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Professor titular de Direito Comercial da Faculdade de Direito da Universidade de São Paulo

PAULO DE LORENZO MESSINA

Advogado

RACHEL SZTAJN

Professora livre-docente de Direito Comercial da Faculdade de Direito da USP; Advogada em São Paulo

DOUTRINA

"CAPITAL REQUIREMENTS AND THE BRAZILIAN BANKING SYSTEM"

PAULO DE LORENZO MESSINA

1. INTRODUCTION

The banking regulation regarding minimum capital requirements is clearly moving towards closer standards. As the june 19, 1992 Capital Equivalency Report of the Board of Governors of the Federal Reserve System and of the Secretary of the Department of the Treasury, both from the United States of America (US) points out, capital adequacy standards for banks, in twenty two foreign countries surveyed generally fall into two categories: risk-based capital requirements — latter explained in this paper — or requirements based upon the amount of capital in relation to total assets or categories of liabilities, disregarding the risk carried by them. Only two (Brazil and Venezuela) of the twenty two countries included in the above mentioned report continue to rely on the method of ordinary capital measure instead of a risk-based capital standard.[1]

Considering the competitive advantadge of international banks over banks restricted to domestic markets[2] and the absolute necessity to follow clients abroad, either on the present war for a piece of the international commerce (exports) or on the run for lower costs of production (imports),[3] Brazilian banks

1. The survey includes Belgium, France, Germany, Italy, the Netherlands, and the United Kingdom, from the European Community and members of the Basle Committee; Canada, Japan, Sweden, Switzerland and the United States, members of the Basle Committee; Irland, Spain, Austria, Finland, Australia, Hong Kong, Israel, Korea, Mexico, and Taiwan, not members of the Basle Committee that have adopted capital requirements under the general lines precribed by the Basle Framework. For a explanation regarding the Basle Committee see part IV — The Basle Accord for Capital Adequacy of Banks, in this paper.

2. International banks have the ability to raise or supply capital in any country, are less dependent on local money markets and, thus, better able to satisfy their customers's needs. Also, they can take advantadge of the spreads in interest rates, and are less bound by the constraints of host countries monetary policy. Dimitri A. Germidis, Charles Albert Michalet, *International Banks and Financial Markets in Developing Countries*, Paris, Development Centre of the Organisation for Economic Co-operation and Development, 1984, at p. 27.

3. In the year end 1992, Brazilian surplus in the trade balance reached U$ 15.7 billion, due to U$ 36.2 billion in exports and U$ 20.5 billion in imports.

face the chalenge of how to conciliate the historical tendence of the country's public international policy, which is clearly marked for avoiding participation in international treaties and conventions, with the international harmonisation of the banking legal framework for minimum capital standards.

The purpose of this paper is to clarify what rules, if any, are actually applied by the Brazilian bank regulator towards the preservation of some desiderable minimum level of capital, and the eventual similarities with international tendencies. Further, what consequences can be predicted for Brazilian banks with international operations, considering the new legislation thas has been enacted in the main international financial centers (European Community, Japan and the US) and the present domestic legal system.

The first part addresses some general characterists of the Brazilian banking system, including an overview of the legal framework and some general data related to the banks with international activites. The second part summarizes the specific pieces of regulation regarding capital requirements for banks in Brazil. Then this paper marks relevant peculiarities of the systems of capital adequacy requirements elaborated by the Basle Committee for Banking Regulation and Supervision,[4] by the European Economic Community (EC), by the US, and by Japan. A conclusion is traced to discuss in what extent the international rules for capital adequacy of banks makes sense when considering institutions coming from very dissimilar financial centers. Some points against the general ideal that the capital requirements are a real protection for the safety and soundness of the international banking system are remembered for the readers. In addition, is it possible to create a level playing field for international banks starting from a standard of minimum capital based on risk assets? At the end, what are the implications for Brazilian banks, present in the international market, considering the actual legal disparities dealing with minimum capital requirements; is it mandatory the implementation of local banking regulation following the risk-based principles of capital adequacy in order to allow the maintenace of Brazilian banks with branches in foreign countries? The majority of the comments in the conclusion are based on the relation of Brazilian banks in the US and the EC markets, where they have more representative operations.

4. See part IV — The Basle Accord for Capital Adequacy of Banks, in this paper.

2. GENERAL CHARACTERISTICS OF THE BRAZILIAN BANKING SYSTEM

The Brazilian banking system[5] is primarily regulated by the Federal Law 4,595, enacted december 31, 1964. This law is the framework of the national financial system and, among other provisions, establishes the main public institutions and their respective attributions. Notwithstanding, the most significant change for the national banking system was introduced by the Resolution 1,524 (9.21.88) of the National Monetary Council (CMN) and by the Circular 1,364 of the Banco Central do Brasil, the Brazilian Central

5. For a report about the historical and structural trends of the Brazilian financial system see Francis A. Lee, James M. Botts and Rubens Penha Cisne, *Banking and Financial Deepening in Brazil*, St. Martin's Press, New York, 1991, at pp. 103-152.

Bank. These pieces of regulation created the so-called multiple bank[6] ("bancos múltiplos") which bear some characteristics of the German "universal banks". The multiple banks can perform the activities of commercial banks, investment banks, savings and loan institutions, and consumer credit companies, under the same license, being one single corporation. Insurance and leasing activities must be operate by separate entities, which might be subsidiaries of a multiple bank.

Despite of the modern concept of multiple banks, in effect since the end of 1988, the national financial system has been waiting new regulation since the promulgation of the Federal Constitution on october 5, 1988, which made reference that a complementary law should be enacted to govern the financial system, following the main constitutional principles of art. 192, disposing of: the conditions for the participation of foreign capital in the financial system, cosidering specially the national interest and the international agreements; the creation of a fund or insurance to guarantee credits, investments and deposits up to especific values; and the maintenance of a restrictive criteria to limit the transfer of savings from regions with income inferior to the national average to the more developed ones; and the conversion of credit cooperatives into banks; the involvement of banking institutions in non-banking activities, such as insurance. Foreign banks activities in Brazil are treated by Art. 52 of the Act of Transitory Constitutional Dispositions, a provisory annex to the Constitution of 1988, which determines that, as long as the conditions regarding the participation of foreign capital (Art. 192, III) are not enacted by a complementary law, the establishment in Brazil of new agencies of foreign financial institutions, and the increase of foreign participation in the capital of existent institutions remain prohibited. Nevertheless, there is a provision allowing any king of authorization resulting from international or reciprocity agreements.[7]

The CMN issues the main regulation for the domestic financial system, while the Central Bank has the authority to implement those rules, and to charter and supervise financial institutions.

Table 1 shows the number of authorized participants in the Brazilian market and respectives branches inside the country.

Banco do Brasil, a public company,[8] is the major international Brazilian bank,

6. The multiple bank concept was developed based on the Mexican model and with support from the World Bank. A multiple bank can operate with several departments, the so-called "carteiras", each one related to a specific activity and subject to different requirements (article 1 of the regulation annex at the Resolution CMN 1.524/1988). For instance, a single bank can have a commercial department and an investiment department, with some operations permited to be performed only by the commercial department (checking accounts, access to the clearing system, personal loans, etc...), some only by the investment department (corporate securities underwriting, administration of mutual funds), and some others in both departments (rural credit, corporate lending, trading in government securities, trading in gold, guarantee of foreign currency obligations).

7. The paragraph "único" of Art. 52 asserts that the general prohibition established by the article does not apply for authorizations resulting from international agreements related to reciprocity or of the Government interest.

