

**THE COSTS AND BENEFITS OF IMPLEMENTING BASEL III
IN EMERGING ECONOMIES**

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ABSTRACT

The aim of this research is to study the impact of the forthcoming banking regulations, generally dubbed Basel III, on emerging market economies (EMEs). Since the governments of most of these nations have already introduced successful banking reforms over the last two decades, their economies were adequately prepared to weather the calamities of the global meltdown. This paper starts by outlining the Basel III impending supervisory requirements. The projected reforms rest on three main pillars namely: the enhancement of capital adequacy measures, the augmentation of liquidity requirements and the introduction of leverage ratio. In the second part of the paper the effects of the projected Basel III are simulated to forecast the impact on economic growth on a sample of forty-seven EMEs. The sample is divided into two panels comprising newly industrialized nations and secondary EMEs with relatively less industrialized economies and shallower financial markets. The extra measures required by Basel III are found to be highly costly and unnecessary. Finally, a set of policies are proposed to prepare the economies of emerging markets to minimize the costs of implementing Basel III.

Keywords: Financial crisis, Banking regulations, Basel III, Emerging economies, Economic forecasting

JEL classifications: G01, G17, G28, G38

1. Introduction

As the global economy is gradually stepping out of its most callous financial predicament, it is evident that neither has the global economy “fallen off a cliff” nor has it “gone off the rails”. Those words that Warren Buffet and Paul Krugman irately uttered at the dawn of the crisis were undoubtedly directed at the rather lax global regulatory framework that treated the forewarning of risk managers against an imminent catastrophic failure with total oblivion. Given the highly entwined global financial markets and the extent of wide-reaching infectivity, the global community has grown increasingly concerned about enhancing the regulation of activities that affect the stability and security of the international financial system.

To this avail, the Basel Committee on Bank Supervision (BCBS)¹ elicited worldwide collaboration to help develop a full-fledged regulatory regime to ensure the vigour of international financial markets and the vitality of national economies. To this avail, the Committee circulated a number of consultative documents sketching out proposals for reinforcing regulation of banks' capital and liquidity in order to improve the resilience of the financial system.² After embracing the recommendations of banking experts, economists and financial analysts the Committee passed a set of universal banking rules, termed Basel III, in December of 2010. The new accord does not solely build on the capital adequacy framework of Basel II as set out in the 2006 draft, but has been extended to embrace rules for managing liquidity risk on the premise that most financial crises expose banks to serious solvency pressures. The macroeconomic underpinning of this requirement is to avoid restraining investments during deleveraging crises when capital market funds tend to dry up.

As vital as this global regulatory framework might be for bolstering bank capital and liquidity, it has indeed provoked an acrimonious debate as it failed to muster the consensus of all stakeholders. At one extreme, regulators argue that Basel III is a sorely needed code of financial conduct to upgrade baseline markers for leverage, loan-loss provisions, liquidity and systemic risk coverage. Given the extent of the damage inflicted by the global economy and the bailout bills shouldered by taxpayers, stringent regulations do not appear to be an unfair stipulation. This is all the more pertinent to emerging economies, whose financial markets are comparatively thin, hence compelling central banks to cushion their economies to both home-grown and imported crises by resorting to a combination of an exchange rate depreciation and a partial depletion of international reserves (Rojas-Suarez, 2008). At the other end, bankers sternly argue that the stringent rulings will feed into the pricing of loans, and hence will hamper global macroeconomic growth. Also joining the rival camp are emerging economies, which protest that they should not be penalised for the avariciousness of investment bankers and the leniency of western regulators. More vitally, banking regulation needs to be coupled with a full-fledged economic restructuring process since financial crises have habitually exposed the inherent structural imbalances in the system, leading to concurrent crises of financial systems, currencies, and corporate sectors (Llewellyn, 2010).

