2. THE EFFECTS OF BASEL II ON DEVELOPING COUNTRIES: A SUMMARY OF A GLOBAL PUBLIC GOODS NETWORK EFORUM ON BASEL II

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1. INTRODUCTION

During the May 26–June 14, 2004 period, Global Public Goods Network (gpgNet) held a discussion forum (eForum) on International Financial Stability—Basel II: Accord or Discord.[1] Over 250 participants from around the world registered for the e-Forum, but relatively few submitted comments or replies. This article summarizes some comments and provides excerpts from others that were posted on the gpgNet web site for the eForum.[2] They are presented here in the order in which they were sent. No changes or corrections were made in the comments that are quoted. The full-texts of all of the comments are available on that same website.[3]

Several points suggested for debate included:

- What effects will Basel II have on developing countries?
- What measures could be introduced to reduce the potential negative effects, such as taking the diversification of risk into account?
- Why have measures to curb its potential negative impact on developing countries not been taken into account?

2. COMMENTS AND REPLIES

2.1. Mistakes in Basel Could Harm Developing Countries

The eForum began by asking participants to review a paper by Stephany Griffith-Jones, who argues that Basel II would significantly overestimate the risk of international bank lending to developing economies.[4] This would lead to the increased cost of borrowing by those countries, and to a decline in loans to the developing world. Stephany Griffith-Jones and Stephen Spratt go on to say that sophisticated international banks have diversified their portfolios, but Basel II does not take this risk reducing factor into account.[5]

2.2. Insights from a Global Survey on Bank Capital

Insights from a Global Survey on Bank Capital, by Benton E. Gup, revealed that of the 66 countries that responded to the survey, all met or exceeded the 8% capital requirements of Basel I.[6] About half of the respondents would apply Basel II, and most of the remaining countries were contemplating it. The fact that banks in many countries have excess regulatory capital mitigates some of the effects of Basel II's higher capital requirements for riskier loans.

2.3. Micro vs. Macro

Sunada Sen pointed out that Basel II is focused strictly on the micro-finance of banks; and it ignores the macro-economic aspects of global capital flows.[7]

2.4. Procyclicality

Paul Bance presented a paper on "Prudential Supervision Against Banking Procyclicality: A Critical Assessment of the Line of Defense of the Basel Committee."[8] He says that "The New Basel Capital Accord may heighten the procyclical impact of the financial system through its proposal for a risk-sensitive regulatory framework. The line of defense of the Basel Committee for Banking Supervision relies on a strengthened supervision mix of public and private discipline to carefully monitor banks' positions and actions and to efficiently prevent them from adopting imprudent behaviors. This essay argues that the impact of increasing supervision on banks' prudential behavior is not monotonic through the economic cycle and may be counterproductive in some points of the cycle."

2.5. Making a Fragile System More So

Avinash Persaud and Stephen Spratt argue that Basel II is too complex and places too much emphasis on risk-sensitivity.[9] ". . . the purpose of bank regulation is not to assess private risks: this is the job of the banks and the markets. The purpose regulation is to consider where social risks are different from private risks, and then to use regulatory capital to make those social risks internal to the bank. If the failure of a particular bank would have no negative effects on confidence in the financial system—if, for example, there would be no strong reason to bail out that institution—then it is not clear why we would regulate it any differently than we would regulate a non-financial corporate with concern for the health and safety of its consumers and employees. We regulate banks further because we are worried about their spill-over risks. Sensitivity to private risks is a red-herring. Of course, it is what big banks would like regulators to worry about, because then regulatory capital will be aligned to their narrow risks. Instead regulatory capital should focus on the difference between internal assessments of risk and the regulators' assessment of the wider social risks."

They conclude by saying that "Basle's prescriptions are at the root of its enormous complexity. Complexity is the avenue of capture. Faced with over 200 pages of complex rules and exceptions, the supervisors will be more easily manipulated, the consultants will be happily employed and the big banks will pick off smaller banks straining under the financial costs of implementation."

