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Implementing Basel III in emerging economies: a process not free of pain

- **Basel III is now being transposed into several emerging markets legislations**
  The process of implementing stricter regulation is in a more advanced stage in China and Brazil, where the adoption of Basel III is actually ahead of the global calendar. Many other emerging countries are now stepping towards the adoption of Basel III.

- **Emerging countries have some incentives to follow Basel III recommendations**
  In addition to trying to find a way to create a more robust global financial system, emerging economies have at least two other reasons to welcoming the new regulatory framework. First, emerging markets' financial systems are well capitalized and in a much better position to meet Basel III recommendations than banks in developed economies. Second, the new regulation looks attractive for regulators in many emerging countries which are currently facing an excessive credit expansion.

- **The impact of Basel III could, however, be potentially huge when calculated from a long term perspective,**
  even though it is generally considered that emerging economies are less vulnerable to new regulations. A recent study by BBVA Research actually shows that the negative effects of capital and liquidity requirements are higher in emerging countries in terms of banking penetration and GDP per capita than in developed costs.

Implementing Basel III in emerging economies: a process not free of pain

Emerging economies around the world have been warmly welcoming the implementation of the measures presented by the Basel Committee on Banking Supervision (BCBS) known as Basel III.

In addition to trying to find a way to create a more robust global financial system, emerging economies have at least two other reasons to welcoming the new regulatory framework. First, emerging markets' financial systems are well capitalized and in a much better position to meet Basel III recommendations than banks in developed economies. Second, the new regulation looks attractive for regulators in many emerging countries which are currently facing an excessive credit expansion.

Countries such as China and Brazil are, therefore, speeding up implementation of stricter financial regulation based on Basel III. Supervisors in both countries have recently announced calendars for adopting the new regulation that are ahead of BCBS' proposed calendar[1].

In early of May, China Banking Regulatory Commission (CBRC) announced its plans to step up efforts to strengthen supervision by implementing new and stricter regulations based on Basel III principles by the end of 2016. In particular, the CBRC plans to impose differing criteria for systemically important financial institutions (SIFIs) and non-SIFIs although it has yet to specify banks' classification into the two groups. The new rules are to include counter-cyclical capital adequacy ratios (up to 2.5% on top of the normal capital ratio requirement, 11.5% for SIFIs, and 10.5% for non-SIFIs), a leverage ratio (4% as minimum requirement), provision/total loans ratio (2.5% as a minimum) and liquidity ratios (liquidity coverage ratio and net stable funding ratio set at 100%).

Brazil announced the rules and the compliance timeline for the implementation of Basel III in February. Supervisors plan to adopt Basel III regulations in Brazil before they come into effect internationally. The Central Bank of Brazil will add conservation and counter-cyclical buffers to normal capital requirements and, total required capital will be 11% in 2013 and within the 10.5% - 13% range (depending on whether a counter-cyclical requirement will be added or not) from the beginning of 2017 on. Regulators also set (although in some case in preliminary terms) a leverage ratio (3% as minimum requirement) and liquidity ratios (liquidity coverage ratio and net stable funding ratio set at 100%). (For more details on the rules announced and compliance timeline in both Brazil and China see the table below).

1: For the calendar recommended by Basel III see: http://www.bis.org/press/p100912b.pdf

