Closing the gap: developing countries and international banking standards

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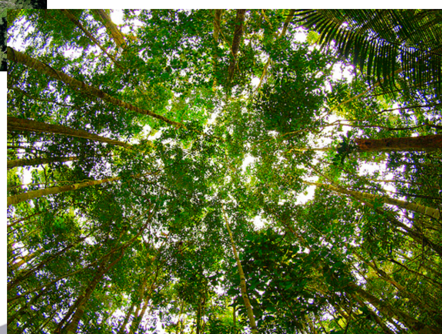
Same system, different perspective



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Basel II/III pose challenges for developing countries

If regulations were designed for LICs/LMICs, wouldn't look like Basel II/III:

- **Excessive complexity** given available resources (regulator and banks) (esp. macroprudential elements)
- **Financial infrastructure gaps** (e.g. credit ratings industry)
- **Poor match for financial stability risks** (e.g. counterparty risks for derivatives exposures vs. volatility in capital flows)
- **Exacerbate information asymmetry** between regulator and banks
- **Distort regulatory agenda**
- **Deterioration of credit composition** / bias against lending to risker sectors (e.g. SME financing)

(See e.g. Barth and Caprio 2018; Beck 2018; Griffith-Jones and Gottschalk 2016; Kasekende 2015; Murinde 2012; Murinde and Mlambo 2010; Rojas-Suarez 2018; Rojas-Suarez and Muhammad 2018)

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…full-scale adoption of the [Basel] framework **may distract many EMDEs** – particularly low-income countries – **from more basic and urgent reform priorities** (IMF, WB, FSB 2011)

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Research Questions

- How are regulators outside of the Basel Committee (esp. LICs/LMICs) responding to international banking standards?
- Why? What factors shape regulatory decisions?
- What are the policy implications?

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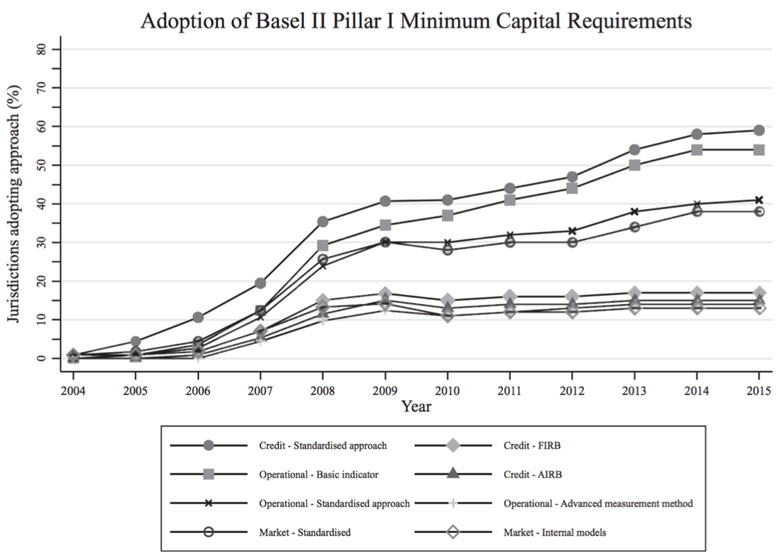

Figure 3. Adoption of Basel II subcomponents from time of introduction among Basel non-members.

Source: data from FSI surveys (up to 2015), analysis in Jones and Zeitz (2017)

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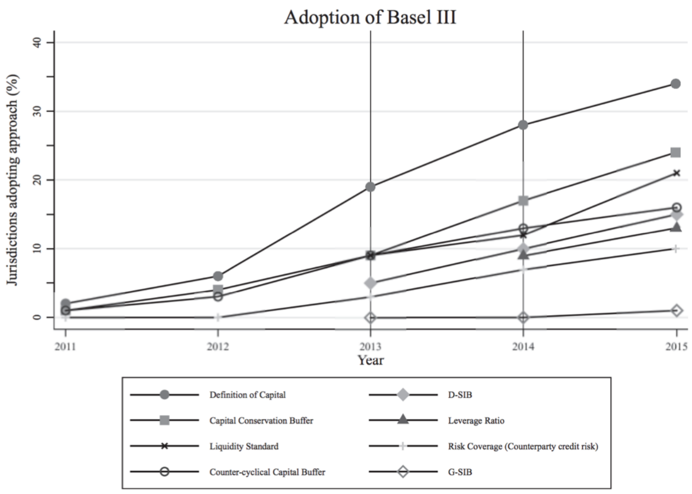

Figure 6. Adoption of Basel III subcomponents from time of introduction among Basel non-members.