8. Banco do Brasil S/A, is a stock corporation in which the Federal Government holds the majority of the common stocks, but it is a public company, with large participation of private investors holding mainly preferred stocks (no voting rights).

running branches in all international financial centers.[9] Ranked in 1991[10] as the 75th bank in the world by total assets size, Banco do Brasil operates, in the US, the main byer of Brazilian exports, a branch in New York and three agencies — Los Angeles, San Francisco and Miami — holding in these offices U$ 840.4 million in commercial and industrial loans, U$ 1,284.9 million in assets, and U$ 846.6 million on deposits (june 1991).

Table 1: number of national licensed financial institutions and domestic branches

INSTITUTION	CHARTERS	BRANCHES
COMMERCIAL BANKS	36	4,531
MULTIPLE BANKS	199	14,568
DEVELOPMENT BANKS	08	10
INVESTMENT BANKS	20	74
LEASING COMPANIES	64	225
REAL ESTATE CREDIT	25	162
SAVING AND LOAN	02	01
BROKERAGE/DEALER	646	1,276
CREDIT FINANCE COMP.	39	178
CO-OPERATIVE COMP.	840	—
OTHERS	1,611	4,850
TOTAL	3,490	26,875

Source: Banco Central do Brasil, march 02, 1993.

The data provided in Table 2 is an indication that Brazilian international banks do not originate significative percentage of their earnings from foreign markets, since out of sixteen Brazilian banks present in the US financial system, where is located the most significant concentration of Brazilian banks offices outside Brazil, just three sustain more than 5% of their total assets in the US foreign offices, only one maitains more than 15% of its assets in New York, and seven banks operate with less than 1% of their total assets in the US. Brazilian banks are present in Europe, mainly in the United Kingdom, with four branches and five representative offices in London.[11] In Japan only two banks are present through branches (Banco do Brasil and Banco do Estado de São Paulo — Banespa).

9. Francis A. Lee *et al.*, supra note 5, at p. 141, points out that Banco do Brasil operates 46 branches overseas.

10. Source: American Banker — 1992 Ranking the Banks — Top Numbers 1992 edition — july 1992, at p. 16-A.

11. Source: Bank of England Banking Act Report for 1991/1992, at p. 34.

Table 2: Brazilian banks in the United States — june 1991
(numbers in U$ million)

Financial Institution	Parent Assets	C & I Loans	Assets in the U.S.	Deposits in the U.S.	Ratio	Location of offices and type of activity
1. BAMERINDUS-CURITIBA	6,946	23.7	272.5	138.9	3.9	NY-B
2. BANDEIRANTES-SÃO PAULO	518	—	4.0	—	0.8	NY-B
3. BRADESCO-SÃO PAULO	13,004	6.4	51.2	3.4	0.4	NY-B
4. BCN-SÃO PAULO	2,191	21.6	90.2	3.5	4.1	NY-B
5. BANCO DO BRASIL-BRASÍLIA	75,767	840.4	1,284.9	846.6	1.7	NY-B,LA-A,SF-A,MI-A
6. BANESPA-SÃO PAULO	13,992	393.7	800.7	420.5	5.8	NY-B, SF-A, MI-A
7. ESTADO DO PARANÁ-CURITIBA	2,247	—	16.0	15.8	0.7	NY-B
8. EST. RIO DE JANEIRO-RIO DE JAN.	2,242	—	3.3	0.1	0.1	NY-B
9. EST. RIO G. SUL-PORTO ALEGRE	1,980	—	3.8	—	0.2	NY-B
10. ECONÔMICO-SALVADOR	4,308	0.5	20.5	6.9	0.5	NY-B
11. ITAÚ-SÃO PAULO	9,624	11.3	87.9	3.3	0.9	NY-B
12. MERCANTIL DE SP-SÃO PAULO	1,380	—	44.0	0.1	3.2	NY-B
13. NACIONAL-RIO DE JANEIRO	4,268	32.5	265.1	189.4	6.2	NY-B, MI-A
14. REAL-SÃO PAULO	5,746	35.0	183.1	38.0	3.2	NY-B, MI-A, LA-A, DC-B, CHI-E, HOU-E
15. SAFRA-SÃO PAULO	2,380	32.4	413.3	293.1	17.4	NY-C
16. UNIBANCO-RIO DE JANEIRO	4,223	9.1	59.9	9.6	1.4	NY-B
TOTAL		1,406.6	3,600.4	1,969.2		

Source: American Banker — 1992 Ranking the Banks — Top Numbers 1992 edition, at. p. 136.

Table Explanation — Ratio: the june 30, 1992 assets of the banks U.S. offices to the bank total worldwide assets the previous year end; NY: New York City; LA: Los Angeles; SF: San Francisco; MI: Miami; DC: District of Columbia; HOU: Houston; CHI: Chicago; B: branch; A: agency; C: corporation; E: edge bank; C & I Loans: commercial and industrial loans.

3. CAPITAL REQUIREMENTS IN THE BRAZILIAN BANKING SYSTEM

The regulations imposed by the CMN subjects the financial institutions to different requirements related to their capital. First, a minimum net worth,[12] based on the sorts of activities carried by a multiple bank, must be observed

12. The Annex of the CMN Regulation 1,524 (9.21.88), in Art. 3, refers to minimum "capital" plus "patrimônio líquido" (net worth). Capital means paid-up capital, and net worth consists of capital, capital's monetary atualization (reflects the adjustments resulted from the inflation on the nominal value of the paid-up capital), capital reserves, profit reserves (reflects the legal reserve, articles of incorporation reserve, contingency reserves, expansion reserves), revaluation reserves (consists of revaluation of real estate properties and assets of affiliates), profits or losses accumulated (consists of profits non distributed as dividends or losses non compensated), treasury shares of stock, and profits or losses from the current period. José Alexandre Colli, Mario Fontana, *Contabilidade Bancária*, Atlas, Fifth edition, 1990, at p. 138.

to receive the license from the Central Bank. Institutions already in activity when the CMN Resolution 1,524 was released have five years, begining in 9.21.88, to comply with the minimum net worth requirements. The miminum amounts required are:[13] commercial banking activities — U$ 9,600,000; investment banking activities — U$ 9,600,000; savings and loan activities — U$ 4,800,000; consumer finance activities — U$ 2,800,000; commercial banking activities under foreign majority ownership — U$ 19,200,000. According to the number and category of the domestic or foreign branches in operation, the amounts of net worth above described are increasead following the rules of Art. 4 of the CMN Resolution 1,524. For instance, a Brazilian bank is required to maintain, in addition to the minimum net worth for approval, a minimum net worth of nearly U$ 3,460,000 for each foreign branch in activity. If foreign exchanges operations are requested to be carried by a single domestic branch, almost U$ 3,200,000 are required to be added to the already imposed minimum net worth.

An important point results clear from the precedent comments: Brazil does not grant national treatment[14] for licensing foreign banks in its domestic market, since twice as much net worth is requested from them if compared with national banks.

Notwithstanding the requirements of minimum amounts of net worth, implying exigences of certain capital, Brazil has not yet adopted any king of capital adequacy standards based in the methodology of the Basle Accord (see below for detailed explanation), establishing minimum percentages of capital over assets adjusted as a function of their risk. However, the banking sector is heavily regulated and a myriad of conditions have to be accomplished. Among the Resolutions and Circulars released by the CMN and the Central Bank, respectively, the following deals with some sort of relevant limits.[15] — Resolution 1,556 (12.22.88) — total liabilities shall not exceed fifteen times the net worth;[16] Resolution 1,556

13. The minimum net worth requirements were established in amounts of National Treasury Bonus (BTN) with their value settled daily by the Central Bank, tending to reflect the effects of internal and external inflation. The conversion in equivalent U$ dollars is given in Francis A. Lee *et al.*, supra note 5, at p. 117.

