

Six Recommendations for Making Basel III Work for Emerging Markets and Developing Economies

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The 2008 crisis originated in the financial systems of advanced countries. Not surprisingly, one of the important responses to prevent another credit crunch, the Basel III international standards, is focused primarily on the stability needs of these countries. Basel III, a detailed and wide-ranging set of measures developed by a forum of bank regulators representing mainly the G20 nations, aims to strengthen the regulation, supervision and risk management of large banks around the world. While it is calibrated primarily for advanced countries, many emerging markets are in the process of adopting and adapting to these rules. Many others, too, are considering it.

In [previous blogs](#), we have analyzed the potential repercussions of Basel III for emerging markets and developing economies (EMDEs). These blogs focused on potential spillover effects from the implementation of Basel III in advanced countries and possible effects in EMDEs from implementation of Basel III in these countries. As an outcome of intensive discussions among a [CGD Task Force](#), the new Task Force report on *Making Basel III Work for EMDEs* offers recommendations resulting from this analysis that urge EMDEs to adapt Basel III according to their unique needs and capacities.

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Our conceptual framework starts from five specific characteristics of EMDEs that, while not universal, are common enough to not be disregarded. These characteristics include variable access conditions to international capital markets; high macroeconomic and financial volatility; less developed domestic financial markets; limited transparency; and capacity, institutional, and governance challenges. These differentiating factors help explain why the impact of regulatory reforms, such as those under Basel III, is expected to be different in EMDEs than in advanced countries. Our analysis

underscores the need for a differentiated approach to bank regulation to make Basel III work in these countries.



Launch and discussion of the CGD Task Force report. Participants included high-level authorities, including representatives from supervisory institutions, multilateral organizations and standard-setting bodies. Joint G-24/ CGD Roundtable at the IMF on April 10, 2019.

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In the following, we discuss six of the key Task Force recommendations. These recommendations all refer to specific principles that have guided our analysis.

Minimizing Potential Spillovers on EMDEs

The first principle is to *minimize/reduce negative spillover effects* of Basel III adoption in advanced countries. These negative spillover effects might come through cross-border lending to EMDEs and through the creation of uneven playing fields between domestic banks and affiliates of global banks in EMDEs.

1. Global Regulators Need to Facilitate Regular Assessments of Basel III Spillover effects on EMDEs

One important area of concern is the three significant changes in the volume and composition of cross-border financing to EMDEs since the Global Financial Crisis: a reduction in cross-border lending from global banks, a heavier reliance by EMDEs on debt issues rather than cross-border lending, and an increasing role of South-South lending.

While not necessarily (and certainly not exclusively) driven by Basel III, these three developments have important policy implications, but also call for more analysis. On the one hand, regulators from advanced economies may follow the US Federal Financial Institutions Examination Council's (FFIEC) example of making bank-level data on foreign exposures public, including on loans to EMDEs to thus expand the, currently extremely limited, research on the effects of Basel III on cross-border lending to EMDEs. However, if this data cannot be made public, the Task Force recommends that [The International Banking Research Network](#) (IBRN), a group of researchers from over 30 central banks and multilateral institutions, broaden and deepen their analysis on cross-border spillover effects for EMDEs. These spillover effects should be part of a broader evaluation agenda for regulators across the globe and multilateral organizations.

2. EMDE regulators and multilateral organizations should increase efforts to develop infrastructure as an asset class

Another specific area of concern is infrastructure finance. While it's not clear whether Basel III has been a major factor behind the relative reduction in private infrastructure finance in EMDEs, an ongoing challenge is that infrastructure is currently not an asset class in itself. If projects can be developed in a more standardized fashion and there is agreement on the different dimensions of risk and how they should be quantified, then it may become easier to issue securities backed by infrastructure projects. The Task Force therefore supports efforts to develop infrastructure as an asset class (or a set of asset classes) and to seek standardization in various aspects of infrastructure project development. Lower risk weights might then be appropriate for such standardized projects.