2.6. Benefits of International Diversification

Djamester Simarmata addressed the issue of international diversification[10]. "... we need more information in order to shed more lights on the problem of financial flows to developing countries from international banks. The problems are related to the following issues:

1) The procyclicality of the credits to the developing countries. At the boom times, the credit will be abundants, but it will be scarce at the recessionary periods, where the needs were really mounting to push the economic growth.
2) The price of commodities in developing countries follows the boom and bust cycles, where the bust cycles were generally longer than the boom cycles. We need more information on the periods of these cycles between commodities and between countries. By common sence we could concludes that the bust cycles will be in line with the recessionary periods in the developed countries.
3) How could we adjust the simultaneity of those cycles to help the economic growth of the developing countries. Here comes the problem of procyclicalities of credits to the fore again.
4) How could we manage the diversification issues in relation to the above issues on boom-bust of commodity prices, procyclicalities, and so on."

"By regading the previous published risks by the BIS for several countries, the new Basel-II could give way to the reduction of risks, so that it could reduce the necessary loss provision. In that publication, it was shown for the year 2001 by the BCBS publication that the risks in Indonesia was leading to CAR (minimum capital requirements) of 12 percent, while that for Malaysia was only 4 percent. The Malaysian case show that if the internal situation were conducive, the risks were low, leading to a required CAR of less than Basel-I one-size-fit all of 8 percent. From this point, there could be an incentive for developing countries to manage their economy well following the Basel—II criteria leading to a low CAR."

2.7. Strengthening Asia's Financial System

Amador Honrado, Jr. presented the Asian Bankers' Association position paper on Strengthening Asia's Financial Systems."[11] "1. The Asian Bankers' Association (ABA) notes that recent developments, including significant declines in asset prices, the emergence of major corporate governance failures, renewed financial troubles in emerging markets and lingering concerns about security have generated an atmosphere of considerable uncertainty, aggravating the current economic weakness in key markets and threatening to delay the process of recovery in most Asian economies from the effects of the 1997–98 financial crisis.

2. We see the need for urgent action by individual governments and more active cooperation within bodies such as the Asia-Pacific Economic Cooperation (APEC) forum to restore investor confidence in key markets while accelerating the resolution of bad debt problems and further strengthening Asia's financial systems against risks of recurrent crisis and contagion."

... "In the light of this situation, we see even greater urgency for the full implementation of measures we have recommended in the past to APEC Economic Leaders and Finance Ministers, multilateral financial institutions, and financial authorities ... We reiterate our call for cooperative measures to assist bank supervisory authorities in ***preparing to implement the new Basel Capital Accord***."

2.8. Differing Goals

Frank Sammeth stated that "The problem is in fact complex because development policies and banking on the one hand, and macroeconomic aspects of growth and microeconomic particularities of capital flow and financial markets seem to collide.[12]

On the one side there is the urgent need of capital for development and on the other side the private banking system which is interested in lowering the risks of any credits given.

The main two questions are: does the BCA negatively affect capital flow to countries in need of capital for growth, and if so what can be done to reduce those effects?

Before you can answer the second question you have of course to agree on the first one.

The key is the method risk—assessing and—management which can differ whether you represent the interests of a private bank or of a development organisation, because the perspective is different: creditors look at the projects themselves and its chances of success under the aspect of risk, while international organisations have to include socio-economic, political, ethical and other aspects according to their mission. The result can be that a NGO or IO approves a project because of its long-term positive impact and sustainable effect on an aspect of development while a private investor may disapprove because he settles the risks to high and prefers to give not the credit."

... "What are the different interests of the agents? Governments want to encourage private banks to lend to developing countries in order to relax national budgets affected by high unemployment and low growth rates. Banks want to minimize their risks, and of course make profit. Developing countries and agents or institutions in development cooperation are in need of capital and defend the long—run and global perspective of growth, including qualitative aspects you see rarely in monetaristic or specific approaches.