14. Sydney J. Key, *Is National Treatment Still Available? US Policy in Theory and Practice*, 9 Journal of International Banking Law, Winter 1990, at p. 366: "A policy of national treatment, applied *de facto* as well as *de jure*, attempts to provide equitable treatment for entry and operation of foreign banks within a host country. The OECD National Treatment Instrument defines national treatment as treatment under host country laws, regulations and administrative practices no less favorable than that accorded in like situations to domestic enterprises".

15. Those operational limits have been enacted through releases from the National Monetary Council (CMN), the so-called "resolutions" (resoluções), and from the Central Bank, the so-called "circulars" (circulares). The Law 4,595 of 31 december 1965, attributes to the CMN the duty to formulate the monetary policy and powers to increase, to decrease, and to extinguish any kind of operational limits for banks, regardeless of a specific law for that purpose.

16. Net worth is defined for these regulation as total assets minus total liabilities, less the participation in capital of other financial institutions chartered by the Central Bank, and less investments in foreign branches and

(12.22.88) — total risk operations with one single client shall not exceed 30% of net worth, and total operations of underwriting or any kind of guarantee in those transactions for issues of a single company or investment in securities of one single client shall not exceed 30% of net worth; Resolution 1,775 (12.6.90) — aquisition of debentures and other securities, except shares of stock, issued by an affiliate is prohibited;[17] Circular 2,190 (6.26.92) — interbank deposits maintained with each bank shall not exceed 30% of the net worth, unless either both institutions are controled by the same shareholder, directly or inderectly, or one of them holds more than 20% of the other's capital; Resolution 1,942 (7.29.92) — the so-called "permanent assets", which comprises investments, fixed assets and deferred assets, shall not exceed 90% of the net worth.

Banks operating spot, future and options with gold shall comply with certain limits asserted by Circular 1,542 (10.25.89). Activities in the future and option markets with securities subjects banks to specific deposit guarantees, under the regulation and supervison of the Brazilian Securities Commission (Instruction CVM 120 of 6.6.92).

Besides restrictions intending to preserve the safety and soundness of banks, the CMN imposes regulations constraining the credit available through banks to the private and public sectors, by the determination of limits on the total amount of credit operations for each bank during certain periods.

In general, nothing from the principles of the Basle Accord capital standards, that provided the recent patterns for the US, Japan, and European Community banks, is present in the Brazilian legal framework. Only Regulation 1,942 (7.29.92) imposes some indirect relation between bank's assets and capital, but with different purposes. First because it does not make any distinction between the components of the net worth, like the Basle Accord makes between Tier 1 and Tier 2 capital (see explanation below in this paper), holding all classified net worth accounts together; second because it does not consider the significance of bank's current assets, but just investments and imobilized assets, indicating that the only objective in the rule is to limit the engagement on long term transactions and investment in real property; and finally because it ignores completely the concept of distinct risk weight for assets.

Even considering the actual absence of regulation to impose minimum ratios of capital based on risk weighted assets, the Basle Accord principles, it is important to verify how Brazilian banks with international activities are structured in terms of capital and assets amounts. The data available permits only a comparison between net worth, similar to total capital (Tier 1 plus Tier 2 of the Basle Accord) and total assets not risk weighted, contrary to the Basle Accord concepts. Table 3 refers to Brazilian Banks that operates branches in the US and show their ratio of net worth and total assets, on a worldwide cosolidated basis.

participations in foreign financial companies (Resolution 1,949, 7.29.92).

17. An affiliate under this regulation means a company that either owns 10% or more, directly or inderectly, of the capital of another company, or the same shareholders hold together more than 10% of the capital in both institutions, or if a company holds more than 10% of the bank's capital.

Table 3: percentage net worth/total assets of Brazilian banks with branches in the US (consolidating worldwide group)

INSTITUTION	NET WORTH/TOTAL ASSETS RATIO
BANCO DO BRASIL - BRASÍLIA	8.36%
BANCO BANESPA - SÃO PAULO	10.09%
BANCO BRADESCO - SÃO PAULO	21.20%
BANCO ITAÚ - SÃO PAULO	20.72%
BANCO UNIBANCO - RIO DE JANEIRO	12.89%
BANCO ECONÔMICO - SALVADOR	11.10%
BANCO NACIONAL - RIO DE JANEIRO	8.44%
BANCO BAMERINDUS - CURITIBA	11.20%
BANCO SAFRA - SÃO PAULO	12.85%
BANCO REAL - SÃO PAULO	11.76%
BANCO DE CRÉDITO NACIONAL - SÃO PAULO	14.88%
BANCO MERCANTIL - SÃO PAULO	41.70%
BANCO BANDEIRANTES - SÃO PAULO	15.74%
AVERAGE EXCLUDING BANCO MERCANTIL	13.27%

Source: Exame Melhores e Maiores — august 1992.

As reported by The American Banker — 1992 Ranking the Banks — Top Numbers 1992 Edition, at p. 73, considered the top 100 US banks, the mean level of the fraction total capital /total assets rose to 6.22% at the year end 1991 from 5.76% at the year end 1990. By contrast, Table 3 above displays that only two out of fourteen Brazilian banks with foreign branches in the US present the same fraction lower than 10%, but both over 8%, which is significantly superior than the US top 100 banks 1991 average of 6.22%.[18]

4. THE BASLE ACCORD FOR CAPITAL REQUIREMENTS OF BANKS

On december 10, 1987, the Basle Committee on Banking Regulation[19]

18. The Brazilian legal system considers different hierarchies among the possible species of law, prevailing the Constitution, then the Amendments to the Constitution, then the Complementary Law, etc..., with harder procedures for the enactment of the laws in the higher levels.

19. The Basle Committee on Banking Regulation and Supervisory Practices, established in 1975, meets under the auspices of the Bank for International Settlements (BIS) in Basle, Switzerland, and includes Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, United Kingdom, United States, Swizerland, and Luxemburg. The Committee has no authority to impose its standards on the participant countries, but only to recommend the implementation. Notwithstanding, many other non member countries

released the "Proposals for International Convergence of Capital Measurement and Capital Standards" and, in july 1988, it released the "International Convergence of Capital Measurement and Capital Standards", the latter hereinafter referred as the Basle Accord.

In recognition of the relevant international differences among the tax and accounting treatments affecting banks,[20] the regulatory authorities in each country had some degree of discretion in applying the capital adequacy rules. Although the concepts of the Basle Accord minimum standards were originally intended to apply only to banks with international activities, the internal regulation in the US and in the UK[21] does not make any distinction in this sense, and subjects to the same rules any bank, regardless of its range of operations. In addition, the Basle Accord states that the framework is intended to be applied to banks on a consolidated basis, including subsidiaries undertaking banking and financial business.