Design Regulations Proportional to the Needs and Capacities of EMDEs

The second important principle is that of *proportionality*. The application of Basel standards has to be adapted to the circumstances in EMDEs to maximize the stability benefits for their financial systems. This implies both proper specification of risks and adequate calibration and adaptation of the standards to the risks without weakening the prudential and supervisory framework.

3. EMDE regulators should use local or regional data to calibrate capital requirements

Capital requirements in EMDEs are often gold-plated, providing for additional capital buffers on top of international standards to reflect higher risks. The Task Force rather calls for the proper calibration of risk weights. We recommend that, where loan-level data are available, risk weights for credit exposures should be calibrated specifically to country circumstances, thus better reflecting actual risk rather than advanced country profiles and characteristics. Supervisors can then compare these country-specific calibrated risk weights with capital risk weights under both the standardized and the internal ratings-based approaches of Basel III before deciding on the risk weights prescribed by regulators.

4. EMDE regulators might have to look beyond Basel III for regulatory tools

The Basel III capital and liquidity requirements might not be sufficient for EMDEs' stability needs. High reliance on commodities that are subject to volatile price cycles, sectorally concentrated economies, and high reliance on foreign currency assets and funding call for cruder instruments than proposed under Basel III. These specific restrictions would include lending and exposure restrictions as already existing in some EMDEs. Such restrictions would go beyond single-exposure limits and could refer to sectoral, geographic, or foreign-currency lending exposures. Similarly, the variable access to international capital markets, the shallowness of interbank markets and the high correlation in liquidity positions across banks might make a centralized, systemic liquidity management tool necessary. Specifically, banks could be required to maintain a fraction of liquid assets set aside to fulfill Basel III requirements in a centralized custodian such as the central bank. This would aid monitoring and would allow the relevant authorities to publicize the system-wide liquidity available, thus boosting confidence and actually preventing a systemic problem from occurring in the first place.

Minimize trade-offs between financial stability and development

A third principle is to *minimize financial stability versus financial development trade-offs*. While the primary objective of financial regulation is financial stability, the economic and social returns to further financial

deepening are substantially higher in EMDEs than in advanced economies—calling for a balance between stability and development concerns.

5. Greater financial stability under Basel III calls for increased efforts to develop local capital markets in EMDEs

While the financial stability goal in Basel III is necessary, policymakers must keep in mind the, sometimes sharp differences between advanced economies and their emerging market counterparts. **The growth benefits from deeper and more efficient financial systems are larger in emerging than in advanced markets.** And when banks are—correctly—subject to increasingly tighter regulatory standards, there is a premium on developing non-bank segments of the financial system, such as insurance companies, pension funds, and public capital markets. These segments, though, are still underdeveloped in most developing economies. Therefore we recommend strengthening the developmental objective of regulation or supervision of nonbank segments of the financial system as a secondary objective to thus rebalance the trade-off.

Looking forward

Beyond recommendations for advanced and EMDE regulators and multilateral organizations on how to adapt Basel III to the needs of EMDEs, the Task Force also makes forward looking recommendations.

6. Compliance with the Basel Core Principles for Banking Supervision and not with Basel III should be the primary signal of regulatory quality in EMDEs

One important challenge for international policy coordination is that although the Basel III framework might not be fully appropriate for many EMDEs in its current form, as we have discussed above, its adoption is often seen as important signal to the international investor community. It might be worthwhile considering elevating other standards to fulfil such signaling functions. For example, compliance with the Basel Core Principles of Effective Supervision (BCP) is a prerequisite for effective implementation of Basel III recommendations. However, in many EMDEs, there are significant deficiencies in meeting key BCPs. Thus, the Task Force thinks that it is important that multilateral organizations (including the Basel Committee) make explicit efforts to favor adoption of BCP as the *primary* signal of regulatory quality in EMDEs. This key repositioning could help change the public perception that compliance with Basel III is the right metric to follow in EMDEs.

As Basel III is transforming the global financial landscape, we hope that policymakers from both advanced economies and EMDEs, as well as multilateral organizations, can work together effectively to ensure that Basel III truly becomes a global public good—promoting financial stability and supporting economic growth for all.

