

Basel-III not Suited for Emerging World Banking

Capital norms meant to guard the security-centric developed world financial system are ill-suited for deposit-intermediating developing country banks, and would hurt growth too



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There are fundamental differences between financial systems in advanced market economies (AMEs) and those in emerging market and developing economies (EMDEs). These differences, *inter alia*, explain why financial intermediation held up relatively well in these economies even as financial markets froze in AMEs during the recent global financial crisis.

The biggest difference is that AMEs have increasingly moved towards reliance on short-term money and capital markets for funding, and 'money created' against volatile financial assets and innovative products exchanged over the counter ('shadow banking'). EMDEs, however, continue to be dependent on more stable deposit-based funding.

This difference is critical. Financial systems in both EMDEs and AMEs become vulnerable during downturns in the business cycle on account of deterioration in asset quality. Ever since deposit insurance was put in place following the banking panic during the Great Depression, deposit-based banking is no longer susceptible to funding risks arising from financial panics and bank runs. As long as their capital is calibrated to cover asset quality deterioration during business downturns, EMDE banks no longer face major funding risks other than a general decline in financial savings, as long as external currency-denominated deposits are kept within prudent limits through capital controls.

AMEs are, in addition, exposed to funding risks arising from financial panic characteristic of build up of leverage in capital markets. This vulnerability has increased following the repeal in 1999 of the Great Depression-era Glass-Steagall Act in the US that drew a firewall between deposit-based banks and those (investment banks) that rely on capital markets.

Basel-II banking capital norms were calibrated to cover risks arising out of traditional deposit-based banking. They were not designed to cover funding risks emanating from sharp maturity mismatches and attendant difficulties in rolling over credit on account of financial panic that can result in rapid deleveraging, credit freeze and a breakdown in financial intermediation.

Financial panics in some way or the other always been preceded by a considerable rise in leverage. The primary drivers of leverage in AMEs and EMDEs are strikingly different. Increasing leverage in AMEs in the period leading up to the global financial crisis was an attempt to increase returns on capital in an environment of low returns. High credit growth in EMDEs, like India, on the other hand, was primarily to finance high rates of growth and investment in the real economy. The returns on capital in EMDEs are now significantly high-



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er, as a result of which global production has long been migrating to these countries.

There was, of course, also speculative investment in certain asset classes, but margins on such credit were incrementally raised in response to the rising pace of credit expansion through conservative macro prudential financial regulation. This is a defining characteristic of EMDEs like India, where regulators have not hesitated to spot and prick asset bubbles, rather than simply waiting to clean up after they burst.

Following the recent global financial crisis, a slew of financial regulatory reforms are being contemplated under the aegis of the G20, Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and other standards-setting agencies to protect the integrity of financial intermediation. Are these headed in the right direction?

EMDEs clearly need to increase financial savings to accelerate growth and development, notwithstanding the fact that in recent years, capital was flowing uphill from EMDEs to AMEs. This was arguably a temporary and unsustainable phenomenon that may be about to change as the global economy rebalances. AMEs, on the other hand, need major regulatory changes that inoculate them more effectively against the risks their financial system face, and also roll back some of the more extreme forms of financialisation that exposes them to greater risk in the first place without commensurate impact on growth.

While financial regulatory reforms are expected to be implemented across all jurisdictions, the immediate impact of most would be felt acutely in the relatively lightly-regulated AMEs, rather than in the more tightly-regulated EMDEs. The impact of the new Basel-III banking capital adequacy norms, however, will be almost equal across both AMEs and EMDEs even though the nature

of risks in their financial systems is quite different.

While no amount of capital can be large enough to inoculate banks and other financial institutions against financial panic and bank runs, as sovereign and central bank bailouts would always be required, they nevertheless need to hold higher amounts of capital and/or pay a special ('financial transaction') tax in normal times, to at least partly compensate the general taxpayer for such bailouts. Basel-III, which seeks to enhance the quantity and quality of capital that banks need to hold, and the proposal to levy a 'financial transaction tax', is to be seen in this light.

While the rationale for tightening capital adequacy norms for the banking sector in AMEs is self-evident, the case for immediately migrating from Basel-II to Basel-III in EMDEs is not. The argument generally given against calibrating capital requirements to differential risks faced in AMEs and EMDEs

is that this would result in regulatory arbitrage. This is, however, not very convincing because capital would migrate to a more regulated environment, which has its own additional costs. Regulation is a proxy tax, admittedly difficult to quantify.

On the other hand, there is a danger that scarce savings in EMDEs might be pulled away from investment necessary to sustain current levels of high growth to cover non-existent risks in their financial systems precisely when their savings are falling. Thus, Basel-III constitutes a double whammy for countries like India that would aggravate both the growing savings — investment gap manifest in a widening current account deficit — and the runaway structural fiscal deficit of a government that

would need to cough up a substantial chunk of the additional capital by virtue of its large ownership of the banking sector. The cost of capital is already high in EMDEs on account of the savings-investment gap and tighter regulation. The enhanced capital requirements of Basel-III are almost guaranteed to keep it high in the foreseeable future.

The moot point is, why should EMDEs be pushed towards a regulatory framework calibrated for risks in AME financial systems that would extract a high developmental cost through foregone growth?

So where do we go from here? There are elements in Basel-III that could be applied to Basel-II, such as tighter definition of tier-I capital, and a countercyclical buffer in the event of build-up of excessive credit according to national circumstances. A number of EMDEs, such as India, follow some variants of this macro prudential principle anyway. However, raising overall capital requirements, and especially the additional conservation buffer of 2.5%, is not relevant for EMDEs at this stage.

There is, of course, no good reason to suppose that EMDE financial systems will remain where they are now. There are two separate issues: first, stage of development, and second, regulatory choice. Tighter regulation could keep shadow banking in check. Alternatively, if some EMDEs see benefits in the development of innovative shadow banking, they could move towards lighter-touch regulation — strengthened by current regulatory changes in the pipeline — in which event these EMDEs could migrate to AME-type financial systems in future. Financial Sector Assessment Programmes (FSAAPs), mandated for all systemically-important economies and jurisdictions, could periodically assess whether and when Basel-II jurisdictions should migrate to Basel-III.

(The author is a civil servant. Views are personal)