The main objectives of the Basle Accord are evinced in its following statement: "The Basle Committee on Banking Regulations and Supervisory Practices has, for several years, been working to achieve a strengthening in capital resources of international banks in order to help strengthen the stability of the international banking system. At the same time, achieving some convergence of capital adequacy standards in national supervisory regimes has been increasingly realised to be a desirable objective in order to remove an important source of competitive inequality for banks operating internationally".[22]

The Basle Accord[23] considers the total capital of a bank in two separate elements — Tier 1 and Tier 2, as defined below — with separate requirements. Tier 1 (Core Capital) consists of common equity and after tax reserves (such as retained earnings), less the goodwill on the balance sheet. Tier 2 (Supplementary Capital), limited to 100% of total amount of Tier 1, consists of: undisclosed reserves,[24] revaluation reserves, unrealized securities gains (subject to a discount of 55% of the difference between the book value and the market value of the portfolio), general loan loss provisions (limited to 1.25% of risk-adjusted assets), other debt instruments (preferred stock, perpetual debt instruments of the UK, mandatory convertible debt instruments of the US), and term subordinated debt (limited to 50% of the Tier 1). As a matter of discretionary evaluation, local regulators are able to decide whether to deduct cross-holdings of other bank's capital from the holder's total capital base because of the concerns regarding double-counting of capital when a bank

have followed the guidelines suggested by the Basle Committee in order to promote the same international standards for their internal banking systems.

20. For the purpose of this article the term "bank" refers to both, banks and bank holding companies.

21. Implementation in the United Kingdom of The Directive on Own Funds of Credit Institutions — Notice to Institutions Authorised Under The Banking Act 1987 — Banking Supervision Division — Bank of England — BSD/1990/2, issue of december 1990.

22. Paragraph 1 of the Basle Convergence Agreement.

23. The classification explained in this paper is based in Thomas H. Hanley, Aaron S. Gurwitz and Jay M. Weintraub, *International Bank Capital Adequacy Proposals: Our Initial Thoughts*, 1988, pp. 4-15.

24. Undisclosed reserves or hidden reserves are defined by Joel G. Siegel and Jar K. Shim, in the *Dictionary of Accounting Terms*, Barron's Educational Series, 1987, at p. 202, as an understatement of owner's equity or net worth that can arise either from the undervaluation of assets or from a complimentary overacrual of liabilities.

holds capital instruments issued by a subsidiary organization. But it is required that the aggregate amount of investiments in unconsolidated[25] banking or finance subsidiaries shall be deducted from bank's total capital. Finally, national discretion involves all categories of capital permitted for Tier 2 capital, so that regulators will be able to tight the restricitons as a function of the local financial markets.

Because capital adequacy is expressed as a percentage resulting from a fraction where the numerator is the capital and the denominator is the total amount of the risk weighted assets,[26] the attribution of the risk weight is of fundamental importance. Under the Basle Accord each asset type is assigned a weight from 0% to 100% to reflect its inherent credit[27] risk characteristics. The so-called on-balance-sheet-assets are risk weighted as follows:

0% discount (no deduction) — cash, balances at and claims on domestic central bank, loans to domestic central Governments, securities issued by domestic central Governments, loans and other assets fully collateralized by cash, or domestic central Government securities or guarantee.

0% to 20% (discretion) — claims on regional development banks.

20% — claims on domestic and foreign banks with original maturity of under one year, claims on domestic banks with an original maturity of one year and over and loans guaranteed by domestic banks, cash items in process of collection, claims on foreign central Governments in local currency financed by local currency liabilities.

0%, 20% or 50% (discretion) — claims on the domestic public sector, excluding central Government (at national discretion) and loans guaranteed by such institutions.

50% — loans to owner-occupied residential housing, fully secured by mortgage.

100% — claims on the private sector, cross-border claims on foreign banks with an original maturity of one year and more, claims on commercial companies owned by the public sector, fixed assets, real estate and other investments (including nonconsolidaded investment participations in other companies), capital instruments issued by other banks (unless deducted from capital), all other assets.

In addition, the so-called off-balance-sheet-assets are coverted into on-balance sheet credit equivalent, based on its risk of exposure, using a percentage for the conversion, as follows: general guaranties of indebtedness (including standby letters of credit) and acceptances are considered integrally (100%); sale and repurchase agreements and assets sales with recourse, remaining the credit risk with the bank, are totally considered (100%); forward purchases, forward deposits and partly paid shares and securities, representaing commitments with centain drawdown, are rated at 100%; note issuance facilities and revolving underwriting facilities are converted at a 50% rate; other commitments with original maturity exceeding one year (such as credit lines and standby facilities) are converted at a 50% rate; similar commitments with less than one year maturity or possible to be canceled are not considered (0%); certain contingent items (performance bonds, bid bonds, warranties, standby letters of

25. See footnote 46 below for a concept of consolidation.

26. Total risk-weighted assets is obtained by multiplying the book value of each asset or the credit equivalent amount of each off-balance sheet item by the assigned risk percentage of the category, and adding all the amounts together.

27. The risk-based capital system does not consider other types of risk such as investment, interest rate, exchange rate and concentration risk.

credit related to specific transactions) are converted to 50% of their value; short-term, self-liquidating, trade-related contingencies (documentary credits collateralized by the uunderlying shipments) are reduced in 20%. Foreign exchange and interest rate contracts require distinct treatment because the exposure is only the potential cash flow adjustments and a broad discretion is given to the local regulators.[28]

Countries applying the risk-based capital framework tend to implement uniformly the Basle minimum capital ratios of four percent Tier 1 capital and eight percent total capital in relation to total risk-weighted assets. Some discretion is permited to national regulators for the inclusion of certain components in Tier 2 capital.

5. CAPITAL REQUIREMENTS IN THE EUROPEAN COMMUNITY

The main purpose of the European Community (EC) financial services legislation[29] is the creation of a single market throughout the EC, the result of a process that began with the First Council Directive of 12 december 1977 on co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions — EEC 77/780 (First Banking Directive). Because the primary tool for this achievement is the "single license", meaning that a financial institution meeting the necessary minimum conditions for authorisation to carry on banking in one Member State ("Home State") will not need further authorisation to carry on these activities in another Member State[30] ("Host State"), whether through a branch or by providing cross-border services, high standards of legal harmonization were required.[31]

Originally established by the Basle Accord on a nom mandatory basis, and already adopted by some countries,[32] the regulation regarding the capital adequacy for EC banks was the subject of: the Council Directive of 17 april 1989 on the own funds of credit institutions — EEC 89/299 — (Own Funds Directive),[33]

28. See Hanley et al, footnote 23 supra, at 12-15, explaining the original exposure method and the current exposure method to asses the credit risk of interest rate contracts (singe currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and similiar contracts), exchange rate contracts (cross-currency interest rate swaps, forward foreign exchange contracts, currency futures, currency options purchased and similars).

29. For further information regarding the EC banking legislation, and a comparison among the local law of Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxemburg, The Netherlands, Portugal and Spain, see Anthony Thompson QC, "The Second Banking Directive" — Current EC Legal Development Series — Butterworths — 1991.

30. It is important to emphasize the different treatment given to non-EC Member States credit institutions entering the Community market. Subsdiaries of these institutions once licensed to operate in any EC-Member State will benefit from the principle of mutual recognition and will be able to branch in all EC Member States without further licenses, by merely sending a formal letter to the host country — "single banking license" — (Second Banking Directive Art. 19(1)). On the other hand, branches of these institutions are not considered a authorised credit institution by a home state, and therefore do not benefit from mutual recognition, being prohibited to freely expand inside the Community.

31. See Gruson, M. and W. Feuring, *The Single Market and the Law of Banking*, R. Cranston, ed., 1991 — Chapter 2. at 19.

