

**UPDATE ON THE ECONOMIC AND BANKING ENVIRONMENT  
OF LATIN AMERICA**

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It is a pleasure to have the opportunity to participate in this important conference and to be on the same program with my esteemed colleagues from the Federal Reserve. We have heard this morning from Governor LaWare on broad supervisory issues and from President McDonough about the role of international banks in U.S. markets. I have been asked to discuss the economic and banking environments in Latin America and the challenges we face there in supervision and regulation. As I am sure you know, the economic and political changes that have taken place in Latin America over the last several years have been truly momentous in their historic significance. This significance is perhaps greatest for the people of those countries who stand at long last on the threshold of economic development and growth that is the basis for higher living standards for all their citizens.

Because of these breathtaking changes, I believe that Latin America may finally be on the road to fulfilling its great potential. However, the region still faces many problems that hinder its acceptance as a full member in the community of advanced economies, including free access to foreign banking markets. For instance, since the passage of the Foreign Bank Supervision Enhancement Act (FBSEA) two years ago, the Fed has approved only one foreign bank application from a Latin American country. It was from Banco de Chile. This solitary approval

compares with 13 other approvals in that same two-year period for nine banks based in Asia, mainly from Taiwan and South Korea, and four in Europe. This comparison alone may be more revealing than anything else I say about the complexity of the situation in Latin America.

I know from personal experience that it has been very frustrating for Latin American bankers who wonder why the Fed has been so chary in its approval of Latin American foreign bank applications. The situation is also frustrating for our examiners who must deal with a complex and rapidly changing environment in Latin America, which does not make their job any easier. In addition, the recent closing of the second largest bank in Venezuela along with its Edge Act affiliate in Miami this January, provides ample evidence that banking and supervision in Latin America is in a state of flux.

This morning I would like to give you an "insider's view," so to speak, on the progress we have been making with Latin American banks and their supervisors in fulfilling the requirements of FBSEA. I will conclude with a few remarks about the promise for the future of Latin American banking in the United States. Before doing that, however, I would like to set the stage by providing some information about the economic, financial, and banking environment in Latin America.

### **The Economic and Financial Environment of Latin America**

As a region, Latin America continues to enjoy a meaningful economic recovery from a ten-year period, often called the Lost Decade of the 1980s, when stagnation, accelerating

inflation (and, in some cases, hyperinflation), and net capital outflows plagued various countries of the region. The Organization for Economic Cooperation and Development (OECD) forecasts a 3.5 percent rise in the gross domestic product for the region as a whole in 1994, building on about 3 percent regionally last year. The range runs from negative growth of about half a percent in Venezuela to about 4.5 percent in Chile and nearly 5 percent GDP growth in Argentina and Peru.

Much of this growth is being sustained by the success of many countries in reforming macroeconomic policies and in introducing market-oriented structural reforms. Deficit reduction, more credible monetary policies, and privatization of state-run enterprises have been successfully implemented in many countries of the region. Inflation has been slowing in most of the major countries, although Brazil is still a significant exception to the rule with inflation of about 40 percent *per month*. However, economic stabilization measures have not been without pain, as witnessed by civil unrest in Venezuela and Mexico, including Chiapas and Tijuana where the leading presidential contender was assassinated last week. Overall, though, I believe the fundamental change in the economic outlook for Latin America is truly remarkable.

Importantly, these monetary and fiscal policy reforms have succeeded in bringing flight capital back to the home countries and in persuading American, European, and Japanese investors to make new investments in the region. The OECD estimated that inflows of capital into the region tripled from around \$16 billion in 1990 to about \$50 billion in 1993. In Chile, this financial turnaround has been aided by the creation of private pension funds, which will serve

as a major source for investment capital. On another encouraging note, other Latin American countries are beginning to emulate Chile. In addition, the stock markets in various countries are much more vibrant than they have been in past years.

Everything I have mentioned so far is all the more remarkable given the history of debt crises in Latin America. There have been three in the past 100 years, the most recent being that of the 1980s when Mexico and other lesser developed countries fell into arrears. I do not have to remind those of you in this room how that crisis affected our money center banks.

Before moving onto a discussion of the banking environment, I would like to discuss the financial reforms in a bit more depth. Let me begin with the most obvious financial change, namely, the considerable reduction in the amount of troubled external debt since the onset of the debt crisis in August 1982. According to World Bank figures, commercial bank debt has been reduced by nearly \$100 billion from 1986 to 1992, a decline of almost half. Some countries are completely out of arrears while most have established comprehensive programs for reduction of both debt and debt service. Furthermore, much of the renegotiated debt has been securitized, thereby significantly spreading the risk.

