

Mind the Gap: Making Basel Standards Work for Developing Countries

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SUMMARY

The prudential standards that govern global finance are developed by a small group of financial regulators, largely from advanced economies. Basel II and III are not designed for low and lower-middle income countries (LMICs) with less complex and smaller financial markets, and where regulatory authorities face substantial resource constraints. Off-the-shelf adoption of international standards in LMICs poses high costs and risks. Nevertheless, regulators in many LMICs are pressing ahead with Basel II and III. In today's world of globalised finance, LMIC regulators cannot simply ignore international standards, even if they are ill-suited to their regulatory environment. The adoption of international standards is one of the only mechanisms they have for signalling to international investors and other regulators that their banks are soundly regulated. LMIC regulators perceive the adoption of international standards as crucial for helping their banks expand abroad, and for attracting investors into their financial sector.

International standard-setting bodies have been working to avoid unintended consequences for developing countries, but much more needs to be done. The international policy community needs to move from a minimalist 'do no harm' approach, to actively designing international standards that are genuinely useful for LMICs and support financial sector development.



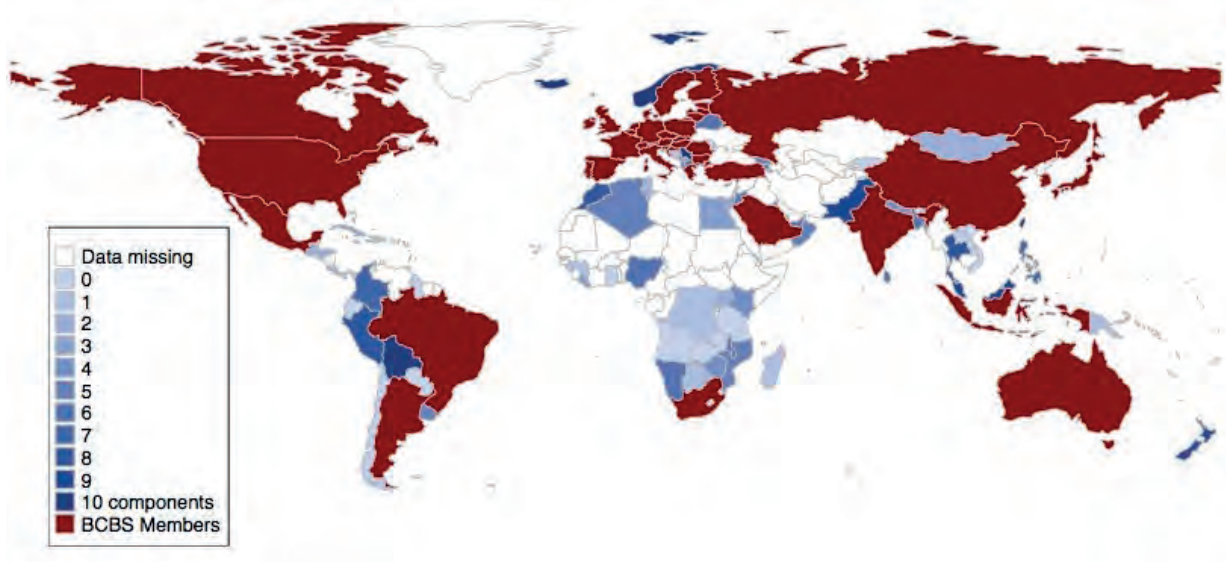
We recommend that the Financial Stability Board, IMF and World Bank:

- **Prevent an ill-fated race to the top** among LMICs towards maximum Basel II and III implementation by clarifying under which conditions proportional or non-implementation of specific Basel II and III components is recommended;
- Mandate the Basel Committee on Banking Standards to **build in proportionality** into the design of Basel Standards as a matter of course, so they can be readily tailored to a wide variety of local contexts;
- **Open the standard-setting processes** to more meaningful input from LMIC representatives. At a minimum the Basel Consultative Group should include representatives from LMICs and there should be greater engagement with the Group when international standards are designed;
- **Recognize the signalling function of Basel standards** as a seal of regulatory quality and devise complementary methods to assess and communicate the quality of prudential financial regulation in LMICs;
- **Engage in further research** on the repercussions of Basel II/III implementation for credit allocation in the real economy and for financial inclusion.

