Making Basel III Work for Emerging Markets: Containing the Risks of Financial Crises

Center for Global Development

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Can Basel III Help Contain Financial Crises 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

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 that complement Basel III standards

Basel III in EMDEs: Assessing Risks Correctly - Three Examples

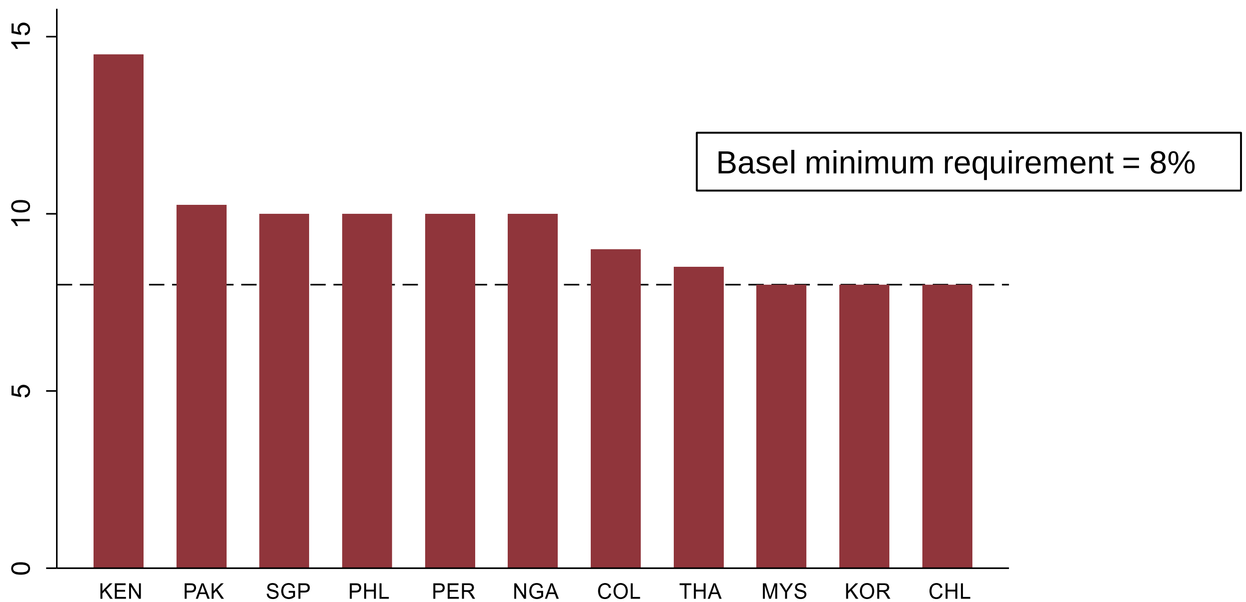
I. Capital Requirements

- **Gold plating:** While many EMDEs already meet Basel III minimum capital requirements, gold-plating has been a common practice even in the pre-Basel III period

Examples of Gold-Plating in EMDEs

Minimum Capital Adequacy Ratio

2018, as % of RWA



Source: Central Bank data

Basel III in EMDEs: Assessing Risks Correctly - Three Examples

I. Capital Requirements

Recommendation:

- **To better reflect risks, 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.

    - To avoid <u>excessive</u> reliance on the principle of proportionality (as the idea of a standard may be lost and cross-country comparisons would be difficult), it is advisable that countries enter into regional agreements on the proposed context-specific calibration.

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II. 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.

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II. Liquidity Requirements

Recommendation:

Because many EMDEs have **variable access to international capital markets, face high macroeconomic and financial volatility and have 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.

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III. Beyond Capital and Liquidity Requirements

Issues:

- Because of the characteristics of EMDEs, Basel III capital and liquidity requirements and core regulatory toolbox in advanced countries might not be sufficient to address critical financial stability concerns in many EMDEs:
  - **A high dependence on commodity price and high sector concentration economies result in higher asset concentration on banks' balance sheets,** rising fragility and higher potential losses.

  - **High price and exchange rate volatility can translate into volatility of banks' liquidity and solvency position**, especially in financial systems whose clients (corporations) rely heavily on foreign currency assets and funding. Changes in exchange rates can thus easily result in asset-liability mismatches or -even if FX assets and liabilities are matched- in liquidity or credit risk.