Both the level and composition of financing have become more varied. Whereas in the 1970s and early 1980s by far the most common form of meeting credit needs was through foreign commercial bank lending, such traditional loans are now infrequently made. This drop is largely the result of an understandable reluctance on the part of foreign banks to extend traditional loans

in Latin America after the problems of the past decade. Higher capital standards that banks are required to meet have tended to reinforce that reluctance. I mentioned a moment ago that the debt crisis of the 1980s was the third within Latin America in the past 100 years. It differed from the previous two due in part to the constraints of Glass-Steagall, which prohibited U.S. commercial banks from selling bonds to the general public. As these constraints are gradually eroded, and as U.S. banks expand operations in such less constrained markets as London, we are again seeing more sensible, risk-spreading financing via securities.

While bank loans have diminished in volume, securities--both bonds and equity--are becoming more common. This growth in securities is fairly broad in terms of issuers. Privatization of government-owned industries has been accompanied by major issues of new securities. In addition, there are encouraging signs that private-sector corporations, especially exporters, have been able to issue equity shares and commercial paper abroad.

With this shift in the form of financing has come a shift in the composition of creditors. Along with commercial banks, which are involved through securitization, underwriting, and trade finance, as I noted, we are seeing more investment banks and institutional investors. Likewise the national composition of creditors has broadened. Aside from a higher volume and greater diversity of sources of funds, there has been more than a twofold increase in foreign direct investment from 1990 to 1993, according to World Bank figures. This growth is no doubt due to the more favorable financial and economic climate implied in all of the foregoing.

Again, the main reason for this healthier financial outlook is macroeconomic policy reforms that have succeeded in lowering inflation, rekindling growth, and increasing the creditworthiness of many countries. Market reforms such as tariff cuts, reductions in other barriers to trade and foreign investment, and privatization have been vital as well. Also, the decline in interest rates, especially in the United States, has lowered debt service burdens and made refinancing easier.

Notwithstanding these very favorable developments, there are some significant hurdles that remain. Among the evolving economic and political reforms taking place in many countries, one area that has not yet become firmly implanted is private property and contract law. In the United States, we take such laws for granted. However, in countries where nationalization has been a recurring theme, private property exists on shaky grounds. Setting up an enduring legal system as a foundation for newly privatized companies and property is a daunting challenge, but one that must be met. Otherwise, private and corporate citizens will continue to operate as though the government could take their property at a moment's notice. It is in fact this very real fear of enforced nationalization that caused the extremely complex pattern of offshore holdings that developed in many Latin American countries and, for our purposes, most particularly among the banks in the region.

The other large hurdle yet to be cleared is the establishment of a supervisory and regulatory framework for banks. The encouraging news is that many Latin American countries have begun to overhaul their outmoded banking laws to bring their banking systems more in line

with international standards of regulation. I am much encouraged by developments in Colombia, Chile and Argentina, for example. But now comes the hard part--the actual implementation of these new laws.

### **The Banking Environment in Latin America**

If I were to ask any of you here today to describe your impression of Latin American banks, I would not be surprised if "offshore operations" and "money laundering" were the first phrases out of your mouth. Of course, your impression would not be true for every country, but, fairly or unfairly, this impression is exactly what Latin American banks and their supervisors must confront when they apply to open foreign offices in the United States. For instance, money laundering is indeed a reality in many Latin American countries (as it is in the United States), made more complex by the existence of flight capital. It is often difficult to distinguish between the two; and the fact that some Latin American countries do not have laws against money laundering complicates matters further. I would make four observations about the banking environment in Latin America:

First, the fear of nationalization or recurring bouts of high inflation has created a general distrust of government. Let me give an example of the effect this distrust has had on banks. Banco de Crédito del Perú, a private-sector Peruvian bank, had set up significant offshore operations in the Cayman Islands that were literally out of the reach of the Peruvian government. When the government nationalized the banks in the late 1980s, the bank, for the benefit of its shareholders, simply spun off that entire operation, which has continued to function as a private

bank. The organizational structure that allowed this spin-off to happen is fairly common within Latin America. Highly complex organizational structures, usually involving offshore holdings in so-called secrecy jurisdictions, were deliberately set up to move wealth out of the reach of the governments and into hard-currency investments so as to maintain value.