This policy brief summarizes the findings of a three-year research project on Basel adoption in LMICs at the Blavatnik School of Government, University of Oxford. The project is led by Professors Emily Jones, Ngaire Woods (Oxford) and Thorsten Beck (Cass Business School), with generous funding from the DFID-ESRC Growth Research Programme. It combines quantitative research using data from ca. 100 jurisdictions and in-depth case studies of 11 countries on 3 continents.

BASEL II/III ADOPTION: WIDESPREAD BEYOND THE BASEL COMMITTEE

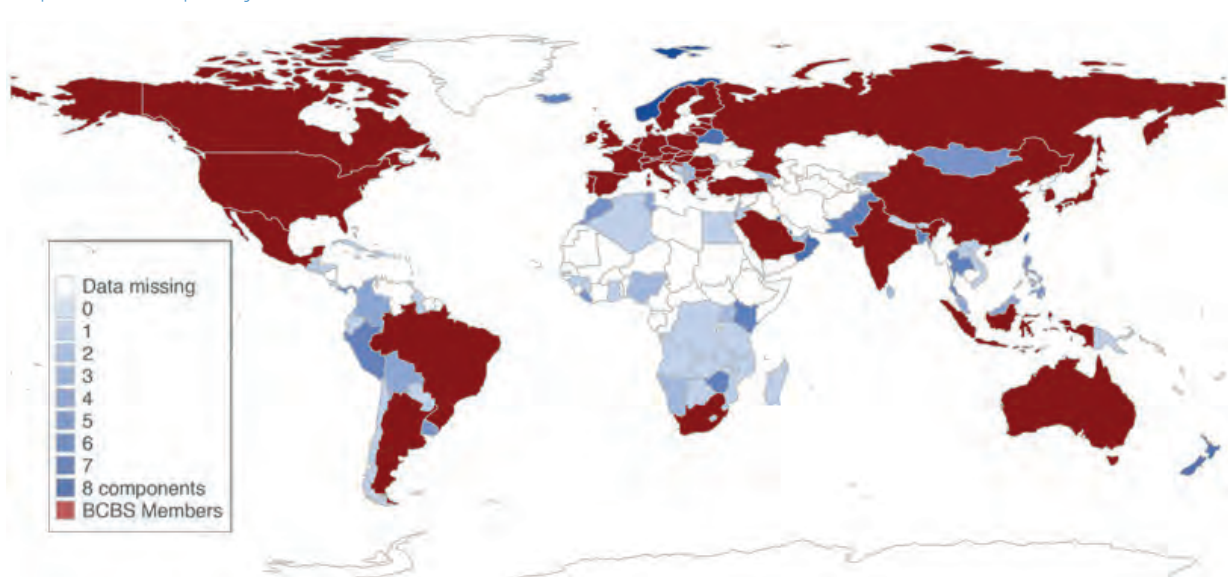
Figure 1: A map of Basel II adoption by non-members



Many non-members of the Basel Committee adopt Basel banking standards even though they have no seat at the standard-setting table.

The Basel Committee on Banking Supervision (BCBS) sets prudential standards that are negotiated by and for its 28-member jurisdictions, most of which are advanced economies. However, implementation of the first Basel standard is almost ubiquitous, and the newer two standards – Basel II and III – have found widespread acceptance beyond the perimeter of the Basel Committee. Analysis of data from the Financial Stability Institute at the Bank of International Settlements shows that 90 out of 100 surveyed non-member jurisdictions have implemented Basel II at least partially, or are in the process of doing so. Moreover, 81 jurisdictions reported that they had taken steps towards the implementation of at least one component of Basel III¹. The graphs below and the results of our quantitative research on the drivers of Basel adoption in ca. 100 countries can be found in a series of publications².