In this chapter we discuss the legitimacy of imposing Basel III upon emerging economies, given that they had already incurred hefty expenses to reform and regulate their banking sectors throughout the nineties of the elapsed century. In section 4.1, we throw light on

¹ The BCBS was established in 1974 and is hosted in Basel by the Bank for International Settlements, the banker of central banks. Its members originally comprised of central bank representatives of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, the United Kingdom, and the United States, in addition to the host country, Switzerland. Since 2008 its membership was expanded to 27 nations, engulfing 14 additional EMEs: Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, Singapore, South Africa and Turkey. BCBS also consults supervisors from non-member countries

² The following three consultative documents were issued and circulated by the Basel Committee to solicit feedback from practitioners, academics and policymakers in countries: *Strengthening the Resilience of Banking System*, *International Framework for Liquidity Risk Measurement, Standards and Monitoring* and *Principles for Enhancing Corporate Governance*.

the evolution of the political economic thought that has given birth to Basel III and we discuss the apprehension of emerging economies about the impending reforms. In Section 4.2 we gauge the potential impact of this severe external structural shock on the economies of emerging nations. In the final section we propose alternative regulatory policies that better suit the special conditions of emerging economies.

2. Basel III: Is the third time the charm?

It is generally alleged that the lack of supervision of the so-called “shadow banking sector” was the main culprit in the global financial crisis. During the last two decades, hedge funds and money market funds have grown exponentially whilst steering clear of the domain of regulations. Concurrently, the purportedly regulated segment of the financial sector got entangled in extending loans to non-creditworthy customers and subprime mortgage buyers as a means of collecting higher profit margins. Moreover, the vision of private credit rating firms was obscured by the opaqueness of the risky pools. But it was not till the loan book default rate escalated and financial contagion spread to other parts of the world that central bankers around the globe worked with unprecedented cooperation.

The G20 established the Financial Stability Board in 2009 to join hands with the Basel Committee to formulate broad supervisory standards for financial regulators and best practice guidelines for bankers. The initial step that the Committee took to harmonise its member countries’ supervisory techniques dates back to 1988. This was when it introduced a capital measurement system commonly referred to as the Basel Capital Accord, or simply Basel I. The first of the Basel sequel was solely designed to suit the largest of international banks, whose headquarters are housed in the G10 nations. As the accord earned more credibility by other OECD nations, the need arose for an all-inclusive regulatory framework with credit, market and operational risk coverage, which was delivered by Basel II.³ At the dawn of the global crisis, most OECD regulators boasted about the abidance of their banking systems by the rigorous regulatory capital standards, but the fact that these nations stumbled into the quagmire of bankruptcy poses an obvious conundrum.⁴

The question that immediately poses itself is: if the capital rules of Basel I and II failed to adequately shelter the financial system, what are the guarantees that Basel III will this time accomplish what its predecessors failed to achieve? More importantly, will the unvarying set of costly and binding stipulations add to the burdens shouldered by the already overtaxed emerging economies? Are these overriding rulings absolutely necessary for these nations that have already

³ The G10 nations implemented Basel I in 1992, but Japan adopted the accord as late as 1996. Basel II capital adequacy measures were introduced in June 2004 and implemented in 2006 by most OECD nations, save the US. Most emerging economies that had reformed their banking sectors fully adopted the accord around the same period.

⁴ Basel II uses two approaches to define capital requirements. The Standardized Approach was a step up of Basel I, evaluating the risk-weighted asset portfolios of banks and the required amount of capital based on the estimates of private credit agencies. Alternatively, banks whose risk estimate models meet the criteria of the supervisors are allowed the Internal Ratings-Based (IRB) Approach, where their internal risk measurement models are used instead. The main criticism was directed at the IRB, especially in the absence of adequate corporate governance standards.

reformed their banking systems and whose financial sectors are overly shallow and unsophisticated, and hence unexposed to immense market systematic risks?

In order to attempt to answer these questions, it is imperative to uncover the root-causes responsible for both systemic and systematic risks. The global banking system resembles an interlocked computer network that is highly vulnerable to viral infectivity and contagion. In such a highly interconnected system if one of the computers capsizes with a vicious viral infection it poses a systemic risk, threatening to take other computers down with it. To avoid such systemic virus risks regulators fortify firewalls, enhance the virus protection system and urge users to backup their files. However, all of these indispensable efforts will prove futile if regulators do not exert parallel efforts to abate the invincible viruses that are caused by systematic risks. Highly analogous to this example is Basel III, which is no more than one small piece in a big jigsaw puzzle, especially if applied to the case of emerging economies. In this regard, the more serious systematic risks that need to be addressed by the policymakers of these nations are the weak macroeconomic frameworks, deficient deposit insurance schemes, archaic accounting standards, corruption and cronyism in bank lending. Thus, a comprehensive plan is needed in order to safeguard the financial sectors and economies of EMEs from the impacts of both internal and external shocks and to reduce the contagion effects.

