GUATEMALAN EXPERIENCE ON REGULATION OF THE FINANCIAL SECTOR

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General

Reviewing the history of Guatemala we can identify three major events that mark major changes in the definition of the institutional and legal structure of banking and monetary system in my country. The first dates back to 1924 with the installation of the Guatemalan Quetzal currency legal tender. This regime is characterized by its stiffness to react to the global environment of the Great Depression and World War II, besides being accompanied by a deflationary fiscal policy and a continuous contraction of bank credit facilities.

Later in 1946, with the advice of officials of the Board of Governors of the Federal Reserve System of the United States, laws that governed the monetary and banking operations for more than 56 years in the country were enacted. This scheme experienced major adjustments in their 80's and 90's, as they marked the events of recorded history, according to international flows led to an acceleration of financial liberalization processes supported by principles of competition, deregulation and reduction of the distorting effects of state intervention in economic activities. However, despite many warnings that such actions were accompanied by a strengthening of prudential regulation and greater oversight, now question the speed with which such actions were taken.

Therefore supported by the dynamic growth of financial transactions, the emergence of new corporate structures, internationalization and sophistication of financial transactions and the issuance of international standards in financial matters, it became necessary to modernize these legal instruments taking place the reform of 2002, in which the Monetary Law, the Organic Law of Banco de Guatemala, the Law on Banks and Financial Groups and the Financial Supervision Act in force today, were approved.

It is important to highlight that the last reform incorporated the components of the current scheme of bank safety net that includes, among others, an explicit scheme of deposit insurance and bank resolution scheme, with the objective of maintaining user confidence in the system and minimize the damage that may result from the exit of failed institutions.

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1 Paper prepared for the UNCTAD meeting multiyear, March 2010.
Reform Promoters

As demonstrated by international experience, financial reforms have generally been promoted after the crisis that countries are experiencing or macroeconomic shocks. But one aspect is also important to note, is the perspective that guide them and the benefit that usually is intended as the strengthening of the financial stability.

Without wishing to be exhaustive, we can mention as an example some organizations that have played a decisive role in the regulatory and institutional perspective, as part of the driving forces of change in the international environment and by means of collegiate recommendations promulgate what it becomes, in many cases, in standards of best practices. Thus, the ideas promoting the changes that today our financial systems experience, resulting largely from the dynamics of change in financial regulations promoted, among others, by the World Bank (WB), International Monetary Fund (IMF); standardization bodies in monitoring and best practices as the Bank for International Settlements (BIS), International Organization of Insurance Supervisors (IAIS), International Organization of Securities Commissions (IOSCO) in the fight against money laundering, the Financial Action Task Force (FATF), in comparable financial information, the International Accounting Standards Committee (IASC).

Consequently, we have many institutions that have acquired over time, moral authority, issuing statements regarding their competence that should be evaluated and considered by those developing such activities. Therefore they gain legitimacy in the international environment and its observance is expected to become standards of good practices.

In this regard it is noteworthy that, in late 2000, Guatemala was evaluated by teams from the IMF, as part of the Financial Sector Assessment Program (FSAP). This work included assessing the degree of compliance with the standards cited. The result served to design the matrix to incorporate aspects of financial reform that culminated in 2002. For this reason it is considered that largely prudential standards represented an important parameter to strengthen the requirements for authorization of new entities, for the transfer of ownership of banks, capital requirements, requirements for disclosure, risk management, cooperation between supervisors and improving supervisory procedures and certainly one of the most important, improve resolution procedures and deposit insurance scheme. Also, the program provided access to technical and financial assistance to implement these recommendations.

On the other hand, seeking the benefits of financial stability, the supervisory body in the past years has stimulated research into possible sources of instability, with a pragmatic approach, visualizing the task as a prudent exercise to support regulation and monitoring of the system. For this reason, from 2007 documents that are prepared annually analyze the strength and prospects of financial system risk. This publication is designed to strengthen transparency and enhance market discipline and is available on the website of the Superintendencia de Bancos (www.sib.gob.gt).
Additionally, in the context of actions that tend to improve the legal and institutional framework governing financial activity, market players have also played an important role in monitoring the implementation of best practices by countries, and therefore to promote changes in the institutional and legal infrastructure. They have prepared assessment methodologies and indicators to illustrate the soundness of financial systems, thus is the case of the rating that is preparing eStandardsForum Doing Business - World Bank and International Finance Corporation, Global Competitiveness report - World Economic Forum, Millennium Challenge Corporation, among others.

A determining factor in the assessment undertaken by the degree of compliance to standards by each one of the countries lies in transparency. This in view of the fact that many of the organizations that are monitoring the progress in each subject supporting their analysis on information available to the general public and thus not one that is provided on a bilateral basis as in the case of the IMF, to cite a example. Therefore, the supervisory body carried out self-assessment exercises to compliance with the standards in the banking and insurance matter, as well as on money laundering matter, adding them to the information available on the Internet.

