

Global Banking Regulation and Emerging Markets

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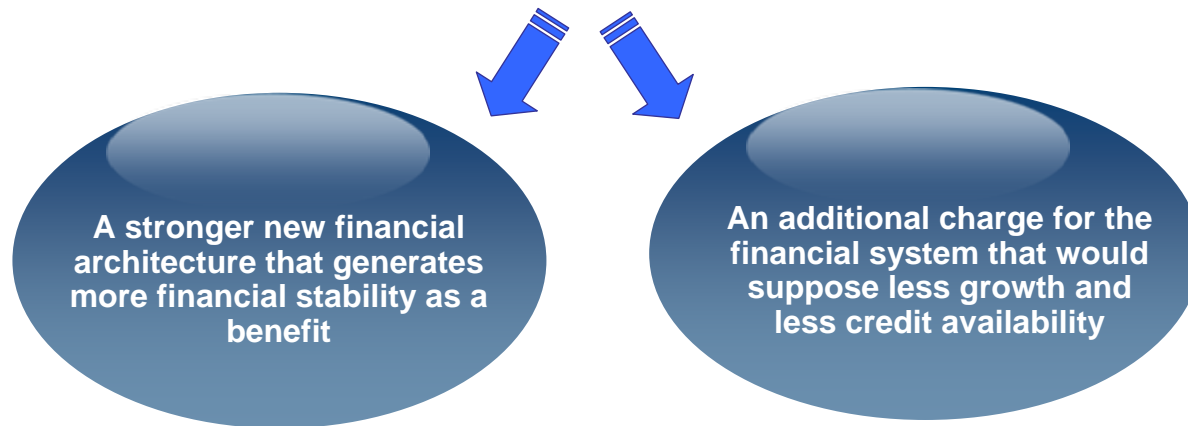
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Main messages

- There is a trade off between stronger regulation and financial development.
- Compromise should take into account differences arising from different levels of development.
- In EMEs financial vulnerability has been mostly linked to macroeconomic shocks (external in many cases), while in Developed ones, they seem to be more related to microeconomic problems: ability of regulators and supervisors to keep pace with financial innovations and to prevent excessive risk-taking, for instance.
- Four issues coming from Basel III that are very relevant for EMEs:
 - Higher capital requirements
 - Counter- cyclical buffers focused in “excessive” growth of Credit/GDP ratios
 - Regulation to SIFIS, the role of global diversification and the business model
 - Importance of supervision.

Global Regulatory Innovation: There are trade offs

After the financial crisis, the new regulatory / supervisory framework can be seen in two different ways



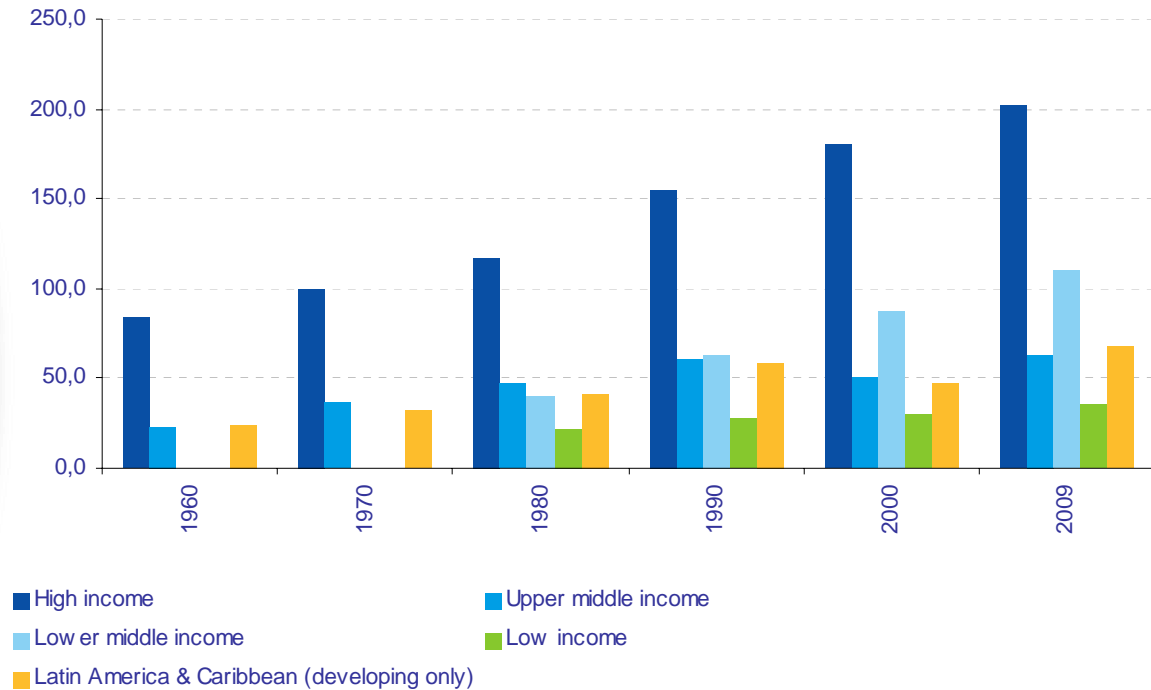
- 1. We need to find a compromise**
- 2. This compromise must recognize diversity arising from different degrees of development**

