UNIVERSITY OF OXFORD

POLICY BRIEF
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Room to Manoeuvre: How Developing Countries Can Tailor Basel Standards

Emily Jones, Thorsten Beck, and Peter Knaack

SUMMARY

The prudential standards that govern global finance are developed by a small group of financial regulators, largely from advanced economies. Basel II and III are not designed for low and lower-middle income countries (LMICs) with less complex and smaller financial markets, and where regulatory authorities face substantial resource constraints. Wholesale adoption of international standards in LMICs entails significant risks and costs, including excessive complexity and the diversion of scarce regulatory resources. Nevertheless, regulators in many LMICs are pressing ahead with Basel II and III. Politicians, bankers, and regulators perceive the adoption of international standards as crucially important for helping their banks expand abroad, attracting investors into their financial sector, and cooperating with bank supervisors in other jurisdictions. In today's world of globalized finance, LMIC regulators cannot simply ignore international standards, even if they are ill-suited to their economic and financial environment.

To address this tension, regulators outside the Basel Committee on Banking Supervision can use the freedom they have as non-members to tailor global standards to meet domestic regulatory needs. This enables them to credibly signal that their banks are soundly regulated without implementing aspects of the Basel framework that are ill-suited to their needs.

To tailor Basel II/III standards to the idiosyncratic needs of their jurisdictions, regulators in LMICs can:

- Implement Basel II and III selectively, focusing only on the components that address key risks in their banking sector;
- Tailor the standards when they are implemented, rewriting them rather than copying and pasting, so they are carefully adapted to local circumstances;
- Deepen mechanisms for learning from other LMIC regulators, rather than looking chiefly to international standard-setting bodies for advice;
- Coordinate with other LMIC regulators and jointly advocate for changes to international standard-setting bodies, so the interests of LMICs are better represented.
- Examine the repercussions of Basel II/III implementation for credit allocation in the real economy and for financial inclusion.

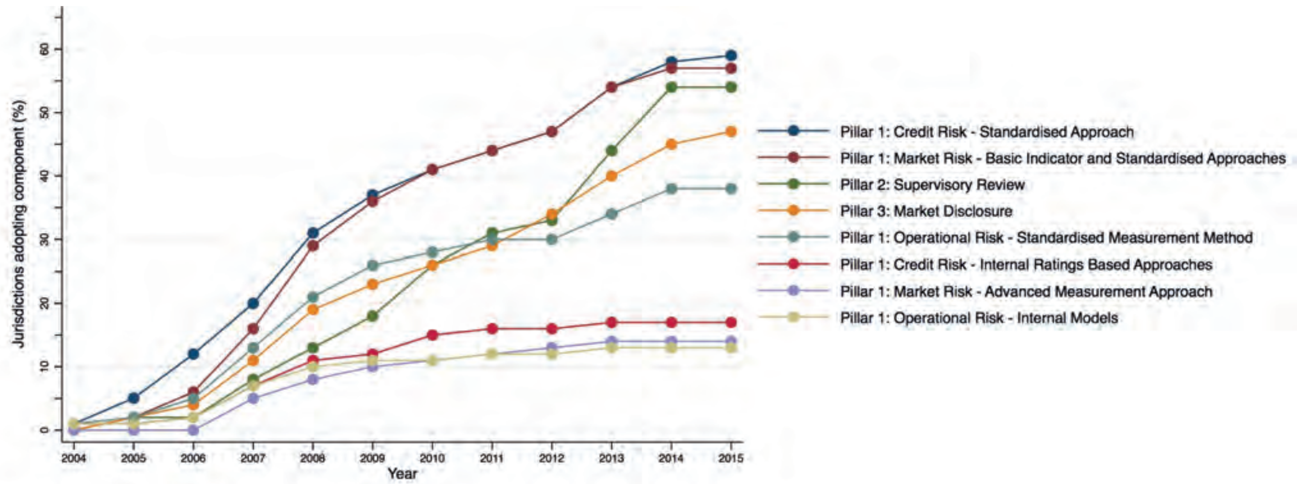
This policy brief summarizes the findings of a three-year research project on Basel adoption in LMICs at the Blavatnik School of Government, University of Oxford. The project is led by Professors Emily Jones, Ngaire Woods (Oxford) and Thorsten Beck (Cass Business School), with generous funding from the DFID-ESRC Growth Research Programme. It combines quantitative research using data from ca. 100 jurisdictions and in-depth case studies of 11 countries on 3 continents.

