The Impact and Implementation Challenges of New Banking Regulation (the Basel III Framework) for Emerging Markets and Small Economies

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Regulation can be justified only by some important differences vis-a-vis non-financial sectors

- Financial intermediation and banking especially is essentially a business with “promises” which are to be fulfilled in more or less distant future

- Potential contagion (“domino effect”) – possible negative externality

- Banks provide the economy with means of exchange and with a store of value – disruption of this function can severely harm non-financial sectors and households

- Other economic reasons: ability of risk assessment by individual banks, herd behavior, structure of the banking sector, maturity mismatch (short run liabilities versus long run assets)

”...We find only one economic justification for regulating banks – the reduction of the negative externalities from moral hazard and agency costs that accompany poorly structured (government-provided) deposit insurance“

According to this theory, the basic distinction for regulatory measures is whether they REDUCE or INCREASE MORAL HAZARD

**INCREASE**
- Widening of deposit insurance
- "Bank levy“ without relation to risks
- Additional funds to solve future bank problems ...

**AMBIGUOUS**
- Limited entry
- Leverage restrictions

**REDUCE**
- Risk-sensitive capital requirements
- Liquidity conditions
WELL, THERE GOES THE NEIGHBORHOOD...
Goals of the Basel Consultative Group Work:

• How to promote the intended consequences (make banking sector more robust, stable, and supporting real economy)
• How to address, cope with and mitigate the unintended ones

EMSEs have some common features:

• their financial markets are often more volatile;
• they are experiencing stronger credit growth; catching-up process;
• they usually have lower credit ratings and shallower government bond markets; lower stock of high quality liquid assets;
• they face a whole range of home-host issues.
Stocktaking list of concerns (FSB September 2013):

- Adverse implications
- Deleveraging by internationally active banks
- New liquidity standards
- Sequence of implementation
- Supervisors focus on implementations, not on real economic implications

- Nevertheless, there is broad support from EMSEs for the reforms based on the Basel framework
Basic areas of the Basel Consultative Group analysis (based on the Basel III framework):

1. Capital framework
2. Liquidity framework
3. G-SIFI and D-SIB issues
4. Home-host issues and cross-border colleges
5. OTC derivatives markets reforms
Capital

• EMSEs, in general, do not have major difficulties in meeting the new definition of capital (their capital structure usually involves only Tier 1 instruments)

• the size of the capital buffers should not present a challenge for the EMSEs, given the usual high capital adequacy of their banks

• an issue might, however, be the interaction between these buffers and additional buffers required by supervisors under Pillar 2; and between these buffers and liquidity standards

• the deduction of Deferred Tax Assets (DTA) proposed by Basel III seems to weigh relatively more in EMSEs than in advanced economies

- overall impact of the deductions and market risk adjustments on the CET1 ratio is largest for LAC, MENA and ECA regions
Basel III introduced **more transparency**, disclosure remains an issue

- financial reporting is not yet compatible with international standards
- there are **not sufficient established auditing standards** or requirements for the auditing profession
- supervisors **lack the power** to remove or reject substandard external auditors
- supervisors **lack the power** to require sufficiently and timely information from banks

*Implementation planning should start by **building capacity to manage the process effectively**.*
Credit ceiling or the risk floor for EMSEs

- The criteria for estimating risk weighted assets (RWA) for exposures in host-countries are decided by parent banks and home-country supervisors.
- Higher capital requirements imposed on subsidiaries operating in EMSEs.
- Banks in EMSEs with relatively fast economic growth will inevitably need to issue (or “find”) additional capital to support their asset expansion.
- Lack of local infrastructure to facilitate the issuance of structured capital instruments.
- EMSEs are also disfavored on international markets (lack of credibility and transparency).

To cultivate domestic markets, to develop legal environment.

Need to provide guidance on how global banks may assign RWA, at the consolidated level, to their foreign subsidiaries’ risk exposures to local sovereigns denominated and funded in local currency.
Basel III provides an incentive to move to the use of the more advanced risk measurement techniques

- banks may be incentivized to apply on a larger scale the internal rating-based (IRB) method instead of the standardized approach
- IRB approach would generate higher demands and costs for both banks (data and IT, risk management, etc.) and their supervisors (complex regulation, knowledge and capacity for initial approvals and on-going control)
- the unintended consequence would be a decline in consistency and comparability due to excessive variation in risk measurement without better management of the underlying risks

The optimal reaction to such a point of departure is gradual development of risk-sensitive approaches.
Long-term trade finance

• global banks reduce their assets by lending less to certain regions and/or by reducing their exposure to certain risky asset classes

• adverse effects on the real economy through a tightening of financial conditions. Equally, deleveraging pressures are affecting certain specialty finance lines such as aircraft and shipping

To require a policy response to minimize the negative impacts on the real economy.
Countercyclical capital buffer calibration