32. The Basle Accord on capital standards was implemented in the United Kingdom in 1989.

33. Directives are the primary legislative instrument used in the EC to obligate Member States to enact specific internal legislative measures to implement, with some discretion, the directions constituted.

instituting the standard definitions of capital for credit institutions, required to be implemented no later than 1 january 1993; and the Council Directive of 18 December 1989, on a solvency ratio for credit institutions — EEC 89/647 — (Solvency Ratio Directive).[34]

Following the recommendations of the Basle Accord, the methodology used by the EC is based on the measure of the qualifying assets weighted on a risk basis, and the requirement for the maintenance of a certain percentage of that amount of risk weighted assets as capital (capital ratio). For the EC Member States, the Solvency Ratio Directive requires 8 per cent of total capital (Tier 1 plus Tier 2) over risk-weighted assets as a minimum ratio, although the Member States are free to establish higher standards.[35] The Own Funds Directive did not explicity segregate the capital into two separate categories (Tier 1 and Tier 2), as the Basle Accord did, but the aplication of the Article 6 limitations results in the tiering of capital. It seems that all the EC countries will follow the Basle Accord in establishing the Tier 1 (core capital) and Tier 2 (supplementary capital) definitions of capital and their respective limits, making easier the comparisons among the differet systems.

In contrast with the Basle Accord, the EC Directives prohibit the use of latent revaluation reserves[36] as Tier 2 capital. But, like the Basle Accord, the EC Directives allow some discretion to the domestic regulators, but just by being more restrict than the common rules. Appendix 1 at the end of this paper gives an idea of how some EC Member States have been releasing different regulation for considering capital requirements of credit institutions.[37] As in the US, but unlike Japan, the standards of minimum capital apply to all credit institutions incorporated in the EC Member States, rather than only to banks with international operations.

Among several important resolutions,[38] the Second Council Directive of 15 december 1989 on the co-ordination of laws, regulations and administrative

34. Several Directives have been released to promote some level of legal harmonisation in the EC for the creation of a "single market" for financial institutions: The First Council Directive of 12 december 1977 on Banking Co-ordination (77-780/EEC), The First and Second Consolidated Supervision Directives of 1983 and 1990 (83-350/EEC and 90-451/EEC), The Banks Account Directive of december 1986 (86-635/EEC), The Bank Branches Directive of 1989 (89-117/EEC), and the Second Banking Co-ordination Directive of 15 december 1989 (89-646/EEC).

35. "The Bank of England tends to apply a ratio of approximately 10 per cent (or even higher in the case of banks which have large exposures to a particular person, sector or country)". Simon Firth — Material for Lecture 6 at Boston University School of Law — December 1992 — p. 7). As pointed out by Leigh Drake (7 JIBL — 1991 — p. 285) the Bank of England "has formally stated that it will continue to set trigger and target risk asset ratios for each bank on an inidividual basis, and that in most cases these will be considerably higher than the eight per cent minimum".

36. For a concept of latent reserve see infra VI — Capital Requirements in Japan.

37. The Council Directive (EEC 89/647) on a Solvency Ratio for Credit Institutions, amending the Council Directive (EEC 89/299) on the Own Funds of Credit Institutions, that imposes the capital requirements for the Member States, enunciates that it applies to all credit institutions, which First Bank Directive (EEC 77/780) defines as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account" (article 1 of the First Bank Directive).

38. L. Rita Theil, *Banking in the Single Market: Strategic Decisions for Non-EC Banks*, Butterwords Journal of International Banking and Financial Law, january 1993, at 26-30. The Second Banking Directive introduces the

provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780 — EEC 89/646 — (The Second Banking Directive), sets basic rules for local regulators and supervisors, which can be expanded by them, to be applied for foreign banks willing to get a license[39] to operate in anyone of the EC Member States — *e.g.* a) the initial capital shall not be less than 5 million ECU or, for particular categories of credit institutions not less than 1 million ECU,[40] and the capital may not fall below those amounts;[41] b) disclosure of shareholders identity and respective holdings; c) take in account the necessity of sound and prudent management of the credit institution.

6. CAPITAL REQUIREMENTS IN THE UNITED STATES

The US has been, along with the UK, the most severe country in appling the Basle Accord guidelines for capital adequacy of banks. In addition to the 8% total capital / risk-weighted ratio, the American regularors require a 3% and over leverage ratio (Tier 1 / total assets without adjustments for risks characteristics),[42] depending on the risk profile of each bank. The purpose of the leverage ratio is to limit the interest-rate risk, because the Basle Accord guidelines only consider the credit risk, since the assets' weight is based on a credit risk basis.[43]

As a consequence of the historical development of the banking system in

concepts of mutual recognition, meaning that each Member State recognizes the competence of other Member States *vis à vis* the regulation of domestic credit institutions in the interest of the consumer and home country control, and the home country control, implying the authority in charge of supervision is the one where the credit institution has its head office, remaining with the host country (different Member States where the banks has its branches, agencies or offices) supervisor the power to regulate branching activities that relate to monetary policy and consumer protection.

39. Art. 3 (1) of the First Banking Directive (EEC 77/780) prescribes that the Member States shall require credit institutions to obtain authorisation before commencing their activities.

40. Art. 4 (2) of the Second Banking Directive (EEC 89/646) precribes that the Member States have the option to grant authorisation to particular categories of credit institutions with minimum capital of 1 million Ecu, but does not specify what are the conditions for considering a "particular category" under the rule. However, in granting authorisation for a "particular category" of credit institution, the Member States shall notify the EC Commission explaining the reasons for adopting the exception, and the list published by the Official Journal of the European Communities (art. 3(7) of the First Banking Directive) with the name of all authorised credit institutions in the EEC will indicate that these are different institutions.

41. Art. 10(1) — Second Banking Directive. In addition, paragraph (2) permits the Member States to grandfather the already exintent institutions with lower levels of capital, since they do not fall below their highest level reached after the implementation of the Directive.

42. The capital tests (risk-based capital test and leverage test) in the US are in 12 C.F.R. paragraph 225 — appendix A and D (1991).

43. The Capital Equivalency Report, cited below in footnote 48, at p. 40, explains further that the risk-based capital ratios, by itself, would not constrain banks from buying certain long term securities, rated at 0% or low discount ratios funding these operations, for example, with short-term borrowings. While the Basle Commite is studing these issues to implement the international standards for banks, only the US has implemented a leverage measure. From the Report comments at p. 41, it seems that the US regulators will not focus on the leverage ratio in supervising foreign banks, because the "internationally agrred basis for assessing the capital adequacy of internationally active banks was the risk-based capital standard".

the US, the three federal banking agencies (Federal Reserve Board, Officce of the Comptroller of the Currency-OCC, and Federal Deposit Insure Corporation-FDIC) issued the guidelines related to the minimum capital adequacy for banks, bank holding companies, and foreign banks operating in the US,[44] which is closely based on the premises of the Basle Accord. Unlike Japan, that has separate capital requirements rules for banks with transnational activities, the US rules apply to all banks[45] under the regulator's jurisdiction, and on a consolidated basis.[46]

