

BASEL II IN LATIN AMERICA AND THE CARIBBEAN

RESULTS OF THE SURVEY CONDUCTED AMONG BANKS FROM MEXICO, CENTRAL AMERICA AND THE CARIBBEAN, AND SOUTH AMERICA- PROGRAMA DE COOPERACIÓN TÉCNICA ATN/MT - 9513 – RG

EXECUTIVE OUTLINE

This survey was conducted within the framework of the *Convenio de Cooperación Técnica no reembolsable ATN/MT 9513-RG* (Non-refundable Technical Assistance Programme) called “*INTERACCIÓN PÚBLICO- PRIVADA PARA MEJORAR LA SEGURIDAD EN LOS MERCADOS FINANCIEROS*” (“*PUBLIC-PRIVATE INTERACTION TO IMPROVE FINANCIAL MARKETS SECURITY*”) entered into between FELABAN (Latin American Federation of Bankers) and the IDB/MIF (Inter-American Development Bank /Multilateral Investment Fund).

This survey was conducted in May 2006, among 132 banks from Latin America and the Caribbean. 59% of the banking organizations surveyed were from South America, 31% from Central America and the remaining 10%, from Mexico.

43% represented local Private Capital Banks, 30% international Private Capital Banks, 13% Public Banks and 13% Mixed Capital Banks.

86% of the banks surveyed are among the top 10 banking groups in the region ranked by deposits. Different types of banks participated in this study, namely: Wholesale, Retail and Universal Banks and Asset Management/Investment.

Hereinbelow you will find the main conclusions of this work:

Banks from Latin America and the Caribbean regard Basel II as a very important issue, and it is generally agreed that the final result will have a positive impact on the banking organisations, the financial system, and the economy of each country and the Region.

“It is one of this Bank’s top priorities”, “It will strengthen the bank’s rating and will help build consumer confidence”, “Basel II confers international rating and quality to banking groups from this Region”.

But they still have a long way to go and many obstacles to remove; and they are a bit concerned that changes, costs and processes inherent to Basel II implementation may lead to asymmetries between banking organizations.

“This process will be neither short nor easy”, “Much advice is needed, guidance to coordinate the different countries and a joint effort between supervisors and organizations”.

Supposedly, the three pillars will be implemented in the next four years, though most banks have not started the process yet.

The expectations of the Region banking groups are that they may count on FELABAN and the IDB’s support, within their capacity, to help them implement Basel II.

Results are divided into four big sections: The impact of Basel II on the Region, on the Country, on the Bank and lastly the SWOT Matrix (Strengths, Weaknesses, Opportunities and Threats).



A) REGION

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Latin American and the Caribbean bankers believe that the implementation of Basel II will have a positive impact on the Region. Concerns have been raised about the operational aspects inherent in the processes necessary to ensure Basel II effective implementation.

Throughout this study, key Banking groups in the Region have expressed a good opinion of Basel II. The biggest barriers to be removed are the following:

- a) The characterization, to different extents, of countries in the Region as emerging economy countries.
- b) The need to make a cultural change vis-à-vis the introduction of risk models, and
- c) To be able to afford the new requirements, quite costly if we take into account the profitability of the operations carried out by banking groups in this Region.

In your opinion, what are the main difficulties that the Banking industry in the Region will have to overcome to meet Basel II requirements? Multiple answers- %

The lack of historical risk databases for the implementation of internal models.	39
Regulations are not appropriate for banks in emerging economies since they do not have access to sophisticated risk systems.	25
The impossibility to afford the technological equipment to meet Basel II requirements.	17
Minimum capital requirement.	16
Poor guidance by local regulators	15
Difficulty in measuring the risk either because there are no capital markets in the Region or because they are more volatile.	12
The impossibility to afford to provide the staff with the necessary training in risk prevention and monitoring.	10
The inclusion of market, credit and operational risks in just one risk measure.	10
Poor implementation of risk policy by Banks.	10



21% believe that it won't have negative repercussions in the medium and long term, whereas the rest think that it might, for example:

- It might unfairly advantage larger banks' competitiveness (21%); it might lead to a concentration of banks so that they can afford the costs of moving to Basel II (13%); it might make the credit aimed at banking groups in emerging economy countries more expensive (due to the country risk rating) (10%); from the competitiveness viewpoint, an adverse-selection related differentiation might benefit internationally active banks' subsidiaries vis-à-vis the regional banks which do not belong to this definition, (9%); credit reorientation (rates will increase since banks will find it more risky to grant loans to certain sectors, small-sized companies or individuals with certain jobs) which might restrict the economic development of a country (9%); and probably reduce the banks' lending activity toward Small and Medium-sized Enterprises (8%).

