



Institute of
Development Studies

**Basel II implementation in developing
countries - effects on SME development**

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Structure of the Presentation

- Aims
- Key questions
- Approaches for Basel II adoption
- Basel II implementation in low-income countries:
key issues
- Conclusions

Aims

- Provide low-income countries' (LICs) views and concerns on Basel II implementation.
- Look at Timetable and the approaches LICs are taking/planning to take towards Basel II implementation.
- Discuss possible implications of Basel II for competitiveness of LIC banking sectors and financial inclusion.
- Indicate possible ways forward.

Key Questions

- What are the main challenges facing LIC regulators to implement Basel II (human, financial resources)?
- To what extent will Basel II be implemented at all? What are the different approaches being proposed for adoption? What are the main obstacles for implementing the different approaches? Are variations being considered?
- What about the banks' preferences re adoption of Basel II?
- What are the macro and equity implications?
- To what extent LIC regulators/others feel Basel II should be adapted to their own needs/circumstances?

Intentions re Basel II Adoption: A Global Picture

Table 1: Number of Countries intending to adopt Basel II

Regions	Number of Respondents	Respondents intending to adopt Basel II	Percent % in total
Africa	17	12	71
<i>Asia¹</i>	16	16	100
Caribbean	7	4	57
Latin America	14	12	86
Middle East	8	8	100
Non-BCBS Europe	36	30	83
Total	98	82	84

¹ Excludes Japan as BCBS member-countries were not included in the survey.

Intentions re Basel II Adoption: An Asian Picture I

Table 2. Number of countries adopting the different credit risk approaches over 2007-2015

	2007	2008	2009	2010-2015
Standardised	7	14	14	14
FIRB	3	7	8	14
AIRB	1	5	6	10

Source: Financial Stability Institute (2006).

Intentions re Basel II Adoption: An Asian Picture II

Table 3. Number of countries adopting Pillars 2 and 3 over 2007-2015

	2007	2008	2009	2010-2015
Pillar 2	8	14	15	16
Pillar 3	6	14	15	16

Source: Financial Stability Institute (2006).

Timetable for Basel II Implementation in LICs

Table 4: Timetable for implementation of Basel II in low-income countries

Country	Credit Risk			Operational Risk		
	<i>STA</i>	<i>FIRB</i>	<i>AIRB</i>	<i>BIA</i>	<i>SA</i>	<i>AMA</i> ¹
Vietnam	End-08	Q4-08	End-08	Q4-8	Q4-08	Q4-08
Bangladesh	Jan-09	Not decided	Not decided	Jan-09	Not decided	Not decided
Botswana ²	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
India	Apr-09	Not decided	Not decided	Apr-09	Not decided	Not decided
Nepal	Jan-07	Not decided	Not decided	Jan-07	Not decided	Not decided
Pakistan	Jan-08	Jan-10	Jan-10	Jan-08	Jan-08	Not allowed
Ethiopia	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
Ghana	2008	Not decided	Not decided	End-06	End-09	Not decided
Kenya	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
Lesotho ²	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
Sierra Leone	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
Tanzania	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
Uganda	End-10	Not decided	Not decided	End-10	Not decided	Not decided
Zambia	End-08	Not decided	Not decided	End-08	Not decided	Not decided

Sources: Standard Chartered Bank; Central Banks' websites; interviews and email communication.

¹ Standardised Approach (STA); Foundation Internal Ratings Based (F-IRB) Approach; Advanced Internal Ratings Based (A-IRB) Approach; Basic Indicator Approach (BIA); Standardised Approach (SA); and Advanced Measurement Approach (AMA). ² Middle-income country.

Findings from our countries' interviews (8 in total) I

- Lack of human skills and resources to deal with Basel II issues.
- In face of that, most bank regulators had not decided by then when or how they were going to implement Basel II.
- At that point, they were still trying to understand how Basel II works, and to have a better grasp of their possible implications. It was what we called a **'better wait'** approach.

Findings from our countries' interviews (8 in total) II

However, some countries had already decided how to move forward:

- **Gradual approach**, through starting with Pillars 2 and 3, and
- In a second phase, moving to Pillar 1 with the adoption of the simplified standardised approach.
- Moving to the IRB only happen when built a data base and capacity within the Central Bank.
- Timetable for adoption of the various phases not set at that point (except for one country – Ghana)

What are the issues?

- 1) Capacity to validate models and monitor their use**
- 2) Presence of foreign banks**
- 3) Collaboration between home and host regulators**
- 4) Competitiveness issue**
- 5) Credit portfolio concentration and access to credit by SMEs**
- 6) Pro-cyclicality**
- 7) Technical assistance**

What are the issues?

1) Capacity to validate the models and monitor their use

- Major challenge: insufficient technical capacity to validate the more complex models and to monitor their use
- Lack of sufficiently long and reliable data base to run models adequately (main reason for not adopting the more complex approaches)

What are the issues?

- But not even intending to adopt the standardised approach, due to lack of domestic rating agencies (or to their low penetration) and initial stages of establishing credit bureau systems.
- Instead, they intend to adopt the simplified standardised approach (risk weights for different categories of assets are fixed and pre-determined by the regulatory authorities.
- Some countries have still to fully comply with the Basel Core Principles, put in place a risk-based supervision – Pillar 2 of Basel II – and build an adequate legal and regulatory framework.

