Brandeis International Business School
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GLOBAL FINANCE BRIEF

The Impact of New Financial Regulations on Emerging Markets: A Synthesis of a Global Survey

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Vladislav Prokopov, a Master's candidate in International Economics and Finance, led a project on financial regulations under the supervision of Dr. Catherine L. Mann, Barbara '54 and Richard M. Rosenberg Professor of Global Finance and Director of the Rosenberg Institute of Global Finance at Brandeis International Business School. The project team included Ali Alsulaily, Namig Amiraslanov, Håkon Bjerke, Daqiang Chen, Joosuk Chae, Sean Greene, Angelo Innamorato, Jonida Kapo, Jee Eun Kim, Hoa Le, Sarah Llibre, Ewa Nucinska, Teresa Nainde Evaristo, Risan Shllaku, Tyler Smith and Tom Weaver. The results of the project and survey were presented and discussed at a conference at Brandeis International Business School with Norah M. Barger of the Federal Reserve System, David Gutschenritter of State Street Corporation and Nicolas Véron of the Peterson Institute for International Economics. Project participants thank Professor John Balder Jr. for his support throughout the project and comments on the draft.

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Executive Summary

The global financial crisis revealed the fragility of the global financial framework under the current Basel agreements and provided an impetus not only for curtailing the risky activity of banks but also for rethinking what affects the stability of the global financial system. The recent Basel III agreement was designed to provide additional levers that should make national financial systems, and by extension the global financial system, stronger. This paper discusses the key findings of a global survey of financial, economic and political stakeholders conducted by students from Brandeis International Business School on whether the Basel III agreement will be able to construct and maintain a sound financial regulatory framework.

Our research arrived at the following conclusions:

- Developed and developing countries have different perceptions of liquidity and capital requirements.
- US and EU financial institutions are concerned about the cost of implementing the Basel III framework.
- Financial institutions in countries that have already implemented Basel II and institutions in some Asian countries are not as concerned about the cost of Basel III implementation.
- While 'financial stability' has different meanings for different players, all equally understand the concept of 'macro-prudential' policies.
- There are major roadblocks to developing a framework whose fundamental objective is to level the global playing field.

The Rosenberg Institute of Global Finance

The Rosenberg Institute of Global Finance seeks to analyze and anticipate major trends in global financial markets, institutions, and regulations, and to develop the information and ideas required to solve emerging problems. It focuses on the policy implications of economic globalization. To this end, it sponsors informal exchanges among scholars and practitioners, conducts research and policy analyses and participates in the School's teaching programs. The Institute, founded in 2002, is named for Barbara C. Rosenberg '54 and Richard M. Rosenberg.

Introduction

The turbulence in financial markets that resulted from the 2007/2008 financial crisis in the US revealed deficiencies in risk management mechanisms at financial institutions around the globe and exposed the limited capability of governments to effectively supervise and regulate these institutions. To reduce the likelihood and impact of future financial crises, the International Monetary Fund suggests that policymakers focus on the following key goals for reform:[1]

- Achieve a level playing field in regulations to ensure global coordination and higher competition and minimize opportunity for cross-border and cross-sector arbitrage.
- Improve the effectiveness of financial supervision to reduce future leveraging and excessive risk-taking. Cross-border exposures are a key element of financial supervision.
- Develop coherent and effective operational tools for achieving financial stability.
- Develop an effective macro-prudential framework in which government authorities focus on improving the resilience of individual institutions and strengthening the resilience of the financial system as a whole. Strong macro-prudential levers are an important element of sound financial stability policy.
- Address imbalances in the entire financial system. While banks were the source of the 2007/2008 financial crisis, reforms should exhibit a broader perspective to prevent risky activities from migrating to less-regulated segments of the system. These policies should address the shadow banking system, rating agencies, etc.

Responding to these challenges, the Basel Committee on Banking Supervision released a series of amendments to the existing Basel II framework, referred to as "Basel III." The amendments include new bank capital and liquidity requirements, as well as a new capital conservation buffer and countercyclical capital buffer.[2] According to the Secretary General of the Basel Committee on Banking Supervision, the Basel III framework has been developed with the following goals:[3]

1. Establish the liquidity framework. This forces banks to withstand massive capital outflows and reduce their dependency on public sector liquidity support during a crisis. Such a framework should be able to correct pre-crisis extremes at a cost acceptable to the public sector. Therefore, the liquidity framework under Basel III should penalize excessive liquidity risk-taking and encourage sound banking models.

2. Establish a new leverage ratio to discourage banks from taking on excessive leverage. The 2007/2008 financial crisis was exacerbated by the deleveraging process once banks were hit by the crisis. A lower leverage ratio would prevent a major unwinding of bank leverage, which is damaging during a crisis and further harms the financial system as whole. The Basel Committee on Banking Supervision found a strong correlation between leverage ratios and bank failure rates during the crisis; thus, limiting bank leverage should limit risks within the financial system.

A number of issues remain. First, in order for new requirements to be effective and to eliminate arbitrage opportunities between regulatory regimes, Basel III must be applied consistently around the world. In other words, Basel III needs to create a level playing field for all participants in the global financial system. Otherwise, banking activity may start to migrate to financial institutions in less regulated geographies or into the less regulated shadow banking sector. Hedge funds, money market mutual funds and the securitization process exacerbated the 2007/2008 financial crisis and need to be overseen more closely by regulators.