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They think that Basel II requirements should be adapted to the macroeconomic reality of Latin America and the Caribbean, namely technological changes and time frame.

There are three important aspects that should be adapted:

The IT infrastructure necessary to develop and keep the Bank's historical loss data records (31%).

The compliance time frame (20%).

- The existence of clear medium-term incentives for the development of the internal models which foster a more efficient allocation of resources in these economies (12%)

B) COUNTRY

4

*7 out of 10 Banks in the Region think that Basel II will have a positive impact on the economy of their countries in the long run.
The threat: the impact of the implementation processes in the short run.*

“At first it won't have a positive impact because we will have to make significant investments but as time goes by, the results will depend on the control exerted over them”.

Although 70% of the officers surveyed say that implementing Basel II in their country financial system will have a positive impact on the country's economy, they anticipate certain problems during the implementation process.

Two Basel II requirements are likely to have the biggest impact on the economy of their countries: An increase in the required Operational Risk Capital (48%) and an increase in the costs of borrowing, especially in the case of Small and Medium-sized Enterprises. (18%)



5

The implementation of Basel II will impact not only on the Region's financial system but also on the future of the country where it is implemented.

For every 10 banks surveyed:

- 9 think that Basel II will promote greater stability in the financial system and will change, for the better, the concept of the banking model as risk management.
- 8 think that it will help reduce the country risk rating, make it easier for Banks in the country to access world financial markets and improve people's opinion of the financial system.
- 7 think that it will foster the public-private sectors interaction to determine and identify the problems and weaknesses inherent in each country's financial system.

The Banks in the Region agree that the implementation of Basel II (within a time frame more flexible than the one stipulated for the European banks) will have a positive impact on the stability of the financial system in Latin America and the Caribbean and on both its internal and external image as well as on the country's economy, since it will facilitate the reduction of the country risk rating and the access to world financial markets.

The implementation of Basel II will depend on the combination of innumerable factors:

- Those inherent to the country (such as its economy, country risk rating, the political decision to implement it and the presence of credit scoring and risk assessment associations)
- Those inherent to the Banks (such as their databases and their capacity to afford the IT equipment to meet Basel II requirements).

C) BANK

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8 out of 10 Banks in the Region have decided to implement Basel II and regard it as one of their top priorities.

However, the process is still very much in its early stages: 6 out of 10 Banks are still in the pre-study or initial stages, at the most, of Pillar I implementation.

The values are stipulated as per Region and per capital sources, and higher significance is assigned by Banks in Central America and the Caribbean.

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6 out of 10 Banks in the Region will have already implemented Pillar I by 2008, and 9 by 2010.

Pillars II and III would be implemented right after the Pillar I requirements were met.

Banks have decided to take the measures necessary to meet Basel II's requirements (72%); however, they say that they are in the early stages of Pillar I implementation (62%).



The measures taken focus on credit scoring and risk assessment models (61%) as well as on the risk equation calculation model (59%).

Over half of Banks (58%) believe that certain significant changes must be made, half of them have already estimated the costs, and 4 out of 10 have already defined the minimum capital requirements and have drafted an action plan to carry out the implementation process.

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They think Basel II may have a positive impact on the Banks in the Region, thus strengthening their internal risk management, assessment, pricing and profitability. Although they have not estimated the lower costs arising from loss reduction they do not envision the implementation as a business incentive or competitive strength.

From the perspective of 7 out of 10 Banks in the Region, Basel II will have a positive impact on their internal management, especially risk assessment, although they think it won't have such a significant impact on the bank's internal communication, alignment process and businesses. Only 2 banks could not predict its impact and just 1 thinks that it won't entail any competitive advantage.

The Banking Organizations surveyed believe that moving to Basel II will result in two internal Strengths (it will improve management and consequently its equity, rating and credit scoring capacity; and it will improve risk management methodologies and facilitate communication between different sectors and their commitment level), and will give the Bank two Opportunities to improve its market penetration (it will improve its positioning, image, competitiveness, access to international credit and its lending capacity to Small and Middle-Sized Enterprises in the medium and long term after the implementation).