BASEL II/III ADOPTION: WIDESPREAD BEYOND THE BASEL COMMITTEE

Many non-members of the Basel Committee adopt Basel banking standards even though they have no seat at the standard-setting table.

The Basel Committee on Banking Supervision (BCBS) sets prudential standards that are negotiated by and for its 28-member jurisdictions, most of which are advanced economies. However, implementation of the first Basel standard is almost ubiquitous, and the newer two standards – Basel II and III – have found widespread acceptance beyond the perimeter of the Basel Committee. Analysis of data from the Financial Stability Institute at the Bank of International Settlements shows that 90 out of 100 surveyed non-member jurisdictions have implemented Basel II at least partially or are in the process of doing so. Moreover, 81 jurisdictions reported that they had taken steps towards the implementation of at least one component of Basel III[1]. The graphs below and the results of our quantitative research on the drivers of Basel adoption in ca. 100 countries can be found in a series of publications[2].

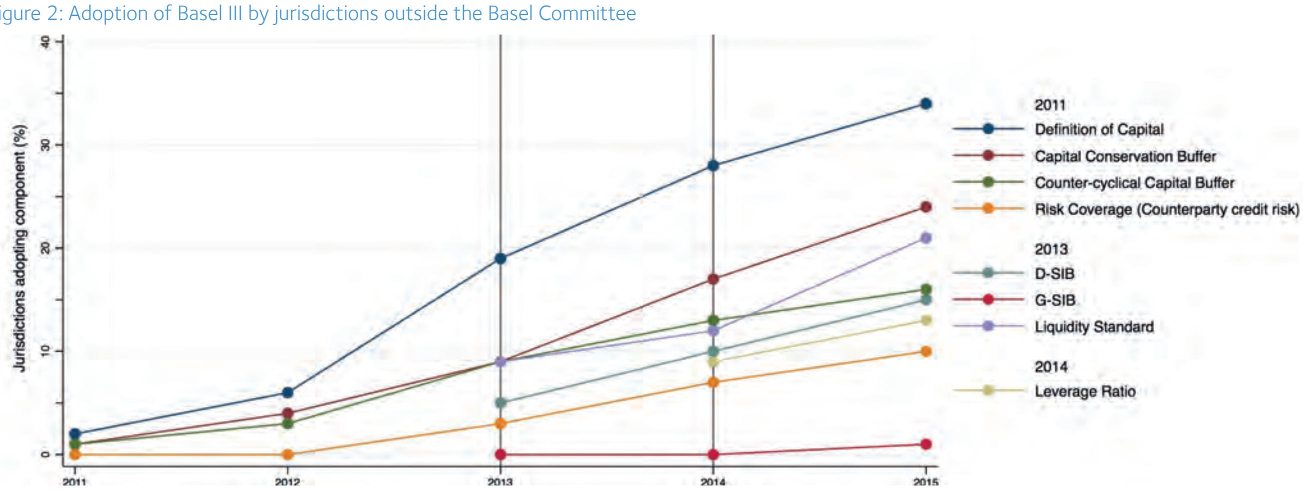
Figure 1: Adoption of Basel II by jurisdictions outside the Basel Committee



The adoption of Basel II and III standards is widespread even in developing countries.

