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 <u>this</u> ***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**: <u>not</u> to pick and choose, <u>not</u> to weaken prudential standards, <u>not</u> to dis-level playing field..
- **Rather:** ensure effective oversight given limited resources

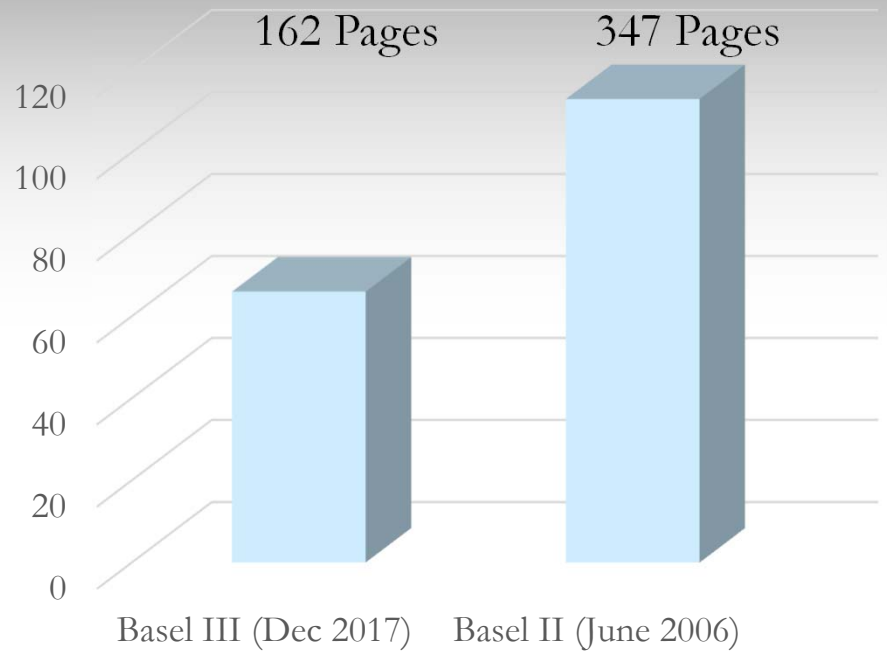
Proportionality/Materiality

- Proportionality: "….corresponding in size or amount to something else."
- Materiality: "…being relevant or significant"
- Not new concepts. S**upervision,** Basel Core Principles.

"..by reinforcing.. ***proportionality..*** the revised Core Principles accommodate a diverse range of banking systems"

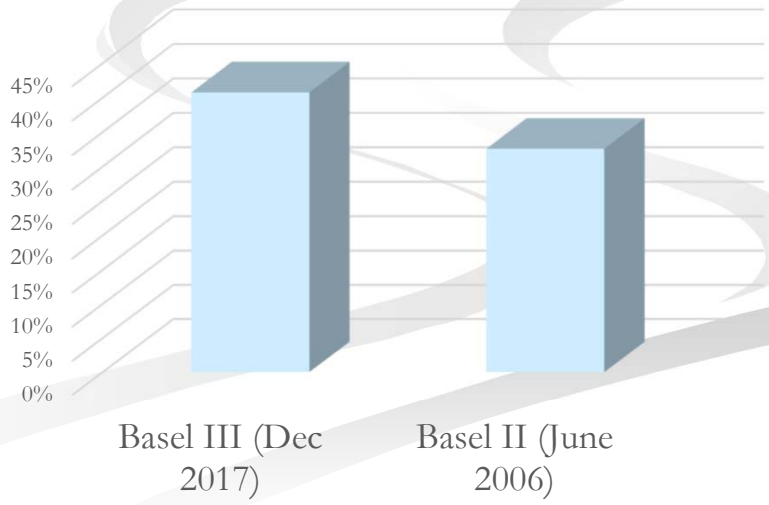
"The ***proportionate*** approach.. allows assessments of compliance.. commensurate with the risk profile and systemic importance of a broad spectrum of banks…"

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. 49 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: 58 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: 90 all relevant and **material** information in assigning ratings to borrowers and facilities. Information must
- Page: 91 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: 92 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 Overdrafts will be obligation at a **material** credit-related economic loss. • The bank consents to a caused by the **material** forgiveness, or postponement, of principal, interest or (where relevant)
- 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** pending 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)