The recent report by Fitch Ratings\(^2\) on Central American banks reveals that the economy like Guatemala's banking system showed some degree of resistance to global economic and financial crisis, which is reflected in the economy is recovering gradually without have experienced increased pressure for institutions participating in the market, this leads to a better level of financial stability.

**Changes in the structure of the system**

Guatemala is located geographically in the Central American region, with 13 million inhabitants and a GDP of U.S. $ 37.8 billion by 2009. The Guatemalan banking system operates under the central banking scheme, whose ultimate authority is the Monetary Board. In this system, the Bank of Guatemala as a central bank is responsible for monetary policy, exchange and credit, while the supervisory function is exercised by the Superintendencia de Bancos mandated by the Political Constitution of the Republic.

In December 2009, 18 banks operated in the country that managed assets of U.S. $ 16.7 billion representing 82.7% of the assets of credit institutions operating in the country. There is a state bank and it has 1.8% of assets in the market. Also at that date, 79.2% of bank assets were concentrated in 5 banks. Over the past 5 years it has been a restructuring of the square, featuring 7 fusions of entities and 2 processes of banking resolution that was applied by the monetary authority.

As mentioned, the main components within the scheme of bank safety net provides a bank resolution scheme, which was activated on October 20, 2006 and on January 12, 2007 with the suspension of operations of two banks.

The first case known as Bancafé, gained importance because it was the fourth largest bank, which represented the 8% of the system with 1,011,809 deposit accounts. This situation was triggered by the exposure of the financial group that caused a banking subsidiary based in Barbados that held securities in custody in the U.S. broker of commodities and futures contracts Refco. However, as shown in the literature of bank failures, in this case were identified elements that were added to poor management practices and high levels of credit-linked.

A timely implementation of the mechanisms under the safety net, and the performance of the supervisory body, away from all odds, allowed the cessation of operations will not cause negative effects on key macroeconomic variables and minimize the risk of a systemic effect. It is noteworthy that international agencies accompanied the process and expressed satisfaction with the implementation of bank resolution mechanism.

Despite the obvious success of these events the attention of bank resolution, a new visit by IMF staff, to the scene of the current crisis in international financial markets, recommended revising the bank resolution scheme to more severe stages and evaluate the response of these mechanisms as well as the level of coordination of state agencies that participate in such a scenario. To meet this recommendation was programmed a simulation exercise involving external consultants and key government officials who would be involved in a bank failure in significant quantities, these being Banco de Guatemala, Ministry of Finance and Superintendencia de Bancos.

The simulation exercise was successful in its assessment of the level of response and coordination of government authorities in emergency situations, although some protocols need to improve communication in crisis situations. It also revealed the need to strengthen the capital of the Trust Fund for Bank Capitalization and the Fund for Savings Protection, as well as flexible mechanism lender of last resort to emergency situations of significant dimensions for the system.

However bank failures leave their mark on the heritage and minds of users of financial services and notwithstanding the continuing efforts to regain public trust user recovery is gradual. For this reason, efforts directed to this end should be assigned progressively, aware that public confidence is a tutelary asset.

As part of the action taken to regain public trust user a campaign of financial education was launched, that includes de preparation of material aimed at raising the level of knowledge of banking practices and the risks inherent in their products. In this line of action, the vice presidency has led a program of government transparency which is part of the supervisory body, as part of the actions taken includes issuing a law on free access to information.

In the supervisor's scope of action it was established a customer service office, which aims to attend any queries from the general public that relate to ongoing operations of the supervised entities or with the functions of the supervisor. Also organized a special investigation team, that among other attributions receives and investigates complaints at
an administrative level of possible integrated financial intermediary operations undertaken by people outside the law, resulting in complaints to prosecutors, the state agency responsible for criminal prosecution, and in publications in newspapers alerting the general public of such anomalous practices.

Also there are considered conferences to executives of supervised entities to strengthen corporate governance practices and where the adverse effects of bad banking practices in public confidence are analyzed.

**Cooperation between supervisors**

In terms of regional supervision, with the purpose to coordinate supervision efforts in Central America, on September 12, 2007, members of the Central America Council of Superintendents of Banks, Insurance and Other Financial Institutions signed a multilateral memorandum of exchange and mutual cooperation and cross-border consolidated supervision. This instrument led to the formation of a liaison committee, which, under the coordination of the Superintendency of Guatemala, implemented from January 2009 strategic actions that include exchange of information, approval and monitoring procedures border surveillance exercise. In this process regularly scheduled virtual meetings, in order to follow up on the main risks of regional financial conglomerates, with emphasis on the evolution of liquidity. For this work and because this is sensitive information was necessary for each oversight body to appoint persons to guarantee their integrity and confidentiality. The protocol and operational difficulties have been successfully cleared and procedures are working properly.