The main aspects of the US framework bearing on capital adequacy are: 1) *Teir I Capital* — includes paid-up share capital, retained earnings, minority interests and current year profits or losses. Non-cumulative perpetual preferred stock issued may be included and goodwill and other intangible assets — except limited amounts of purchased mortgage servicing rights and purchased credit card receivables — shall be deducted. Diversely from the Basle Accord rules that considers it like Tier 2 capital, cumulative perpetual preferred stock is considered like Tier 1 capital, but just for bank holding companies — not banks — and they can correspond up to 25% of total Tier 1 capital. 2) *Tier 2 Capital* — Consists of general loan loss reserves[47] (limited to 1.25% of total risk-weighted assets), hybrid capital instruments and term instruments (limited to 50% of total Tier 1 capital) such as subordinated term debt and limited life redeemable preferred stock. Because of the general accounting principles adopted by the US, it is prohibited the creation of undisclosed equity reserves (all reserves shall be disclosed in Tier 1 capital), the revaluation of fixed assets and the update of investment portfolios to market prices (marking to market). 3) *Deductions from Total Capital* because of the consolidation accounting rule, all investments in uncosolidated banking and finance subsidiaries must be deducted from the group's capital. Reciprocal holdings of capital instruments of other banking institutions shall also be deducted if these cross-holdings are international. 4) *Risks Weights* — Under the permited discretion, the US regulators apply a 20% weight ratio on claims collateralized by cash or OECD government securities, while the Basle Accord suggests 0%, and, for the claims on, or guaranteed by, domestic public sector entities, a 20% weight ratio on general obligation, and a 50% weight ratio on revenue obligation. Industrial development bonds issued by state and

44. 12 C.F.R., paragraph 225.1 — the definition of bank holding company includes foreign bank organizations.

45. For further considerations concerning capital adequacy in individual banking acquisition see Rodgin Cohen, *Bank Consolidation: Regulatory Issues and Considerations*, Wake Forest Law Review — v. 27-1992-n. 3 at p. 68-72. "The Federal Reserve's capital standards for banks acquisitions appear designed to force banks to adhere to two basic policies that the Federal Reserve has been unable or unwilling to set forth in its published capital tests. The first policy is to maintain capital levels well above the published minima. The second policy is to disregard intangibles interely in evaluating capital adequacy, notwithstanding a stated position that identifiable intangibles, as opposed to goodwill, should not be treated as a reduction of capital".

46. Consolidation is an accountig method for an overall evaluation of two or more companies activities with interrelated participation on their capital. Thus, a consolidated financial statement bringhs together all assets, liabilities and operating accounts of a parent company and its subsidiaries, eliminated the effects of the intercompany transactions. Joel G. Siegel and Jae K.Kim, Dictionary of accounting Terms, Barron's-1987, at 88.

47. It is allowed the inclusion of country risk reserves as general loan loss reserves.

local governments are discounted at a 100% ratio.

The Board of Governors of the Federal Reserve System[48] (FED) justified that "Banking regulators in the United States have recognized that strict application to foreign banks of capital standards with definitions identical to those applied to US banks would disregard important differences in capital instruments and accounting practices in other countries. A fundamental premise of the Basle Accord is the acceptance of such differences in order to advance the international covergence of capital standards". Although at first glance it appears a concession to different legal systems, the fact is that a tolerance will be provided just under the basic principles of Basle Accord, related solely to the inclusion or exclusion of some financial instruments in the capital categories (Tier 1 and Tier 2) and the weight applicable to assets.

The above mentioned, FED's "Capital Equivalency Report" (the Report) adresses the "Guidelines for converting foreign bank capital data into equivalent US standards", in response to Section 214(b) of the Foreign Bank Supervision Enhancement Act of 1991, which required these guidelines for purposes of Sections 3 and 4 of the Bank Holding Company Act of 1956 — dealing with obligatory approval by the FED for the etablishement or merger of bank holding companies and the aquisition of interests of banks, bank assets, or control of bank or bank holding company securities, and the acquisition of permissible nonbanking companies or engagement in such nonbanking activities — and Section 7 of the International Banking Act, requiring FED's approval for foreign banks to establish a federally or state-licensed branch or agency or acquiring ownership or control of a commercial lending company.

A first principle to be considered comes from the FED's opinion that "In general, foreign banks seeking to establish operations in the United States have been expected to meet the same general standards of strenght, esperience, and reputation as required for domestic institutions".[49] With regards the capital adequacy, the guidelines assert that banks from countries that comply with the Basle Accord, will be required first to meet the home country regulation.[50] But the US regulator goes further in its guidelines and states that the minimum capital necessary for operating in the US banking system can be greater than the 8% as a function of the risk associated to the activites to be performed, what implies in a discretionary evaluation case by case. The treatment for foreign banks from countries not subscribing the Basle Accord, like Brazil, was briefly described in the Report, which requires full disclosure of the country's regulation regarding capital exigency and" information sufficient to

48. Board of Governors of the Federal Reserve System and the Secretary of the Department of the Treasury — Capital Equivalency Report of june 19, 1992, p. 3.

49. Id., at 43. The FED's report also enumerate several factors considered to the approval of a foreign bank license: "financial and managerial resources of the applicant, future prospects of the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potencial public benefits, and the competitive effects of the proposal". Accordingly, because there are not just numerical tests the FED retains broad discretion to evaluate foreign proposals.

50. Id., at 43. The Report explains that the standard applied the Basle Accord "provides a commom basis for evaluating the general equivalency of capital among banks from various countries", that the 8% ratio is appropriate to international banking activitiy, and that it assures equality for US banks operation in their own market, regardeless of the discretion of domestic regulators.

evaluate the applicant's capital position adjusted as appropriate for accounting and structural differences. The applicant will also be requested to provide, to the extent possible, information comparable to the Basle format".[51] Banks comming from countries with different accounting approches and not recognizing as a prudent operational measure the minimum fraction of capital over weighted-assets, as the Basle Accord idealized, will be required to adjust its accountig system to provide to American supervisors sufficient disclosure of its credit risk.

Although a large discretion is used by the American regulators in considering a foreign bank application to operate in the US market, there is a specific legislation regarding the standards of approval of federal branches and representaive offices of foreign banks (12 USCA — Chapter 32 — paragraphs 3.101/3.110-Cummulative Annual Pocket Part — 1992), and the standards of termination of foreign banks offices in the US, which are subject to judicial review in the United States court of appeals.[52] The national treatment principle related to the capital adequacy for banks is applied by the US regulators with the legal support of paragraph 3105-USCA — (d)(3) and (e)(1)(B)(i) — that determines, respectively, as a standard for approval of a foreign bank office, the parent and affiliates' compliance with applicable US law, and as a standard for termination of foreign banks' offices activities a violation of law or engagement in an unsafe or unsound banking practice in the US.

7. CAPITAL REQUIREMENTS IN JAPAN

Japan, a member of the Basle Committee, amended its capital adequacy rules on 22 december 1988, through the Guideline (Tsutatsu) Concerning the Maintenance of International Credibility of Authorised Foreign Exchange Banks.[53] The Minister of Finance (MOF) imposed new standards only for authorised foreign exchange banks with overseas branches, while the ones with purely domestic branches maitained its already existing standard.[54] In addition, the MOF prescribes administrative rules related to the capital and assets: the own capital must be greater than 10% of total deposits, fixed assets and equipment must not exceed 40% of equity capital, and dividends are generally limited to 15% of equity capital and 40% of after-tax net income.

As Sugahara estimates,[55] out of almost 1,000 existent Japanese banks (in several different categories), only ten city banks,[56] one specialized foreign exchange

51. Id., at 45.

52. 12 USCA, paragraph 3.105 (f).

53. For further considerations regarding the capital adequacy implications on Japanese Banks see Masaharu Sugahara, *The Impact of the Capital Adequacy Reguirement on Japanese Banking* — (1991) 7 JIBL 257-263. See also Allen B. Frankel and Paul B. Morgan, *Deregulation and Competition in Japanese Banking*, Federal reserve Bulletin, August 1992, at 587-591.

