Implementation of Capital Requirements in Emerging Markets

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2017 Seminar for Senior Bank Supervisors from Emerging Economies
Regulatory Tsunami

• Basel Committee since 2008:
  – Over 250 papers

Not to mention the FSB...
Are the international standards appropriate for developing economies?

• Focus on sophisticated financial markets
• Universal lessons:
  – Lack of capital
  – Quality of capital
  – Macroprudential dimension
  – Liquidity requirements
  – Early corrective measures
  – Resolution framework

Many EMDEs need to tackle several of these issues
How EMDEs Should react?

• Should Implement:
  – Basel II
  – New RWA approaches
  – BIII Capital
  – Buffers
  – Leverage ratio
How EMDEs Should react?

**Basel Core Principles sets the direction**
- Get Basics right!
- Not just about Capital
- Not just about Pillar I

**Lessons from the crisis apply to EMDEs**
- New International standards benchmark

**Adaptations possibly necessary**
- Simplification, Calibration, timing, instruments
- More conservative, not less
  - Volatility, loan recovery challenges, market illiquidity,...
Basel II
Basel II: The three pillars

| Pillar 1 | • Minimum risk based capital requirements; definition of capital  
|          | • On and off balance-sheet |
| Pillar 2 | • An assessment of risks - both quantitative and qualitative  
|          | • Proportionate to complexity and scale, whole group, forward looking.  
|          | • Assess banks’ Governance and Risk Management frameworks  
|          | • Assess banks’ own analysis of risk profile  
|          | • Preventive supervision; structured dialogue; capital above the minimum |
| Pillar 3 | • Disclosure to complement, enhance and reinforce Pillars 1 and 2  
|          | • Capital adequacy must be publicly disclosed  
|          | • Transparency on capital structure and risk exposures,  
|          | • Transparency on risk management and internal controls |
Should Implement BII?

**Important**
- Securitization, fund investments
- Pillar II / Pillar III

**Attention if**
- Implementation at early stages
- Already imposes higher capital requirements than 8%

**Possible way forward**
- Simplification: market risk, securitization, derivatives
- Wait for BIII RWA rules
- Calibration (up!)
Risk weighted assets
Main changes

Credit
- Mortgages more sensitive
- Update calibration
- Off balance

Market
- Stronger border
- Enhanced granularity and risk sensitivity
- Expected shortfall

Operational
- Elimination of AMA
- Business indicator
- Use of operational loss data
Should Implement new SA credit risk?

**Important**
- Mortgages and exposures to funds are relevant
- Off-balance sheet exposures

**Attention if**
- Exposures concentrated on corporates and retail

**Possible way forward**
- Focus on relevant portfolios
- Consider go beyond Basel revisions
- Adjust parameters
Should Implement new SA market risk?

**Important**
- Trading book is relevant
- Off-balance sheet exposures

**Attention if**
- Small TB with simple instruments
- Banks do not have reliable pricing models

**Possible way forward**
- Keep BII rules (but recalibrated)
- Revise boundary
- Enforce sound valuation practices
- Attention to IRRBB
Should Implement new Op. risk?

Important
- AMA
- Large banks
- Loss data base

Attention if
- Small banks
- Have implemented “gross income” approach recently

Possible way forward
- Incentivize operational loss databases
- Avoid additional reporting requirements
Basel III Capital
Capital: from Basel II to Basel III

**Basel II**
- Tier 3 market risk
- Tier 2
- Other Tier 1
- Common equity

**Basel III**
- Tier 2
- Other Tier 1
- Common Equity
- CET1 > 4.5% RWA
- Tier 1 > 6% RWA
- Total Capital > 8% RWA
- Tier 1 > 4% RWA
- Total Capital > 8% RWA

* Deducted from both Tier 1 and Tier 2
** Deducted from Tier 1

- Capital instruments: MSR, DTAs
- Goodwill, Intangibles, etc**
Should Implement BIII Capital?

Important for
- Loss Absorbance Capacity
- Not excessively complex

Attention if
- Common Equity already majority; and
- Deductions not relevant
- But,…

Possible way forward
- Simplification: “eliminate basket"
- Calibration: higher thresholds (not reduce current level)
Buffers
Reducing procyclicality

Macro Dimension

\[ CAR = \frac{9}{100} > 8\% \]

Loss $3

\[ CAR = \frac{6}{100} < 8\% \]

-SIFI?
- Set of banks?

\[ IB = \frac{6}{75} = 8\% \]

lower RWAs

Issue $2

\[ IB = \frac{8}{100} < 8\% \]
The buffer zone

Counter Cyclical

G-SIB/D-SIB

Capital Conservation

CET1
Should Implement Buffers?

Important for

- Macroprudential dimension
- Escalation of actions
- Too-big-to-fail

Attention if

- Severe shortcomings in basic supervision and regulation
  - problem assets, supervisory reporting, risk management,...

Possible way forward

- Minimum requirements calibration
- Methodology for D-SIFIs
- Indicators for CCyB
- Rules vs discretion
Leverage ratio
Leverage Ratio: the backstop to risk-based capital

\[
\text{Capital} \\
LR = \frac{\text{Exposures}}{\text{Exposures}}
\]
Should implement leverage ratio?

Important for
- Limit advanced approaches model risk
- Off-balance and 0% risk weight exposures

Attention if
- Standardized Approaches
- Off-balance not an issue
- Not excessive low risk weight exposures (0%)

Possible way forward
- Derivatives exposures
But what is the priority?

Priorities

1.
2.
3.
Possible Work Plan

Needs case by case evaluation!

1. Fix Basel Core Principles weaknesses
   - Get Basics right
   - Resources, independence, supervisory powers and tools, risk management, provisions,…
   - Resolution
   - Caveat: assessment not always readily available
Possible Work Plan

Needs case by case evaluation!

2. Implement Basel III considering EMDEs specificities
   - Ensure quality of capital
   - Differentiate minimum requirements from buffers
   - Ensure D-SIBs have higher capital charge
   - Enhance data collection for systemic risk
   - CCyB might need high level of institutional development
Possible Work Plan

Needs case by case evaluation!

3. Improvements on RWA calculation
   - Ensure appropriate risk coverage
   - Improve risk sensitivity of relevant portfolios
Thank you!