Basel III, Emerging Economies and Proportionality

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* Opinions are strictly my own and not those of the IDB, its Board of Executive Directors, or the countries they represent.
Motivation

- The complexity of regulations (B-II and reforms as a response to the *global financial crisis*) has increased
- EM’s escaped the worst of *this crisis*, & learnt lessons from previous EM crises (1980’s, 1990’s, early 2000’s)
- How should EM’s implement the new standards? To:
  - get the best from the new recommendations and
  - build on the previous lessons-learned?
- *Proportionality* may be a useful concept in this regard
- **Objective**: not to pick and choose, not to weaken prudential standards, not to dis-level playing field..
- **Rather**: ensure effective oversight given limited resources
Proportionality/Materiality

- Proportionality: “….corresponding in size or amount to something else.”
- Materiality: “…being relevant or significant”
- Not new concepts. Supervision, Basel Core Principles.
  “..by reinforcing.. proportionality.. the revised Core Principles accommodate a diverse range of banking systems”
  “The proportionate approach.. allows assessments of compliance.. commensurate with the risk profile and systemic importance of a broad spectrum of banks…”
In Regulation: Basel II/III

In Basel III (Dec 2017) 66 Mentions of:
  - “Material”,
  - “Materiality” or
  - “Proportional”
and 113 Mentions in Basel II
(Comprehensive version, June 2006)

Basel III: > 40% mentions per page
Basel II: > 30% mentions per page
Examples of “material” from Basel III (Dec 2017)

- Page: 14: counterparty bank has material default risks and limited margins of safety. For these counterparties,

- Page: 18: or no other material assets or activities, and therefore little or no independent capacity

- Page: 20: does not involve material risk.

- Page: 26: expected that the material dependence condition would predominantly apply to loans to corporates, SMEs

- Page: 28 criteria on how material dependence should be assessed for specific exposure types. For

- Page: 31 Any material credit obligation that is past due for more than 90 outstandings; Any material credit obligation is on non-accrued status (eg the sold at a material credit-related economic loss; A distressed restructuring of any caused by the material forgiveness, or postponement, of principal, interest or (where relevant)

- Page: 38 not have a material positive correlation with the employed CRM technique or with the

- Page: 49 giving rise to material maturity or liquidity mismatch.

- Page: 50 or no other material assets or activities…

- Page: 59 and no other material assets on its balance sheet.

- Page: 66 doing so for material IPRE exposures at the same time.

- Page: 73 all relevant and material information in assigning ratings to borrowers and facilities. Information must

- Page: 79 all relevant and material information, including that which is outside the scope of the be no known material biases…. all relevant and material information not considered by the model.

- Page: 82 new rating if material information on the borrower or facility comes to light….update relevant and material information on the borrower’s financial condition, and on facility characteristics

- Page: 94 All material aspects of the rating and estimation processes must be approved

- Page: 95 and must approve material differences between established procedure and actual practice. Management must also

- Page: 96 incorporate all relevant, material and available data, information and methods. A bank may utilise

- Page: 97 days on any material credit obligation to the banking group.26

- Page: 98 This must include material discount effects and material direct and indirect costs associated with discount effects and material direct….costs

- Page: 99 …are relevant and material, this longer period must be used. The data should include all relevant and material data…

- Page: 101 …to be the material drivers of EAD. The choices must be supported by credible all relevant and material information in its derivation of EAD estimates. Across facility types, of EAD when material new information comes to light and at least on an adjusting only ‘material’ observations affected by product transformation…

- Page: 106 must specify all material elements of the receivables purchase programme, including the advancing rates, all relevant and material factors

- Page: 111 when information indicates material changes in the market.

- Page: 119 market risk factors material for the transactions with a counterparty must be simulated as

- Page: 123 risk are always material and must be calculated regardless of whether or not the

- Page: 129 to the most material region and sector…

- Page: 135 …and capture all material activities and exposures…

- Page: 136 Material “timing losses” should be included in the loss data set. Material “timing losses” should be included in the loss data….may represent a material misrepresentation of the institution’s financial statements.

- Page: 153 or more conservative material terms as those in the corresponding written credit derivative.
On Basel II/III and EM’s
What are some of the issues?