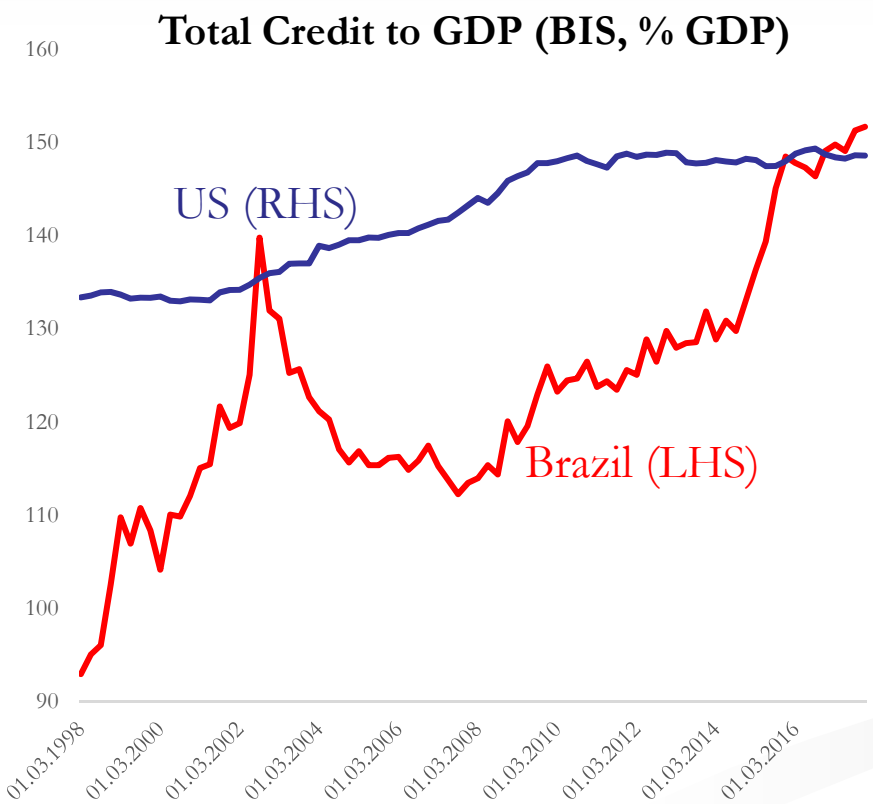
1. Basel II/Approaches
EM's Between Two Stools?

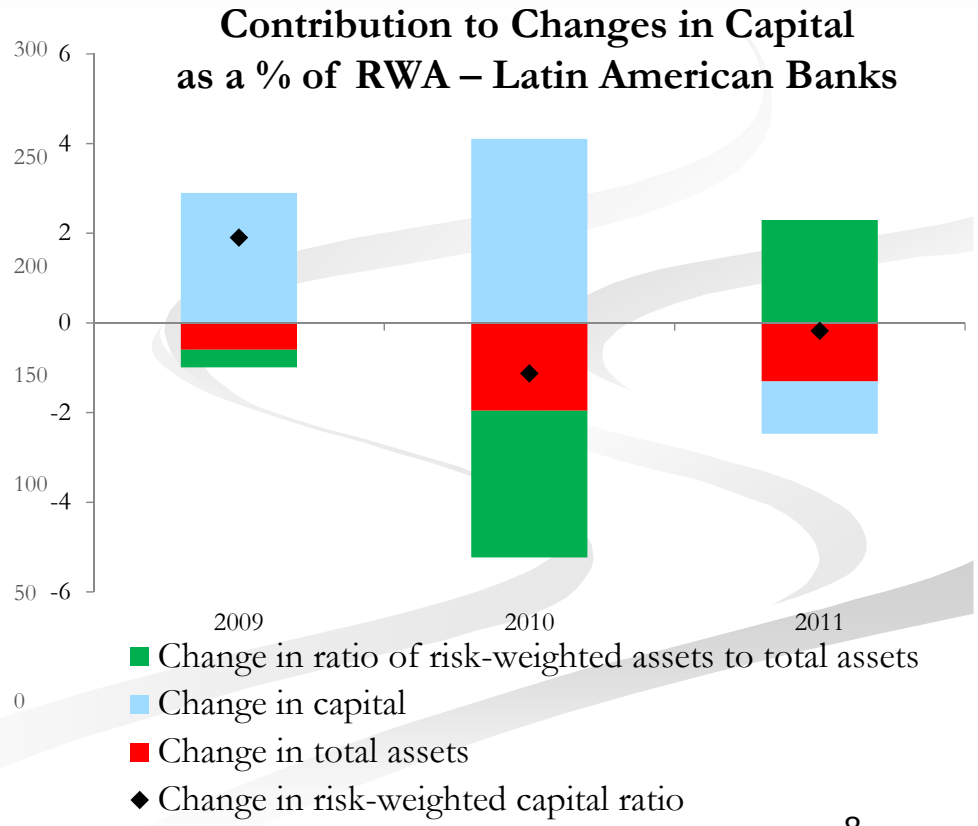
- BII Standardized Approach: lack of rated claims, low risk sensitivity
- Internal Ratings Based Approaches:
  - high degree of autonomy to banks, against "regulatory culture"
  - difficult to supervise, significant resources required
  - calibration concerns (correlation too low, 99.9% tolerance too 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