- buffer at **non-zero level** will increase in banks’ funding costs
- potential negative consequences for EMSEs arising from a limited understanding of credit cycles and mechanical use of credit-to-GDP guide
- EMSEs are mostly in a process of economic convergence, mostly with relatively low initial stock of credit
- faster credit growth simply often means financial deepening, not excessive borrowing

„*Do not apply credit-to GDP limit (guide) mechanically...“*
EMSEs represent **heterogeneous group** of countries

- **different level** of credit-to-GDP ratio (i.e. phase of financial deepening)
- **different historical patterns** of credit-to-GDP ratio

Source: BIS, CNB
stably high credit growth (convergence in credit to GDP reflects initial low level of financial intermediation and catching up hypothesis)

banking sector restructuring/deleveraging (bad assets in the 1990s) complicates the calculations of the CCB further (calculating the trend since 1995 - downward sloping - indicates that the CR would be well above trend)

Development of credit to GDP ratio in CEE countries

Credit to GDP in the Czech Republic and its trend

Source: IMF IFS, CNB calculations

Source: CNB, CNB calculations
Adverse sovereign-financial sector feedback loop

- the Basel III framework generally provides preferential treatment of sovereign exposures
- growing recognition that the current prudential framework does not require sufficient regulatory capital against sovereign exposures
- encourage banks to set their exposures at a pace consistent with their business activity and to a level that is commensurate with their financial strength and internal risk

Macroprudential limit on the size of sovereign debt exposures for banks could be set if deemed necessary.
HQLA concerns

- LCR can be a bigger issue than capital requirements
- supply of HQLA is limited
- in addition, HQLA carry lower yield ("search for yield behavior")
- generate a perverse outcome by creating an incentive for governments to issue more debt
- Despite the emphasis on diversification, concentration risk, particularly to sovereign debt (a “level 1” asset), can easily emerge
- increase in credit risk for some securities and to crowding-out of private sector lending
FX liquidity framework

• require banks to hold a larger amount of foreign-currency HQLA to comply with the LCR by currency
• for some EMSEs, the LCR may increase foreign currency risk if banks meet LCR shortfalls in domestic currency with foreign currency assets
• this higher demand for foreign-currency HQLA may affect the availability of such assets, as well as their price
• supervisors’ decision in this area should consider various factors (e.g., degree of dollarization, level of financial internationalization, existing foreign exchange, currency convertibility and volatility)
Domestic systemically important banks (D-SIBs)

- “too big to fail,” paradoxically increasing the moral hazard problem; this consequence is probably going to be more important in smaller countries with a bigger ratio of banks identified as D-SIBs
- the negative externalities associated with the existence of D-SIBs should be reduced by imposing higher loss absorbency (HLA) requirements

Recovery and resolution plans are very important
How to reduce the contagion?

- **Deposit insurance** helps to reduce possible negative externalities.
- **Lender-of-last-resort** (LLR) function of a CB could supplement or even substitute deposit insurance.
- In principle, deposit insurance possible on private markets, **BUT problems of adverse selection** and **moral hazard** combined with possible contagion effect.

*The best solution is „Recovery and resolution plans“*
Home-host issues:

- equal treatment, sharing information, respect responsibilities
- global banks use global credit ratings, rather than their subsidiaries’ local ratings, to assign RWA and estimate capital charges for their overseas exposures
- parent banks apply a sovereign credit rating ceiling or cross-border add-on factor to calculate the risk weights of their foreign exposures

Cross-border colleges may represent a very useful mechanism
OTC derivatives, CCP

- new capital charge might unduly increase the costs of OTC derivatives transactions used for hedging by SMEs
- there are few alternatives to reducing the capital charge given the low use or nonexistence of credit default swaps and central counterparties to clear local currency instruments
- mandatory CCP clearing for OTC derivatives may not be feasible in countries where there are not enough large players or high-volume transactions
- it can shift business from small countries to countries where CCPs are available
## Conclusion