Figure 2: A map of Basel III adoption by non-members



1 Financial Stability Institute (2015). Basel II, 2.5 and III Implementation. Basel: Bank of International Settlements.

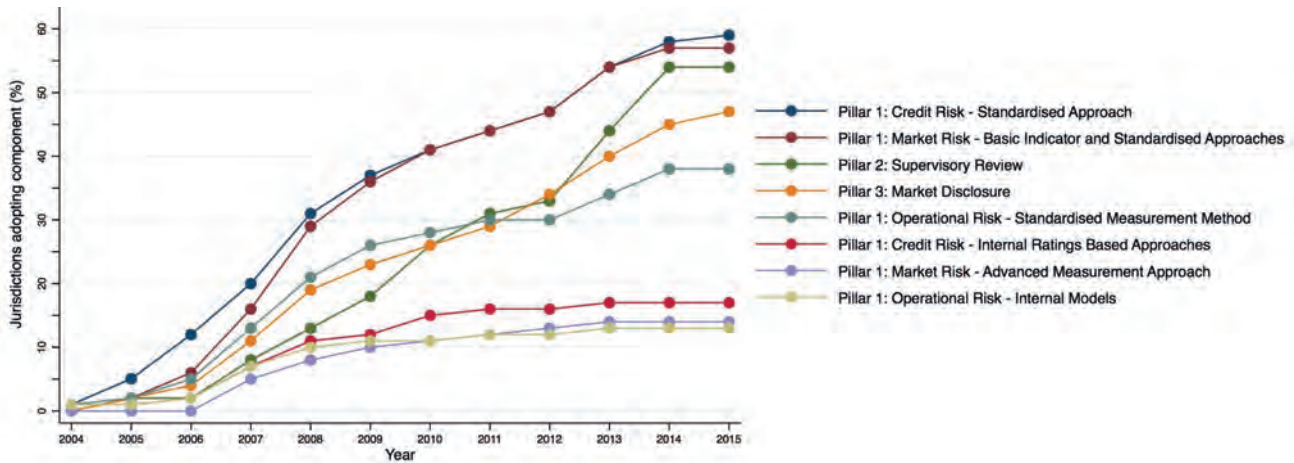
2 Jones, E., & Zeitz, A. O. (2017). The Limits of Globalizing Basel Banking Standards. *Journal of Financial Regulation*, 3(1), 89-124. Jones, E., & Zeitz, A. O. (under review). *Regulatory Convergence in the Financial Periphery: How Interdependence Shapes Regulators' Decisions*.

The adoption of Basel II and III standards is widespread even in developing countries.

Basel standards are designed to address financial risks emanating from large, complex banks with international operations. Regulators in many LMICs adopt them even though their jurisdictions feature simpler banking systems and

different financial risk profiles. As Figures 1, 2 and 3 show, some components of Basel II have been implemented in the majority of non-members of the Basel Committee.

Figure 3: Adoption of Basel II by jurisdictions outside the Basel Committee

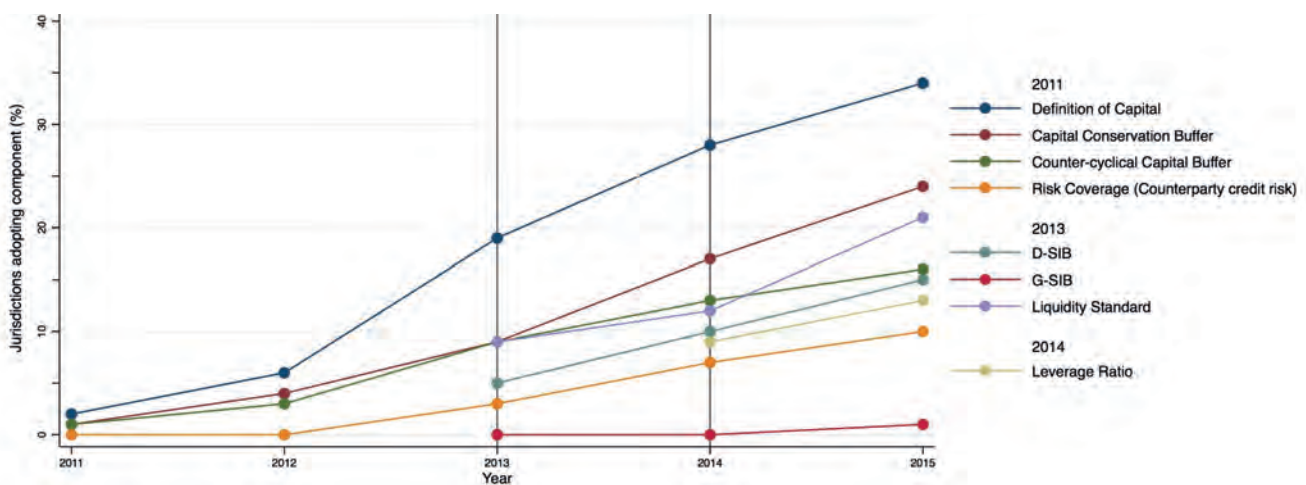


Regulators in LMICs are typically selective adopters, choosing some components of Basel standards while eschewing others.

