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Implementing Basel II: Impact on Emerging Economies

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Executive Summary

The paper discusses the impact on the emerging economies from two points of view. The first are the consequences emerging economies will have to face because of Implementation in advanced countries. They are the primary sources of capital to Governments & banks in emerging economies. The second is the impact because of the implementation within the emerging economy. The paper discusses the problems faced by the emerging economies and the positive & negative impacts of implementation. The competitive forces of the increasingly integrated world would force the emerging economies to go in for Basel II norms sooner or later. The final part includes recommendation of the form, methodology and extent of implementation and measures to cushion the negative impacts.

Introduction

The BIS Basel II recommendations have been acknowledged the world over as a new paradigm in Risk Management, Supervision and corporate governance.

While the Basel II recommendations are mandatory only for Internationally active banks of G-10 countries, Central Banks across the world have been working on its implementation. The Three Pillars of the CP3, are difficult to implement, especially for weak banks and in countries which have faced financial crises in the past few years. The Impact on Emerging Economies both on Implementation & non-implementation could be extremely precarious.

Section I: Implementation of Basel II in Advanced Countries & Consequent Impact on Emerging Economies

Most of the large and internationally active banks belong to the Advanced countries who are already on the way to implement the Basel II norms. Major multilateral lending institution such as the World Bank would also implement them. Let us discuss the Impact of this on the emerging economies.

1.1 High Cost Lending and Reduced Lending to Emerging Economies

The Basel II accord has provided two approaches towards credit risk management. Banks in advanced countries and multilateral lending institutions are expected to implement Basel II and they are the major lenders to the emerging economies. Under the Standardized approach the **biggest change**

would be experienced by borrowers rated B and below, as the risk weight for such borrowers would increase from today's 100% to 150%. On the other hand, an **IRB approach would be even more stringent** and applies extraordinarily heavy risk weights. It is to be noted that a large no. of emerging economies have ratings below B and they would be adversely impacted. Table 1.1 shows the relative impact of an IRB approach.

Table 1.1 Change in cost of borrowings

Rating	Probability of Default (%)	Risk Weight (%)	Change in cost of funding (basis points)
AAA	0.00	14.8	- 89
AA	0.00	14.8	- 89
A	0.03	14.8	- 89
BBB	0.20	44.8	- 57
BB	1.40	110.8	11
B	6.60	202.9	107
CCC	15.00	307.2	216

LGD = 45%, Maturity = 2.5 years, EAD = 100%, Current Risk Weight 100%

Source: Ward, J. "The New Basel Accord and Developing Countries: Problems and Alternatives" (2002), Cambridge Endowment of Research Finance, Working Paper No. 4, http://www.cerf.cam.ac.uk/publications/files/Ward04.pdf, p. 14

- **The Vicious Circle of Curtailment of Credit to Emerging Countries**

The lower ratings will **reduce the availability of funds** in the emerging countries. This has the **potential to deteriorate** the situation in these countries leading to further recession. The **reduced market access** and **high costs of funding** will **further impact the ratings** of these countries leading to a **vicious circle** with each aspect feeding the other in a downward spiral.

- **Higher Interest Costs & Competitive advantage of corporate borrowers**

  Globalisation has meant increased competition with **financial engineering an important source of the competitive advantage,** more so for emerging economies where the strength has been cost competitiveness. The Higher Interest costs to the banks will ultimately translate into higher cost of borrowing for the corporate **skewing the playing field** in favour of the developed countries.

- **Impact on Infrastructure development**

  Major sources of funding for infrastructure in India and in many other emerging market countries have been multilateral lending institutions such as World Bank. The Basel II document impacts the **Interest rate determination process** and attributes higher risk to project finance than corporate finance. All the emerging economies have been suffering from the paucity of Infrastructure to sustain development and this has the potential of **severely hampering the Infrastructure development process**.

1.2 Shorter Term to maturity of lending

Both the Basel I & II accords have a **preference for short-term lending**. This is because of the ease in exiting the investment in case the situation turns adverse. Also the **interest rates on short term will also tend to be lower** further incentivising such borrowings. This shall **impact both banks and ultimate**

borrowers in emerging economies because of the change in the interest rate term structure and the need for ALM.

- **Impact on capital flows**

Short Term lending will further **increase the volatility of capital flows** within emerging countries. This was a major reason of the Asian financial crises. There would be a **tendency to press the panic button** at the smallest change in the situation, further deteriorating it, leading to crisis. In the highly integrated global economy of today this will lead to stronger world economic cycles.