54. Itzhak Smary and Barry Topf, *Global Financial Deregulation, Commercial Banks at the Crossroads*, Blackwell, Cambridge-MA, 1992, at p. 202, "The standard of capital adequacy that will be applied to banks without international operations is the following pre-existing capital ratio: capital ratio = *shareholders equity plus various reserves plus other specialized items* x 100 average total assets (excluding acceptances, but including guarantees)

The capital ratio calculated as above should exclude specific loan loss reserves. The target was 4 percent, and commenced at the and of March 1991".

55. Sugahara, footnote 53 supra, at p. 258.

56. The city bank group consists of the ten major banks.

bank, three long-term credit banks, seven trust banks, and some of the first regional banks, are actually targeted by the Japanese capital adequacy regulation.

Among the Basle Accord parameters left under the contries' regulators discretion, the Japanese banking system features: 1) *Revaluation Reserves of Equities* — generally carried at book value, the participation in other companies' capital (restricted to 5% in one company for banks, unless it is a financial subsidiary) has its current market value (stock exchange or over-the-counter market) frequently higher, what originates a latent reserve. Japanese banks can use 45% of such latent revaluation reserves as supplementary or Tier 2 capital.[57] 2) *Interest and Exchange Rate-Related Items* — Japanese banks, not the regulator, have the discretion to apply either the current exposure method or the original exposure method to adapt the value of these off-balance sheet operations, if they are in small amount or "the operational preparation for addopting the current exposure has not yet been made".[58] 3) *Claims on the Domestic Public Sector, Excluding Central Government and Loans Guaranteed by Governmental Institutions* — considering the 0 to 50% discount range suggested by the Basle Accord, the MOF approved a 10% ratio.

The MOF has not yet released the sanctions against the banks in noncompliance with the 8% minimum capital ratio and ancillary requirements.

Japanese banks have been facing a hard fight to achieve the Basle Accord standards since the stock market crash of 1990. Accordingly, on June 22, 1990, the MOF enacted new regulation allowing the use of subordinated debt, a component of the Tier 2 capital, for banks to increase their capital. From June to september of that year, Japanese banks issued new subordinated debt of almost U$ 8.3 billion,[59] in the domestic and foreign market, and from september to March 1991, additional U$ 13.3 billion were distributed.

Foreign banks willing to operate in the Japanese market receive national treatment standard, prescribed by the Banking Law of 1981, which subjects domestic and foreign banks to the same law requirements, including the legislation of capital adequacy.[60]

8. CONCLUSION

Important criticisms have been made to the Basle Accord capital adequacy framework for international banks. Some comments, based on economic theory values, argue "why should regulators be presumed to be better than the market at judging proper risks?".[61] A different point is made in relation to the limited scope of protection given by the system, since it mainly adresses the credit risk part of bank's operation, that has become less relevant than the interest rate, exchange

57. The Basle Accord suggests a maximum discount of 55% on the latent revaluation reserves before adding them to the Tier 2 capital.

58. Sugahara, footnote 53 supra, at p. 259.

59. Sugahara, footnote 53 supra, at p. 260 — Data given in yens and converted to U$ dollars at Y120.00=U$1.00

60. For additional comments on foreign banks in Japan see Brian Wallace Semkow, *Foreign Financial Institutions in Japan: Legal and Financial Barriers and Opportunities-Part I*, Butterworths Journal of International Banking ans Financial Law — february 1993, 62/67, and "The National Treatment Study" of the Department of the Treasury, 1990, 16-19 and 207-224.

61. *Governing Banking's Future: Market vs. Regulation*, edited by Catherine England, Norwell, Massachusetts, Kluwer Academic Publishers, 1991.

rate, and position risks, more important actual features of international banking.

In addition, it is important to notice that, in effect, a consequence of the Basle Accord standards is to limit banks operational activities if adequate capital (Tier 1 plus Tier 2) is not sufficient. That means that, at some point, a bank will have to decide either to abstain to engage in profitable operations or to incur in additional costs of raising capital, what will reduce profits.

The risk argument is based on the sense that banks use depostiors funds to engage in risky operations and that the capital is a cushion for protection against losses in defective transaction. This in fact does not occur since the so-called Tier 1 capital consists basically of equity (paid-up capital) which has been used also for riky operations like loans and guarantees. As long as a bank, like any company, raises capital from stockholders, it will soon invest this resources in order to secure the return for them. So, the capital of a bank merely represents another source of funds, like the liabilities (deposits) are, and do not signify any kind of a cash reserve to repay creditors or depositors. In this sense the capital requirements operates as an operational limit and not as a guarantee of effective payment for creditors and depositors.

Because local financial markets have different configurations, the cost of raising capital differs at considerable rates, and that causes banks from some countries operacional advantages or lower costs to augment operational activities.[62-63] Thus, not only the different costs of capital but also a great disparity in the availability of instruments to raise capital in the respective local markets, are potencial causes of burdensome costs for banks coming from developing countries like Brazil. Appendix 1 lists several different instrumentalities by which banks from developed countries can raise capital, either to compose Tier 1 or Tier 2 Capital, while the Brazilian financial market avails only common stock (voting power), preferred stock (no-voting power), and debentures.

Also, the degree of freedom of the EC Member States, jointed to the discretion permited by the Basle Accord to the US

62. See Robert N. McCauley and Steven A. Zimmer, "The Cost of Capital for Banks in International Competition", in *game plans for the* 90'S-The 26th Annual Conference on Bank Structure and Competition (May 9-11, 1990)-Federal Reserve Bank of Chicago, at pp. 536-561. "The cost of capital for a bank is defined as the required spread or fee that a financial product must generate in order to meet the required market rate of return on the regulatory capital that must be alloted to it". This study is based on a sample of 34 large commercial banks of the US, Japan, Germany, Canada, the UK and Canada. It concludes that US, UK, and Canadian banks bear high capital costs, Swiss and German banks face moderate capital costs, and Japanese banks face low capital cost. Is indicated also that high cost of capital banks are likely to face substantial difficulty in competing in low margin bank products. It is important to observe that this study is based on data from 1984 to 1989, not considering the effects of the Japanese stock market crash that affected their banks capital value for the purposes of the Basle Accord measures.

63. George G. Kaufman, "Issues in Financial Regulation" (Federal Reserve Bank of Chicago-WP-1991/10), *Capital in banking: past, present and future*, analysing the history and present situation of the US banks, concludes that higher ratios of capital will more likely be achieved through reductions in bank assets than through increases in capital, and that the risk-based capital standards "may be contributing to the perception of a credit crunch by encouraging banks and thrifts to invest in government securities and mortgage-backed securities, which have no or lower capital requirements...", at p. 21.

and Japan regulators, has ensued in a potencial significant different regimes for banks operating internationally, what results in additional costs to comply with all national legislation. A good picture of the actual discretion exercised by domestic regulators is given in Appendix 1. Because international banks are supervised in a consolidated basis (principle adopted by the Brazilian accounting system) they will have to develop some elastic accounting procedures to comply with the different allowances and prohibitions under each banking system, being possible, at the same moment, to achieve the minimum standards required by one country but not in another. Despite of the present dissimilarities, it is clear that there is a tendency towards a harmonisation of the accounting rules, what will result from the continuous increasing globalisation of the financial markets.