In particular, regulators are more likely to adopt the simpler Basel II standard approaches to credit, market and operational risk instead of much-disputed advanced approaches that rely on internal risk models by banks. Similarly, Figure 4

shows that simple components of Basel III such as the new definition of capital and the leverage ratio are more popular than complex requirements such as the liquidity ratios or the countercyclical buffer.

Figure 4: Adoption of Basel III by jurisdictions outside the Basel Committee



REPUTATION AND COMPETITION CONCERNS DRIVE BASEL IMPLEMENTATION

Regulators in LMICs do not merely adopt Basel II or III because these standards provide the optimal technical solution to financial stability risks in their jurisdictions. Instead, regulatory decisions are also driven by concerns about reputation and competition.

Our research reveals that a series of factors drive the adoption of Basel standards in LMICs:

Signalling to international investors.

Politicians advocate for the adoption of Basel standards in order to signal sophistication to foreign investors. For example, in Ghana, Rwanda, and Kenya, politicians have championed the implementation of Basel II and III, and other international financial standards, as part of a drive to establish financial hubs in their countries.

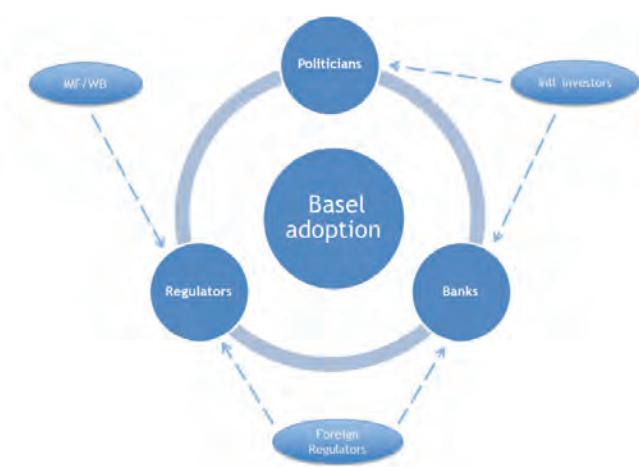
Reassuring host regulators.

Banks headquartered in LMICs may endorse Basel II or III as part of an international expansion strategy, as they seek to reassure potential host regulators that they are well-regulated at home. We see this at work in Nigeria, where large domestic banks have championed Basel II/III adoption at home as they seek to expand abroad. Their fervour has been met with reluctance among politicians who fear that a rapid regulatory upgrade may put weaker local banks in jeopardy.

Facilitating home-host supervision.

Adopting international standards can facilitate cross-border coordination between supervisors. In Vietnam, for example, regulators were keen to adopt Basel standards as their country opened up to foreign banks, to ensure they had a 'common language' to facilitate the supervision of the foreign banks operating in their jurisdiction.

Figure 5: Key actors that influence Basel adoption



Peer learning and peer pressure.

Even while acknowledging the shortcomings of Basel II and III LMIC regulators often describe them as international 'best practices' or 'the gold standard' and there is strong peer pressure in international policy circles to adopt them. In the West African Economic and Monetary Union (WAEMU), for example, regulators at the supranational Banking Commission are planning an ambitious adoption of Basel II and III with the support and encouragement of technocratic peer networks and the IMF. Domestic banks however have limited cross-border exposure and are concerned about the high compliance costs.

Technical advice from the International Monetary Fund and the World Bank.

This plays an important role in shaping the incentives for politicians and regulators in developing countries. While the Financial Stability Assessment Programmes (FSAPs) evaluate the regulatory environment of client countries against a much more basic set of Basel Core Principles, we find evidence that Fund and the Bank provide inconsistent advice with regards to Basel II and III adoption.