2.1 The political economy of the build-up of systemic risks

It is quite palpable that financial complication and immense risk taking could not have singlehandedly caused a crisis of such severity and contagion. Financial analysts agree that a large number of factors have interacted and resulted in the eruption of the recent turmoil. If anything, the domino effect of the global financial crisis underscores that, beyond its benefits, globalisation has created systemic risks and vulnerabilities that national policies are ill-equipped to tackle. As mentioned in the previous chapters, the last two decades stood witness to the Washington Consensus surmounting all other contending views and commanding compliance of the debt-burdened Southern hemisphere. After encountering tumultuous episodes of bank failures and non-performing loans (NPLs) the governments of most emerging economies undertook rigorous bank reforms, which were resonant with acquiescence to the conditional loans of the World Bank and the International Monetary Fund (IMF). These two Bretton Woods institutions compelled the governments of many debt-stifled countries to adopt the one-size-fit-all Structural Adjustment Program (SAP) in the eighties and nineties of the elapsed century. This program aimed at a uniform privatization of state-owned enterprises, raising sources of public finance, lifting subsidies, cutting public expenditure and modernising and/or introducing stock exchanges. The IMF typically included in the SAPs the full-fledged modernization and liberalization of the financial sector, the floatation of interest rates and the introduction of prudential ratios inspired by the Basel Committee (Kaminsky and Reinhart 1999).

The mixed outcomes of the SAPs preside over issues that have served as unremitting fodder for political controversy. The first astringent criticism directed at the SAPs is that the enhancement of macroeconomic performance has come at the expense of the poor's living

standards (Amin 1995). It is quite peculiar that the godfather of this set of policies, John Williamson, alleges that the lack of concern for equity is not simply a drawback of the Washington Consensus, but of the discipline of economics at large (Williamson 2004). A few years afterwards the second attack was directed at the precarious financial liberalisation that has resulted in incurable bank failures. During the nineties, 42 intermittent episodes of banking crises plagued EMEs and non-performing loans skyrocketed, hence launching heated deliberations on the risks of premature financial liberalisation (Laeven and Valencia 2008). This is because it is generally perceived that prudential regulations were restricted to requiring banks to meet the Basel risk-weighted adequacy ratio (Demirgüç-Kunt and Detragiache 1998).

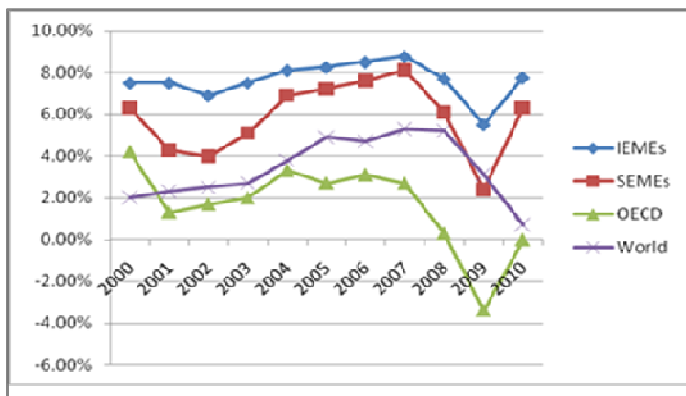
2.2 Basel III through the lens of EMEs

Emerging economies harbour grievances against the Basel Committee due to their limited involvement in drafting the rulings of Basel II. In spite of increasing the number of emerging market representatives to comprise almost half of the members of the Committee, the Basel qualifications have turned out incompatible with their less sophisticated banking systems and shallow financial sectors. Moreover, large international banks have engaged in immense lobbying to influence the rulings of the accord, which jeopardises the macroeconomic growth of emerging markets in a number of ways. Firstly, since lending to emerging and developing nations inflicts extra credit risks upon lenders, the higher capital requirements needed to back these risky assets are surely expected to restrict lending to these nations (VanHoose, 2007). Secondly, the pouring of short-term funds or hot money into emerging markets has proved to be pro-cyclical, which exposes their economies to excessive vulnerabilities at stressful times. Thus, emerging economies complain that Basel II discriminates against them as it renders their loans costly and susceptible to abrupt reversals, which come at the expense of the attainment of their developmental objectives (Griffith-Jones, 2008). The outcome of the synthetic deliberations on Basel III unreservedly serves the explicit political interests of the G20 nations and rules out the interest of other less affluent emerging economies. While the main aim of the G20 is to avoid a recurrence of the crisis, the appetite of EMEs is for an uninterrupted rise in GDP to cater for the needs of a rapidly expanding population.