Regarding the monitoring procedures, the liaison committee conducted an assessment of experience in supervision and consolidated supervision of member countries, concluding in a draft manual that presents the procedures to be used for field and office supervision, this includes inter alia, procedures for assessing levels of risk concentration, corporate governance and technology platform. It also set out an annual work plan for the regional groups that results presented at meetings of the Board of Supervisors within Central America.

Additionally it has signed agreements on cooperation in financial supervision and money laundering with other supervisory bodies, improving supervisory skills.

**Effects of the international environment**

The global crisis affected the Guatemalan economy through the fall in exports, remittances, tourism receipts and net inflows of private capital. The monetary authorities' strategy has been to adopt moderately countercyclical policies, maintaining a flexible exchange rate, progress in implementing reforms to strengthen the financial sector and other priority actions contained in the National Economic Emergency and Recovery. One of the law projects derived from that program, which is under consideration in Congress, is the Law of Public-private Partnerships that will allow the
implementation of infrastructure projects with private resources, which consequently will contribute to the improving conditions for attracting foreign investment.

According to the evaluation of the global economic environment, IMF experts estimate that world trade will grow 2.5%, below the average observed in the period 1990-2008 (average 6.6%). Because of this, in the Guatemalan context, economic growth is estimated between 1.3% and 2.1% for 2010, these estimates the role of economic agents' expectations is a key factor to economic recovery process, since an improvement in them regain the confidence of the banking system for granting credit to the private sector, which in turn will bring out the growth of consumption, investment and economic activity in general.

As discussed above, following the departure of two market institutions and the implementation of bank resolution scheme, the bank became conservative in their policies of placing, showing a slowdown in portfolio growth during 2008 and a stagnation of bank credit during 2009. The slight mobility that was appreciated in 2009 was mainly due to the effect of a depreciation of the quetzal against the dollar during the second semester, showing an appreciation of foreign currency assets. This effect was reversed in early 2010 with an adjustment to the appreciation of the currency.
In relation to the investment portfolio, banks held in December 2009 to $ 3.9 billion in the investment portfolio representing 23% of total assets. This portfolio was made up to 82.8% from investments in government securities, central bank and official institutions and 12.8% for mortgage bonds. One of the main structural problems is the poor development of secondary market values.

The implementation of incentive packages for several countries and the consequent adoption of fiscal policies that support such measures, have awaken on taxpayers and economic agents the need to propose actions that help to prevent this situation from recurring. In this sense, statements emerge from the G-20 and reports that highlight among other recommendations, to review the level of capital debt that internationally active institutions operate, for example, documents that study the Northern Rock case show up leverage levels of 46 times its capital. Given the socio-cultural characteristics of the population, and traditional Guatemalan banking the use of structured instruments has not proliferated, consequently the level of leverage is moderate about 10 times its capital.

Main Initiatives

In response to the volume of investments held by banks and limited secondary market, in a complementary and temporary, facilitated the early redemption of investments constituted the central bank to provide liquidity in domestic currency, representing Q100 million in 2008.

Similarly it was necessary to adopt some temporary monetary policy measures that provide foreign currency liquidity to the banking system due to the contingent cancellation of foreign credit lines, as lack of liquidity in international markets. With this mechanism was provided with U.S. $ 142 million system until May 2009. In addition, greater supervision visits at the institutions supervised.

Additionally, some actions were taken aimed to strength prudential regulation, and dispositions were issued to strength gradually the generic reserves for credits of doubtful recovery; regulation was issued to strengthen the banking equity, covering the
credit exchange risk, for managing liquidity risk and amendments to the existing banking legislation were proposed.

In this last case, the reform that was suggested and in study at the Congress incorporates prudential measures, such as strengthening the concentration limits to prevent exposure of transactions with related companies; provide alternatives to proceed with the implementation of the banking resolution scheme; reducing the risks of offshore operations; and review the performance of lender of last resort in systemic cases.

Also on the agenda of modernization it is considered to promote the approbation of the Law on Insurance Business; the preparation of law projects aimed at regulating the securities market operations, credit cards and microfinance. In these projects we have considered the designation of a supervisory and regulatory body for such operations, implying a migration of the auto-regulatory scheme they are operating with currently.

The future will provide a cultural change, after experiencing financial damage it is time to review the structures and the way we do things, which arise countless advices from the experts. Many agree that the main actions should be oriented towards the regulation, supervision, corporate governance and risk management of financial institutions. However, financial stability is perceived by the public's confidence in the infrastructure and institutions that make up a financial system so it should also promote initiatives that strengthen the discipline, transparency and improve the mechanism of cooperation among supervisors.

In conclusion, the mechanisms of the safety net are subject to improvement, nevertheless functioned efficiently in time. The main difficulty may always be the speed with which future changes are adopted, its implications and under requiring much consensus.