OFF-THE-SHELF BASEL II/III ADOPTION COMES WITH TRADE-OFFS AND RISKS

While the reputational benefits of a full embrace of Basel II and III appear to be significant, the risks of a wholesale implementation of the global standards may be less obvious. Financial regulatory experts in academia and policymakers assert that there is an inevitable divergence between the international Basel standards and the sui generis regulations that would be most appropriate to each jurisdiction's economic structure, financial regulatory framework, and political preferences. This divergence is particularly stark for LMICs.³

The Basel Committee has recognized the need for differentiation, and while it seeks to provide a common set of minimum standards, it also allows national authorities substantial leeway in standards implementation. However, the range of options provided by the Basel Committee remains inadequate for LMICs, raising the following six implementation challenges:

1. **Financial infrastructure gaps.** Even the simpler components of Basel II and III presume a degree of financial development and the existence of infrastructure that is not in place in many LMICs. For instance, the standardised approach to credit risk under Basel II relies on credit rating agencies. Many countries outside the Basel Committee do not have national ratings agencies and the penetration of global ratings agencies is limited to the largest corporations. Public capital markets in LMICs may not be deep and liquid enough for investors to exert the kind of market discipline that is envisioned in Pillar III of Basel II. The Basel III counter-cyclical buffer relies on the supervisor's ability to accurately anticipate credit bubbles, which is particularly challenging in developing countries where large swings in economic performance are common and macroeconomic data of lower quality. Furthermore, the supply of high-quality liquid assets in LMICs may not be sufficient for banks to meet the liquidity requirements of Basel III.
2. **Poor match for financial stability threats.** Basel II and III are designed for banks operating in advanced economies and sophisticated global financial markets. They address financial risks that may be of little relevance in the simpler financial systems of LMICs, such as counterparty risk for derivatives exposures or liquidity mismatches arising from wholesale funding. Conversely, Basel II and III may not adequately address key macroeconomic threats to financial stability in LMICs, such as large swings in global commodity prices and other external shocks.
3. **Human and Financial Resource Constraints.** Implementing Basel II and III imposes significant adjustment costs onto both banks and regulators. The costs derive not from regulatory stringency – capital requirements in most LMICs are higher than Basel III – but from the complexity of Basel rules. The implementation of the new global standards, especially the advanced, internal-ratings based approaches of Basel II and the macroprudential elements of Basel III exacerbates regulatory resource constraints that are already significant in many developing countries.
4. **Exacerbated information asymmetry.** The advanced components of Basel II endow banks with substantial leeway to use internal ratings-based models to calculate their capital requirements. The global financial crisis of 2008 has highlighted the inadequacy of such models and the failure of regulators even in advanced economies to scrutinize the risk exposure of banks in their jurisdiction. In many developing countries, remunerative differences and brain drain to the private sector already pose challenges for regulatory authorities. Such inequalities may be exacerbated when the more sophisticated elements of Basel II and III are implemented. Moreover, banking supervisors in many developing countries lack the political and operational independence as well as the enforcement powers that are required for effective Basel II and III implementation. Thus, implementing the advanced approaches of Basel II may widen the scope for regulatory arbitrage and thus be detrimental for financial stability.
5. **Distorted regulatory agenda.** Implementing Basel II and III may take scarce resources away from other priority tasks of the regulatory agency. Regulators in LMICs recognize the need to improve corporate governance, strengthen regulatory independence, and bolster their authority for timely supervision and prompt corrective action in order to safeguard financial stability. These features of a strong regulatory regime are enshrined in the Basel Core Principles. In contrast, implementation of Basel II/III does not necessarily address underlying weaknesses in the regulatory system or the political entrenchment of vested interests. These global standards embody a complex financial regulatory regime, not necessarily a strong one.
6. **Deterioration of credit composition.** Banks that implement Basel II and III may have an incentive to shift their portfolio away from sectors of the economy that are key for inclusive economic development. Higher risk weights for trade letters of credit due to the Basel III output floor for example may increase the cost of trade financing, even though previous rule changes have taken emerging markets into account. Higher risk weights for loans to small and medium enterprises (SME) under Basel III may not properly reflect the potential benefit of diversification away from a few large enterprises and discourage financial inclusion. Moreover, the Basel III liquidity ratios may raise the cost of infrastructure lending because they require banks to match such exposures with long-term liabilities that are in relatively short supply in developing countries.