Table 1
Rules announced and compliance timeline in China and Brazil

Category	China	Brazil
Capital Adequacy	• Minimum capital adequacy ratio (CAR) for core tier I capital, tier I capital and total capital are set as 5%, 6% and 8%, respectively.	• Minimum capital adequacy ratios (CAR) are set as core tier I capital: 4.5%; tier I capital: 5.5% for 2013 and 2014 and 6.0% from then on; and total capital: declining from 11% in 2013 to 8.0% in 2019.
	• On top of the minimum CAR, banks are also required to set aside 2.5% extra capital.	• By the end of 2011 the new definition of total capital will be set.
	• A countercyclical capital buffer (0-2.5%) will be required when necessary.	• By July of 2012 the calculation of the required capital for counterparty credit risk will be revised and by the same time it will start the phase-in of deductions from common equity of items such as tax credits (two years ahead of the recommended by Basel III).
	• SIFIs are required to maintain CARs of 1% higher than non-SIFIs, which means that under normal circumstance (i.e., when no countercyclical capital is imposed) the CARs of SIFI and non-SIFI would be at least 11.5% (8% minimum +2.5% extra +1% SIFI) and 10.5% (more or less what they are now for large and small banks, respectively).	• Compliance timeline: beginning of 2013.
	• Compliance timeline: SIFI by end-2013 and non-SIFI by end-2016.	• By the end of 2012 the regulation on both conservation and counter-cyclical Capital will be adopted and financial institutions could be required to meet new goals anytime from the beginning of 2016 and 2014, respectively, depending on the macroeconomic cycle.
Leverage Ratio	• A minimum leverage ratio, defined as the ratio of core tier I capital to adjusted total asset, is set at 4%.	• Minimum leverage ratio: 3% (preliminary)
	• Compliance timeline: SIFIs by end-2013 and non-SIFIs by end-2016.	• By July of 2017 the final methodology for the calculation of the Leverage Ratio will be informed (preliminary information will be released before July of 2012).
		• Compliance timeline: beginning of 2018.
Liquidity	• Liquidity coverage ratio and net stable funding ratio are introduced into the current liquidity supervisory framework.	• Final methodologies to calculate liquidity coverage ratio and net stable funding ratio will be announced by the end of 2013 and 2016, respectively (preliminary methodologies will be announced by the end of 2012 and 2014, respectively).
	• The minimum regulatory levels of both new indicators are set at 100%.	• The minimum regulatory levels of both new indicators are set at 100%.
	• Compliance timeline: liquidity coverage ratio by end-2013 (for both SIFIs and non-SIFIs), and net stable funding ratio by end-2016 (for both SIFIs and non-SIFIs).	• Compliance timeline: liquidity coverage ratio by the beginning of 2015 and net stable funding ratio by the end of 2018.
Other	• The minimum Provision/Total Loan ratio is set at 2.5%.	
	• The minimum Provision coverage ratio (the ratio of provision to non-performance loans) is set at 150%.	
	• The authorities will dynamically adjust the provision requirement.	
	• Compliance timeline: SIFI by end-2013 and non-SIFI by end-2016	

Source: CBRC, Central Bank of Brazil, and BBVA Research

The announcement of the implementation of Basel III in Brazil and China was followed by the announcement of some measures to improve the supervision of the financial system. In the former, the Central Bank of Brazil announced an internal restructuration to increase its capacity to regulate and supervise the financial system. On top of that, a Financial Stability Committee within the Central Bank structure was created to evaluate financial stability in the country and to implement strategies to keep systemic risks under control. In the latter, some goals were included in the new 5-year Development Plan to create a better supervisory environment: i) improve financial regulatory agencies and coordination between different departments; ii) improve financial management of local governments, and increase local governments' responsibility for small - and medium-sized institutions; iii) develop cross-sector and cross-market financial regulatory rules, and strengthen the supervision of systemically important financial institutions; iv) improve financial laws and regulations; v) accelerate the construction of a credit system and regulate the development of credit rating agencies; vi) strengthen cooperation with international organizations and foreign regulatory bodies.

The implementation of Basel III is in a more advanced stage in China and Brazil, but other countries are also taking measures to adopt a stricter financial regulation in line with the new recommendations. In Peru, for example, regulators approved in July a regulation for the new additional capital adequacy requirements with the goal to limit the impact of capital fluctuations on financial companies. The measure will be implemented gradually and should be fully implemented by July 2016.

In Colombia, financial authorities have expressed the intention of implementing some of the capital and liquidity requirements currently discussed under Basel III. They are currently evaluating how to implement these regulations. In Mexico, financial authorities presented in May a project to incorporate Basel III regulation in the country and on September the Ministry of Finance put forward in the General Economic Policy Criteria for 2012 the early adoption of this framework as a key macro prudential element to preserve financial system's stability. Chile and Argentina are currently focused in the implementation of Basel II recommendations, but they are also expected to follow the global calendar for the implementation of Basel III.