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Banks are analyzing, on average, three changes and acquisitions to implement Basel II

The priority given to the changes to be made by their organizations if they want to implement Basel II, is directly proportional to the costs said changes entail. First, the IT infrastructure necessary to support the information, data keeping and storage systems; second, the implementation of risk assessment and control procedures; and third, the centralization of information.

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From the viewpoint of the Banks in the Region, three factors are likely to have a larger impact on credit risk management programmes:

- » One which is inherent to the Bank (the credit risk assessment methodology currently used- 28%),



- » Another which is external to the Bank (the credit portfolio positioning according to the country's economic activity- 19%), and
- » A third one which encompasses the situation of the Bank and of the country where said bank operates (the increase in the loss level- 15%).

The measures already taken or to be taken by the Banks deal with the creation of a new model, the generation of databases and the analysis of credit risk data records, whether historical or the new records generated as of the implementation of Basel II. They are also working on operational risk data storage and assessment tools.

Internal training and information are the steps to which most Banks have paid the least attention, so far.

As far as the early or initial stage is concerned, only 4 out of 10 Banks in the Region have already set out the capital requirement calculation methodology. Most of them prefer to introduce Basel II methodology though no clear evidence has been found yet to suggest that they prefer Basel II Standardised Approach (20%) over the Advanced IRB Approach and vice versa. (15%)

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Implementing Basel II is not regarded as the responsibility of just one area within the Banks in the region.

Achieving this goal involves on average three different areas within the Banks

The Credit and Risk Assessment areas; thus, in 4 out of 10 Banks, bank heads are having an active participation, 3 banks have also demanded the participation of the Risk Controller/Treasury Inspector Office, Financial Area/Treasurer's Office and IT/Technology. 2 Banks have also required the participation of the Internal Audit Department, the Legal Department and the Compliance Department.

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Not all the Banks agree on the measures to meet the IT structure requirements: the options range from adapting the systems currently used (28%) to purchasing new systems (20%) or implementing mixed systems (30%).

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Most Banks (92%) have not calculated yet the investment to be made in relation to the Bank's annual expenditure budget.

Half of them have not decided yet how they will finance the implementation costs, the other half are planning to use their own resources (45%)

Half of the Banks in South America have decided to use their own resources to finance the implementation; in Central America and the Caribbean, 4 out of 10; and in Mexico, 3. Few banks have considered the possibility of resorting to International Credit Organizations.

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*Central Banks and Banking Superintendencies will be in charge of supervising the implementation of Basel II (77%)
It is feasible that they will interact with the Banks in each country (88%)*

D) SWOT MATRIX REGARDING THE IMPLEMENTATION OF BASEL II

Strengths

- » Most Banks consider Basel II to be a priority.
- » It may have a positive impact on the financial system of the Region and of each country.
- » It may have a positive impact on the country's economy.
- » For every 10 banks surveyed:
 - 9 think that Basel II will lead to the stability of the financial system and will change, for the better, the concept of the banking model as risk management.
 - 8 think that it will help reduce the country risk rating, make it easier for Banks in the country to access world financial markets and improve people's opinion of the financial system.
 - 7 think that Basel II will have a positive impact on their internal management systems, especially risk assessment.

Weaknesses

- » There are quite a few operational and cost-related problems to overcome.
- » The process may lead to important asymmetries between Banks.
- » Differences between the Banks risk assessment culture and the new methodology to be adopted.
- » IT and training costs are too high if we take into account the kind of business and the profitability of the operations in the Region.
- » Very few organizations have accurate risk assessment models.
- » Lack of historical risk databases.
- » Lack of local regulations.
- » It is likely that small Banks performance will be negatively affected
- » Its implementation is not regarded as an incentive to business or to the Bank's internal communication and alignment process.

Opportunities

- » The adaptation of certain requirements and time frame.
- » Banks' interest in Basel implementation.
- » Banks would highly appreciate FELABAN AND IDB'S support in the implementation of Basel II.

Threats

- » The characterization of most countries as emerging economy countries.
- » 5 out of 10 Banks think that the implementation process may have a negative impact on the financial systems and the Region economies.
- » Most Banks are in the pre-study or early stages of the implementation process and have not calculated yet the investment to be made.
- » Slightly over a quarter of the Banks in the region have already calculated the degree of risk mitigation and therefore, loss reduction due to the implementation of Basel II and 50% of said segment do not think its implementation will actually result in loss reduction.