Second, as you can well imagine, moving businesses offshore to places like the Netherland Antilles, the Bahamas, and the Caymans causes serious structural problems, which hamper thorough bank examinations. These confusing organizational structures and the historical lack of consolidated financial statements in the region greatly frustrate proper analysis. As banking laws are now slowly changing to require financial statement consolidation, it has been our observation that Latin American banks have done such a good job hiding their offshore holdings from their governments that they are having trouble finding their holdings themselves.

Third, in general, many Latin American countries have reasonably good bank supervision within their borders, although the same attention has not been paid to offshore operations. Needless to say, such a system prevents consolidated, comprehensive supervision and regulation of banks--a legal prerequisite for any bank desiring to enter the U.S. market.

Fourth, there is the soft currency issue. Since Latin American bank capital is generally held in soft currency, banks there may have the tendency to become over-dependent on U.S. affiliates for hard-currency liquidity. At the same time, Latin American banks are interested in preserving the wealth of their customers by converting it to hard currency.



These four observations give a good sense of the environment in which Latin American banks operate. But, of course, there is also the broader backdrop of banking changes on a global level. While the Foreign Bank Supervision Enhancement Act came in response to the problems revealed by the collapse of BCCI, in a larger sense, it represents a continuation of earlier moves toward international bank supervision. From the mid-1970s, we have seen a slow movement from the view that bank supervision is unilateral to the current view that it must be multilateral in order to protect the international banking system.

This movement began with the formation of the Bâsle Committee in Switzerland in the mid-1970s, which was established in reaction to the failure of Herstatt Bank. We often think of Bâsle mainly as the source of international capital adequacy standards. However, the committee actually originally addressed itself to two propositions: that no foreign bank should be able to escape supervision and that supervision should be adequate throughout the world. Currently, many other countries besides the G-10 countries have adopted the Bâsle capital requirements. I expect market forces will bring increasing pressure to bear on banks of all countries, including those in Latin America, to meet the internationally agreed-upon capital rules. Meanwhile, FBSEA has made clear what is expected of foreign banks applying to enter the U.S. market: consolidated, comprehensive supervision of well-capitalized and well-managed banks.

### **Challenges for Supervision and Regulation**

This brief overview of the complex banking environment, both globally and within the Latin American countries, will, I hope, make it easier to understand the many challenges facing

those who are involved in the supervision and regulation of Latin American banks--both in-country and in the United States.

Before discussing these challenges, I would first like to point out that there are "good" banks in "bad" countries and "bad" banks in "good" countries. As examiners and regulators, we cannot assume that every bank from a country with a well-regulated financial system will be well capitalized and well supervised. Nor can we assume the opposite--that there are no sound banks in a country that lacks comprehensive supervision. As Latin America slowly evolves toward improved supervisory programs, a major challenge will be sorting out the good from the bad among those banks presently operating in this country. In our part of the United States, we are currently engaged in sorting out the problems left by one of the "bad" banks. In early January of this year, Banco Latino, the second-largest bank in Venezuela, failed.

Banco Latino had an Edge Act affiliate in Miami with about \$250 million in deposits. As you know, Edge Act corporations must be well capitalized because they are uninsured institutions with concentrated portfolios, and they cannot come to the Fed's discount window for liquidity support. Unfortunately, the Miami-based Banco Latino affiliate was unable to fend off a run when its parent bank failed, and depositors began to line up outside the Edge in Miami to withdraw their money. The affiliate then took the unprecedented action of seeking protection in U.S. bankruptcy court.

Similarly, a large Curaçao affiliate of Banco Latino experienced a run, and it, too, was intervened. At this time, it seems that losses on a massive scale were present in both Caracas and Curaçao. This is an appropriate point at which to touch on the concept of multilateral supervision, which I mentioned earlier--namely, that a partnership must be established among supervisors. In the case of Banco Latino, this partnership broke down. The supervisor in Venezuela was not informed of the problems at home and seems to have been completely uninformed of the problems in Curaçao. Although the failure of this Latin American bank and its Miami-based Edge Act affiliate did not affect the U.S. system, it did starkly remind those of us involved in international bank supervision of the possible adverse results that can arise without strict and comprehensive supervision and regulation of bank operations.