The table below provides an overview of the main recommendations of the Task Force.

Principles	Proportionality	Minimize Spillovers	Balance stability/development
Issues			

Principles	Proportionality	Minimize Spillovers	Balance stability/development
Issues			
Understanding the large reduction in cross-border lending to EMDEs and shift from bank- to market-based borrowing by EMDEs	<ul style="list-style-type: none"> a) FSB, BCBS and MDBs to undertake regular surveys and assessments of the spillover effects of Basel III for EMDEs as implementation proceeds; b) FSB, BCBS and MDBs to undertake more research on the impact of Basel III on cross-border credit to EMDEs and procyclicality of market vs bank lending 		
Dealing with emerging risks from increased South-South lending such as over-indebtedness	<ul style="list-style-type: none"> a) EMDE regulators to subject R-SIBs to a set of regulations that would combine elements from Basel III for D-SIBs with those for G-SIBs; b) EMDE regulators to strengthen supervision, risk management and transparency of the new EMDE lenders; c) EMDE regulators to deepen bilateral cooperation of supervisors of lenders and borrowers in the Global South 		
Standardizing the treatment of infrastructure finance under Basel III	<ul style="list-style-type: none"> a) FSB, BCBS and MDBs to undertake efforts to develop infrastructure as an asset class; b) FSB, BCBS and MDBs to undertake more research on the impact of Basel III on infrastructure finance 		
Addressing the differential treatment of sovereign exposures by subsidiaries of foreign banks vs domestic banks	<p>Regulators across the globe to start intergovernmental discussions to identify conditions to be met by host countries that would encourage home-country supervisors to apply host-country treatment. One possibility could entail agreeing upon a set of a macrofinancial indicators as benchmarks.</p>		
Dealing with the excessive complexity in Basel III and limited supervisory capacity	<p>EMDE regulators to prioritize key risks in their banking sectors, including credit and liquidity risks, matching their efforts to the country's supervisory capacity</p>		
Adapting liquidity requirements under Basel III for EMDEs	<ul style="list-style-type: none"> a) EMDE regulators to possibly adopt or keep simpler liquidity ratios; b) EMDEs to consider to create a centralized, systemic liquidity tool 		

Principles	Proportionality	Minimize Spillovers	Balance stability/development
Issues			
Improving on the gold-plating of capital requirements	<ul style="list-style-type: none"> a) EMDE regulator to calibrate risk weights where data is available; to improve collection where it is not; b) EMDE regulators to use a regional approach to agree on a set of proportional rules including capital requirements 		
Finding more appropriate indicators for activating the countercyclical capital buffer	EMDE regulators to explore alternative gauges such as real credit growth, profits and credit spreads, as suggested by the BCBS		
Basel III capital and liquidity requirements may not be binding or address important stability concerns particular to EMDEs even after adaptation	<ul style="list-style-type: none"> a) EMDE regulators to consider more crude instruments than proposed under Basel III, including lending/exposure restrictions that go beyond simple exposure limits and could refer to sectoral, geographical or foreign-currency lending exposures; b) EMDE regulators to undertake more country-specific research and global cooperation on macro-prudential policy tools 		
High social return on financial deepening in most EMDEs vs advanced countries which has to be balanced with stability needs			EMDEs to undertake a cost-benefit analysis before introducing new regulatory standards which should be announced early with long implementation periods
Regulatory tightening in the banking system might create funding gaps in key sectors crucial for development			EMDEs to develop and strengthen contractual savings institutions in EMDEs, together with public and private capital markets
Financing constraints on underserved groups such as SMES			EMDEs to use nonregulatory tools, such as partial-credit guarantees and focus on the institutional framework that enables lending to such groups

Principles	Proportionality	Minimize Spillovers	Balance stability/development
Issues			
Basel III may not be appropriate for some EMDEs but acts as an important signal for investors	IFIs (including the Basel Committee) to make explicit efforts to favor adoption of BCPs as the primary signal of regulatory quality in EMDEs		

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