

SME's, Basel II, Government Interventions and Emerging Markets

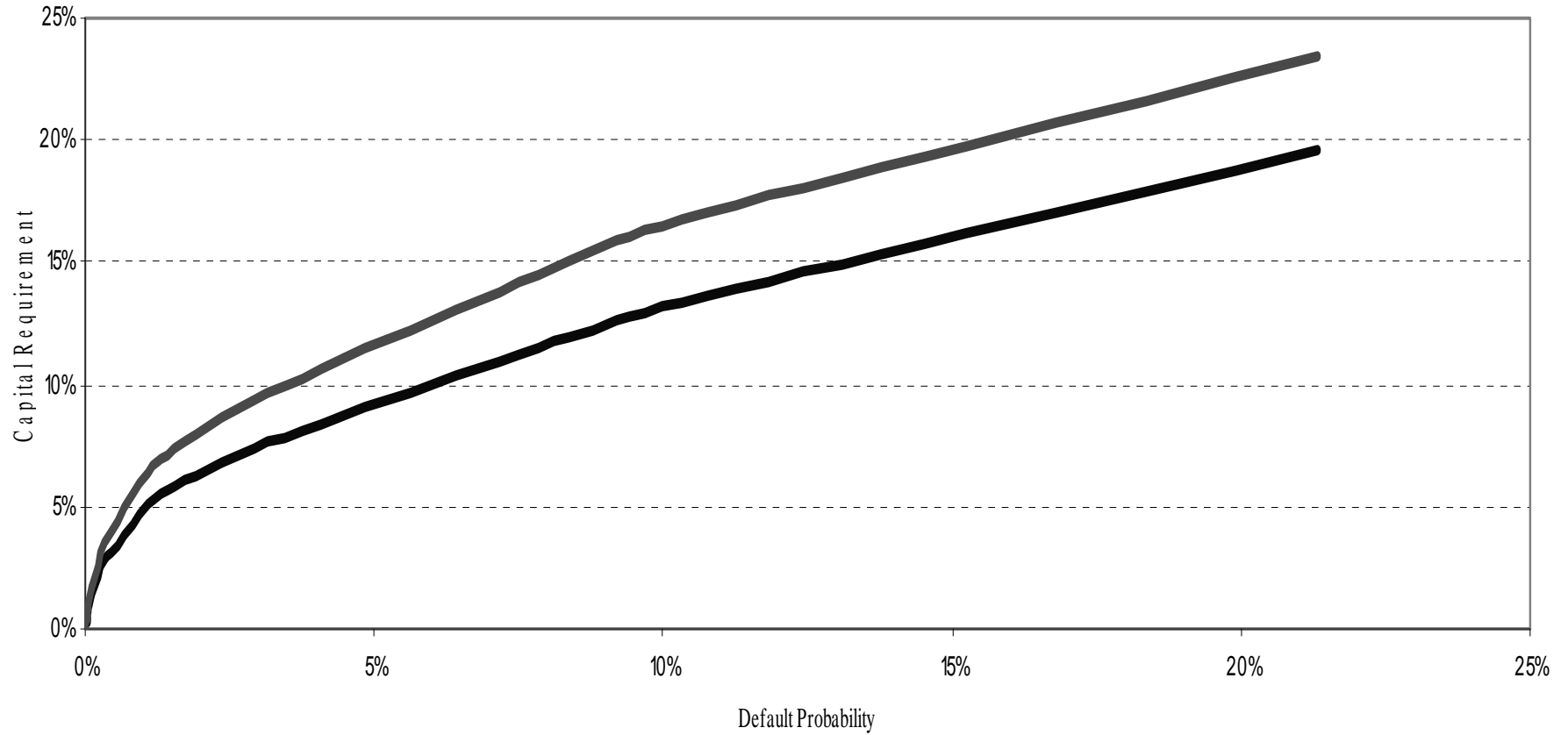
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Plan of the Discussion

- Basel II and SME's: the presentation
- Emerging markets, Basel II and SME's
- Government interventions: a comment
- Conclusions