  - Another area of concern not properly addressed is the **large common credit exposures across banks in economies which are not sectorally well diversified**, i.e., banks being exposed to the same dominating sectors in the economy.

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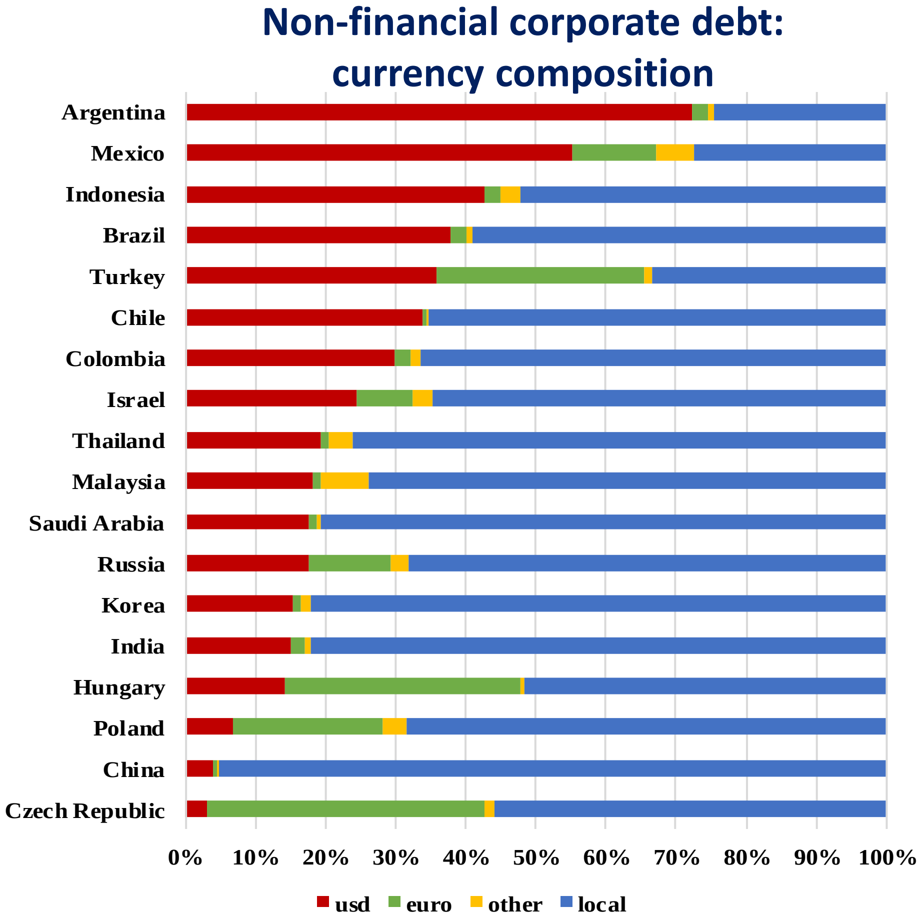
Available data show that Latin American corporations, in general, are more vulnerable to dollar appreciation than other corporations in Emerging Market regions



Source: IIF

The degree of vulnerability, however, depends on the extent of unhedged exposure by corporations, for which data is not fully available. Hard to assess currency mismatches

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III. Beyond Capital and Liquidity Requirements

Recommendations:

- **Higher macroeconomic volatility in EMDEs** might require the usage of cruder instruments than proposed under Basel III, including lending and exposure restrictions as already existing in some EMDEs. **These restrictions would go beyond single exposure limits and could refer to sectoral, geographic or foreign currency lending exposures**. For example, focusing on zero net foreign exchange position (i.e., matching foreign assets with liabilities) is not sufficient.

- **Macro-prudential tools play a critical role in the regulatory toolbox, but there is still limited knowledge of what works under which circumstances**. EMDEs are – on average – more advanced that AEs in the use of macro-prudential policy tools. This provides an important learning opportunity across EMDEs. **Increased cooperation among regulatory authorities in this area is needed.**

Back to Basics in the Face of Complexity

- **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

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