This begs the question whether the need arises for the imposition of such stringent rules especially that EMEs have tolerably weathered the monster storm that swirled over their economies. As shown in Figure (4.1), western economies pale in comparison in spite of their unprecedented fiscal stimulus packages, massive bailout plans and exceptionally loose monetary policies. As OECD nations are displaying signs of dawdling economic recovery, coupled with intractable unemployment, one would have expected higher levels of capitalisation and liquidity requirements to be imposed on their banks, whilst reducing the requirements for the more resilient emerging economies.

In order to avoid the problem of aggregation and typecasting economies sharing different circumstances, we divide the 47 EMEs into two categories. The variation in the average performances between secondary emerging market economies (SEMEs) and industrial emerging

market economies (IEMEs) mask considerable variation. For example, real GDP contracted by 11 percent in parts of emerging Europe, while it rose by one percent in some Asian nations. Similarly, sovereign spreads rose by more than 1,000 basis points for some EMEs amidst the global financial crisis but by only around 100 basis points for others. This raises the question of whether the older article of faith assuming that the banking sector in emerging markets need bigger capital and liquidity buffers, should continue to hold (Taylor, 2010). In this vein, it is advisable to discontinue resorting to a stereotypical global benchmark, when the previous one-size-fit-all policies proved to have long-lasting damaging effects on developing economies during the intellectual hegemony of the Washington Consensus.



IEMEs comprise of 14 newly industrialised nations with relatively deeper financial markets, while SEMEs include the 33 nations with lower levels of industrial and financial development.

Sources: - OECD Stats.

- United Nations Department of Economic and Social Affairs (2011) *World Economic Situation and Prospects (WESP) 2011*, UNDESA, New York.

Figure (1) Real GDP Growth (2000-2010)

3. Towards a Consistent Framework for Emerging Economies

With a view to distill policy messages and to draw implications for the future of financial regulation, we need to identify the factors that led to some EMEs being less affected by the global crisis than others. This will help provide a framework within which the vast array of regulatory responses and reform efforts enacted by emerging economies can be categorised. The causes behind the difference in performance depended on the level of preparedness of the regulatory authorities to absorb financial impacts of crises, the degree of openness of financial markets to the global economy and the extent of response of fiscal and monetary authorities to the financial meltdown. In order to test whether the Basel III rulings are draconian or indispensable for the adequately capitalized banking sectors of emerging economies, we need to examine the all-inclusive banking reforms that EMEs have undergone as well as their policy responses to the GFC, both of which greatly determine the extent of the contagion from which their financial sectors suffered.

Now that we recognize that not all EMEs have travelled at the same pace in regard to the level of complexity and the depth of their financial sectors, it is advisable to conduct a comparative analysis of the financial sectors of both categories of EMEs after introducing their comprehensive financial overhaul and banking reforms. As displayed by Table (4.1) the banking sector seems to be better performing its intermediation role in the more industrialised emerging economies, whether in regard to mobilising deposits or extending loans. Also the fact that the problems of non-performing loans (NPLs) and inadequate regulatory capital have been properly tackled in the more industrialised emerging nations has culminated in the deepening of their capital markets and the rise in the level of their national savings. If anything, this implies that even within the broad category of EMEs, it is both erroneous and unwarranted to treat all emerging economies as one unified category that shares similar circumstances. All the more, SEMEs are unduly penalised due to the bank-centric nature of their financial sectors.

