GLOBAL FINANCIAL SECTOR REFORMS AND THE EMERGING ECONOMIES

Anwar Nasution

New Delhi, September 13-14, 2011

The BASEL III Accord

- The Basel III Accord (B3) was endorsed by the G20 Summit in Seoul in 2010.
- B3 is the basic foundation for transforming the global financial system to build a safer financial system and to ensure its resilience to periodic stress tests.
- B3 was mainly designed for banks in advanced countries with matured and well developed financial markets in response to the Global Financial Crisis of 2007-09.

The B3 ……..

- B3 primarily covers standards and regulations for banks and shadow banks with complicated derivatives;
- To build effective and efficient financial markets, B3 strongly recommends the use of credit rating and credit scoring systems and stress testing;
- The tests supplement the shortcomings of the VAR (value-at-risk) model, which uses the normality assumption.

Micro and macro prudential regulation

- The B3 framework covers both micro and macro economic prudential regulation related to capital, liquidity and leverage of the banking system. The micro type of regulation helps strengthen the resilience of individual banking institutions. This comprises three areas, namely:

  * First, improving banking system ability to absorb shocks arising from financial and economic distress;

  * Second, improving risk management and governance in the banking system;

  * Third, upgrading bank transparency and disclosure;
- Macro economic regulation includes the introduction of the capital conservation buffer.

Three components of bank capital

1. Minimum common equity requirement is raised to 4.5% of risk-weighted assets (RWA) from 2% under Basel II;
2. Introduction of a conservative buffer amounting to 2.5% of RWA. This enables banks to maintain capital levels above the minimum requirement throughout a significant sector-wide downturn;
3. Countercyclical buffer of between 0% and 2.5% of RWA. This makes CAR high during boom periods and low during downturns, thus partly correcting the inherent pro-cyclicality of capital regulation and mark-to-market accounting.

Two purposes of countercyclical capital buffer

- First, to allow banks to extend credit during periods of stress so as to help prevent a vicious circle of spiraling asset price devaluation;
- Second, to dampen credit growth during a boom period that could induce asset price bubbles.

Stricter definition of bank capital

- B3 uses a stricter definition of core capital and simplifies and harmonizes the deductions and filters that are applied to its calculation;
- B3 simplifies and harmonizes the deductions and filters that are applied to the calculation of Tier 3 capital, in particular;
- B3 also corrects the complex set of minimums and maximums for various elements of capita (Tier 1, Tier 2 and Tier 3), such as hybrid innovative.

Focus on Tier 1 to mitigate “too big to fail” problem

- To mitigate “too big to fail” problems, B3 focuses on common equity, the highest quality component of a bank’s capital. This forces banks to bear the costs of any failures they impose on society;
- In addition, Tier 1 also includes other instruments, such as retained earnings, other reserves and certain preference shares, that have a loss-absorbing capacity on a “going concern” or bank solvency basis;
- Tier 1 capital will be simplified. It typically consists of subordinated debt, and provides loss absorbing capacity on a “going concern” basis following insolvency and liquidation.

Higher capital requirements

- As a percentage of RWA, common equity rises from 2% under B2 to 7% under B3 (the minimum 4.5% plus a 2.5% conservation buffer). Tier 1 rises from 4% under B2 to 8.5% under B3. Total capital rises from 8% under B2 to 10.5% under B3. In addition, B3 imposes a counter cyclical buffer of between 0% and 2.5% of RWA;
- The higher capital requirements and stricter definition of core capital under B3 increase costs in the banking industry, and thus have the potential to curtail bank lending and negatively affect economic growth.

Strengthening market infrastructure

- The Basel Committee endorses the establishment of CCPs (central counterparty clearing houses) and trade reporting on OTC (over-the-counter) derivatives in order to resolve the problem of interconnectedness. The CCP system improves the management of counterparty risk, simplifies multilateral netting of exposures and payments, and increases transparency;
- To supplement the shortcoming of the VAR (value-at-risk) model, the Basel Committee encourages banks to conduct periodic stress tests that better capture tail events and incorporate the systemic risk dimension in banks' risk management;
- B3 introduces a leverage ratio to constrain the build up of leverage in the banking industry.