Basel II and SME's

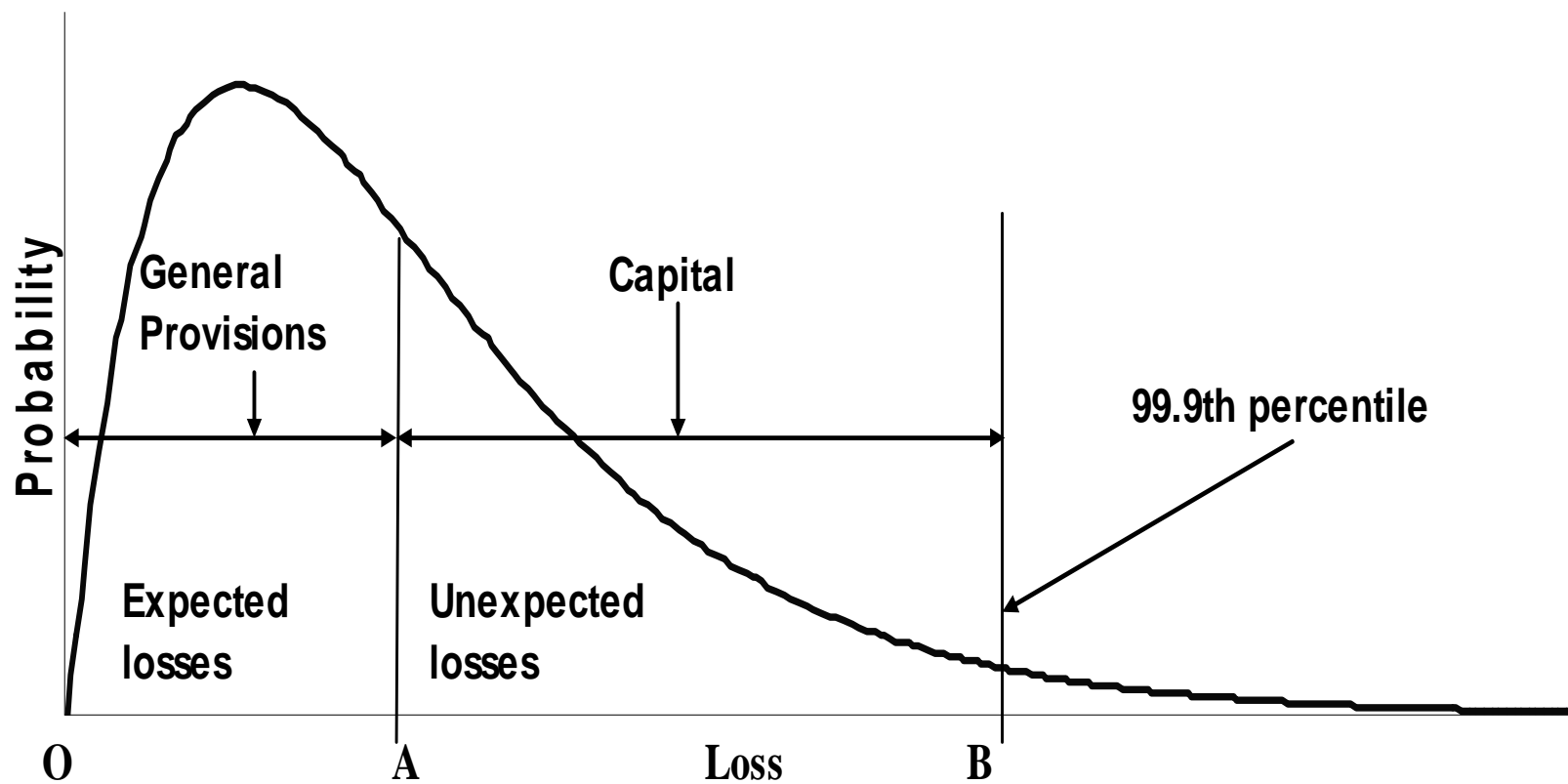
The IRB Curve & SME Adjustment



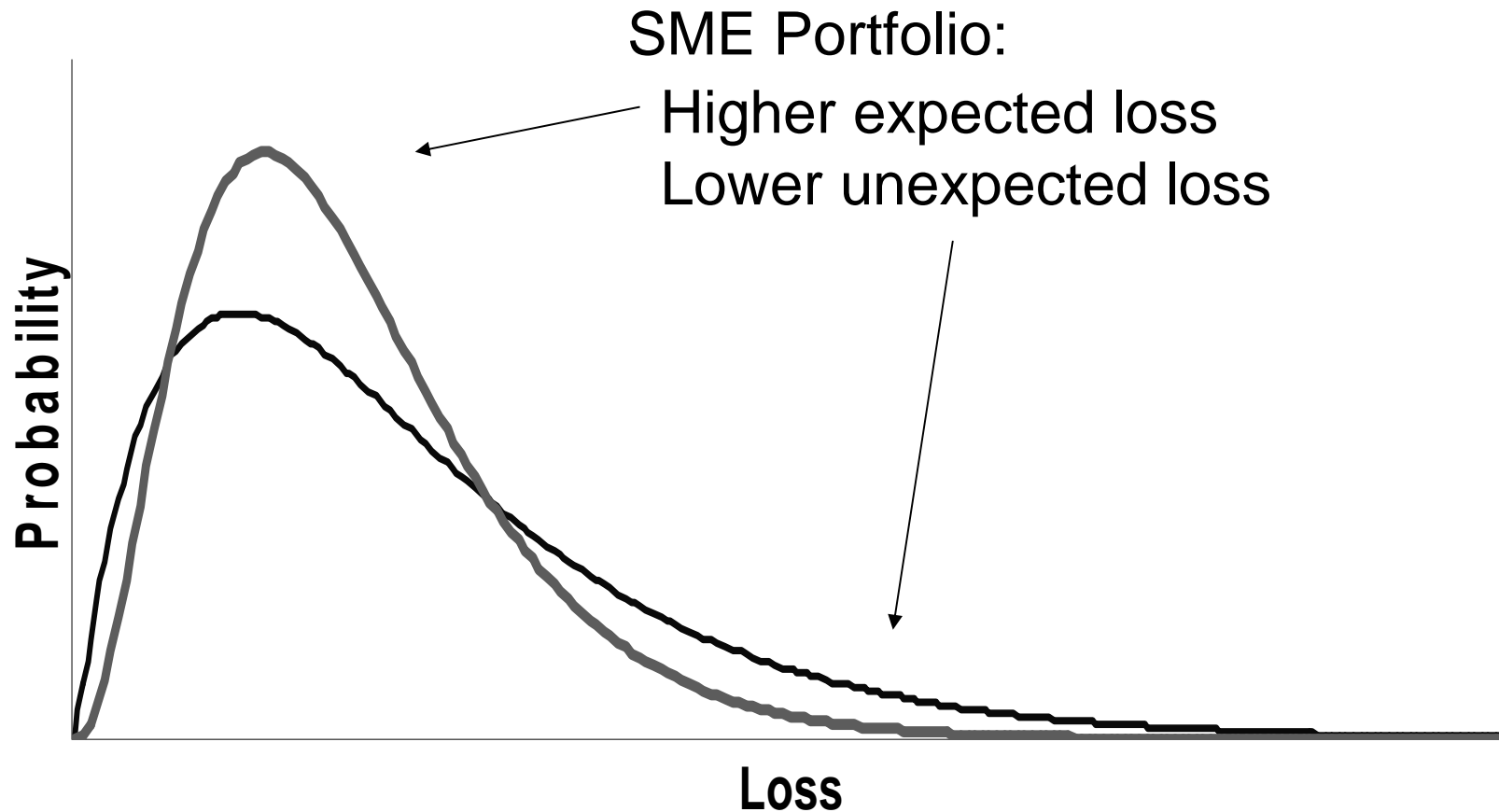
— SME (<5 mn sales)

— Corporate (>50 mn sales)

Basel II's VAR-type Approach



What's the idea with a Portfolio of SME Loans?



Results

- This is apparently what the paper finds
- Using a Carey-inspired boot strapping methodology.
- Authors find for portfolios of smaller firms:
 - higher default rates “expected losses” (roughly)
 - But lower “unexpected losses”

What's the Puzzle

- The puzzle is that the authors present evidence that SME's are more linked to systemic risk.
- The presentation suggests that SME regressions have higher R^2 and also higher sensitivities to certain cyclical "factors"
- So how can SME's have lower unexpected losses?