Table (1) Key Banking and Financial Indicators

	SEMEs*		IEMEs*	
	1998	2010	1998	2010
NPL/total loans	11.3	14.9	12.2	6.8
Regulatory Capital/risk weighted assets	6.5	9.2	7.2	14.7
Bank deposits (% of GDP)	88.3	71	110.7	103.6
Bank loans (% of GDP)	76.2	54	84	75.1
Market capitalization (% of GDP)	25.2	33.1	44.4	75.3
National savings (% of GDP)	16.2	18.5	18.6	23

* EMEs comprise 47 nations in accordance with the FTSE Global Equity Index Series Country Classification

In actuality, the fact that not a single member of the secondary emerging economies is represented on the Basel Committee stands witness to the incessant bias in favour of industrialised nations. Thus, it would be unfair to solely blame global regulators for designing a stagnant one-size-fit-all western-centric regulatory framework that does not address the specific needs of emerging economies. Nor would it be fair to lay the full responsibility on developed nations. Equally responsible are EMEs, which are overwhelmed with addressing their internal developmental aspirations and tackling their home-grown socioeconomic and political instabilities at the expense of fighting for their own rights. In true fact, some emerging economies are equally keen to recapitalise their banks as a means of accessing cheaper funds from the Paris and London Clubs (Griffith-Jones *et al.*, 2003).



SIFI: Systemically Important Financial Institutions

Figure (2) Culprits of Overlooking the Specific Needs of EMEs

Figure (2) reveals that a more dynamic focus should be adopted to accommodate the needs of all countries of the world. During the era that marked the ascendancy of the Washington Consensus, the Bretton Woods institutions designed a global framework that culminated in the transformation of poor emerging countries to mere sweatshops, with a large proportion of their populations living in absolute poverty. The birth of the Seoul Consensus in 2010 on the hands of the G20 is the first triumph against this global corporatism, which marks a one-way irreversible change. In the spirit of voicing of the muted legitimate demands of the emerging world and in the dawn of the embryonic world solidarity, it is only judicious to redesign the international financial architecture in an egalitarian and democratic fashion to accommodate the needs of all nations.

4. The Model

In true fact, this is a golden opportunity for emerging economies to join the G20 deliberations and to embed this concern in the Seoul Consensus. In this context it is crucial that the G20 nations should avoid preaching what they had previously been battling with. The specific needs of secondary emerging economies have to be satisfactorily addressed and the impact of Basel III on the economies of these nations should not be overlooked on the premise of designing a globally enforceable regulatory framework.

4.1 Basel III Framework

As the global recession unfolded fiscal and monetary agents round the globe constructed a raft of measures that ranged from pumping liquidity into the market, boosting government spending,

cutting taxes, depreciating domestic currencies and reducing interest rates.⁵ As most economies rebounded into jobless growth, countries started to focus on restraining the deficits in their fiscal budgets and balance of payments (Davis, 2010). In addition a set of parallel defensive unconventional monetary policy tools were adopted and various restrictions on multi-layered financial instruments were imposed. The unprecedented costliness of the rescue packages has elicited support for introducing the globally standardized Basel III.

The new accord covers both micro-prudential and macro-prudential aspects since it was designed to set out higher and better-quality capital as well as wider risk; constrain the buildup of leverage; and introduce capital buffers. Table (4.2) summarises the types of regulatory measures. The first and most important requirement is to enhance risk coverage and to raise both the quality and quantity of the regulatory capital base. Secondly, the liquidity requirements aim to improve banks' resilience to liquidity stress. The liquidity coverage ratio (LCR) introduces a specified stress scenario requiring banks to maintain liquidity buffers to cover net cumulative cash outflows during a one-month period. The net stable funding ratio (NSFR) introduces minimum requirements for the use of longer-term and more stable funding sources. Finally, the leverage ratio is supposedly a simple and no-risk-based measurement that accounts for the leverage caused by the mushrooming of off-balance-sheet activities, which highly engineered risk-sensitive regulatory capital measures and accounting standards fail to fully capture.

Table (2) Basel III Regulatory Measures

	2013	2014	2015	2016	2017	2018	Jan 1 2019
<u>Capital Requirements</u>							
• Capital	8%	8%	8%	8%	8%	8%	8%
• CCB*	--	--	--	0.625%	1.25%	1.875%	2.5%
<u>Liquidity Requirements</u>							
• LCR**	Introduction		← Full implementation →				
• NSFR***			Introduction		← Full implementation →		
<u>Leverage Ratio</u>	← Parallel Run Period →					Pillar 1 (3%)	

*CCB: Capital Conservation Buffer is a fund the bank can draw on during times of economic stress

** Liquidity Coverage Ratio should ensure that banks survive a severe stress situation lasting for around one month.

***Net Stable Funding Ratio provides reliable sources of funds over one year under extended idiosyncratic stress.

Source: Basel Committee on Banking Supervision (2010) A Global Regulatory Framework for More Resilient Banks and Banking Systems, BIS, Basel.

