Making Basel III Work for Emerging Markets and Developing Economies

A CGD Task Force Report

Washington DC
April, 2019

FAIR GROWTH
SHORT
GOAL
MILLIONS SAVED
Due
Diligence

Basel III in EMDEs

- Although the adoption of Basel III is optional for the large number of EMDEs, many countries perceive the benefits of the new standards and are in the process of adopting and adapting it and many others are considering whether to do so.

- However, it is recognized that the process of implementation is not free of challenges and might be subject to some unintended consequences

- How can EMDEs maximize the benefits from Basel III?

By considering a framework that takes into account the particular characteristics of EMDEs

The Framework

Potential challenges of Basel III on EMDEs can arise from three areas:

A. **Effects on the volume, composition and stability of capital flows arising from the implementation of Basel III in advanced economies (spillover effects)**

B. **Financial stability and level playing field effects from the adoption of the Basel III framework by subsidiaries of global banks operating in EMDEs**

C. **Challenges posed by the actual implementation of Basel III in EMDEs**

The CGD Report develops recommendations in these three areas

The Framework

Objective: Making Basel III Work for EMDEs

EMDE Characteristics

- Variable access conditions to international capital markets
- High macroeconomic and financial volatility
- Less developed domestic financial markets
- Transparency and data availability
- Capacity and governance challenges

Principles

- Proportionality
- Minimization of negative spillover effects on EMDEs from the adoption of Basel III in advanced economies
- Minimization of financial stability and financial development trade-offs

Recommendations

The Framework

The characteristics of EMDEs inform Principles

Characteristics \ Principles	Proportionality	Minimize externalities	Balance stability/development
Variable access conditions to international capital markets		✓	✓
High macroeconomic and financial volatility	✓	✓	
Less developed domestic financial markets	✓	✓	✓
Limited transparency and data availability	✓		
Capacity and governance challenges	✓		

Minimizing the spillover from the Implementation of Basel III in advanced countries: An example

Infrastructure Finance

Issue:
Infrastructure finance has stalled in EMDEs since GFC; new capital and liquidity requirements can reduce investment in what is already a difficult area even further

Recommendation:
Efforts to develop infrastructure as an asset class should be pursued and intensified; standardization can make it easier to assess risks thus allowing for securitization and might justify lower risk weights.

Challenges from the Implementation of Basel III in EMDEs: Three Examples

I. Complexity of Implementation

Issue:

Reliance of many elements of the Basel III framework on ready and ample availability of data and large supervisory capacity; scarce in many EMDEs

Recommendations:

- Proportionality suggests that **where risk modelling is costly and data is unavailable** (e.g. **operational and market risk), consider using simple capital surcharges rather than trying to apply data-intensive models**.

- **However, it's important to avoid an excessive *reliance* on the principle of proportionality,** as the idea of a standard may be lost; the level playing field could be eroded; and cross-country comparisons or assessments would be difficult. **We recommend a regional approach where groups of regulators across EMDE regions agree on a set of proportional rules.**

Challenges from the Implementation of Basel III in EMDEs

II. Capital Requirements

Issue:

Gold plating: There might be a push to maintain the distance between international and national standards, which can have negative repercussions for lending for riskier borrowers, such as SMEs.

Recommendation:

- **Proper calibration of risk weights rather than gold-plating level of capital requirements**:
    - Through the use of country/regional data from credit registries. Supervisors can then compare these calibrated risk weights with those under the standardized and IRB approaches of Basel III before deciding on the risk weights to be prescribed.

    - **Where such data are unavailable, or supervisory capacity is inadequate, it is key to improve on constraints.** Meanwhile, use capital risk weights under the Basel III standardized approach.

Challenges from the Implementation of Basel III in EMDEs

III. Liquidity Requirements

Issues:

- Liquidity in financial markets is lower in EMDEs than in most AEs**, due to smaller scale and limited depth of capital markets**.

- An additional constraint is **the propensity to want to switch to foreign currency assets during stress times in many EMDEs**.

- These also make **assets usually considered as highly liquid (such as government paper) a less useful liquidity buffer than in many advanced economies, as some of these assets largely lose their value in times of crisis**. Thus, liquidity requirements based on Basel III's definition *of high-quality liquid assets* (HQLA) might give a false impression of secure liquidity.

Challenges from the Implementation of Basel III in EMDEs

III. Liquidity Requirements

Recommendation:

Because of many EMDEs having **variable access to international capital markets, facing high macroeconomic and financial volatility and having shallow capital markets**

- Complement Basel III's bank-specific liquidity requirements with a ***systemic liquidity reserve tool.*** Banks could be mandated to maintain a fraction of liquid assets required to fulfill Basel III with a centralized custodian such as the central bank. The liquidity requirements should be remunerated. The tool would aid monitoring and would allow the relevant authorities to publicize the systemwide liquidity available, boosting market confidence.

Looking Beyond Banks: Financial Development and the Real Economy

Issue:

To the extent that banks play a smaller role in long-term finance, given new liquidity requirements restricting their ability to transform maturities, there is a need for other, non-bank financial institutions, such as contractual savings institutions, to take a stronger role in.

Recommendations:

- Consistent with the **principle of minimizing the tension between the objectives of financial development and financial stability**:
  - I**mportant to strengthen the developmental objective of regulation/supervision of non-bank segments of the financial system** by setting it as a secondary objective to rebalance the trade-off
  - **Avoid political interference in this process**
  - **Long-term finance champion?**

Additional Challenges for EMDEs in meeting international standards

- **Looking for an alternative signaling tool** to international investors:
  - **Basel Core Principles of Effective Bank Supervision** (BCP) as such alternative gauge?
  - A regular assessment cycle of the BCPs, undertaken by, e.g., the World Bank and/or the IMF is needed

- Can non-FSB members be included in FSB (on a rotating basis?)

Center for Global Development

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