The solution is a risk-calculation method which satisfies them all: governments, by being supported by private banks concerning the overall capital flow to developing countries; the banks who are sure they are running low risks and the development agents who get more funds.

So, finally, does Basel II go into that direction? I think yes, because it offers a common approach applicable to all agents, making internal or other ratings less crucial for decision making. Secondly, if all banks implement Basel II, their practice will converge and will be more predictable."

2.9. Normal Times vs Crises

Ashima Goyal wrote that "In lending to emerging market economies we need to distinguish between risk in normal times and that in times of crises.[13] In normal times risk is low, and portfolio diversification works to lower it further. Moreover the productivity of such lending is high. The problem with sophisticated Var models is that they would overstate risk in such times, but cannot cover the sharp rise in systemic risk in times of crises. Systemic risk at such times is aggravated by herd behaviour which punishes countries for circumstances they are not wholly responsible for. Therefore individual or micro risk cover can never be sufficient. Some macro intervention linked to a new international financial architecture has to be designed to supplement Basel II.

Second we need to distinguish between sophisticated banks which will be able to lower risk cover and gain a competitive advantage over the others. The latter are largely small banks in emerging market economies. Since these tend to be tightly regulated by central banks, and are a major source of the portfolio diversifying type of credit to the small firm or farmer, there is a rationale for lowering their capital adequacy requirement while giving them incentives to graduate to higher levels of sophistication. If Basel II increases their capital requirement it would be inefficient as well as inequitable."

2.10. Adjusting Capital for Diversification

Stephen Spratt & Stephany Griffith-Jones responded to a question about correction factor for the Capital Accord that would take diversification into account.[14] "One such mechanism has been proposed by the Spanish bank BBVA.

In A practical proposal for improving diversification treatment in Basel 2 the authors define a "correction factor" which measures the error made when using a single factor model—such as that envisaged in Basle 2—when in fact there are two (or three) factors affecting diversification of the portfolio. These factors could be geographical areas (emerging vs. non emerging economies), industrial activities or a combination of the two. The correction factor is defined as the ratio between the capital calculated with the two (or three factor model) and the capital obtained with the single factor model. The paper then develops a diversification index to measure the degree of diversification in a portfolio (a diversification index of 35% indicates maximum diversification and 100% indicates maximum concentration), and the authors demonstrate a clear relationship between the correction factor and the diversification index. In a situation of no diversification the discrepancy between the one-factor model (to be used in the Basel 2 and which does not take account of the benefits of diversification) and the two and three factor models is zero: they produce the same result as there is no diversification to take into account. However, as the level of diversification increases so does the discrepancy between the Basel 2 one-factor model and the more sophisticated two and three factor models: as diversification increases the Basel 2 one-factor model becomes increasingly inaccurate in its overestimation of the capital required.

In practical terms, the maximum capital savings for broad diversification in the BBVA empirical work (for both the two and three factor models) range from 16% to 21%. It is interesting that these figures coincide with our own simulated calculations, suggesting that something beyond a particular case is being captured here. In short, if a one risk factor model is used as in Basel 2, it would require capital requirements to be higher than the two and three factor models by between 16% and 21%, which can be seen as a proxy for the failure to take account of international diversification.

BBVA propose a simple practical adjustment mechanism that enables the introduction of the benefits of international diversification into Pillar1. The mechanism proposed consists of using the correction coefficient so that regulatory capital is defined from the one factor model currently proposed multiplied by this coefficient,

$$\begin{aligned}\text{Capital adjusted for diversification} &= \text{Capital defined by the one factor model}\\ &\quad \times \text{Correction coefficient}\end{aligned}$$

That is, a fully diversified bank would multiply their total regulatory capital by a coefficient to correct for diversification. In the BBVA study this would be 0.79 for the three factor model and 0.84 for the two factor. Our own simulations would suggest a correction coefficient in the range of 0.77 to 0.80.

