IMPLEMENTING POST-CRISIS FINANCIAL REGULATORY REFORMS

What Does It Mean for Emerging Market and Developing Economies and How the World Bank Group Can Help

THE WORLD BANK
INTRODUCTION

There are ongoing efforts at the international level to monitor the effects of agreed regulatory reforms on emerging market and developing economies (EMDEs). The Financial Stability Board (FSB), in collaboration with the World Bank (WB) and the International Monetary Fund (IMF), issued a report in June 2012 entitled “Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences”. At the Los Cabos Summit, the G20 leaders welcomed the study and encouraged continued monitoring and dialogue to “address material unintended consequences as appropriate without prejudice to [the G20’s] commitment to implement the agreed reforms”. In response to the G20 request, the FSB, Standard Setting Bodies (SSBs), the WB and the IMF stepped up efforts in monitoring the effects of regulatory reforms (in particular, Basel III, OTC derivative markets reform and policy measures for Globally Systematically Important Financial Institutions - G-SIFIs) through existing mechanisms and consultation channels. In September 2013, the FSB provided an update to the G20 on the monitoring developments of the FSB, SSBs, the World Bank and the IMF and reaffirmed the need for continued efforts going forward to foster a better understanding of the effects of regulatory reforms on EMDEs and to facilitate the mitigation of any adverse effects.

The World Bank is making its best effort in helping EMDEs to align their regulatory and supervisory framework with international standards while addressing any unintended consequences. The WB is advancing this agenda through its global operations and availability of an extensive set of instruments. The WB conducts monitoring and diagnostic analysis on regulatory issues in EMDEs through the WB/IMF Financial Sector Assessment Program and Standards and Codes Initiative (FSAP/ROSC) and other regional and country programs. The WB provides technical assistance to help countries improve their regulatory and supervisory framework and also leverages its own financial resources and mobilizes external funding to help EMDEs develop diverse sources of financing. All these efforts aim to assist countries to mitigate the unintended consequences of the internationally agreed reforms by focusing efforts on addressing financial sector prudential weaknesses in EMDEs.

WHERE DO WE STAND TODAY?

IMPORTANT CONSIDERATIONS IN DISCUSSING THE EFFECTS OF REGULATORY REFORMS

There are a number of considerations that would help frame the discussion: First, several factors are at play in shaping the post-crisis financial landscape, which to some extent obscures the effects of the internationally agreed regulatory reforms. These include other regional and national regulatory initiatives, post-crisis balance sheet repair, and deleveraging caused from other regional or domestic structural issues (e.g. the euro crisis). Second, some effects of the regulatory reforms are intended and some are not. It is important to recognize that the agreed reforms are aimed at improving the resilience of the financial sector, which sometimes comes at a cost. Third, the tradeoff between financial stability and financial deepening (and thus growth) tends to be stronger for EMDEs than for advanced economies (AEs). Fourth, EMDEs are a diverse group of countries with different levels of development and different financial structures. Moreover, no definite conclusions can yet be drawn because implementation of the agreed reforms has just started. All of the above implies that the discussion of the effects of regulatory reforms needs to be put into context and be considered as a continuous process with a dynamic perspective taking into account broader developments (e.g., tapering of quantitative easing, movements in currency markets).

BRIEF OVERVIEW OF PREVIOUSLY IDENTIFIED EFFECTS OF REGULATORY REFORMS

BASEL III

Most EMDEs already report higher capital and leverage ratios than those required under the Basel III. There is usually a higher equity component in regulatory capital in EMDEs than in AEs. However, a more cautious view may be warranted since the WB/IMF FSAP and other diagnostic work have identified weaknesses in loan classification, provisioning, risk coverage of capital requirement, capital deductions and consolidated supervision in some EMDEs. In addition, there may be cross-border effects on EMDEs with large foreign bank presence and those that are more reliant on cross-border funding, due to the implementation of Basel III capital framework in home jurisdictions.
Some elements of the Basel III may have an impact on certain types of financing that are critical to EMDEs, may affect the overall cost of intermediation and cause business arbitrage. For example, the net stable funding ratio requirement, which is aimed at reducing maturity mismatch, may have a negative impact on long-term financing including infrastructure financing. In general, since banks will have to hold more capital for the same portfolio of assets, cost of banking businesses is likely to rise. There have been signs of regulatory arbitrage. In this regard, the growing shadow banking activities (for example, asset management businesses, and credit intermediation by insurers) are a notable development.

