World Bank/IMF/Federal Reserve System

Seminar for Senior Bank Supervisors from Emerging Economies

IMPACT OF FINANCIAL REGULATORY REFORMS ON EMERGING AND DEVELOPING ECONOMIES

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1-INTRODUCTION

2-OVERVIEW OF THE FINANCIAL REGULATORY REFORMS (Objectives and rationale)

3-THE MECHANICS OF CERTAIN REFORMS (Basel III)

4-POTENTIAL IMPACTS OF THE REFORMS ON EMDEs

5-WHAT CAN BE DONE TO ADDRESS CURRENT CONCERNS?
1-INTRODUCTION

- Several global financial regulatory reforms have been issued as a response to the crisis
- Their merits are widely recognized
- A sound, resilient financial system is key for both developed and emerging markets
- However concerns have been expressed about possible unintended effects, particularly on EMDEs
- The G20 and the FSB together with other Standard Setter Bodies and International Organizations are paying close attention
- Several initiatives have been taken under the aegis of the FSB to assess the impacts of these reforms
1- FSB: Role and Mandate

  • to enhance international cooperation for financial stability

  • Expanded membership
  • enhanced operating structure
  • broader mandate:
    (develop and promote the implementation of effective regulatory, supervisory and other financial sector policies)
2-OVERVIEW OF THE FINANCIAL REGULATORY REFORMS: objectives and rationale

A-The Basel III Framework

B-Over the Counter (OTC) derivatives market reforms

C-Policy Measures for Globally Systemically Important Financial Institutions (G-SIFIs)

D- Shadow Banking reforms
A-The Basel III Framework

Objective: Designed to strengthen the regulation, supervision and risk management of the banking sector in response to the financial crisis.

Comprehensive set of measures for Capital & Liquidity:
- A stricter definition of capital,
- A high quality and quantity of capital,
- Two dynamic capital buffers,
- A minimum leverage ratio of 3%, and
- Two minimum liquidity ratios: the Liquidity Coverage Ratio – LCR- and the Net Stable Funding Ratio – NSFR-).
### FSI 2013 Survey on Basel II and III Implementation*

<table>
<thead>
<tr>
<th></th>
<th>BCBS</th>
<th>Others</th>
<th>Total</th>
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<tbody>
<tr>
<td><strong>Basel II</strong></td>
<td>2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Implemented/in</td>
<td>27 (all)</td>
<td>64</td>
<td>91</td>
</tr>
<tr>
<td>the process of</td>
<td></td>
<td></td>
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<tr>
<td>implementation</td>
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<td></td>
</tr>
<tr>
<td>2013</td>
<td>27 (all)</td>
<td>73</td>
<td>100</td>
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<tr>
<td><strong>Basel III</strong></td>
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<td></td>
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</tr>
<tr>
<td>Implemented/in</td>
<td>19</td>
<td>32</td>
<td>51</td>
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<tr>
<td>the process of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>implementation</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>27 (all)</td>
<td>45</td>
<td>72</td>
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</table>

- Methodology similar to that of the Basel Committee (BCBS) “Level 1” surveys.
- ** A jurisdiction that has implemented at least one subsection of Basel III is deemed to be in the process of implementation.

Source: Financial Stability Institute
B-OTC derivative reforms

Objectives: to increase the transparency of OTC derivatives markets and to reduce systemic risk.

- Weaknesses in the structure of the over-the-counter (OTC) derivatives markets contributed to the build-up of systemic risk.

- The crisis demonstrated the potential for contagion arising from the interconnectedness of OTC derivatives market participants and the limited transparency of counterparty relationships.

- G20 Leaders agreed to a series of measures:
  - 21 recommendations on standardization, central clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions to trade repositories.
21 Recommendations to address OTC derivatives markets problems:

• All standardized OTC derivative contracts should be traded on exchange or electronic trading platforms

• Cleared through central counterparties

• OTCD contracts should be reported to trade repositories

• Non centrally cleared contracts should be subject to higher capital requirements
C-Policy Measures for Globally Systemically Important Financial Institutions (G-SIFIs): ending the Too Big to Fail problem

• In 2011, the G-20 endorsed a comprehensive framework to reduce the risks posed by G-SIFIs. It includes:

• an effective resolution regimes for financial institutions

• a mandatory resolvability assessment and recovery and resolution plans

• an additional loss absorbency requirements for G-SIBs; and

• an enhancement of the intensity and effectiveness of supervision of all SIFIs.
Banks should be resolvable: G-SIB subsidiary corporate structure