Basel standards are designed to address financial risks emanating from large, complex banks with international operations. Regulators in many LMICs adopt them even though their jurisdictions feature simpler banking systems and different financial risk profiles. As Figure 1 shows, some components of Basel II have been implemented in the majority of non-members of the Basel Committee.

Figure 2: Adoption of Basel III by jurisdictions outside the Basel Committee



1 Financial Stability Institute (2015). Basel II, 2.5 and III Implementation. Basel: Bank of International Settlements

2 Jones, E., & Zeitz, A. O. (2017). The Limits of Globalizing Basel Banking Standards. Journal of Financial Regulation, 3(1), 89-124. Jones, E., & Zeitz, A. O. (under review). Regulatory Convergence in the Financial Periphery: How Interdependence Shapes Regulators' Decisions.

Regulators in LMICs are typically selective adopters, choosing some components of Basel standards while eschewing others.

In particular, regulators are more likely to adopt the simpler Basel II standard approaches to credit, market and operational risk instead of much-disputed advanced approaches that rely on internal risk models by banks. Similarly, Figure 2 indicates that simple components of Basel III such as the new definition of capital and the leverage ratio are more popular than complex requirements such as the liquidity ratios or the countercyclical buffer.

REPUTATION AND COMPETITION CONCERNS DRIVE BASEL IMPLEMENTATION

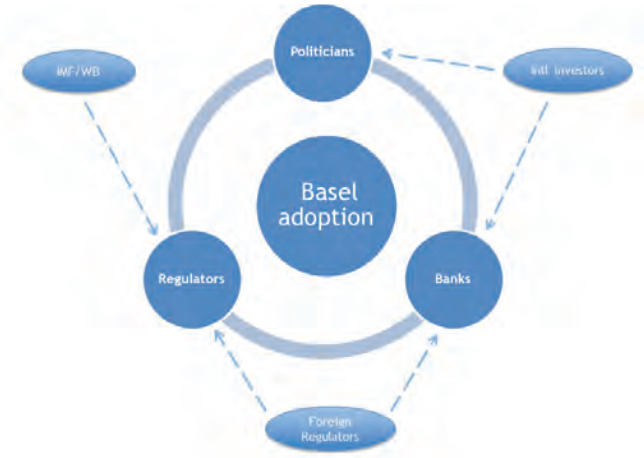
Regulators in LMICs do not merely adopt Basel II or III because these standards provide the optimal technical solution to financial stability risks in their jurisdictions.

Instead, regulatory decisions are also driven by concerns about reputation and competition.

Our research reveals different factors driving the adoption of Basel standards in LMICs:

- Signalling to international investors. Incumbent politicians may adopt Basel standards in order to signal sophistication to foreign investors. For example, in Ghana, Rwanda, and Kenya, politicians have advocated the implementation of Basel II and III, and other international financial standards, as part of a drive to establish financial hubs in their countries.
- Reassuring host regulators. Banks headquartered in LMICs may endorse Basel II or III as part of an international expansion strategy, as they seek to reassure potential host regulators that they are well-regulated at home. We see this at work in Nigeria, where large domestic banks have championed Basel II/III adoption at home as they seek to expand abroad. Their fervour has been met with reluctance among regulators who fear that a rapid regulatory upgrade may put weaker local banks in jeopardy.
- Facilitating home-host supervision. Adopting international standards can facilitate cross-border coordination between supervisors. In Vietnam, for example, regulators were keen to adopt Basel standards as their country opened up to foreign banks, to ensure they had a 'common language' to facilitate the supervision of the foreign banks operating in their jurisdiction.
- Peer learning and peer pressure. Even while acknowledging the shortcomings of Basel II and III LMIC regulators often describe them as international 'best practices' or 'the gold standard' and there is strong peer pressure in international policy circles to adopt them. In the West African Economic and Monetary Union (WAEMU), for example, regulators at the supranational Banking Commission are planning an ambitious adoption of Basel II and III with the support and encouragement of technocratic peer networks and the IMF. Domestic banks however have limited cross-border exposure and show little enthusiasm for the regulator-driven embrace of Basel standards.