⁵ This policy was more effective in EMEs that enjoyed higher interest rates in comparison to western nations that were operating very close to their zero-bound interest rate levels.

4.2 Gauging the Economic Impact of Basel III on Emerging Nations

As benign as the intent of the global community might be in designing an internationally consistent instrument shielding globalised economies against the incidence of system-wide risk, the impending regulations are apt to decelerate GDP as they flow to the real economy through three different transmission channels. The credit channel will inhibit the flow of funds to households and investors, the interest rate channel will stifle liquidity in the money market, and the foreign exchange channel is apt to worsen the balance of payments.

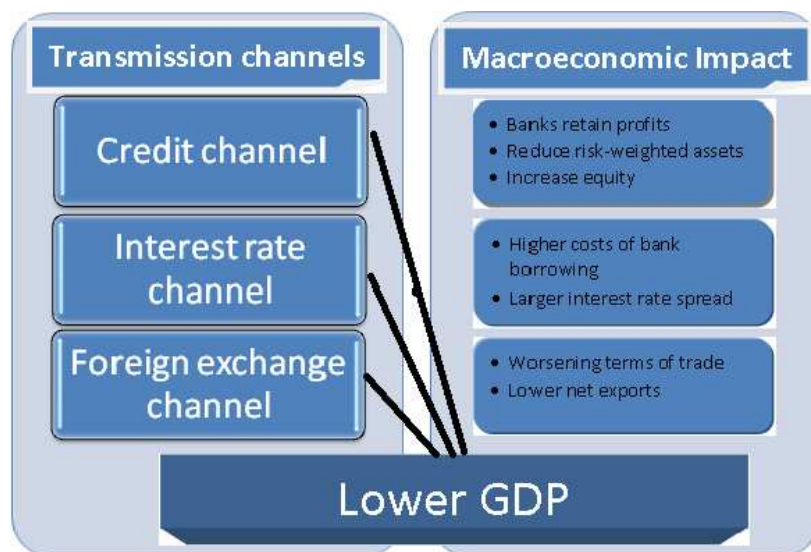


Figure (3) Macroeconomic Impact of Basel III through Three Transmission Channels

In order to gauge the effect of phasing in Basel III a simple regression analysis is utilized to estimate the macroeconomic impact of the regulatory framework as transmitted through the credit and interest rate channels. It is highly inaccurate to determine the costly impact through the interest rate and foreign exchange channels since it is expected that monetary agents would intervene to mitigate the impact of the shock through these two channels. The results of the simulation conducted by the model reveal that the new requirements of Basel III have a negative effect on economic growth causing a slowdown in excess of 6 percentage points throughout the six year period. When the exercise is repeated after removing the leverage ratio, the slowdown is reduced to 4 percent. These results may be indicative of the tendency of banks to change portfolios and transform risk buckets to less regulated jurisdictions or sectors to minimise capital costs (Blundell and Atkinson, 2010).

Using multiple regression analysis, the dependent variable is the impact on GDP using the Z-score, while the explanatory variable of interest is the compliance of the banking sector with the three requirements of Basel III. The Z-score is defined as the average credit growth/GDP plus the recapitalization + liquidity enhancement/GDP divided by the standard deviation of credit growth/GDP growth [$\sigma(C/Y)$].

$$Z'_{ij} = \alpha + \beta_1 X^1_j + \beta_2 X^2_i + \beta_3 X^3_{ij} + \varepsilon_{ij} \quad (1)$$

where, the subscript i denotes the country; the subscript j denotes the bank and ε_i is a random disturbance. (X^1_j) is a vector of compliance with the capital, liquidity and leverage requirements phased out over the six years as per Table 4.2, (X^2_i) is a vector of country characteristics and (X^3_{ij}) is a vector of bank characteristics. The following set of country characteristics capture the macroeconomic outlook: GDP per capita growth, inflation, foreign exchange depreciation, interest rates and Fitch sovereign rating which can affect risk exposure, capital inflows and bank stability.