Possible Answers

- Something wrong with the Bootstrapping
 - Portfolios are not fully diversified
- Something wrong with the regressions (or their interpretation):
 - Missing variables in the regression
 - Micro / idiosyncratic variables

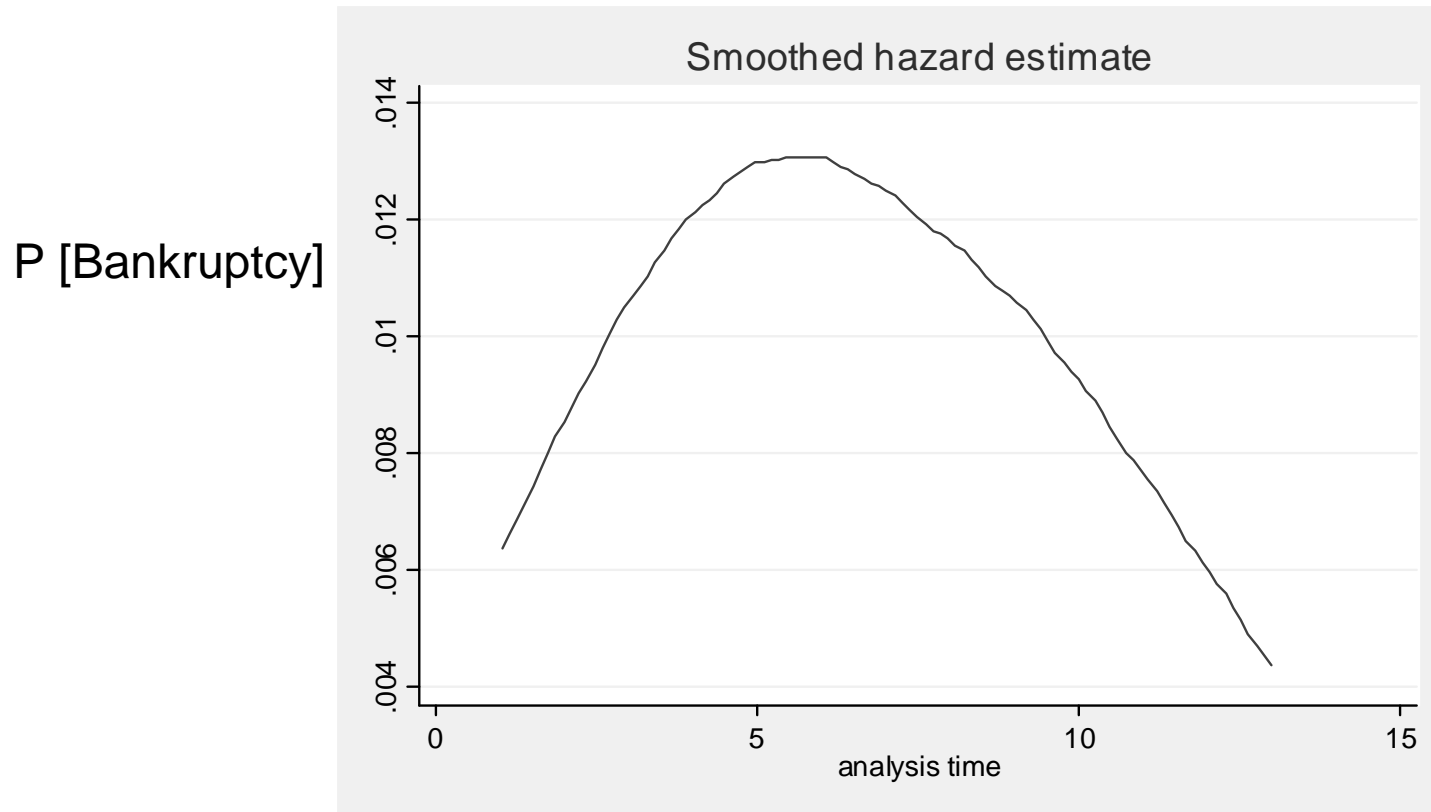
Portfolios are not Fully Diversified

- Authors can simply try increasing portfolio size and see if results change.
- Should show that results are invariant to portfolio size and are robust to number of replications and other variants of the methodology.

Missing Variables in the Regression

- The world is not one factor
- Firm's sector may be an important factor (try sector Gross Value Added)
- Larger firms may be more international so less sensitive to the national business cycle
- Firm longevity – see Castro on Spain

Firm Longevity and Bankruptcy



Longevity (years)