Much in the Accord decreases the incentives for international banks to lend to developing countries. This proposal would offset that to some extent: banks that are already diversified would face less of an incentive to withdraw from developing country lending, whilst those that are not currently engaged in such lending would face lower obstacles to becoming so.

2.11. Globalization of Financial Markets Is The Key

Jose Joaquin Morte Molina said that "One must admit, however, that many of the concerns this forum have underlined are already occurring in the banking industry.[15] Deutsche Banks, one of the leading international banks, has been systematically shrinking its loan portfolio at the same time that trading and investment assets account for the biggest part of its total assets. In fact, due to capital requirements, the bank has been shifting business from traditional banking to investment banking with negative consequences not only for emerging markets but for the SME sector . . . in Germany!!!

My message today will be that while the biggest players are already engaged in a process about how to do business in banking, it is important to analyze more broadly how financial systems currently develops, both at national and at international level."

. . . "In all, if the market approach is to be the result of the new Basel II accord, globalization of financial markets is the key. Admittedly, with globalization, financial markets become more complex. But to reinforce financial stability we have to consider the increasing overlap and interaction between banks and securities markets, and between both of them and the insurance sector."

3. CONCLUDING COMMENTS

The principal intent of Basel II was to enhance the risk management systems of Large Complex Financial Organizations (LCFOs) such as Citigroup, Deutsche Bank, and ABN Amro. By definition, LCFOs are internationally active, and their actions may affect some developing countries. However, the Basel Committee did not address the needs of developing countries. Nevertheless, Basel II will have a direct impact on those countries that adopt it and an indirect impact on the other countries. The comments presented here addressed issues that the Basel Committee should consider as Basel II evolves over time.

ENDNOTES

1. For further information about the gpgNet, see: http://www.sdnp.undp.org/gpgn/about.php. The gpgNet is hosted by the Office of Development Studies in the United Nations Development Programme (UNDP). However the contents of this website do not, in any way, reflect the views of UNDP, or the views of any of the Member States of the United Nations (UN). The "global public goods" concept is an emerging one, and gpgNet places it in the public domain for wider consultation, study and debate.
2. The gpgNet web site for the eForum is: http://groups.undp.org/read/?forum=gpgnet-basel
3. The dates shown below are the dates that the messages were listed on the website. Also see: http://www.sdnp.undp.org/gpgn/index.php
4. Stephany Griffith-Jones, Research Fellow and Professor at the Institute of Development Studies, Institute of Development Studies, University of Sussex, Brighton, UK; May 27, 2004, http://www.ids.ac.uk/ids/news/Archive/Baselmistakes.html
5. Stephany Griffith-Jones and Stephen Spratt (Head of Research, Intelligence Capital), May 27, 2004.
6. Benton E. Gup, University of Alabama, USA; May 27, 2004.

7. Sunada Sen, Academy of Third World Studies, Jamia Millia, New Delhi, India, May 27, 2004.
8. Paul Bance, Department of Economics, European University Institute, Florence, Italy May 28, 2004.
9. Avinash Persaud, Investment Director, GAM London Ltd, UK Stephen Spratt, Head of Research, Intelligence Capital, May 26, 2004.
10. Djamester Simarmata, Faculty of Economics University of Indonesia, Jakarta, May 28, 2004.
11. Amador Honrado, Jr., Assistant Deputy Secretary, Asian Bankers Association, May 28, 2004.
12. Frank Sammeth, Paris, France, June 10, 2004.
13. Ashima Goyal, Professor, Indira Gandhi Institute of Development Research Mumbai, India, June 11, 2004.
14. Stephen Spratt & Stephany Griffith-Jones, June 14, 2004.
15. Jose Joaquin Morte Molina, Council of Europe Development Bank Paris, June 14, 2004.

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