Source: data from FSI surveys (up to 2015), analysis in Jones and Zeitz (2017)

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Uptake by low- and lower-middle income countries (2015)

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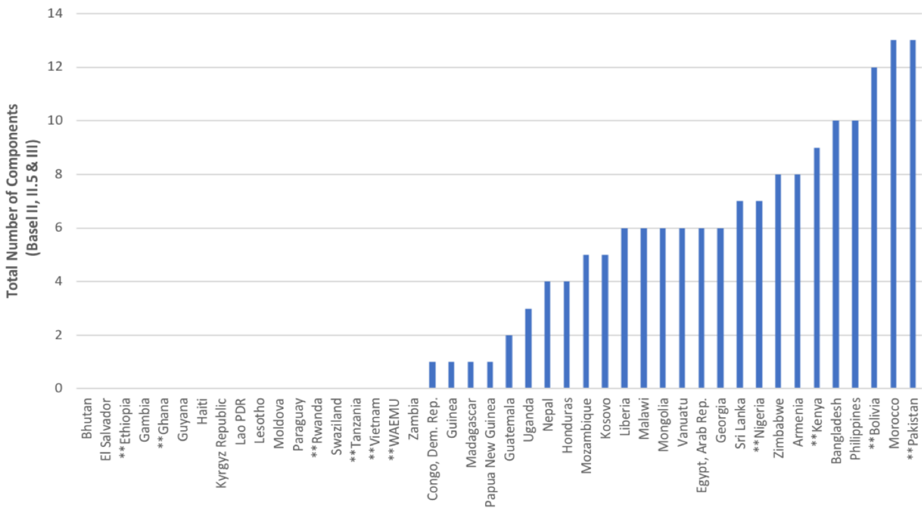

FSI data (2015)

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Why these regulatory decisions? Why convergence on international standards? Why variation across countries?

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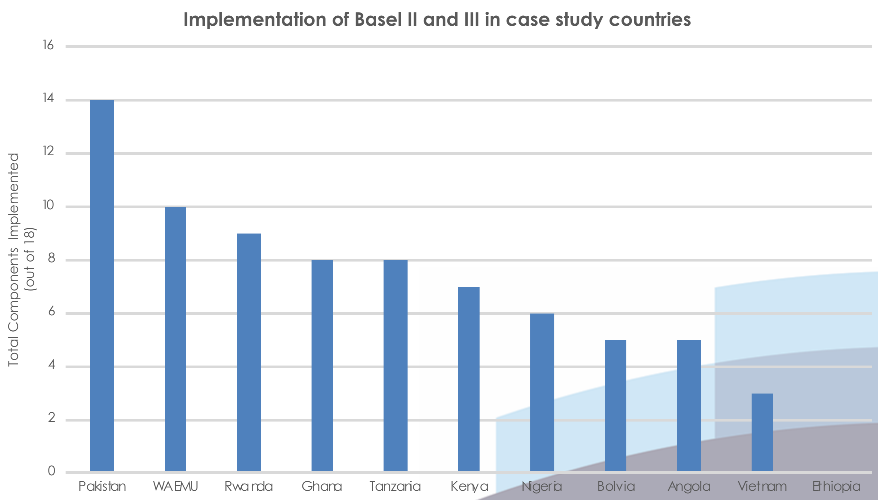
Case studies (Jan 2019)



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Key findings

Growing financial complexity, but also (mainly) political economy dynamics…

Convergence:

1. **Politicians signaling to investors** e.g. Pakistan, Ghana, Rwanda
2. **Regulators engaging with peers** (emulation, professional reputation, 'common language') e.g. Bolivia, Vietnam
3. **Banks internationalizing - reassure host regulators & attract international investors** e.g. Pakistan, Vietnam
4. **IMF advice** (sometimes) e.g. WAEMU