However:

**The issues are not simply – or even mainly – technical.
Broader issues are at stake:**

- Competitiveness of national and foreign banks
- Access to credit by SMEs
- Potential pro-cyclicality of bank lending

What are the issues?

2) Presence of Foreign Banks

- Even if country regulators want to go for the simpler approaches for determining credit risk, will they be able to do so? Possibly not.
- The main reason being most LICs have foreign banks, and these banks intend to adopt the most complex approaches (F-IRB and A-IRB).

Bank ownership structure in Africa

Table 5: Variation in ownership structure across low-income countries, where available

Mainly Govt	Mainly Foreign	Foreign+Govt	Equally Shared	Mainly Local
Eritrea	Botswana	Burkina Faso	Burundi	Benin
Ethiopia	Central Afr Republic	Congo, Dem. Rep.	Ghana	Mali
Togo	Chad	Sierra Leone	Kenya	Mauritania
	Côte d'Ivoire		Rwanda	Somalia
	Gambia, The		Senegal	Sudan
	Guinea-Bissau			Zimbabwe
	Liberia			
	Madagascar			
	Malawi			
	Mozambique			
	Niger			
	Tanzania			
	Uganda			
	Zambia			

Source: World Bank (2006)

Note: Mainly government (foreign; private) means more than 60% of total assets are held by banks which are majority-owned by government (foreign; local private) shareholders. Foreign+Government means these two together concentrate more than 70%. Equally shared is a residual category (in Senegal, foreign plus private local add to more than 70%).

What are the issues?

- For foreign banks to comply with a simplified approach to meet the regulatory requirements of the host country, they would have to have a double reporting system.
- European banks already unhappy with lack regulatory homogeneity between US and Europe. They will certainly oppose it happening again between their home countries and LICs where they have subsidiaries.
- Moreover, the simplified approach is expected to require higher capital levels, thereby creating further tensions between foreign banks and host regulators.

What are the issues?

- Given this, LIC regulators feel they need not just technical assistance but more political support for their negotiations on regulations with international banks – to ensure their regulatory regime is consistent with national aims for both financial stability and sufficient credit, especially to SMEs.

What are the issues?

3) Collaboration between home and host supervisors

- Collaboration thus crucial even if a country decides not to adopt Basel II at all.
- But, according to LIC regulators interviewed, no communication or any sort of collaboration is taking place between them and their counterparts in the home countries to discuss this and other Basel II related issues.
- Why was that not happening yet at that point in time?

What are the issues?

4) Competitiveness issue

- Foreign banks going for more complex approaches may be granted competitive advantage over local banks.
- This would happen because the F-IRB and A-IRB approaches are likely to result in less capital requirements.
- This could lead to banking concentration favouring foreign banks in detriment to local ones.

What are the issues?

5) Credit portfolio concentration and access to SMEs

- Those banks using more complex approaches will have the incentive to lend more to lower risk borrowers and to ration/increase credit cost to those perceived as riskier borrowers. This may end up benefiting the larger borrowers and harming the smaller ones.
- This can cause portfolio concentration -> risk concentration
-> banks more vulnerable to shocks/unexpected changing circumstances. That goes against the main objective of the regulatory measures, which is that of reducing risks and vulnerabilities to which banks are usually exposed.
- Division of labour between foreign and local banks – not good for the stability of the entire financial system.

What are the issues?

6) Pro-cyclicality

- The use of risk sensitive models may make them detect an increase in the probability of default during economic downturns. As a consequence, assets of a portfolio will be downgraded and lead to higher capital charges.
- Recent study (Goodhardt, 2004) shows that the use of internal models imply larger variation of capital requirements over the cycle, compared to Basel I rules for risk measurement.
- This could lead to both increased cost and reduced quantity, reinforce the economic downturn and further impact banks' portfolios.

What are the issues?

- Thus, regulatory measures not neutral. They can have impacts on competitive and equity issues.
- Moreover, bank regulation can exacerbate pro-cyclicality of bank credit and thereby contribute to larger swings in the business cycle.
- In LICs, pro-cyclicality may be mitigated with the adoption of the simplified approach. But for that host regulators would have to be able to enforce its adoption among foreign banks.

What are the issues?

7) Technical assistance

- LIC regulators are keen to learn about Basel II. But little technical assistance is being provided.
- IMF is providing some advice, but mainly to middle-income countries.
- No common view on what sort of assistance might be useful.

What are the issues?

- Of course, LIC regulators are trying to learn as much as possible through attending local/international seminars, and organising awareness forums with their banks and their counterparts in neighbouring countries.
- But for very small countries, even that is not straightforward, due to budgetary constraints.

Conclusions

- Cautious implementation advisable; political support may be needed for that.
- Careful assessment of broader implications, especially for credit policy (which have implications for macro stability and growth), and for access to credit by SMEs (with implications for employment, poverty reduction, equity).
- More regional collaboration – in the mode of the Caribbean Group of Regulators.
- All the above plus TA could help LIC economic authorities decide on pace and modality of implementing Basel II in ways most appropriate for their development objectives.