Figure 3: Key actors that influence Basel adoption



- Technical advice from the International Monetary Fund and the World Bank plays an important role in shaping the incentives for politicians and regulators in developing countries. While the Financial Stability Assessment Programmes (FSAPs) are designed to merely evaluate the regulatory environment of client countries against a much more basic set of so-called Basel Core Principles, we find evidence that Fund and the Bank motivate regulators in LMICs to engage in Basel II and III adoption, in some cases with explicit recommendations.

OFF-THE-SHELF BASEL II/III ADOPTION COMES WITH TRADE-OFFS AND RISKS

While the reputational benefits of a full embrace of Basel II and III appear to be significant, the risks of a wholesale implementation of the global standards may be less obvious. Financial regulatory experts in academia and policymakers assert that there is an inevitable divergence between the international Basel standards and the sui generis regulations that would be most appropriate to each jurisdiction's economic structure, financial regulatory framework, and political preferences. This divergence is particularly stark for LMICs.[3]

The Basel Committee has recognized the need for differentiation, and while it seeks to provide a common set of minimum standards, it also allows national authorities substantial leeway in standards implementation. However, the range of options provided by the Basel Committee remains inadequate for LMICs, raising the following six implementation challenges:

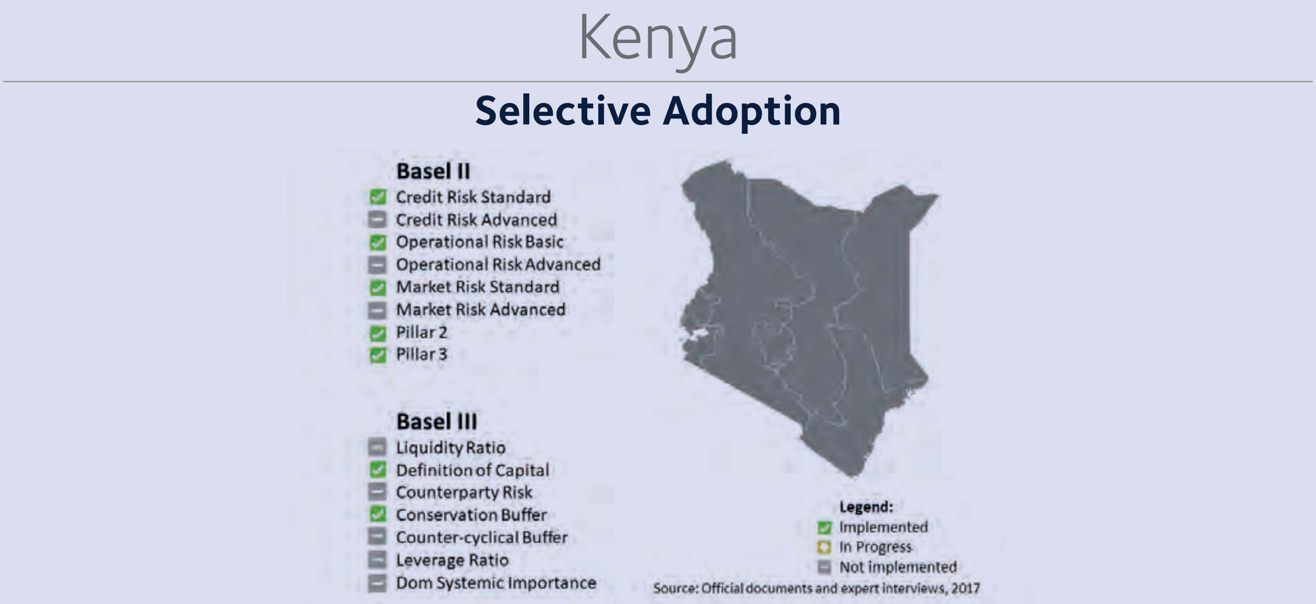
1. Financial infrastructure gaps. Even the simpler components of Basel II and III presume a degree of financial development and the existence of infrastructure that is not in place in many LMICs. For instance, the standardised approach to credit risk under Basel II relies on credit rating agencies. Many countries outside the Basel Committee do not have national ratings agencies and the penetration of global ratings agencies is limited to the largest corporations. Public capital markets in LMICs may not be deep and liquid enough for investors to exert the kind of market discipline that is envisioned in Pillar III of Basel II. The Basel III counter-cyclical buffer relies on the supervisor's ability to accurately anticipate credit bubbles, which is particularly challenging in developing countries where large swings in economic performance are common and macroeconomic data of lower quality. Furthermore, the supply of high-quality liquid assets in LMICs may not be sufficient for banks to meet the liquidity requirements of Basel III.
2. Poor match for financial stability threats. Basel II and III are designed for banks operating in advanced economies and sophisticated global financial markets. They address financial risks that may be of little relevance in the simpler financial systems of LMICs, such as counterparty risk for derivatives exposures or liquidity mismatches arising from wholesale funding. Conversely, Basel II and III may not adequately address key macroeconomic threats to financial stability in LMICs, such as large swings in global commodity prices and other external shocks.