Global Regulatory Innovation: There are trade offs

1. Financial Deepening is closely related to Development levels.
2. History shows that financial crisis might arise at any Development level.
3. In Developing Markets there is a strong correlation between real external shocks (commodity prices and/or sudden stops) and financial crisis (Braun and Hausmann, 2002, IADB, 1995).
4. In Developed countries the problems seem to be more of a microeconomic nature.
5. If so, "one size will not fit all".
6. And what is prudential regulation in Developed Countries might end up hindering growth in Emerging Countries, while not making them more resilient

Bank credit/GDP ratios

Source: World Bank



Global Regulatory Innovation: There are trade offs

International Regulatory Framework

	Global	USA	EUROPE
Strengthening Capital	Basel III	Frank-Dodd Act	CRD IV (in process)
Reducing leveraging			
Improving liquidity management			
Macprudential Supervision	In process		New Institutions
Systemic Risk	In process		
Microprudential Supervision	Pending		
Increasing transparency	In process		Stress-test
Recovery Mechanisms (Living Wills)	FSB initial Proposal		Crisis Management European Framework (in process)
Resolution Changes	In process		
Loss Absorbency Instruments			

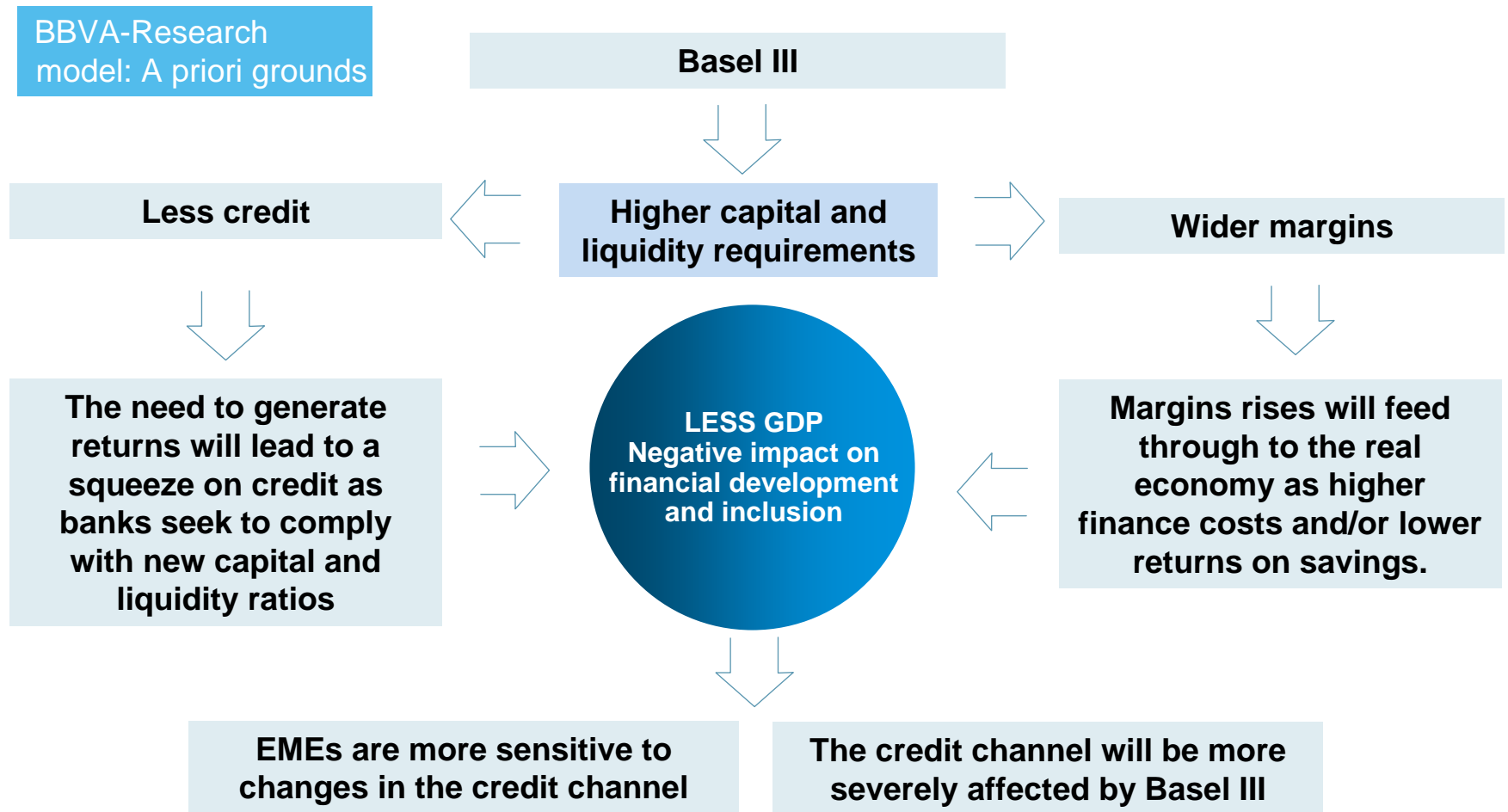
Minimizing the probability of crisis (and avoiding bailouts generating moral hazard)