Source: opencorporates.
D- Shadow Banking (SB) Reforms

Objective: to promote prudent financial intermediation and thereby contribute to more sustainable non-bank financing

• SB has grown rapidly before and after the crisis

• From $26 trillion (2002) to $67 trillion in 2011

• SB plays an important role but…

• It can become a source of systemic risk (interconnectedness with the regular banking system is strong)

• FSB issued in 2011 a set of recommendations subjecting SB to appropriate oversight and regulation.
3-The Mechanics of Basel III

- Tier 1 increases to 6% of which 4.5% is common equity (CET1)

- Capital Conservation buffer (2.5%)

→ The total Common Equity is therefore set at 7% (2% under Basel II)

- Countercyclical buffer of 0% to 2.5% of risk weighted assets, depending on national circumstances.

- For G-SIFIs: additional surcharge of 1-2.5%.
Basel III capital requirements

- Capital surcharge for systemically Important Fls (1-2.5%)
- Countercyclical buffer (0-2.5% max)
- Capital Conservation buffer
- Minimum common equity tier one

% of risk weighted assets
The leverage ratio of 3%

Objective: to contain the build-up of excessive leverage in the banking system

• Bank’s total assets and commitments (including both on and off-balance sheet assets) should not represent more than 33 times the regulatory capital, irrespective of their risks weight.
3-The Mechanics of Basel III (Cont’d)

The LCR

Objective: Banks to hold sufficient high quality liquid assets (HQLA) that can be converted into cash to meet all potential demands for liquidity over a 30 day period under stressed conditions (a bank run for example).

Ratio must be at least 100%

• Numerator: Two categories of easy-to-sell assets classes.

Level 1: government bonds, cash, certain central bank reserves

Level 2: Corporate bonds and covered bonds rated A+ to BBB-, certain equities, and mortgage backed securities that meet specific conditions.

• Denominator: difference between total expected cash outflows minus total expected cash inflows during the 30 day stress scenario.
The Net Stable Funding Ratio (NSFR)

Objectives: promote resilience over a one year time horizon

- Structured to ensure that long term assets are funded with at least a minimum amount of stable source of funding
- Loans with a maturity greater than 1 year are to be covered by stable funding (i.e. bank equity and liabilities such as deposits and wholesale borrowing) greater than 1 year
4-POTENTIAL EFFECTS OF THE REFORMS ON EMDEs

A- Consequences are being identified and addressed

2012 FSB Study on the Unintended Consequences of Internationally Agreed reforms

2013 EMDEs monitoring / Follow up work to the 2012 EMDEs Study

Basel Consultative Group (BCBS outreach group) to issue a report in early 2014

→to understand possible effects on EMDEs and facilitate implementation of agreed reforms
B- Key messages from the FSB survey

- EMDEs just began implementing agreed reforms and most reported that they did not expect significant adverse effects.
- Concerns about potential side effects focused on a few key reform areas (Basel III capital and liquidity framework, policy measures for G-SIFIs, OTC derivatives reforms, national initiatives (e.g. Volker rule)).
- EMDEs’ concerns remain qualitative in nature given early stage of implementation.
B- Key messages from the FSB survey (cont’d)

• Some concerns stem from the way reforms are implemented in other jurisdictions (cross-border effects and indirect consequences through home/host relationships—e.g. consolidated banks applying higher risk weights)

• Some consequences are clearly intended, other may not

• Some potential effects on Long Term Finance

• Several identified concerns are also relevant for advanced economies
4-POTENTIAL EFFECTS OF THE REFORMS ON EMDEs (Cont’d)

Basel III capital reform may increase cost of intermediation

• There is an increase in both the quality (definition) and level of minimum regulatory capital requirements

• Which will raise the amount of regulatory capital that a bank needs to allocate for the same portfolio of assets (by 3 times for banks, by 6 times for G-SIFIs)

• These transactions will also be subject to a leverage ratio that will supplement the risk-based capital requirement
Basel III capital reform may increase cost of intermediation (cont’d)

- The capital charge will be impacted for all types of bank lending, including LT corporate loans
- This may lead to an increase in the cost of LT bank lending or a decrease in its supply
- Banks provide the majority of external financing for LT investments around the world
- SME finance might also be affected but magnitude difficult to predict:

  According to a G-SIFI in Europe «costs of higher capital and funding –as a consequence of the regulatory reforms- were passed to the clients, in particular SMEs, through proactive repricing».
Effects of the Basel III liquidity reform on LTF?