Christian Castro (IDB) – Presentation on
a Hazard Model for Spanish Firms

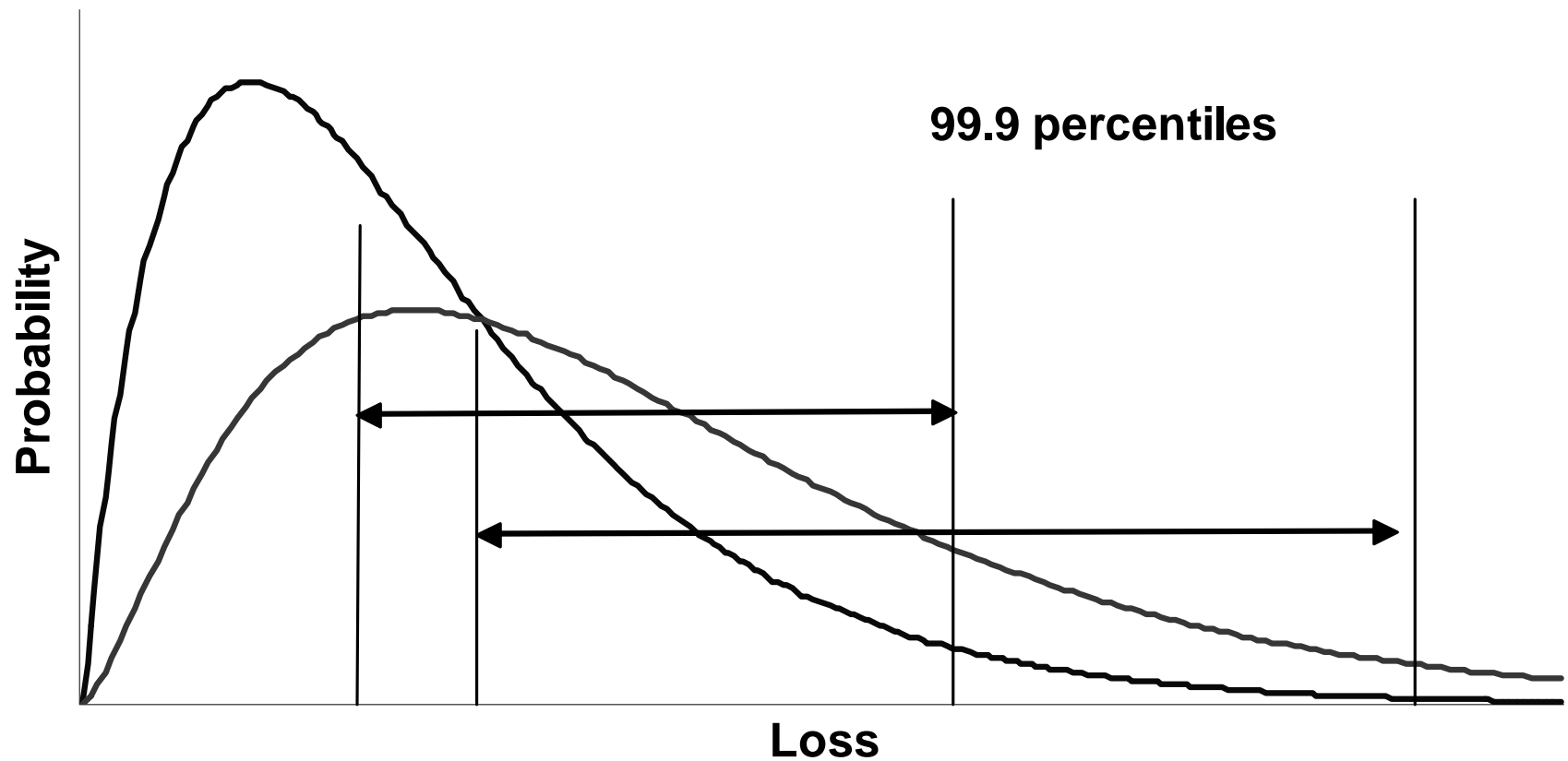
Micro-variables

- Controlling for the Micro-variables may reduce the sensitivity to the national cycle, these may have the national cycle within them!
- Would need to have a differential effect between small and large firms
- An individual effect may be a better control for this purpose or initial micro-variables
- We wish to capture the cycle and all its effects

Basel II, SME's and Emerging Markets

- The SME adjustment cannot be considered in isolation
- There is a need to consider the IRB calibration as a whole