- **Impact on Companies**

The Shortened term funding of banks will **find its way to the balance sheets of companies** because of the need for matching maturities. This would **impact output levels** in corporates and **skew the capital structure** in favour of short-term borrowings and working capital finance. The **Liquidity position** and the companies' **ability to globalise** would be hampered by this difficulty in raising long-term capital.

- **Sovereign ratings have a significant impact on stock returns**

Studies conducted on this topic have shown that sovereign ratings have a significant impact on stock returns. Poor performance of the broader S&P 500 over the past few years has meant that FII investment plays a significant role in

emerging economies' stock markets. The Market Risk norms could see an **outflow of capital** from the emerging economies **hitting stock returns**.

Section II: Implementation of Basel II in Emerging Economies

Emerging Economies do not have to implement the Basel II norms in Toto. After assessing their impact their regulations have the option of deciding how to calibrate the norms for their smooth implementation. We will now look at the potential minefields in Implementation of Basel II within emerging economies and their impact.

2.1 Problems

- **Standardised Approach and External Credit Rating Problems**

One of the two approaches prescribed for Credit Risk in Basel II is the standardised approach, which makes use of external credit ratings for attaching risk weights. Being the **easier of the two approaches** and also because of the continuity from the Basel I norms it is **most likely to be implemented** in emerging countries. One of the major problems is the **availability** of credit ratings in emerging countries. While India has been fortunate in this respect with three major Credit Rating agencies in CRISIL, FITCH & ICRA in this field many emerging countries are not so equipped. Even in India the penetration of credit ratings is not deep. The **supply-demand imbalance** would make it even more

difficult for smaller players to get ratings, High prices **making credit more costly for them**.

- **Difficulties in Implementation of IRB based Credit Risk Management Approach**

  Various models have been proposed for the Internal Rating Based Credit Risk Assessment. A major problem is **data availability**. In India, a large no. of PSU banks are still in the process of computerisation. The extent of historical data required to **formulate** and then **convincingly test** Indigenous IRB models is simply not available. The IRB based approach being one of the more stringent approaches is the **more ideal of the two** to strengthen the financial system. The actual implementation of an IRB based model for credit risk mitigation would require excellent information retrieval and assessment capabilities. A high-end **IT Infrastructure** with Risk Management Software collating real-time information is needed. This preparedness is not there in a majority of banks in emerging markets

  Hurrying into an IRB based approach could cost banks dearly because of the **High Capital Expenditures** involved. **Inaccurate IRB models** could defeat the very purpose of better risk mitigation.

- **Costs of Implementation: IT spending & Training Costs**

  The single largest cost of implementing Basel II is the IT costs. Estimates say it could be as high as **70% of the cost of implementation**. The Capital Expenditure required would be far higher than small banks could bear. There is an **unavailability of trained manpower** for risk management & audits. Many countries have a paucity of skilled manpower in this area. **The training cost** is another factor in implementation, especially in state owned banks in India & China where a majority of the workforce requires retraining.

- **Multiple Supervisory bodies and dearth of skilled professionals**

  The Basel II definition of a banking company is very broad and **includes banking subsidiaries** such as insurance companies. In India and in many other emerging countries there is **no single regulator** to govern the whole 'bank' as per Basel II. In India IRDA, SEBI, NABARD & RBI would regulate different aspects of Basel II. The consolidated balance sheet of the bank has to conform to CAR regulations . In India, Regulatory capital norms do not apply to Insurance companies. Recently, in the falling bond markets scenario LIC & other Insurance companies have acted as saviours for the banks by purchasing their long tenure bonds. Consequently, the Interest Rate Risk brone is very high. The **complex banking structure** in India is another stumbling block. The Pillar II implementation is the more difficult portion of the three pillars. **Risk Audits** in banks are still in their nascent stages in India. The availability of trained risk auditors is another problems. Basel II calls for a

Risk Management structure in banks with Risk Management committees for Credit, Market & operational Risk formulating the Risk Management standards. While banks in India are implementing this, it has remained a ceremonial process without the training at the grass root level **to see every activity with the lens of risk**.

Impacts

- **Improved Risk Management & Capital Adequacy**

One aspect that the staunchest critics of Basel II agree to is the fact that it will tighten the risk management process, improve capital adequacy and strengthen the banking system.

- **Curtailment of Credit to Infrastructure Projects**

  The norms require a higher weightage for project finance, curtailing credit to this very crucial sector. The long-term impacts for this could be disastrous.