Issues I will mention:
1. Credit risk: Adjusted RWA’s, (EM’s between two stools)
2. Counter – cyclical buffer
3. Disclosure rules
4. Vexed issue of foreign banks

Many other issues:
- Market Risk: Simplified approaches for small trading books
- Counterparty credit risk: Simplified rules for banks with low deriv. exposures
- Liquidity ratios: exemptions or modifications of LCR for some banks
- Interest rate risk (banking book): standards (& governance) across diff. banks
- Recovery planning…

Proportionate may also mean stricter requirements:
- Credit risk: 8% not enough, IRB calibration..
- Calibration of the counter-cyclical buffer
- Related lending (Many EM’s have stricter rules than Basel)
1. Basel II/Approaches

EM’s Between Two Stools?

- BII Standardized Approach: lack of rated claims, low risk sensitivity
- Internal Ratings Based Approaches:
  - high degree of autonomy to banks, against “regulatory culture”
  - difficult to supervise, significant resources required
  - calibration concerns (correlation too low, 99.9% tolerance too high?)
- Majnoni and Powell (2005)\(^1\) proposed CRB “Centralized Rating Based”
  - Banks would rate claims on a standardized scale
  - Harness many EM’s public credit bureaus
    (banks already “rate” claims to determine provisions)
  - Consider recalibration, actual IRB formula could be a floor
- Use this information to calibrate supervisory determined variables, smooth transition to IRB from more supervisory to more bank defined parameters
- CRB for larger non-internationally active banks. And as a check on IRB banks, cross-checks for internal ratings

2. Counter-Cyclical Buffer

- EM credit cycles may be different
- EM banks like to keep high and stable capital ratios (in LA, around 15-16% of RWA when requirements are around 10-11%)
- Proportionate may mean more aggressive counter-cyclical rules…
3. Disclosure Rules

- Simplified Pillar 3 disclosure rules for certain types of institutions.
- Fine, but disclosure is important, especially for smaller institutions where supervisors may dedicate less time and resources...
- Disclosure (and market discipline) is complementary to supervision and important for smaller and simpler institutions, should not discard.
- Cross-border aspect of Pillar 3. Useful for disclosure rules to apply to a subsidiary, especially one that is “material” to a host supervisor....
4. Vexed Question of Foreign Banks

- Most host supervisors have a legal requirement to regulate and supervise subsidiaries (and branches if allowed) of foreign banks

- **If a subsidiary is not “material” for the host** and the home regulator shares sufficient information, host could “piggy-back” on the home…

- **If a subsidiary is “material” for a host country but not material for the consolidated group** and the host shares sufficient information then the home supervisor could “piggy back” on host…

- **If a subsidiary is material for both home and host**: excellent cooperation and information between home and host is required, agreement on common approaches would be helpful, joint inspections desirable etc..

- **Currencies, consolidation and RWA’s.** Many EM’s do not allow currency mismatches. So domestic currency assets funded by domestic currency liabilities. Argument for home regulator to allow domestic currency ratings etc. for assets in host’s domestic currency.

- Cooperation becomes more and more difficult as a bank becomes weaker and as conversations turn to protecting liability holders and allocating losses, this suggests agreements on prompt corrective action are critical – for Basel 4, Pillar 2.
How to Implement Proportionality: One box fits all?

- **Categorization Approach:** Simplifications applied to specific types of banks
  - Benefits: Clearer, more transparent, perhaps simpler to implement (in some cases)
  - Costs: Potential cliff-faces, classifications may be arbitrary, distortions, arbitrage

- **Specific Standard Approach:** exceptions/tailor made rules in certain areas
  - Benefits: Headline of following Basel rules may be important, in some jurisdictions hard to have different rules for different sizes/types of banks, more granular, risk-sensitive, less arbitrage…
  - Costs: May appear arbitrary to have many exceptions/adaptations, may lead to much lobbying, less transparent, may complicate supervision..

- An overall concern of *proportionality* is a global standard is lost
- Perhaps regional agreements can be reached to apply proportionality schemes
Complexity and Regulation..
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Chart Title

- Standardized Approach
- Capital Floor
- IRB Approaches
- Size, complexity
- Simplicity of the regulations, reporting and disclosure

Requirements