[1] Majnoni, G. and A. Powell (2005). "Reforming Bank Capital Requirements" *Economia*, Spring 2005 and previously in Powell (2002) "Sailing through the sea of standards" World Bank WP 3387 2002 .

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….

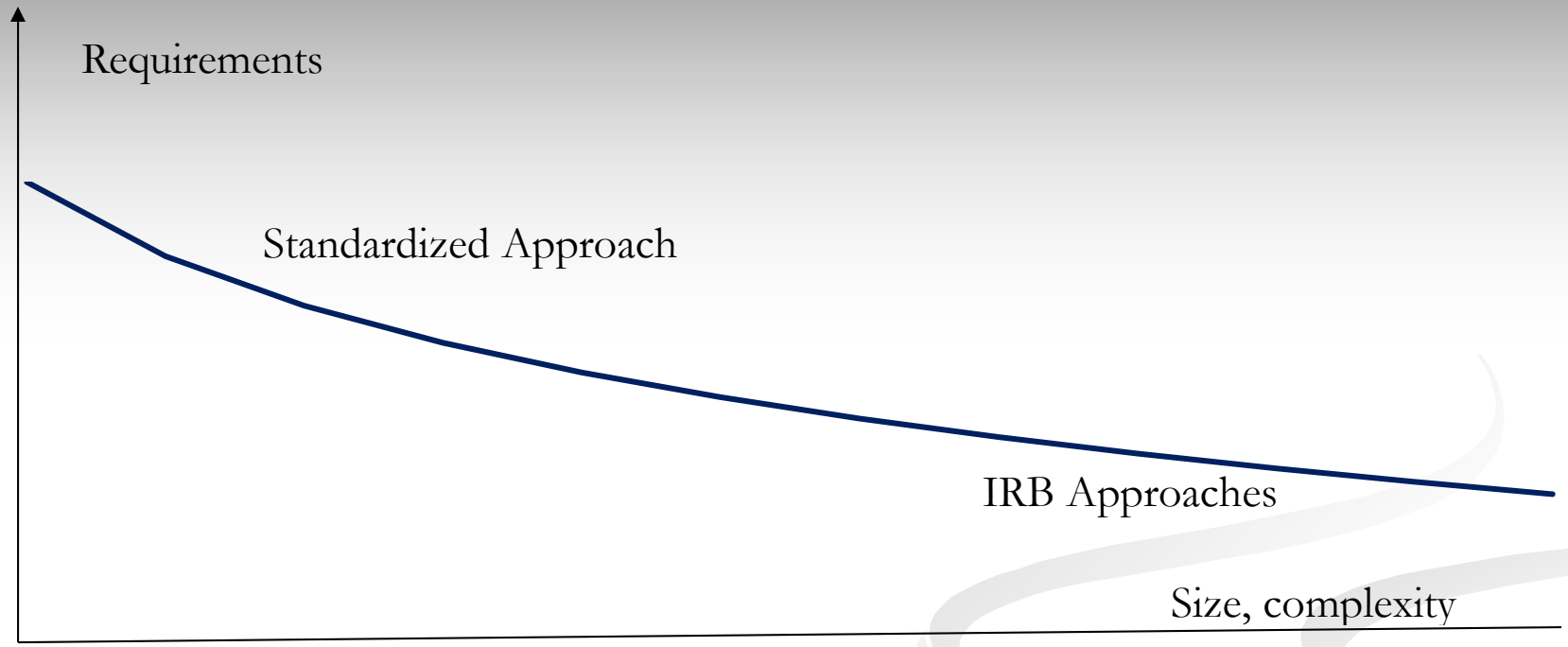
