Systemic Bank Risk in Brazil

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Plan of the Discussion

• Preliminary Comments
• Comments on the Analyses Presented
• Comments on Bank and Sovereign Risk
• Comments on Brazil
Preliminary Comments

• We are witnessing good times in Latin American Banking systems
• Strong credit growth, ample liquidity
• This is a good time to also consider the risks
• Retail and credit cards are growing very fast, do we really know the risks?
• Sovereign risk remains important in several countries – see IDB’s 2005 IPES Publication
• Ample evidence for twin crises: banking and fiscal
• Applaud the authors for attempting to quantify banking sector risks, this is not easy
This Paper

• A sophisticated and detailed study of bank risk in Brazil
• Represents a very significant amount of work over an extended period of time
• Considers banking sector risk and impact of sovereign risk on banking sector risks
Analyses Presented

• Individual banks, no Government default
• Individual banks with Government default
• Systemic Risk in banking system
Individual banks, no Govt default

- Simulation of macro parameters and credit portfolios

  - Credit-risk transition probabilities (system vs individual, crisis vs normal)
  - System vs individual interest rates
  - Choice of 99% rule?
  - What is required capital given VAR rule?
  - What can we say about Basel calibration?
  - Majnoni and Powell (Economia 2005) claim Basel II may call for higher capital requirements, 99.9% of Basel too strict, correlation assumption in Basel too low
  - Emerging countries should reconsider calibration
Sovereign Default

- In addition to private sector lending, banks may lose 0%, 10% or 25% of value of Government loans.
- Issues:
  - What are public sector loans exactly?, Volatility of Brazilian bond prices
  - Use of history) as to analyze what would happen in a default? E.g.: Argentina.
  - What would effect of depositors be on sovereign default?
  - Should an individual bank have capital to withstand the default of its sovereign?
  - Underlying problem is that these assets represent such a large percentage of banks’ assets, moral hazard created.
Systemic Risk

- Multiple bank failures, 3 groups
- Issues:
  - Interbank relations are complex, not just interbank loans, what is effect on depositors?
  - If failures put financial system at risk, Government intervention will occur.
  - Could consider riskiest individual bank’s effect on next two riskiest individual banks.
  - Only the channel from the sovereign to banks is considered, not the opposite.
Bank and Sovereign Risk

• This paper draws attention to risk of public sector lending in emerging economies
• There is a clear need for a Standard here
• Likely that a capital requirement approach not enough, need for an absolute limit
• Limit for public banks should be close to zero
• Basel needs to consider emerging market issues like this head-on to be a useful global standard
Final thoughts on Brazil

• Banks are heavily exposed to sovereign
• Credit to corporate sector from private banks small and expensive
• Corporate credit then subsidized through public sector banks
• The highly segmented credit market implies monetary policy thru’ high and variable interest rates
• This maintains the segmented credit market and high bank exposure to the Government
• Need for greater coordination between monetary and credit policy and move to a better equilibrium