Divergence:

1. **Politicians pursuing interventionist financial policies (policy-driven lending)** e.g. Ethiopia
2. **Politicians directing credit to allies** e.g. Angola
3. **Skeptical regulators** e.g. Ethiopia, Tanzania, Kenya, Vietnam

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Jones (ed.) forthcoming

Banks

Table 2: Results: Spatial-OLS model of the extent of Basel II Adoption in 2008

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
$\mathbf{W}y^{\text{Incoming Foreign Banks}}:\rho$	0.517**					0.352	0.330
	(0.205)					(0.212)	(0.209)
$\mathbf{W}y^{\text{Banks Abroad}}:\rho$		0.555**				0.542**	0.572**
		(0.255)				(0.224)	(0.225)
$\mathbf{W}y^{\text{Supervisory Networks}}:\rho$			1.114***			0.978**	1.085**
			(0.400)			(0.415)	(0.427)
$\mathbf{W}y^{\text{Competitors}}:\rho$				0.418*		0.396*	0.362*
				(0.244)		(0.205)	(0.214)
$\mathbf{W}y^{\text{Trade partners}}:\rho$					-0.698		-1.289
					(1.332)		(1.234)
Controls							
Financial sector depth	0.021***	0.020**	0.026***	0.018*	0.021**	0.017**	0.015*
	(0.008)	(0.009)	(0.008)	(0.010)	(0.009)	(0.008)	(0.009)
FDI inflows (as % of GDP)	0.008	0.015	-0.011	0.025	0.009	0.009	0.005
	(0.044)	(0.041)	(0.041)	(0.044)	(0.045)	(0.040)	(0.042)
Democracy	0.049	0.063	0.022	0.077	0.062	0.027	0.018
	(0.062)	(0.066)	(0.064)	(0.062)	(0.064)	(0.060)	(0.057)
Corruption perception index	-0.052***	-0.053***	-0.072***	-0.043**	-0.063***	-0.041**	-0.049**
	(0.017)	(0.017)	(0.017)	(0.019)	(0.017)	(0.019)	(0.019)
Central bank independence	0.027*	0.023	0.021	0.018	0.023	0.019	0.017
	(0.015)	(0.014)	(0.014)	(0.015)	(0.015)	(0.014)	(0.014)
Banking sector concentration	0.034**	0.031*	0.030**	0.026*	0.023	0.048***	0.048***
	(0.015)	(0.016)	(0.014)	(0.015)	(0.015)	(0.015)	(0.016)
IMF program (last 3 years)	-0.909	-0.769	-0.881	-0.834	-1.157	-0.334	-0.527
	(0.801)	(0.830)	(0.806)	(0.841)	(0.845)	(0.782)	(0.799)
Constant	-1.888	-0.270	0.573	-0.494	2.881	-3.933	-0.286
	(2.496)	(2.285)	(2.239)	(2.255)	(3.789)	(2.574)	(3.843)
Observations	96	96	96	96	96	96	96
R-squared	0.642	0.639	0.652	0.632	0.622	0.693	0.699
Region dummies	YES	YES	YES	YES	YES	YES	YES

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Source: Jones & Zeitz (forthcoming)

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Supervisory networks

Source: Jones & Zeitz (forthcoming)

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Competition for capital

Source: Jones & Zeitz (forthcoming)

The Reform Imperative

- **LIC/LMIC regulators face trade-offs**
  - Basel standards are not "international best practice" rather politically negotiated compromises
  - Substantial costs and risks associated with wholesale implementation of Basel standards esp. in LICs / LMICs
    NB: challenge is complexity and coverage, <u>not stringency</u>
  - Yet in today's globalised economy very strong reputational incentives to implement international standards
- **Proportional implementation = strategy to achieve signal (reap reputational gains) and reduce costs and risks**

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Proportional Implementation

- **Proportionality:** tailoring regulatory requirements to non-internationally active banks, especially smaller and less complex ones
- Basel I, II, III designed for internationally active banks, not whole banking system
- BCP 16 (capital adequacy) invites proportional approach
  - supervisor sets capital adequacy requirements that reflect risks & market context
  - For internationally active banks, not less than the applicable Basel standards