The actual banking regulation in the US is the most specific with regards the methods to be applied by regulators when inspecting the minimum capital requirements, considering either the approval of foreign banks or the exercise of on site supervision for purposes of guaranting the continuity of foreign banks operation. Brazilian banks already established in the US and the ones willing to apply for a license, will have to create a new pattern of accounting system to allow a recategorization of all carried transactions satisfying the US legal classification of assets and equity (Tier 1 and Tier 2 capital) for the purposes of the minimum capital requirements. This special system will have to record the hole group operations, nationally and internationally, since the supervision is carried on a consolidated basis. The fact that Brazilian legislation does not apply the Basle Accord standards for minimum capital actually does not result in any fundamental impediment for domestic banks to operate in the US, since it is clear the kind of a case-by-case analysis imposed by American supervisors and the broad discretion in evaluating the risks engaged by banks. Clearly, what will count is the risk associated to the operations intended to be performed and the adequate capital for that under the American regulator's point of view.

In the EC there is a preliminary question to be faced and it concerns with the reciprocity requirement established by the Second Banking Directive. Art. 9 (1) requires that Member States inform the Commission of any general difficulties encountered by their credit institutions (banks) in establishing themselves or carrying on banking activities in a third country. Section (4) of Art. 9 gives the Commision power to negotiate with third countries that do not grant effective market access to Community credit institutions, comparable to that granted by the Community to credit institutions from that thrid country, and third countries in which national treatment is not received by the Community credit institutions. If no agreement is reached the EC Member States must limit or suspend banking licenses pending at the moment or future requests for authorisations and acquisition of holdings by direct or indirect parent undertakings governed by the laws of the third country in question. In such a case, the already dully authorised subsidiaries in the Community of a parent company from that third country are grandfathered and can continue to operate inside the EC.

As discussed above, Brazil does not grant national treatment to foreign banks, sice it requires greater minimum capital for foreign banks, and does not grant comparable access to EC banks in the local market, because the Constitution prohibits foreign banks to enter and to operate until new legislation is enacted by Congress, which has been pending since 1988. Considering this facts, it is likely that the EC will act against Brazil's restrictions, but bilateral agreements concerning the specific countries of the Community are legally possible.[64]

Although the Second Banking Directive "grandfathered" the rights to participate in the single market (free branching inside the Community regardeless of host countries license) for banks considered to be established in any EC Member State before the implementation of such Directive by those countries, there is controversy about what is "established" in the EC legistation. As L. Rita Theil[65] points out some writers imply that branches of a non-EC bank are not entitled to use the single banking license because they are not an institution incorporated in a Member State, accordingly they are not "grandfathered" by the Second Banking Directive. Since Brazilian banks rarely operate through subsidiaries in foreign countries, new licenses in the EC market will have to be processed in a country by country request, regardless of the already existent branches.

Unlike the US, EC Member States do not have yet enacted a specific body of regulation for dealing with foreign banks willing to enter the banking market through branches, although the national treatment and the consolidation principles are applied to the institutions already in activity, either subsidiaries or branches. As a result the Basle Accord standards will certainly be required for foreign banks either to maitain or to establish new branches. From the texto of the Second Bank Directive it seems that EC will treat banking mathers towards bilateral agreements rather to rigid commom close standards. Again, the mere fact that Brazil does not impose the Basle Accord standards of minimum capital does not result in any restriction for operation or approval of banks in the EC, since the grant of license is based in a case-by-case analysis.

It is not possible, at the moment, to conclude about the actual position of Brazilian banks with regards their capital adequacy, based on the Basle Accord standards, because the country does not obligate banks to comply with them and the domestic accounting system does not require the classification of assets and equity in a form that enables any kind of comparison. But some preliminary ratios relating net worth and total assets of Brazilian international banks evinces that they are in better shape if compared with some important American international banks (Table 3).

Despite the criticisms tha can be made of the Basle Accord capital adequacy guidelines for international banks, the fact is that the developed countries have already adopted them, even with some relevant contradictions, and will apply the capital requirements to all foreign banks willing to operate in their market, on a consolidated basis. Because international activities are mandatory for certain banks, specially considering that Brazil is an active player in export and import market with expressive volume of operations requiring assistance of international banks, it is expected that some harmonisation of rules will occur in the direction of the Basle Accord standards.

64. See footnote 6 above.
65. As cited in footnote 38, at pp. 28-29.

APPENDIX 1: DISCRETIONARY TREATMENT GIVEN TO CAPITAL REQUIREMENTS.

	UNITED STATES	JAPAN	GERMANY	CANADA	UNITED KINGDOM	FRANCE	ITALY
TIER 1							
Non-Cumulative Perpetual Preferred Stock	Permitted	Permitted	Permitted: however none issued to date	Permitted	Permitted	Issues not permitted in domestic market	Permitted
Current year Profit (or Loss)	Profits may be included; losses must be deducted	Profits may be included; losses must be deducted	Profits may not be included; losses must be deducted	Profits may be included; losses must be deducted	Profits included only if published; losses must be deducted	Profits may be included; losses must be deducted	Profits must be included; losses must be deducted
Deduction of Intangible Assets other than Goodwill from Tier 1 Capital	Requiered with exception of Purchased Mortgage Servicing Rights and Purchased Credit Card Receivables	Not permitted by local accounting principles	Required	Not permitted by local accounting principles	Required with exception of US Purchased Mortgage Servicing Rights	Required with exception of lease renewal rights	Required
TIER 2							
Undisclosed Reserves	Prohibited by local accounting principles	Prohibited by local accounting principles	Only in respect of real property and listed securities, limited to 1.4% of risk assets, and with 4.4% minimum core capital	Prohibited by local accounting principles	Prohibited to commercial banks	Prohibited by local accounting principles	Prohibited by local accounting principles
Hybrid Capital Instruments (including cumulative perpetual preferred stock)	Permitted	Permitted, but not prevalent	Permitted	Permitted	Permitted	Permitted	Permitted, but not prevalent
Term Instruments (up to 50% of Tier 1) • Subordinated Term Debt	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted
• Limited Life Redeemable Preference Shares	Permitted and issued	Permitted, but not issued	Not permitted	Permitted and issued	Permitted and issued	Permitted, but not issued	Permitted, but only for Italian subsidiaries of foreign banks
Fixed Asset Revaluation Reserves (on-balance sheet)	Prohibited by local accounting principles	Prohibited by local accounting principles	Only real property revaluation recognized as undisclosed reserves	Prohibited by local accounting principles	Permitted	Permitted	Permitted periodically, when allowed by special law
Latent Revaluation Reserves 55% discount on equities in investment portfolio	Excluded	Included	Only listed securities, recognized as undisclosed reserves, suject to 65% discount	Excluded	Excluded	Excluded	Excluded
General Loan Loss Reserves (up to 1.25%)	Included	Included	Only contingency reserves	Excluded	Included	Included	Included
Deductions — Total Capital							
Investments in the capital of banks/financial institutions	Required, only if sole purpose is to raise capital ratio	Required, only if sole purpose is to raise capital ratio	Not required	Required, if in excess of 10% of voting shares or if sole purpose is to raise capital ratio	Required, but with a market making exemption	Only if in excess of a specific percent of investor's or investee's capital	Only if in excess of a specific percent of investor's or investee's capital

Source: Table developed in the Capital Equivalency Report of June 19, 1992, by the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, at 16/18 of Appendix B. Alterations included by the author related to the Germany system, due to the enactment of the Fourth Act Amending the Banking Act, summarized in the Deutsche Bundesbank Monthly Report-January 1993, at pp. 35-40.