• There is no direct effect on the LT corporate loan from the introduction of the LCR

• However, banks may be incentivized to hold other types of more liquid assets that are treated more favorably under the HQLA definition (e.g. sovereign bonds)

• the real impact of this potential shift is not known at this point.
The NSFR may have some impacts on LTF

• If the LT corporate loan is funded via short-term deposits or other ST liabilities (that are regularly rolled over), there is a maturity mismatch risk

• This mismatch can be covered by lengthening the term of funding (which is more costly) and/or by reducing the maturity of the loan

• Investments, such as project finance, which tend to be long term are likely to be affected

• This could therefore constrain infrastructure development in developing markets: less availability or extra cost for the end-user
Policy Measures for G-SIFIs may also increase cost of intermediation

- Higher Loss Absorbency requirements (capital surcharge) for G-SIFIs may have spillover effects
- G-SIFIs might have two options: exiting from certain countries or pass on the cost to the clients

→ As for Basel III, the cost of credit is likely to increase
→ Banks are changing their business models
Basel III: banks are reacting by changing their business profile…

<table>
<thead>
<tr>
<th>Activity</th>
<th>Overall</th>
<th>North America</th>
<th>Europe</th>
<th>Asia-Pacific</th>
<th>Latin America</th>
<th>Africa/Middle East</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exiting lines of business</td>
<td>43%</td>
<td>22%</td>
<td>17%</td>
<td>17%</td>
<td>64%</td>
<td>75%</td>
</tr>
<tr>
<td>Shifting out of complex, less liquid instruments</td>
<td>43%</td>
<td>50%</td>
<td>33%</td>
<td>17%</td>
<td>75%</td>
<td>75%</td>
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<tr>
<td>Evaluating portfolios</td>
<td></td>
<td></td>
<td></td>
<td>75%</td>
<td>80%</td>
<td>86%</td>
</tr>
<tr>
<td>Exiting geographies</td>
<td>17%</td>
<td>23%</td>
<td>6%</td>
<td>17%</td>
<td>38%</td>
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</tr>
<tr>
<td>Streamlining legal entity structures</td>
<td>11%</td>
<td>23%</td>
<td>38%</td>
<td>41%</td>
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</tr>
</tbody>
</table>

Source: 2013 EY-IIF survey “Remaking financial services: risk management five years after the crisis, A survey of financial institutions”
4-POTENTIAL EFFECTS OF THE REFORMS ON EMDEs (Cont’d)

OTC derivatives reforms impact on LTF provision?

- Reforms imply additional costs through new capital and margining requirements (for non-centrally cleared transactions +compliance costs)

  →These additional obligations are likely to raise the costs of derivatives contracts and may reduce their availability

  →Some costs relating to additional reporting may also be passed through to end-users

- Overleveraged FIs pulling back from certain areas; However, very difficult to quantify the impact. Also, Institutional Investors playing a greater role.
4-POTENTIAL EFFECTS ON EMDEs (cont’d)

To sum up:

• Little tangible evidence to suggest that the reforms have significantly contributed to current concerns (see 2012 FSB report)

• Deleveraging in the EZ is happening but may be triggered by other factors beyond regulatory reforms

• Too early to assess the actual impact of the reforms
  
  • Long phase-in period of new standards (2013/2019) will allow adjustments to policy frameworks
  
  • Some aspects of certain standards are currently being reviewed.
  
  • On-going implementation monitoring process under the BCBS and the FSB umbrellas designed to address possible unintended effects.
To sum up:

In assessing possible impact on EMDEs, other aspects are to be considered:

- Not all countries are equal vis-à-vis any potential adverse side effects of reforms
- Problems could arise from the manner in which banks achieve their new capital adequacy ratios (*deleveraging vs. raising capital*)
- The benefits of applying the regulatory reforms in EMDEs should also be part of the equation.
- Some effects are clearly intended
5-WHAT CAN BE DONE TO ADDRESS CURRENT CONCERNS?

At the G20/FSB level:

- There is a need to do more monitoring and analysis of possible unintended consequences
- This work is underway with the view to find the appropriate regulatory response

At countries level:

- Assess the impact of specific financial regulation on banks’ business
- Identify any factor that is giving rise to material unintended effects, notably on LTF
- Monitor financial institutions’ behavior in relation to the implementation of the reforms (any regulatory arbitrage?)
- Developing domestic non-bank financial institutions and capital markets (to reduce over-reliance on banks for financial intermediation and secure sustainable source of finance)
MANY THANKS FOR YOUR ATTENTION!