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<td><strong>Basel Capital and Liquidity Framework</strong></td>
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<td>Deductions proposed by Basel III may be challenging.</td>
<td>Implement legal changes.</td>
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<td>Role of the supervisor is key to implement mandatory and countercyclical buffers</td>
<td>Strengthen supervisory powers.</td>
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<td>Basel 2.5 led to increases in RWA for trading exposures in EMSEs financial markets; criteria for estimating RWA exposures is decided by parent banks and home-country supervisors.</td>
<td>Further guidance from Basel Committee, assess whether to reevaluate consolidation practices.</td>
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<td>Implementation of Basel III will generate a need for capital replenishment.</td>
<td>Strengthen arrangements to enable issuance of capital instruments, define explicitly non-viability trigger.</td>
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<td>When adopting Basel III, some banks may not reveal and recognize all potential risks associated with their balance sheets and could be tempted to move to IRB approaches without being ready.</td>
<td>Aim at ensuring the robustness, reliability, and transparency of prudential outcomes; Basel II and Basel III standards are designed primarily for large international banks in BCBS states.</td>
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<td>A mechanistic implementation of the countercyclical capital buffer could have negative consequences.</td>
<td>Improve the understanding of credit cycles, consider other macro-prudential tools to tame credit booms.</td>
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<td>Implementation of the liquidity coverage ratio will be challenging for many EMSEs.</td>
<td>Undertake QIS, create a dedicated unit in supervisory agency, BCBS-BCG to issue further guidance.</td>
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<td>Enhanced liquidity requirements are encouraging groups to hold liquid reserves at the parent level, but it is unclear when and how these reserves should be made available; deposits placed at a parent bank by foreign subsidiaries could become subject to bail-in arrangements; operations undertaken by banks in IFCs incur a higher liquidity charge; banks may be “compartmentalizing” their different operations, which may weaken the ownership chain and the availability of group liquidity and capital support.</td>
<td>BCBS should: give greater encouragement to home supervisors to reach understanding with banks and home supervisors on how and when reserves can be made available; allow greater flexibility for treatment of non-retail deposits; and encourage agreement on likely resolution scenarios in advance.</td>
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### Issues

#### OTC Derivatives Reforms

The impact of OTC derivatives reforms in EMSEs varies widely depending on financial market characteristics and stage of development. The cost of creating certain financial market infrastructures might not be justified in EMSEs.

Recommendations: Reforms should be sequential; endorse an explicit reference to thresholds of proportionality.

#### Banks’ Sovereign Exposures

The Basel III framework, together with national discretion, provides preferential treatment to sovereign exposures that could lead to excessive sovereign build up.

Recommendations: Consider approaches to give due regard to risks, preferably on a globally consistent basis.

#### Domestically systemic banks (D-SIB) in EMSEs

D-SIB could be perceived as “too big to fail”.

Recommendations: Prepare bank specific recovery and resolution plans.

In systems dominated by foreign banks, intra-group capital flows could emerge.

Recommendations: Need for close coordination between regulatory authorities; phase capital requirements in home and host jurisdictions.

Parent banks of subsidiaries classified as D-SIB in host jurisdictions may seek to circumvent the higher loss absorbency requirements.

Recommendations: Deter the conversion of subsidiaries into branches; increase authorities’ powers over branches.

#### Cross-border colleges

Supervisors from EMSEs are not likely to be included in the core college.

Recommendations: Introduce a mechanism to ensure all relevant jurisdictions are invited to colleges; sign an MOU before granting a banking license to a cross-border institution; define a set of minimum information to share; supervisors must have power to require capital for a restructuring of the financial group.
Few remarks on regulation from a more general perspective:

• How will new regulatory measures interact the existing regulation?

• Are they going to reduce moral hazard, or to increase it?

• Construct them in line with principles that are complementary and sufficiently supported by theory wherever possible.

• A few principles which I hope most theorists and regulators can agree with, but the list is not and cannot be exhaustive…
A few principles of regulation

• Regulator should always assess its ability to enforce the newly proposed rules realistically. Those rules which cannot be effectively enforced or even monitored should only be indicative and should not be heavily relied upon.

• Regulation should function on a parametric base wherever possible. Recent efforts to differentiate regulation according to specific features of individual agents may be a dead end. Agent-specific regulation may seem theoretically appealing because it can be tailored to fit the individual agent, so that, in theory, it could have better results with lower losses of efficiency than parametric regulation. In practice, though, regulatory measures cannot be perfectly tailored. More importantly, there is a risk of substantial subjectivism on the part of the regulator, and there is also a danger of serious government failure.
A few principles of regulation

- **“Regulatory snowball effect”:** one regulatory rule may induce a need for another rule and this in turn for another regulation and so on.

- **What we want to achieve by any given measure.** The answer to the question of what is to be achieved by regulation must also contain an answer to the question of what functions of financial intermediaries are to be retained, modified or suppressed. For example, the liquidity rules for intermediaries tend to increase the liquidity.
Current regulatory framework is a mixture: some measures have solid theoretical rationale, some have no theory behind them, on some points the theory does not give clear answers.

However, some regulatory measures based on the Basel framework give tools to mimic "the first best solution."

Some of the regulation is done with too much haste, and some of the regulation is ahead of theory, consequences are only partially predictable.
The Future

• When will the regulatory measures be finally **final**?

• If regulation is to **mimick** the “first best solution”, then NEVER

• As long as **financial innovations** continue, so must continue modifications of the regulatory framework!

• Banking will remain a business with promises and no regulation can replace trust, regulators should not aim at “perfect regulation”

**THE ”PERFECT REGULATION” DOES NOT EXIST**
Thank you for your attention.