In Asia, most emerging economies have already announced their intention of adopting Basel III and are, at this stage, analysing how to do it. In HK, for example, supervisors have not yet come up with any specific plan to implement Basel III although they stated at the beginning of the year that they intend to fully adopt international recommendations for financial regulation in accordance with the BCBS' timetable. In India, regulators have taken a number of initiatives to ensure smooth transition of the banking sector to Basel III framework and provide comfort to begin implementation of the new framework as per the time schedule fixed by BCBS. In Korea, authorities have not taken steps to enact Basel III reforms but have tested the financial health of its banks against recommended requirements. In Indonesia, regulators should also adopt the global timeline for the adoption of Basel III.

In practically all emerging countries in Asia and Latin America, supervisors have recently highlighted how well capitalized and how good were liquidity and leverage ratios when commenting on the implementation of Basel III (which was, in some countries such as India, South Korea, Chile and Brazil, supported by analysis and stress experiments conducted by regulators). Even tough the adoption of Basel III recommendations will be smoother in emerging countries than in developed economies, the adoption of stricter financial regulation will impose series of challenges for banks in emerging markets.

In China, for example, there is some concern about the profitability of banks as they could be under pressure following the introduction of new requirements, especially the recently announced 2.5% minimum loan-loss reserve requirement. Some analysts fear suggested that Chinese banks will face a significant funding gap in the next five years[2].

2: See "Chinese banks to face capital stress after Basel III" in http://www.china.org.cn/business/2011-08/20/content_23249493.htm

In Brazil, the extra pressures that will be imposed by the adoption of Basel III on profitability will add to the current (and forthcoming) pressures related to a structural reduction of banking spreads. In the Brazilian case, the deduction of tax credits from capital measures are among the main sources of concern as these assets are currently very significant[3]. On top of these concerns, the existence of official banks such as the National Development Bank (BNDES), whose credit policies usually follow more the tone of macroeconomic policies than changes in the regulatory environment, could weaken the effects related to the adoption of the counter-cyclical buffer and create distortions in domestic markets.

As in other countries, the implementation of new regulation will unavoidably increase the cost of financial institutions. The early implementation of Basel III may, actually, affect Hong Kong's competitiveness as an international finance center. These concerns explain why local authorities are welcoming new regulation but, at the same time, wondering whether it should have "more flexibility, taking into account local circumstances".

Another potential source of costs is the issue of the SIFIs, which has not yet been fully addressed by the BCBS. China has already implemented stricter requirement for its SIFIs (although has not yet came up with a methodology to classify institutions as SIFIs or no-SIFIs), but countries such as Brazil could have their banks affected by BCBS recommendations on the issue, which are at this moment mainly focused on SIFIs in developed economies even though banks in emerging markets will be increasingly important at a global level.

These concerns about the adoption of stricter regulation are certainly generalized among other emerging countries and are a sample of the costs these countries will face when implementing Basel III.

All in all, emerging countries will certainly face significant costs when implementing stricter financial regulation. A recent study by BBVA Research[4] actually shows that the negative effects of capital and liquidity requirements are higher in emerging countries in terms of banking penetration and GDP per capita than in developed costs. Therefore, although it is generally considered that emerging economies are less vulnerable to new regulations (mainly on the ground of their better economic momentum and the healthy situation of their banks capital), the fact is that the impact of Basel III could be potentially huge when calculated from a mid to long term perspective.

3: A recent study by Barclays suggests that the losses related to the deduction of tax credits would be around R$ 64 billion were this change to be implemented at this stage. See, for example, http://admin.valoronline.com.br/impresso/financas/104/452047/bancos-perderao-r-64-bi-de-capital

4: "Impact of Financial Regulation on Emerging Countries", BBVA Research Working Papers, Number 11/08; 8 March 2011. See: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1108_tcm346-249241.pdf?ts=2892011

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