³ For an extensive review of the relevant literature see Jones, E., & Zeitz, A. O. (2017). The Limits of Globalizing Basel Banking Standards. *Journal of Financial Regulation*, 3(1), 89–124. see also: Castro Carvalho, A. P., Hohl, S., Raskopf, R., & Ruhnau, S. (2017). Proportionality in banking regulation: a cross-country comparison (FSI Insights No. 1). Center for Global Development (2018). Making Basel III Support Development in Emerging Markets and Developing Economies. URL: <https://www.cgdev.org/working-group/working-group-basel-iii-emerging-market> FSB. (2017). Implementation and Effects of the G20 Financial Regulatory Reforms: Third Annual Report.

CHANGES NEEDED IN INTERNATIONAL STANDARD-SETTING

Given the challenges and risks associated with implementing Basel II and III, regulators in LMICs face difficult choices and trade-offs.

LMIC regulators are under pressure to adopt the full suite of international Basel standards in order to signal to regulators in other jurisdictions and to international investors that their banks are soundly regulated. Yet there are major challenges and risks associated with implementation. Ideally, regulators would tailor the local adoption of global banking standards to harness their benefits in prudential and reputational terms while avoiding the costs of an off-the-shelf implementation. This is not straightforward – sifting through the full suite of international standards and adapting them to fit the local context is a painstaking and resource-intensive task.

Development prerogatives remain at the margins of regulatory debates at the Basel Committee.

During the negotiations of Basel I and II, the Basel Committee was an exclusive club of regulatory agencies from advanced economies and questions of suitability of the global standards for developing countries received minimal attention. In 2009 the membership of the Basel Committee was expanded to incorporate representatives from ten emerging market economies of the G20, so developing countries had a seat at the table during Basel III negotiations. Nevertheless, even though they are formally represented, regulators and market participants from developing countries have been far less engaged than their peers from advanced economies. The Basel Consultative Group is tasked with facilitating dialogue between members and non-members but LMICs are not represented, and the Group has little influence over the design of international standards. Hence, international standards are not designed with LMICs in mind, and their regulators receive little guidance from the Basel Committee regarding benefits and risks of Basel II or III implementation for their financial sector development.

Regulators in LMICs face disincentives for tailoring global standards.

Full adoption of Basel II and III is often considered “global best practice” in the regulatory community and among financial market participants worldwide. In contrast, there is no range of best practices for tailoring Basel standards to meet development needs, and peer learning mechanisms among developing countries are still in their infancy. National regulators in LMICs often lack the resources to adapt global standards to national circumstances. Moreover, they face the risk having to explain to incumbent politicians why the adapted rules and regulations fall short of “global best practice”.

Regulators in LMICs have little guidance for proportional Basel standards adoption and adaptation.

Even though key stakeholders in the global regulatory community have endorsed the proportionality principle in global financial standards implementation, useful guidance for regulators in LMICs is still lacking. Existing publications have analysed proportional implementation of Basel III among advanced economies, looked at unintended consequences for emerging market G20 members, and offer advice on the Basel Core Principles. The 2016 regulatory consistency assessment of Indonesia also offers potential lessons for other LMICs. But guidance on how to approach proportional Basel II or III implementation from a development perspective has not been compiled systematically.

“As explicitly stated, implementation of the capital adequacy regimes under Basel I, Basel II or Basel III is not a prerequisite for compliance with the Core Principles. This is of great relevance for the proportionate (i.e., risk-based) implementation of capital adequacy requirements, particularly with respect to smaller, less complex institutions.”

BCBS (2016, 21). Guidance on the application of the Core Principles for Effective Banking Supervision to the regulation and supervision of institutions relevant to financial inclusion.

Proportionality needs to be hard-wired into the design of international standards.

Instead of placing the burden of retrofitting complex international standards on regulatory agencies in LMICs, proportionality should be hardwired into international standards. The international policy community has advised LMICs to 'go slow' in their adoption of Basel II and III, recognising that full implementation may be ill-advised.