Equation (1) is estimated by OLS with standard errors clustered by country to allow for correlated residuals within each country over the six-year period from 2000-2006: (t, t-5). The effects are simulated over a six-year period, which is the time needed to phase in Basel III requirements. The simulation is conducted by using a combination of retaining profits, reducing risk-weighted assets, and increasing equity. The period is selected to avoid the external shocks exerted by the global financial crisis. We use as the dependent variable $\ln(1+ Z_j)$ to avoid truncating the dependent variable at zero. The left-hand-side can be interpreted as the number of standard deviations by which GDP growth would have to fall from the mean to accommodate the contraction in credit due to the capital, liquidity and leverage requirements imposed by Basel III. The sample comprises of yields information on a maximum of 1149 banks across 47 countries, with a sample of 23-25 banks for each nation. Banking sector data is collected either from BankScope database or the databases and releases from national banking associations. Macroeconomic data is collected from the International Financial Statistics database.

Table 4.3 outlines two scenarios for the simulation exercise. The baseline scenario is a simulation of the anticipated results of phasing in the exact capital, liquidity and leverage specifications of Basel III. The results are segregated for each of secondary and industrial EMEs. Then, an alternative scenario is presented by repeating the same exercise after excluding the leverage requirements. The reason behind this is that the high capital adequacy ratio of Basel II has urged many banks to shift promises and to expand leverage in quite an unchecked manner into derivatives and other multi-layered opaque financial instruments.

Results from the baseline regression reveal large Z-score for larger banks with more equity levels. Also, higher Z-scores are observed for banks operating in countries with higher levels of GDP per capita growth. All other control variables are not significant. The coefficient of the Basel III compliance is positive but insignificant. Once the leverage ratio is removed, R^2 rises from 11 percent to 19 percent and the fit of the model improves.

Table (3) Compliance with Basel III and Z-Score Results

Variable	SEMEs Baseline Results	IMEs Baseline Results	All EMEs Baseline Results	All EMEs Alternative Scenario
<i>Overall compliance</i>	-0.003 (0.418)	-0.008 (0.321)	-0.006 (0.352)	-0.004 (0.323)
<i>Size by equity</i>	2.170** (0.023)	3.453** (0.122)	3.936* (0.118)	2.432* (0.129)
<i>Liquidity ratio</i>	-0.04 (0.036)	-0.057* (0.016)	-0.067** (0.014)	-0.070 (0.027)
<i>Listing on stock exchange</i>	0.266 (0.278)	0.56 (0.311)	0.428 (0.206)	0.114 (0.108)
<i>ROA</i>	-2.270 (0.663)	-3.019 (0.741)	-3.331 (0.763)	-3.592** (0.738)
<i>Loan/deposit ratio</i>	0.001*** (0.003)	0.001** (0.003)	0.001* (0.003)	0.009 (0.004)
<i>Loan loss provision ratio</i>	0.243 (0.088)	0.23 (0.09)	0.331 (0.061)	-0.156 (0.031)
<i>GDP per capita growth</i>	0.043** (0.063)	0.087* (0.089)	0.061* (0.06)	0.045 (0.041)
<i>Price inflation</i>	0.148 (0.003)	0.298 (0.009)	0.231 (0.007)	0.005** (0.001)
<i>Exchange rate appreciation</i>	-0.313 (0.738)	-0.012 (0.022)	-0.165 (0.190)	0.00
<i>Sovereign rating</i>	-0.044 (0.022)	-0.090* (0.044)	-0.086 (0.041)	-0.078** (0.034)
<i>Constant</i>	2.852*** (0.892)	3.128*** (0.711)	3.331*** (0.643)	3.018*** (0.782)
<i>R²</i>	0.113	0.119	0.116	0.196