Options:

- Selective implementation (some standards, not others)
- Adjust regulatory perimeter (some banks, not others)
- Modify standards to suit local context
  - e.g. risk-weights for SMEs

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Proportional Implementation – Basel members

Implicit size thresholds for the application of the Basel framework[10] Table 2

Jurisdiction (1)	Thresholds (for specific areas) (in general) (2)
Brazil	- **Total exposure/GDP > 10%** (≈ EUR 170.4bn) - Total assets abroad ≥ US$ 10bn
European Union[11]	- **Total assets ≥ EUR 30bn** - Total assets ≥ EUR 5bn and ≥ 20% nat. GDP
Hong Kong SAR[12]	- **Total assets ≥ HK$ 250bn** (≈ EUR 28.8bn)
Japan	- **Smallest bank subject to the Basel framework** (≈ EUR 28.4bn)
Switzerland	- **Total assets ≥ CHF 15bn** (≈ EUR 13.8bn) - Assets under management ≥ CHF 20bn - Privileged deposits ≥ CHF 0.5bn - Required equity capital ≥ CHF 0.25bn
United States	- **Total assets ≥ US$ 250bn** (≈ EUR 222.5bn) - On-balance sheet foreign exposures ≥ US$ 10bn

Sources: National regulation (see Annex); exchange rates provided by the ECB (as of 21 June 2017).

(Castro Carvalho et al., 2017)
https://www.bis.org/fsi/publ/insights1.htm

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But…

Costly to retrofit international standards
& regulators with least resources have to do most retrofitting

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Reform Options (1)

- **Reduce the costs of proportional implementation**
  - CABS, IMF/WB/FSB also BCG, RCGs
    - Research & guidance: how to adjust international standards to local context and regulatory priorities?
    - Strengthen peer-learning on proportional implementation
- **Alternative mechanism for signaling regulatory & supervisory quality**
  - Credit rating agencies, institutional investors, host supervisors, rely on heuristics / proxies (limited due diligence)
  - Basel III implementation weak (and costly) proxy of regulatory quality (esp. LICs / nascent financial markets)
  - BCP compliance as a better proxy? (But limited evidence on efficacy of BCPs, what about non-LICs?)
  - Or bespoke approach plus 'seal of approval' from trusted third party (exceeds minimum Basel standards AND appropriately calibrates risks)?

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Reform Options (2)

- **Reform international standards**
  - Reduce gap between international standards and optimal regulation in LMICs/LICs
  - **Hardwire proportionality** into Basel standards
    - e.g. simplified standardized approach
  - **Greater participation and influence by LICs/LMICs** in the standard-setting processes (Basel *Consultative* Group and Regional *Consultative* Groups)
  - Create an **FSB Independent Evaluation Office** (like the IMF's Independent Evaluation Office) to ensure Basel Committee decisions robustly reflect views of all members and consider implications for non-members
  - **Change the mandate** of the Basel Committee to include impact on non-members, plus financial sector development and financial inclusion as secondary objectives

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Conclusion

- Full suite of Basel II/III standards not appropriate in many LICs/LMICs & not for all banks
- Yet tremendous market / reputational pressure to converge
- Options:
  - Support proportional implementation
  - Increase influence of LICs/LMICs in standard-setting

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Publications

Academic Publications

- E. Jones and A. Zeitz (2017) 'The limits of globalizing international banking standards' *Journal of Financial Regulation*
- E. Jones and P. Knaack (2019) 'Global financial regulation: shortcomings and reform options' *Global Policy*
- E. Jones and A. Zeitz (forthcoming) 'Regulatory Convergence in the Financial Periphery: How Interdependence Shapes Regulators' Decisions' *International Studies Quarterly*
- E. Jones (ed.) (forthcoming) *The Politics of Bank Regulation in Developing Countries: Risk and Reputation* Oxford University Press

Policy briefs and op-eds

- T Beck, E. Jones and P. Knaack (2018) 'Basel standards and developing countries: A difficult relationship' VoxEU 15 October 2018
- T Beck, E. Jones and P. Knaack (2019) 'Mind the Gap: Making Basel Standards Work for Developing Countries' T20 Policy Brief 14 March 2019

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Thank You

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