Emerging economy (EE) financial systems

- In terms of total assets and the number of institutions and branch offices, the core of the financial system in EEs consists of the banking system;
- Institutional investors such as pension funds and insurance companies are at an early stage of development;
- Banking systems in the EEs rely on deposits and loans. Derivatives and complex securitization exposures such as collateralized debt obligations (CDO) are unknown in the EEs. This underdevelopment of the financial sector partly shielded the EEs from the Global Financial Crisis of 2007-2009.

Dominance of state- and family-owned banks

- The domestic banking systems in the EEs are dominated by state-owned banks and private banks that are linked to business conglomerates;
- Because of the legacy of both the popular development concept and the nationalization of foreign-owned banks in the 1960s, the central governments of many EEs own more than one bank, while provincial governments also have their own development banks. The popular school of thought in the 1960's recommended the establishment of development banks to mobilize long-term savings so as to provide funding for essential long-term investment;
- In addition to the limited guarantees provided by deposit insurance companies, state-owned banks are also implicitly guaranteed by government.

Weak commercial orientation of state-owned banks

Even in banks that have been partly privatized, government continue to hold golden shares. The state-owned banks are frequently employed by governments to pursue their industrial and development policies,. Some of these banks are required to provide large volumes of loans to non-bank SOEs operating under soft-budget constraints;

Weak commercial orientation and limited risk management discipline eliminate the incentive for managers of state-banks to monitor and manage risks, upgrade transparency in corporate reporting or provide relevant business information.

Interconnected family banks

- Traditionally, every business conglomerate in East and Southeast Asia owned at least one interconnected family bank. Prior to the AFC in 1997, the main purpose of such banks was to mobilize funds to meet the financial needs of their commercial affiliates or subsidiaries;
- Related lending is prone to insider trading and principal-agent problems as banks tend to evaluate loan applications from affiliates less rigorously than would be the case with unaffiliated credit applications.

Moral hazard

For four reasons, moral hazard is still prevalent in many EEs. First, the roles of state-owned banks and financial institutions continue to dominant in these countries. Second, the state-owned banks are still being used by governments to pursue their industrial policies and development objectives. Third, weak bank supervision. Fourth, weak market infrastructure due to relatively weak legal and accounting systems to protect individual property rights, reduce transaction costs and minimize market asymmetries. Weak legal systems fail to enforce contracts and ensure the realization of collateral pledged by credit defaulters;

Weak bank supervision

- As credits are allocated based on a non-interest basis, and not always on economic considerations, supervisors classify loans based on repayment rather than the creditworthiness of borrowers or the market value of pledged collateral;
- Under conditions of financial repression, bank supervisory officers receive little training in the field of credit analysis and risk management in banking sector organizations;
- Credit rating, credit scoring and stress testing are meaningless due to limited availability of reliable, up-to-date and comprehensive information.

Countercyclical capital buffer

- The newly introduced countercyclical capital buffer in B3 is relevant to open and export-oriented EEs which are inherently sensitive to the business cycle in the international economy;
- The international economic environment affects Ees through (i) the goods market (exports and imports); (ii) labor market (including exports of uneducated and unskilled labor) and (iii) the capital markets, which affects the cost of foreign borrowings;
- In addition, currency realignment can have important effects on the prices of exports and imports, and the balance sheets of economic units.

Sound macroeconomic policies

- Learning from crises of the past, many EEs, particularly those in Latin America and Asia, have adopted stringent short-run macroeconomic stabilization policies. A countercyclical capital buffer and stable economy create a sound environment for their financial institutions;
- An explicit inflation target, more flexible exchange rate regime and explicit fiscal discipline that ensures a stable and sustainable debt-to-equity ratio are now the three pillars of short-run macroeconomic stability policies in many EEs. Some EEs have adopted the Maastricht Treaty criteria to set a government budget ceiling of 3% of annual GDP and maximum debt-to-GDP ratio of 60%.