Two kind of measures

Reducing the crisis costs (crisis management)

Basel III: Capital requirements and the impact over EMEs

BBVA analysis on the potential impact of higher levels of capital and liquidity being required to banks:
Adjustment will happen through reduced access to credit, dampening economic and financial development



BBVA-Research model: Results

IMPACTS OF THE NEW REGULATION ON CREDIT, MARGIN AND GDP BBVA RESEARCH MODEL A 2 stages estimation

CREDIT

STAGE1

MARGIN

CAPITAL +1%

ALL: -0.30%

EMEs: -0.53%

Higher capital reduces credit. Almost double effect EMEs! Liquidity requirements depress credit too, but less than capital

ALL: 0.29%

EMEs: 0.31%

Higher capital increases margins. Liquidity barely affects. No EME differentiation

LIQUIDITY +1%

ALL: -0.08%

EMEs: -0.13%

ALL: 0.03%

EMEs: 0.00%

Period: 1997-2008

129 economies

STAGE2

GDP per capita*

CREDIT +1%

ALL: +0.19%

Credit has positive impact on growth

MARGIN +1%

ALL: -0.07%

Margins have negative impact on growth

CAPITAL +1%

ALL: -0.08%

EMEs: -0.13%

EMEs are more sensitive to capital increases

LIQUIDITY +1%

ALL: -0.02%

EMEs: -0.02%

* Upper range estimates

Basel III: Indicators for the countercyclical buffer for EMEs

Example: Countercyclical buffer

Alternative

1. Take advantage of local discretionary power allowed under the current rules
2. Use it through better rules and indicators:
 - Use GDP instead of Credit to capture the cycle
 - Beware of terms of trade
3. The key is taking into account deviations from trends. We know how to do it for fiscal and current account analysis. We should bring it into our financial stability assessments

BIS proposal: Credit-toGDP ratio

Problems

Emerging markets would be penalized as a result of their ongoing bancarization process.

✓ the built up of a buffer during good times (upswings)

X release of capital during bad times (downturns)