Let me now turn to the basic problems our examiners encounter in Latin America when they try to determine whether a bank fulfills the letter of the FBSEA law. The first problem is the lack of consolidated accounting. As I noted, banks in many countries have not been required to file consolidated balance sheets that incorporate their out-of-country operations. In addition, accounting rules vary significantly from country to country. These two facts pose serious difficulties for U.S. examiners, who are used to pulling up standardized consolidated balance sheets on a bank as their first order of business.

The second problem arises when our examiners try to determine whether the supervisory body in a Latin American country is informed of the activities at all locations of the banks it supervises. We have been working closely with some supervisory and central banks in widening

their reach. However, this kind of change to truly comprehensive supervision does not happen overnight as we saw in Venezuela, where, ironically, the new banking laws had gone into effect only two weeks before Banco Latino failed.

I could list more problems faced by examiners, but these two really encompass more specific issues. They also lead directly to my next point, which is that, in such a situation, perhaps the real challenge for examiners is to remember that effective supervision must be dynamic. In international bank supervision the important question to answer is, What is the capacity of the home bank to support operations abroad? The concern is to be sure that the parent bank is not dependent on a foreign affiliate for hard-currency liquidity. Just as we expect domestic bank holding companies to represent a source of strength to banking affiliates, we expect financial strength to be demonstrated by the foreign bank.

No matter how we handle these issues, though, the toughest challenge for examiners of Latin American banks is determining the financial capacity of the consolidated organization. This task will require many resources because of the general lack of consolidated accounting in many of these countries.

### **Promise for the Future**

At the beginning of my talk, I mentioned that the one bank application the Fed has approved since FBSEA was from Banco de Chile. Chile has become the model for the rest of Latin America in terms of its attention to economic reforms and banking supervision. Its banking

laws were overhauled in the late 1980s. We were able to determine that the home country supervisory authority, the Superintendency of Banks and Financial Institutions, subjects Banco de Chile to comprehensive supervision and regulation on a consolidated basis.

Following Chile's lead, Argentina is in the process of further banking overhaul, Ecuador introduced a new law in 1993, and Peru has sent an examiner here to study our system, which may portend more changes following its financial system reform in 1991. Privatization of banks and new independence for central banks and supervisory bodies have been following close upon one another. I believe we can attribute these reforms directly to a spreading recognition of the importance of consolidated supervision in countries that want banks to be able to do business in the United States. For example, the president of the Argentine central bank told an officer of our Bank last summer, "We understand that if we are going to re-enter international markets, we cannot do it without strong supervision."

Equally promising, I believe, is what we at the Atlanta Fed have been able to accomplish since 1988 when we began doing independent exams of U.S. offices of foreign banks. Starting in 1989, our top international people began making visitations to many Latin American countries in order to open lines of communication. The result has been an increase in knowledge of Latin American regulations by our examiners. We have also begun the process of moving toward partnerships with supervisors in various countries. Members of our international bank examination staff have traveled widely in the Latin American region, and we intend to increase these contacts. I hold out great hope that this kind of activity on our part will make a difference

in how well Latin American countries can solve their supervisory problems to meet the requirements of the Foreign Bank Supervision Enhancement Act.

## **Conclusion**

In summary, the complexity and sheer amount of changes taking place on both economic and political fronts in Latin America causes tremendous challenges for our bank examiners. Using Chile as a model, many countries have unburdened themselves of misguided regulations like foreign investment barriers and government mandates that required banks to allocate credit to certain industries and sectors of the economy. We are now seeing real opportunity for sustainable growth, particularly because inflation is down significantly in most countries and because many Latin American countries have introduced market-based reforms.

However, this rejuvenation can continue only with strong regulation and strong banks--not just U.S., European, and Japanese banks, but also strong Latin American banks. To keep its momentum, Latin America must have banks that can meet the stringent but sensible rules of FBSEA. Only then can they begin to participate in the U.S. market through multilateral supervision.

It is true that Latin American banks, in the main, still operate with a certain organizational vagueness or complexity that is meant to protect their wealth from the reach of governments. They also move their wealth into hard-currency investments in an effort to maintain value. This behavior, compounded by the general lack of consolidated accounting and

comprehensive supervision, without a doubt causes difficulties for examiners. But there is a solid basis for hope that this behavior might change. I believe the day is coming when we will be able to approve many more applications from Latin American banks as our partnership bears fruit. In the meantime, our goal is to recognize the underlying problems in this part of the world and work with Latin American supervisors to help make comprehensive, consolidated supervision a reality.