The Basel III liquidity requirements raise some questions among several EMDEs. There is a limited supply of government bonds and high quality corporate bonds in many EMDEs to meet the requirements for high quality liquid assets (HQLA) under the Basel III. The large holdings of HQLA may have an adverse impact on the development of the bond market, as well as on the availability of financing to the real economy.

**Measures on Systemically Important Financial Institutions**

There is a concern over the cross-border spillover effects of higher loss absorbency requirement for G-SIFIs on EMDEs. The SIFI surcharge, similar to the strengthened minimum capital requirements, may alter the business operations of global banks in EMDEs and increase the cost of capital.

Several EMDEs also raise questions on home-host cooperation and information sharing, in particular in resolution. Home-host cooperation has long been an issue of discussion for some EMDEs with a large foreign bank presence. In the SIFI context, the discussion arises mainly because of inadequate involvement of some host authorities in crisis management groups (CMGs) for G-SIFIs and in the design of group-wide recovery and resolution plans (RRPs). In many cases, a G-SIFI may have operations in an EMDE that are systemically important to the host jurisdiction but only account for a small share of the overall operations of the parent bank.

**WHAT CAN WE DO GOING FORWARD?**

**Maintaining effective international dialogue**

As a key participant in the international policy arena, the WB will continue to work closely with the FSB and SSBs on the development of regulatory reforms and relevant guidance. The WB will also help to promote an open and transparent process for monitoring the impact of the regulatory reforms on sub-groups of EMDEs and sectors of particular importance to EMDEs.

**Intensifying monitoring through the FSAP/ROSC**

The FSAP/ROSC will continue to play a critical role in implementation monitoring and in identifying follow-up technical assistance needs. The FSAP/ROSC facilitates systematical monitoring of the progress and impact of reform implementation. The extensive dialogue with the authorities and in-depth diagnostics conducted during an FSAP/ROSC are key to identifying the weaknesses in the regulatory and supervisory framework of an EMDE and to providing sound recommendations for reforms with proper prioritization and sequencing. The WB has prioritized resources and streamlined processes to meet the increased demand for FSAP/ROSC assessments.
Contributing to capacity building

The WB works with individual EMDEs to conduct targeted technical assistance to help them implement regulatory reforms and mitigate adverse impact. It works with EMDE authorities in improving compliance with key international standards, establishing preconditions for effective supervision and strengthening supervisory capacity.

Efforts have also been made to help EMDEs develop a strategy for implementing internationally agreed reforms with proper prioritization and sequencing. In addition, the WB supports countries to improve diverse sources of financing through capital market development (e.g. securitization, long-term financing instruments with the support of a sound institutional investor base) and to strengthen financial infrastructures in order to promote financial stability as well as financial inclusion.

Improving the impact by leveraging internal expertise and external financial resources

The World Bank Group is actively building “finance” as a core line of business, leveraging the expertise of its staff and a full suite of lending and risk mitigation instruments, to help fill in existing financing gaps and reduce the adverse impact of reform implementation. In SME financing, the WB is working with countries to develop factoring solutions and other means to improve creditworthiness through collateral or guarantees. Multilateral long-term financing, partial credit guarantees and Public Private Partnerships (PPP) financing type arrangements can also address some of the funding maturity issues expected under the Basel III NSFR requirement. In infrastructure and other long-term financing, the WBG’s financial structuring capabilities (including customizable loan structures and guarantee products) can help reduce project and credit risk to private lenders and institutional investors and thus encourage participation and mobilize financial resources from the private sector (e.g. Global Infrastructure Facility). The WBG will continue to develop new financial products and solutions to meet the needs of the EMDEs and to improve the provision of long-term finance.

Notes:

1. Drawing on previous work done by the FSB, in collaboration with the WB, the IMF and the SSBs, including the aforementioned reports.

2. The guidance on the Key Attributes issued by the FSB in July 2013 promotes cooperation and information sharing for resolution planning purposes even for a host jurisdiction that may not participate in the crisis management group of a G-SIB (because the operations of the G-SIB in that jurisdiction are not large relative to the overall size of the parent group) even though the G-SIB’s operations in the jurisdiction are systemic to the local banking system.

3. These include policy areas related to macroeconomic policies, financial regulation and supervision, and institutional and market infrastructure. For details, see Financial Stability Board. Key Standards for Sound Financial Systems.


References:
