that financial institutions obtain the BCB's prior approval before starting operations abroad. Effective July 31, 2000 as part of Resolution 2674/99, foreign affiliates that existed prior to the issuance of the regulation, need to grant access to supervisory information regarding foreign operations. To the extent that access is not granted, the BCB can take further action up to including revoking the license of the subsidiary or branch office. Under regulations in force today—Resolution 2302/96—financial institutions must make available supervisory information on subsidiaries and affiliates in foreign jurisdictions otherwise the BCB requires that the investment be deducted from the adjusted net worth. The effect is that instead of holding 11 percent capital against the investment, the financial institution needs to hold 100 percent.

To facilitate the dialogue, the BCB has established both formal and informal arrangements with foreign supervisors for appropriate information sharing regarding the financial condition and performance of the foreign operations of Brazilian financial institutions. That said, though the BCB can prohibit Brazilian banks from establishing operations in countries with secrecy laws, the assessment team noted that five of the larger Brazilian banks have subsidiaries in Luxembourg, which denies access to the BCB for asset information.

Assessment: Largely compliant—efforts to achieve full compliance underway. The BCB has exchanged and shared information with host country supervisors. However, due to budgetary constraints, it has curtailed on-site inspections of the foreign affiliates of Brazilian Banks.

The overall assessment of largely compliant is based on effective cooperation and information sharing with host country supervisors, but a closer working relationship has been affected by budget constraints that limit travel.

Principle 25: Equal treatment of foreign banks

Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Description: The BCB applies the same supervisory standard to foreign-owned or controlled banks as that used for domestic banks. In its on-going supervision, the BCB does take into account whether the home country supervisor practices consolidated supervision. Where deemed appropriate, information about the local operations of foreign banks is shared with the home country supervisors. The BCB will advise the home country supervisor of remedial actions under consideration. The BCB grants on-site access to home country supervisors to examine the Brazilian operations of foreign banks. Moreover, it has conducted joint on-site inspections of some entities with the home-country supervisor.

Assessment: Largely compliant—efforts to achieve full compliance underway. The supervision of the local affiliates of foreign financial institutions is conducted by the BCB based on the same regulations and similar supervisory procedures as those used for domestic banks. The BCB, before issuing a license to a foreign bank to open an affiliate in Brazil, considers if the approval of the home country supervisor has been received. Budgetary pressures have slowed the process of assessment of whether home country supervisors practice consolidated supervision over the local operations of foreign banks. The assessment team notes that the BCB has been unable to visit many of the countries whose banks have a material Brazilian presence to conclude a view on adequacy of home country supervision. These visits are important in order to determine the adequacy of the reporting procedures and controls used by the headquarters over the Brazilian operations of foreign banks. Establishing communication channels with home country supervisors and with the headquarters management of foreign banks helps to ensure greater coordination of the supervisory process.

The overall assessment of largely compliant is based on the effectiveness of the supervision of local affiliates of foreign banks; however, resource constraints limit a determination of full compliance.