The buffer could be considered as a new minimum by the markets

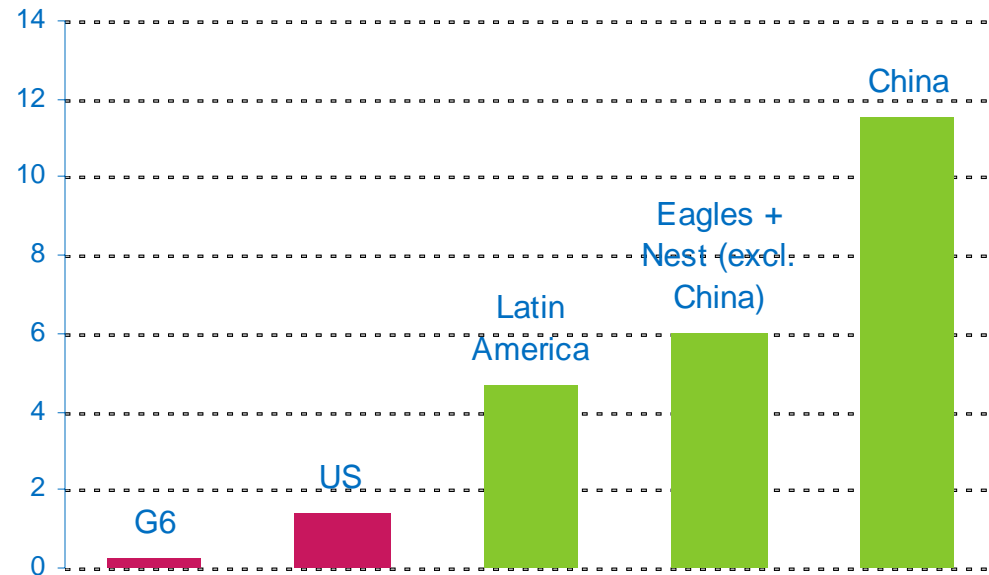
Current Situation: Peru and Colombia have a "Spanish-style" provision systems based on GDP

Basel III: Indicators for the countercyclical buffer for EMEs

1. Financial Deepening is a non-linear process.
2. Non-linearities arise from poor households passing minimum income thresholds that make them eligible for access to financial services by banks.
3. A second non-linearity comes through the reduction in the informal sector as a consequence of development, opening bank services to former informal households and small firms.

Expected % change 2002-10 in the size of population above the banking threshold

Source: BBVA Research:



Beyond Basel III: Other regulatory initiatives. Too BIG TO Fail (SIFIS)

Main Points

- The policy must be **common and apply to all financial institutions** according to the **proportionality principle**
 - All entities are somehow systemic by the very fact of being part of the financial system
- **Entity failure in an orderly manner must remain a possibility** in order to ensure market discipline
- **Lists of SIFIs may exacerbate moral hazard**, erode market discipline and break the level playing field
- The identification is complicated and there is no exact methodology, thus **mitigating factors should be included**

IDENTIFICATION



- **Globality: geographic diversification** has been a source of resilience during the current crisis
- **Most relevant mitigating factor to be considered = business model**
 - **Decentralized model:**
minimizes contagion risks from the subsidiary to the rest of the group
 - **Retail banking:**
 - subject to intense supervision,
 - higher stability (consumer-based business line, large number of small customers, natural hedges: low correlation in earning between products & services)

TREATMENT



- **Capital surcharge must remain a marginal tool.** Balanced approach = development of a toolbox including:
 - **preventive tools** (enhanced supervision),
 - **structural measures** (such as the strengthening of financial market infrastructures)
 - **business models** aimed at reducing the probability of an entity failure
 - measures aimed at enhancing the **entities resolvability**
- **Supervision is key** as it allows an in-depth knowledge of institutions by supervisors and a prompt identification of financial weaknesses.

Impact on EMEs

- **Competitive disadvantages for G-SIFIs:** global banks directly compete with local ones in domestic markets
- **Emerging markets risk to be less attractive for global banking groups** they could face higher requirements than their competitors domestic banks.
- **Jeopardizing banking penetration process and to their economic development:**

Supervision

- **Too much focus on regulation:** Rules are rigid and they barely anticipate where problems will come from.
- **Supervision allows an in-depth knowledge of institutions** by supervisors and a prompt identification of financial weaknesses.
- **An effective supervision must be intrusive and proactive**, with appropriate accountability and specialized resources, established at consolidated level and with global consistency.



Macroprudential Policy

- Designates the set of regulations and tools aimed at ensuring financial stability by **preventing the build up of asset price bubbles and financial system imbalances**.
- Evolutionary concept which tries to **reconcile microprudential policies with the goal of preserving the soundness of the whole financial system**.
- **G20 countries priority (new bodies):** the FSOC in the US, the ESRB in the EU, the FPC in the UK or the FSC in Mexico.



Opportunity for EMES

- Due to the credit cycle momentum and their large capital inflows ,EMEs seem the best suited to take advantage from the benefits associated to using macroprudential policy immediately
- Particular attention should be made to the opinions and needs of this group of countries in the international discussions of macroprudential tools

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