***, **, * denote values for p less than 0.01, 0.05 and 0.1 respectively; standard errors are in parentheses

3.5 Other Predicted Indirect Impacts of Basel III on Emerging Nations

There are a few other inchoate changes that are expected to indirectly impact the economies of emerging nations. First and foremost, the pro-cyclical nature of hot money flowing into emerging financial markets is a double-edged sword. Indubitably, the availability of such

funds assists with nurturing investments in the newly industrialised nations, albeit at the risk of an abrupt seepage in the incidence of an external financial crisis. This allegedly increases the risk exposure of investments in emerging financial markets in comparison to those solely confined to deepened and developed markets (Mishkin, 2001). Since this is apt to lead to higher costs of financing public debt, the resulting higher interest rates will possibly lead to the resurgence of shadow banking and informal channels of lending. Also, as a means of reducing risk-weighted assets, the adverse selection problem will be amplified since smaller borrowers will be elbowed out by the more trustworthy ones (Gordy and Marrone, 2010). This is especially detrimental for the majority of smaller EMEs where small and medium enterprises are the strongest engines of GDP growth and job generation. On the foreign exchange front, the expected decline in lending to exporters will decrease corporate demand for products and services from global and local providers alike. Due to the overreliance of many companies in the emerging world on international trade as a source of revenue growth, the deceleration of global trade is apt to lose banks considerable corporate banking business.

Another problem that banks might encounter is the hefty implementation cost of Basel III. Since many of the less-sophisticated banks in emerging countries neither have robust internal ratings systems nor historical data to estimate capital and liquidity parameters the phase-in period imposed by the new Accord may not be long enough. Additionally, in the absence of reliable credit rating firms in EMEs, the one-size-fit-all risk-weighting system is quite unsuitable for these nations. Not only is systemic risk often inaccurately calculated, but more seriously idiosyncratic risks are not properly accounted for and are overlooked by regulators. Hence, it is best for the regulator of each jurisdiction in EMEs to devise a risk measurement system that best suits it. Similarly, additional strains will be shouldered by the supervisory institutions of small developing states, which are required to monitor not only capital adequacy levels, but also review in detail the risk profile, risk management process, and internal controls of all banks operating in their jurisdiction. Aside from the financial costs, building up such expertise requires more time than that allotted by the Basel Committee.

5. Guiding Principles and the Way Ahead

There is no doubt that Basel III carries a number of constructive proposals, yet there is yet immense scope for stepping up its regulatory reforms. The analysis that we conducted in this chapter carries a number of reform implications in order to augment risk coverage without heavily jeopardising growth for EMEs. The experience of emerging and developing nations with the Basel Committee, as with other standard-setting bodies, has not been favourable as they have been excluded from participation in the formulation of regulatory standards that negatively affect their economic development prospects. Given the threat of ineligibility to access contingent loans of the IMF, the majority of emerging economies should be treated as minor financial players whose potential instability has minimal global systemic consequences. The most apposite method of addressing this problem is by formally strengthening the participatory role of small states in the Basel Committee and/or the Financial Stability Board. Another point that places

smaller countries at a competitive disadvantage is the method of calculating capital requirements, which is apt to increase the pro-cyclical tendency of bank lending. Above all, smaller states which cannot comply with Basel standards will effectively be placed at a disadvantage and will stand to lose potential domestic and international investors.

Another point that is totally overlooked by the new Basel rulings is the method of supervising the shadow banking system and the informal channels of lending that are highly prevalent in EMEs. The regulatory and supervisory activities should be carefully synchronised and integrated in order to avoid passing out risks from the heavily regulated banking system to less regulated industries. In this regard it is best to have close coordination between the supervisors of the banking and non banking financial sectors. Secondly, it is prudent that especially with the lack of stringent supervision that the leverage ratio not be enforced on EMEs.

However, given the development aspirations of emerging nations and the immaturity of most of their financial markets, it is imperative to give incentives to adequately deepen the financial sector and endorse the features of financial strength in terms of mobilising private savings, progressively increasing and sustaining deposits, enhancing financial intermediation and channelling funds to growth-promoting industries. Basel III specifically stifles these goals since the asset risk-weighted methodology stifles investment since banks tend to hold assets in the form of T-Bills instead of directing loans to productive sectors. Thus, it does not suffice to include emerging economies in drafting the universal one-size-fit-all Basel III. Since the costs that they are apt to incur to phase in Basel III are quite hefty, EMEs should insist on designing a framework that best suits their economies and that does not unduly stifle investment. The inclusion of some EMEs in the Basel III deliberations is only a preliminary step, yet in view of the absence of smaller EMEs from most international standard-setting bodies, it is advisable that they launch a coordinated and simultaneous campaign to secure their rightful representation.

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