3. Human and Financial Resource Constraints. Implementing Basel II and III imposes significant adjustment costs onto both banks and regulators. The costs derive not from regulatory stringency – capital requirements in most LMICs are higher than Basel III – but from the complexity of Basel rules. The implementation of the new global standards, especially the advanced, internal-ratings based approaches of Basel II and the macroprudential elements of Basel III exacerbates regulatory resource constraints that are already significant in many developing countries.
4. Exacerbated information asymmetry. The advanced components of Basel II endow banks with substantial leeway to use internal ratings-based models to calculate their capital requirements. The global financial crisis of 2008 has highlighted the inadequacy of such models and the failure of regulators even in advanced economies to scrutinize the risk exposure of banks in their jurisdiction. In many developing countries, remunerative differences and brain drain to the private sector already pose challenges for regulatory authorities. Such inequalities may be exacerbated when the more sophisticated elements of Basel II and III are implemented. Moreover, banking supervisors in many developing countries lack the political and operational independence as well as the enforcement powers that are required for effective Basel II and III implementation. Thus, implementing the advanced approaches of Basel II may widen the scope for regulatory arbitrage and thus be detrimental for financial stability.
5. Distorted regulatory agenda. Implementing Basel II and III may take scarce resources away from other priority tasks of the regulatory agency. Regulators in LMICs recognize the need to improve corporate governance, strengthen regulatory independence, and bolster their authority for timely supervision and prompt corrective action in order to safeguard financial stability. These features of a strong regulatory regime are enshrined in the Basel Core Principles. In contrast, implementation of Basel II/III does not necessarily address underlying weaknesses in the regulatory system or the political entrenchment of vested interests. These global standards embody a complex financial regulatory regime, not necessarily a strong one.
6. Deterioration of credit composition. Banks that implement Basel II and III may have an incentive to shift their portfolio away from sectors of the economy that are key for inclusive economic development. Higher risk weights for trade letters of credit due to the Basel III output floor for example may increase the cost of trade financing, even though previous rule changes have taken emerging markets into account. Higher risk weights for loans to small and medium enterprises (SME) under Basel III may not properly reflect the potential benefit of diversification away from a few large enterprises and discourage financial inclusion. Moreover, the Basel III liquidity ratios may raise the cost of infrastructure lending because they require banks to match such exposures with long-term liabilities that are in relatively short supply in developing countries.