Yet simply telling LMIC regulators, politicians and banks to 'go slow' doesn't solve the problem - it leaves them without a way to credibly signal to international investors and other regulators that their banks are appropriately and effectively regulated. International standards should be designed so that they can be readily adapted for use in a wide range of financial sectors, at all stages of development. This would enable LMICs to keep up with 'international best practices' in a manner that is genuinely aligned with their prudential regulatory needs.

The International Financial Institutions do not provide consistent advice regarding Basel II or III implementation.

The Financial Sector Assessment Programmes (FSAP) conducted by the Fund and the Bank assess the financial regulatory system of client countries against the Basel Core Principles, which are not technically connected to the newer Basel standards. Our research shows that while assessors explicitly warn against hasty Basel II or III implementation in some LMICs, they encourage it explicitly or implicitly in others. The Bank and the Fund are aware of the reputational importance of their assessments: two in three countries surveyed by the Bank in 2014 requested an FSAP "as a signal to the international community". Given these high stakes and the uncertainty of the external assessment, local regulators may be driven towards conservative off-the-shelf adoption of Basel standards. The Bank and the Fund can do more to encourage a tailoring of global standards that safeguards financial stability, highlight positive cases of proportional or non-adoption of Basel II and III, and facilitate peer learning among developing countries.

"The international community should send a clear and consistent message on the appropriate pace of adoption of the Basel II/III framework in EMDEs. The more financially-integrated EMDEs—especially those that belong to the G20/FSB and participated in the development of this framework—should adopt the framework according to the agreed timetable. Other countries, with less internationally integrated financial systems and/or with substantial supervisory capacity constraints, should first focus on reforms to ensure compliance with the Basel Core Principles and only move to the more advanced capital standards at a pace tailored to their circumstances."

POLICY RECOMMENDATIONS: REFORMING INTERNATIONAL STANDARDS-SETTING

So far, the international policy community has adopted a minimalist 'do no harm' approach when it comes to international banking standards, seeking to establish where there have been negative unintended consequences for developing countries and only then looking for remedies. In today's world of globalised finance, regulators in LMICs cannot simply ignore international standards even when they are not appropriately designed for their jurisdiction, as this carries significant reputational risks. As a result, resource-constrained regulators in LMICs face the choice of adopting Basel standards wholesale, knowing that this will pose problems, or taking on the onerous and challenging task of trying to retrofit Basel II and III to meet their specific regulatory needs.

Much more could and should be done at the design stage to ensure that international standards work for an LMIC context and can be readily adapted by regulators. To this end, the Basel Committee on Banking Supervision, Financial Stability Board, IMF and World Bank could take the following steps:

- **Prevent an ill-fated race to the top** among LMICs towards maximum Basel II and III implementation by clarifying under which conditions proportional or non-implementation of specific Basel II and III components is recommended;
- Mandate the Basel Committee on Banking Standards to **build in proportionality** into the design of Basel Standards as a matter of course, so they can be readily tailored to a wide variety of local contexts;
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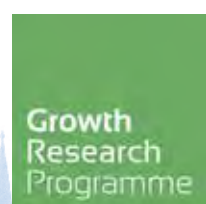
RESEARCH FINDINGS

This policy brief is based on an extensive research project titled 'Developing Countries Navigating Global Banking Standards'. Find out more about our quantitative research, analytical framework, and in-depth case studies of 11 jurisdictions on 3 continents on our website: <http://www.geg.ox.ac.uk/research/navigating-global-banking-standards>. The website is frequently updated to inform you about upcoming publications, which include an edited 15-chapter volume with Oxford University Press, journal articles, and individual case studies. Existing publications include the following:

Jones, E., & Zeitz, A. O. (2017). *The Limits of Globalizing Basel Banking Standards*. *Journal of Financial Regulation*, 3(1), 89–124.

Jones, E. (2014). *Global Banking Standards and Low-income Countries: Helping or Hindering Effective Regulation?* GEG Working Paper No. 91. Oxford: Blavatnik School of Government.

Jones, E., & Knaack, P. (2017). *The Future of Global Financial Regulation*. GEG Working Paper No. 127. Oxford: Blavatnik School of Government.



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