- **Preference for Mortgage Credit to Consumer Credit**

  Lower Risk Weights to Mortgage credit would accentuate bankers' preference towards it vis-à-vis consumer credit. This trend has been observed in many countries with the growth of Mortgage credit outstripping growth of consumer credit. Basel II would further accentuate the situation impacting Industrial growth rate and consumers.

- **Basel II: Advantage Big Banks**

  It would be far easier for the larger banks to **implement** the norms, raising their quality of risk-management and capital adequacy. This combined with the **higher cost of capital for smaller players** would queer the pitch in favour of the former. The larger banks would also have a distinct advantage in raising capital in equity markets. Emerging Market Banks can turn this challenge into **an advantage** by active implementation and expanding their horizons outside the country.

- **IT spending: Advantage Indian IT companies**

  On the flipside, Indian IT companies, which have considerable expertise in the BFSI segment, stand to gain. Major Indian IT companies such as I-flex and Infosys already have the products, which could help them develop an edge over their rivals from the developed countries.

- **Consolidation in the banking Industries**

  The **Inadequacy of Tier I Capital** would hasten the process of consolidation within the banking Industry. The RBI has recently capped the stake of single enterprises in banks at 5%. This coupled with **high government holdings** in PSU banks and the **unwillingness of politicians to disinvest** could lead to a crisis situation. **Implementation cost of Basel II is very high and would dent the Tier II capital**, worsening the situations. The recent **glut of bank**

IPO's have been a response to the CAR norms of the RBI and across the Emerging economies similar scenarios will be re-enacted.

- **Non-implementation could impact Sovereign rating**

Non-implementation of Basel II & a weak banking system would impact the sovereign rating further worsening the situations for banks & the governments which borrow capital from advanced countries.

Section III: The Recommendations

The challenge before the emerging economies is not to decide on the implementation or non-implementation, that will be a fact sooner or later, but to ensure their preparedness to counter its negative impacts and to adapt the norms to their advantage.

- **Incorporation of Anti Cyclical measures**

  To counter the Pro-cyclical impact of Basel II, the central banks should **incorporate anti-cyclical measures in the regulatory & supervisory mechanism**. One way is to incorporate anti-cyclical measures **in the risk model itself**. In countries, such as India, where the Fiscal Deficit is high controlling it would **increase Credit Availability** in the market cushioning the impact.

- **Stronger Equity Markets & regulatory environment**

  Removal of artificially high Interest rates and stronger equity market would ease the pressure of gathering Tier I capital. **Removal or Increase of the current limit set on Single Enterprise Investments of 5% and** Tax Concessions on Investments would help. In India, the government has removed Long term Capital Gains Tax boosting the Equity markets.

- **Clear Roadmap for implementation**

  The most important thing is for central banks to set a **clear phased roadmap** for implementation of the framework and creating awareness. Sooner or later in one form or the other the norms will become a reality in most countries. It is the central banks duty to provide the opportunity to banks to **look before they leap** and prepare themselves in that manner. While the **standardised approach is advisable to start-off** the road map of evolution to IRB should be clear.

- **Capitalisation & depreciation of IT expenditure**

  The major expense in Basel II implementation is IT. It is hence necessary for the governments to provide for capitalisation & depreciation measures in way that it **does not give a sudden jolt to the Tier II capital**.

- **Revision of Curricula to incorporate Risk Management & retraining**

Curricula of the ICAI, ICSI, Banking Professional courses, etc needs to be revised across emerging economies to incorporate risk management & risk audits and **create a fresh body of professionals** to meet the growing demand. There is also a problem of **overstaffing at the regulator's end**, across many emerging market economies, which needs to be handled to improve productivity.

- **Consolidation within Banking Industry**

  A positive approach needs to be taken towards consolidation. Especially In India, which has a large no. of PSU banks. It would be advisable to merge the smaller banks after **a case-to-case analysis** to ensure **critical size & capital**. However in countries where the Industry is dominated by a few foreign banks this would not be favourable for the economy.

The Conclusion

There are many possible negative impacts of an unchecked implementation of Basel II. However, Basel II is here to stay and the **competitive forces will compel banks** to follow the example. The option here is to decide **what form** of the Basel II norms should be applied and **to what extent** to ensure the survival & growth for the economy. Ultimately, the norms are for strengthening the Banking systems globally and **this objective should not be lost**. Emerging Economies

need to be prepared & to adapt to the changing global conditions and to adapt the norms to their own advantage.

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