3 For an extensive review of the relevant literature see Jones, E., & Zeitz, A. O. (2017). The Limits of Globalizing Basel Banking Standards. Journal of Financial Regulation, 3(1), 89–124. see also: Castro Carvalho, A. P., Hohl, S., Raskopf, R., & Ruhnau, S. (2017). Proportionality in banking regulation: a cross-country comparison (FSI Insights No. 1). Center for Global Development (2018). Making Basel III Support Development in Emerging Markets and Developing Economies. URL: https://www.cgdev.org/working-group/working-group-basel-iii-emerging-market FSB. (2017). Implementation and Effects of the G20 Financial Regulatory Reforms: Third Annual Report.

LMIC REGULATORS TAKE DIFFERENT APPROACHES

Our in-depth analysis of eleven LMICs shows that regulatory agencies make decisions that range from low (only a few components) to high Basel adoption (almost all components of both Basel II and III, see Figure 3). These decisions reflect a mix of technical, reputational, and policy considerations.

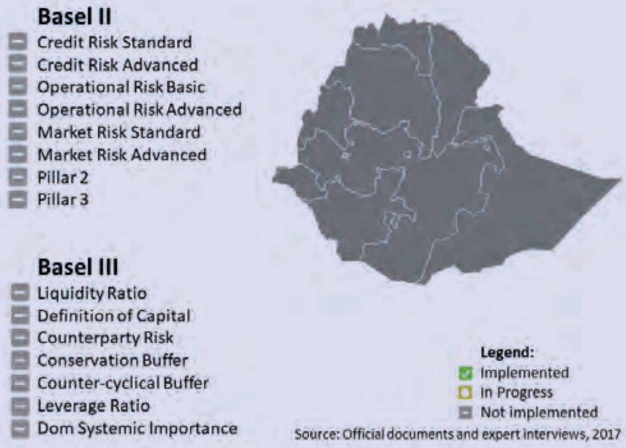
Figure 3: Basel II/III adoption in 11 LMICs



Kenya's selective adoption of Basel II and III is the result of an outward-oriented consensus among politicians, regulators, and banks. As Kenya's financial sector is deepening and diversifying, bringing new risks, regulators at the Central Bank of Kenya (CBK) have sought to improve the regulatory and supervisory framework and have looked to international standards as the basis for these reforms. The government has been keen to adopt the latest international standards in a bid to attract foreign capital to Kenya. On the private sector side, large domestic and some international banks have championed Basel II and III, not least to facilitate regional expansion. However, this confluence of reputational and competitive incentives has not led to an off-the-shelf adoption of global standards. Instead, the CBK has implemented the standard approach of Basel II while eschewing the advanced, internal-ratings based components. Regulators have been equally selective in their embrace of Basel III, adopting only the new definition of capital and the capital conservation buffer. Liquidity requirements in Kenya are simpler than those of Basel III but arguably better tailored to the characteristics of the domestic banking system.

Ethiopia

No Implementation of Basel II and III

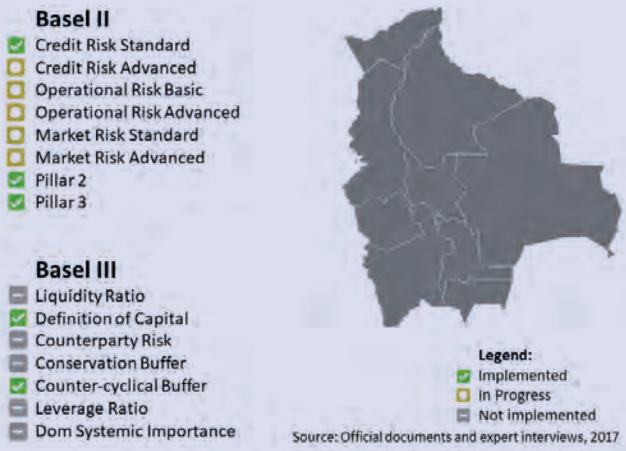


Ethiopia has chosen to not adopt Basel II or III. Despite notable exposure to the Basel standards through donors and the IMF, banking supervisors at the National Bank of Ethiopia (NBE) have little use for Basel II and III. Ethiopia's banking sector is relatively simple, so the regulators have focused on implementing Basel I. The relative isolation of Ethiopia's banking sector and lack of multinational banks gives domestic banks few competitive incentives to adopt the Basel framework.