SME's and Emerging Economies: Higher Risks, Higher Correlations



The SME Adjustment and EM's

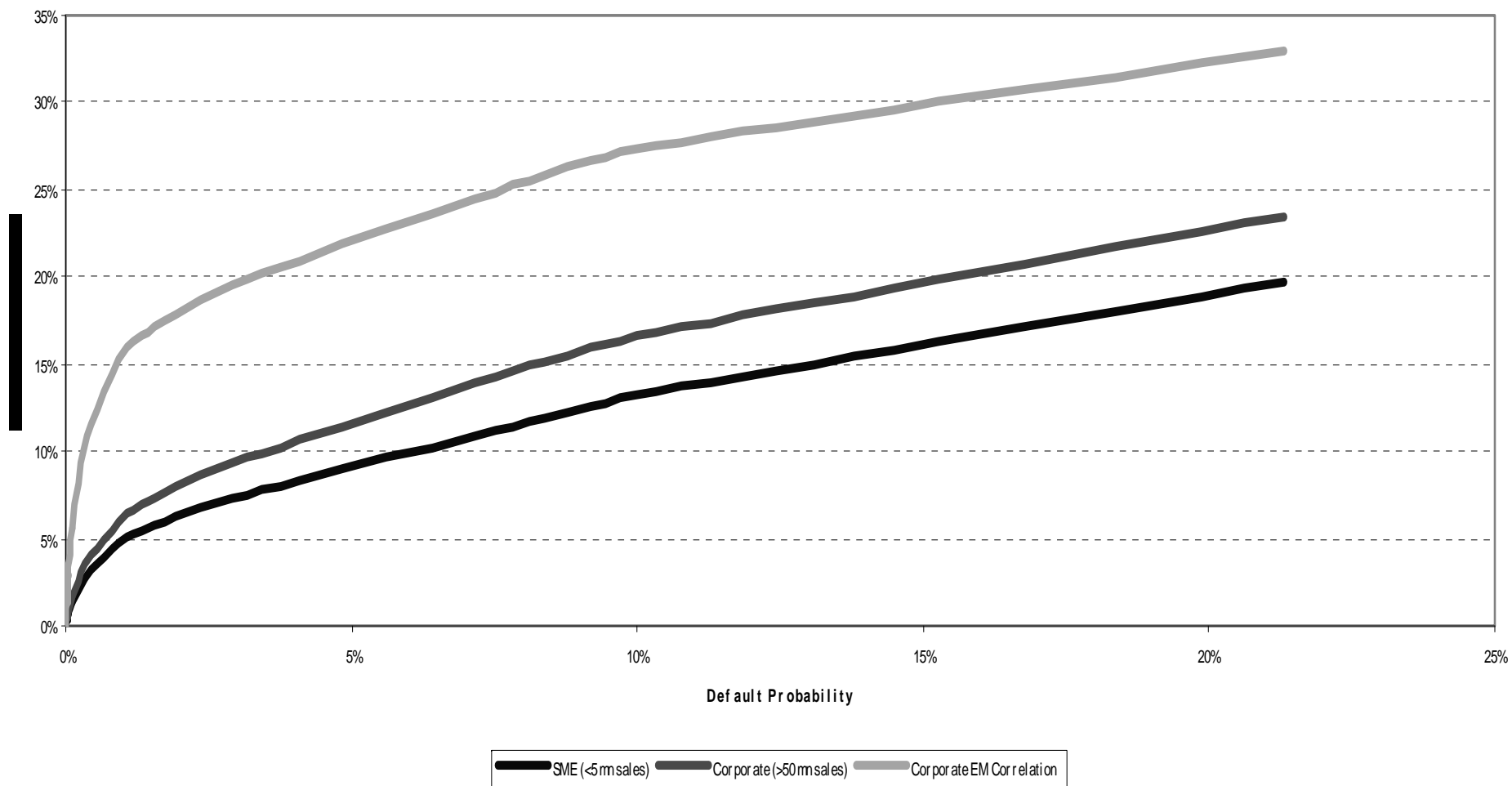


Figure inspired by results of Majnoni and Powell (2005)

Further Results

- Gutierrez-Girault – on Argentina
- Majnoni et al - on Chile
- Appears to be more research on EM's than on G10 in this regard!
- But still more research required...

Argentina before and after...

- Castro, Gutierrez-Girault and Powell, on-going work
- Logit type analysis:
 - Bankruptcy : over 90 days past due
 - Interaction between GDP and Type of Loan (small commercial loans vs larger loans)
 - Smaller commercial loans were less sensitive to GDP than larger commercial loans.
- Consistent with Basel II type assumption
- But values are far from Basel II ones!