4. Vexed Question of Foreign Banks

- 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.

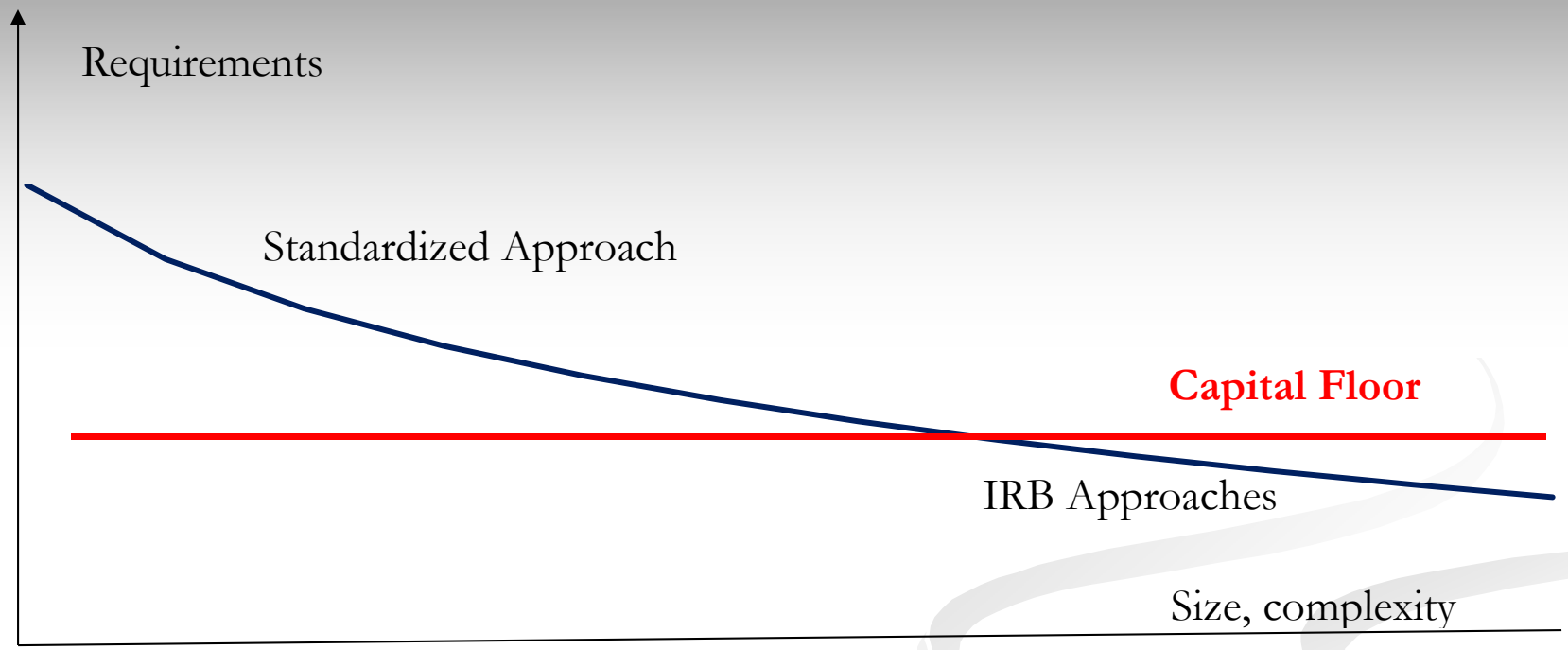
How to Implement Proportionality: One box fits all?

- 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..



Complexity and Regulation..



Complexity and Regulation..