Meanwhile, Ethiopia's government has a strong preference for political control over the financial industry as it seeks to emulate the example of East Asian 'tiger' economies, for whom policy-directed finance represented a key tool in the pursuit of rapid industrialization. Thus, in the absence of strong technical, competitive, or reputational incentives, Ethiopia currently has no domestic champions for Basel II/III adoption.

Bolivia

Basel and Interventionism



Bolivia is implementing aspects of Basel II and III and has legislation that provides for all the advanced components of Basel II. This push for Basel II and III was driven by Bolivian regulators, who are deeply engaged in international policy discussions and regard Basel III as the gold standard for banking regulation. While reputational concerns thus seem to play a significant role for regulators, Bolivian banks have few competitive incentives to adopt the newer global standards. The Ministry of the Economy and Public Finances is more concerned with financial inclusion and domestic development than attracting foreign capital. It grafted onto the draft legislation significant interventionist policies such as interest rate caps and credit targets to certain economic sectors. Thus, Bolivia's Basel adoption is pulling in two directions: adherence to Basel Committee-style best practices and, concurrently, financial interventionism to stimulate economic growth and financial inclusion.

CHOOSING THE OPTIMAL APPROACH: OPTIONS FOR LMIC REGULATORS

What steps can financial regulators in LMICs take to harness the prudential, reputational and competitive benefits of global banking standards, while avoiding the implementation risks and challenges associated with wholesale adoption? Our research highlights several options for regulatory agencies in LMICs.

Identify incentives and distinguish between prudential, reputational, and competitive motives. In deciding whether, to what extent, and how to implement Basel II and III, LMIC regulators need to establish what is optimal from a technical perspective, but they also need to consider how important reputational and competitive concerns are for their jurisdiction. Incumbent politicians keen on the promotion of the country as a financial services hub for example may discount the costs that an off-the-shelf Basel adoption entails both for the regulatory authority and the banking sector. On the other side, internationally oriented domestic banks may push the government to embrace Basel II/III not out of prudential concerns but because they expect to reap reputational and competitive benefits, including vis-à-vis smaller domestic rivals. Regulators must assess the technical fit and weigh the non-prudential competitive and reputational benefits against the costs of Basel II/III implementation, component by component.

Tailor Basel standards to national circumstances. Regulatory agencies outside the Basel Committee on Banking Supervision are not bound by its rules and not subject to peer review procedures. Regulators in the financial periphery can use this freedom to adapt global standards to meet domestic regulatory needs. In order to harness the benefits of global banking standards and reduce the risk and cost that an off-the-shelf adoption of Basel II and III entails, regulators can tailor Basel implementation to domestic circumstances in several ways:

A selection of Basel components. The elements of both Basel II and III vary substantially in the amount of regulatory resources they require, both in the implementation and supervision phase. The internal-ratings based components of Basel II for example are resource-intensive both for banks and supervisors, with benefits for financial stability that are widely questioned by regulatory experts. The macroprudential components of Basel III also pose significant technical and data challenges for regulators, whereas the leverage ratio for example can be implemented more easily. Regulators can identify domestic prudential needs and regulatory capabilities first and then assess the adequacy of each Basel II/III component in matching those needs given existing capacity constraints.

Proportional rules implementation. Regulators can refrain from copying prudential requirements from the Basel II and III rulebook. Indonesian regulators for example implemented a simplified securitization framework that is adequate for the minuscule bank exposure to this market. As a member of the Basel Committee, Indonesia underwent a regulatory consistency assessment and was deemed "largely compliant". Peer reviewers noted that "the rules differ from the Basel framework in many respects", but that the domestic rules are "appropriate for the nature and early stage of development of the Indonesian securitisation market." Thus, regulators in other countries can use their intimate knowledge of the domestic financial system to write rules that match local circumstances better than the Basel template.