Policy Recommendations

- BBVA – recalibrate the IRB curve for EM's using the sovereign rating as a guide to the tolerance limit, so if the country is BB then a 99.1% limit is appropriate .
- Majnoni and Powell (2005) suggested adjusting the correlation assumptions and the tolerance value to national circumstance
- More debate required...

Basel II, EM's and SME's

- Most EM's will implement the Standardized Approach that uses external credit rating agency ratings.
- And most SME's unrated so risk weight is 100% and no change from Basel I
- Conclusion: Basel II will not do much...

Basel II will not do much, except.....

- **Scope of Accord**
 - Level of Consolidation
 - nb: many EM's unlikely to comply
- **Pillar 1**
 - Operational Risk: as little reduction on credit risk, overall requirements in EM's may rise
 - Risk Mitigation: Collateral, Repos etc.
 - Securitization: Very topical!
- **Pillar II: Risk Management Process**
- **Pillar III: Transparency**

EM's Fall Between Two Stools

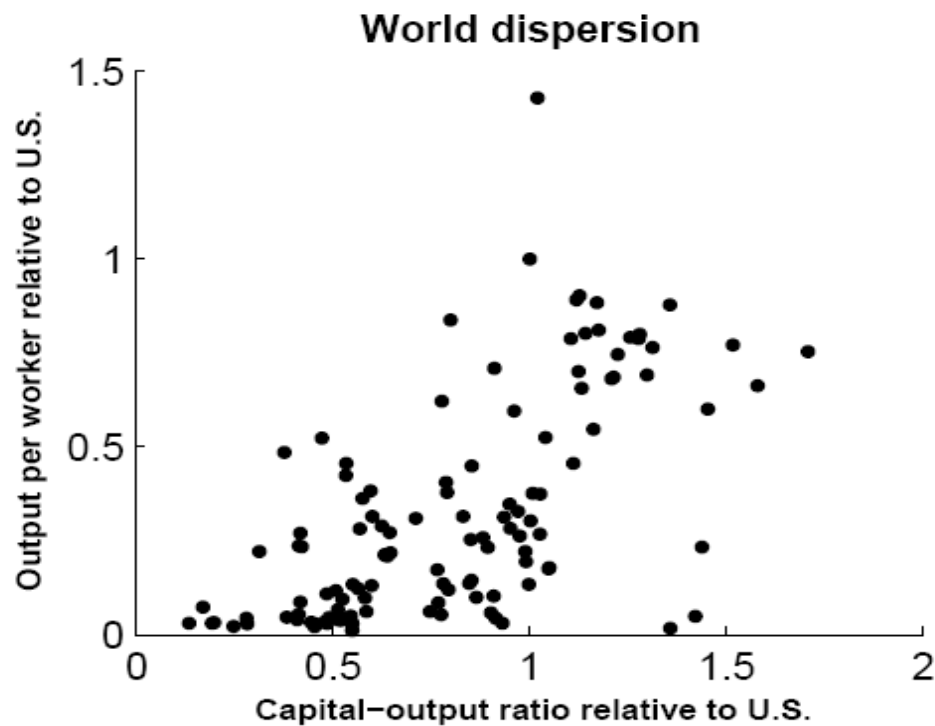
- **IRB** : complex vs. **SA** : little advantage
- **CRB (Centralized Rating Based)** approach:
 - Banks must rate companies according to a standard scale (say S&P type)
 - Rating-scale may be developed by Superintendency and ratings may be monitored and compared easily
 - Could homogenize across countries to create a standard.

*Ref: Majnoni and Powell (2005) *Economia**

SME's and Cross Border

- If international banks implement IRB as written
 - home supervisor rules
- And domestic banks use SA approach
 - local supervisor rules
- Domestic banks at an advantage lending to SME's
 - Best rated claims with international banks
 - Local banks picking up lower and un-rated SME's

Government Interventions: Quality and Quantity



Government interventions either through SME assistance or through prudential regulation need to balance Quality as well as Quantity of Finance

Conclusions

- The paper could be a useful contribution
- Several ways to resolve the puzzle
- Basel II calibration questionable, especially for EM's, need more work
- A need to think of an Accord for top 10 banks in 100 countries
- **Basel III, Emerging!** *“Towards Basel III, Emerging” IDB Powell (2006)*
Available on www.iadb.org and www.asbaweb.org
- A new paradigm for Government intervention:
 - to enhance finance as an input to production
 - Quality vs quantity tradeoff