The perimeter of banking regulation. Basel II and III are designed for banks with significant cross-border operations. Many Basel Committee members apply simpler rules to banks that operate domestically. For example, advanced Basel III requirements in the United States only apply to 15 so-called "core banks". Regulators in developing countries have chosen to apply simpler prudential rules to small financial institutions and development banks. The Basel Committee has highlighted that Basel II and III implementation is not necessary for compliance with the Core Principles, and it recommends the use of simpler prudential rules to foster financial inclusion. Regulators can assure other domestic stakeholders that their jurisdiction can reap the reputational and competitive benefits of Basel II and III even when such rules only apply to large, internationally active banks as intended by the Basel Committee.

> *"As explicitly stated, implementation of the capital adequacy regimes under Basel I, Basel II or Basel III is not a prerequisite for compliance with the Core Principles. This is of great relevance for the proportionate (i.e., risk-based) implementation of capital adequacy requirements, particularly with respect to smaller, less complex institutions."*

BCBS (2016, 21). Guidance on the application of the Core Principles for Effective Banking Supervision to the regulation and supervision of institutions relevant to financial inclusion.

POLICY RECOMMENDATIONS: OPTIONS FOR REGULATORS IN LMICs

Regulators in LMICs can take advantage of the considerable manoeuvring space Basel standards provide: selective implementation of Basel II and III is recommendable and widespread. A strong regulatory regime is not necessarily a complex one. To tailor Basel II/III standards to the idiosyncratic needs of their jurisdictions, regulators in LMICs can:

- Consider the risks of an overly ambitious Basel II/III implementation. Allocate limited supervisory capacity to address the jurisdiction's key financial challenges and assess to what extent Basel implementation may exacerbate reliance on credit rating agencies, information asymmetry between regulators and banks, and the exclusion of economic sectors, including small and medium enterprises.
- Tailor Basel implementation to the idiosyncratic development needs of your jurisdiction. Several components of Basel II and III presuppose financial infrastructure that may not be in place, and they address financial risks that may not be of relevance in many LMICs.
- Implement Basel II and III selectively, focusing only on the components that address key risks in their banking sector;
- Tailor the standards when they are implemented, re-writing them rather than copying and pasting, so they are carefully adapted to local circumstances;
- Deepen mechanisms for learning from other LMIC regulators, rather than looking chiefly to international standard-setting bodies for advice; expand cross-border peer learning to raise awareness of the benefits of proportional implementation and help regulators tailor Basel standards to the conditions and needs of their jurisdiction.
- Coordinate with other LMIC regulators and jointly advocate for changes to international standard-setting bodies, so that they better reflect the heterogeneity of financial systems around the world and the interests of LMICs.

RESEARCH FINDINGS

This policy brief is based on an extensive research project titled 'Developing Countries Navigating Global Banking Standards'. Find out more about our quantitative research, analytical framework, and in-depth case studies of 11 jurisdictions on 3 continents on our website: *http://www.geg.ox.ac.uk/research/navigating-global-banking-standards*. The website is frequently updated to inform you about upcoming publications, which include an edited 15-chapter volume with Oxford University Press, journal articles, and individual case studies. Existing publications include the following:

Jones, E., & Zeitz, A. O. (2017). The Limits of Globalizing Basel Banking Standards. Journal of Financial Regulation, 3(1), 89–124.

Jones, E. (2014). Global Banking Standards and Low-income Countries: Helping or Hindering Effective Regulation? GEG Working Paper No. 91. Oxford: Blavatnik School of Government.

Jones, E., & Knaack, P. (2017). The Future of Global Financial Regulation. GEG Working Paper No. 127. Oxford: Blavatnik School of Government.

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