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1. Viñals, J.Fletcher, J. Pazarbasioglu, J. C. Kodres, L. *IMF Staff Position Note: Shaping the New Financial System*. 3 Oct 2010.

2. Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems" (bis.org/publ/bcbs189.pdf). Rev. June 2011.

3. Walter, Stefan. (2011, April). *Basel III: Stronger Banks and a More Resilient Financial System.* Speech presented at the Financial Stability Institute.

Based on our survey analysis, we do not believe that Basel III will be able to create a global level playing field. Basel III is only one piece of a puzzle, but it will serve as a policy framework to move toward a more stable and sound financial system.

The Brandeis Survey on Financial Regulations

In early 2011, students from Brandeis International Business School surveyed financial and government stakeholders on the impact of Basel III, extending the survey to a wide variety of developing and developed countries. The survey included the following respondents and review of secondary sources:

- Representatives of central banks and private banks in a subset of emerging, developing and developed economies[4]
- Representatives of multilateral organizations[5], global think-tanks, US government institutions and rating agencies
- An extensive review of publicly available information

The survey had three parts. The first, on the **Global Regulatory Framework**, addressed the following issues:

- Whether the global regulatory framework and the level playing field can be achieved under Basel III
- Whether Basel III accounts for national differences in regulatory coverage and accounting standards
- The effectiveness of capital, leverage and liquidity requirements under Basel III
- What effect Basel III will have on financial institutions in the respondent's respective country or group of countries, including those institutions that are involved in cross-border operations

The second part of the survey focused on **Macro-Prudential Policy** under Basel III and addressed the following questions:

- Is there a general understanding of macro-prudential policy across different stakeholders
- What are the main macro-prudential policies being implemented
- How is financial stability defined
- Will macro-prudential tools help achieve financial stability

The final part of the survey touched upon questions surrounding too-big-to-fail institutions, the future role of rating agencies and the question of rising inequality between large and small banks.

While the survey cannot be called comprehensive, it nevertheless offers a look across the dimensions of both policymakers and financial institutions in a diverse set of economies.

Findings of the survey and discussion

The survey revealed interesting insights into the implementation of Basel III and the associated macro-prudential regime. In the assessment of technical requirements, developed and emerging economies were divided; however, all countries saw negative effects on financial institutions. While there was little divergence in the understanding of macro-prudential policy, representatives from country groups diverged in their operational definition of financial stability. Below are some key results of the study.

4. Countries included: Macedonia, Azerbaijan, Vietnam, China, Russia, Austria, Angola, Brazil, Norway, Dominican Republic, Argentina, United States and European Union.

5. The World Bank, International Monetary Fund.

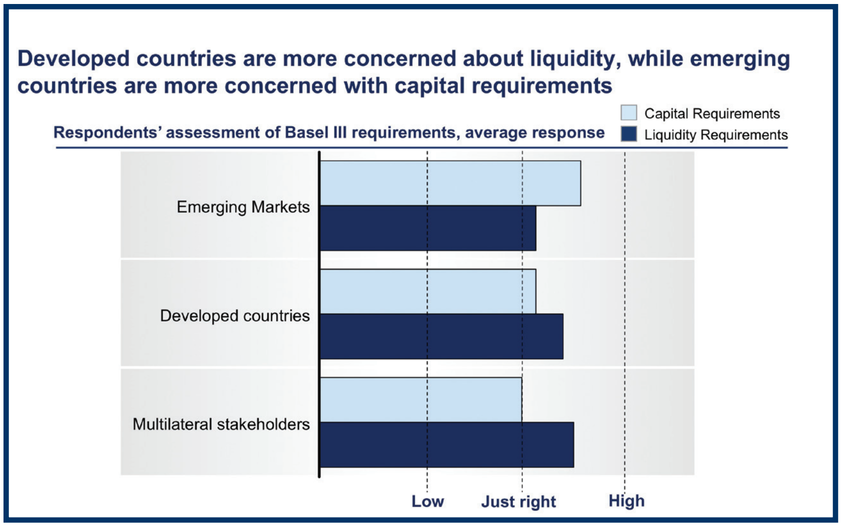

Exhibit 1: Capital Requirements

1. Emerging economies[6] expressed a high level of concern about the capital requirements of Basel III, while developed economies and multilateral organizations considered capital requirements to be set at the right level (Exhibit 1). Both developed economies and multilateral organizations expressed greater concerns about liquidity requirements.

This "one size does not fit all" result was expected. There are a few reasons for this conclusion. First, major differences between the structure of banking systems in the US and EU pose roadblocks to the implementation of a unified Basel III framework. Because the assets of many of the largest banks in the EU exceed national GDP, for example, surcharges for these banks have a different effect than for smaller EU banks as large banks present a greater risk to national economies. Furthermore, as few countries currently operate under Basel II, simultaneous transition from Basel I to Basel III may have a profound effect on these financial systems.[7] Such a transition may lead to a credit contraction and higher cost of lending, and banking activity may migrate into the less regulated shadow banking sector. Both of these are undesirable consequences of the implementation of capital and liquidity standards under Basel III.

2. Respondents were asked to assess the effect of the Basel III framework on their respective financial institutions or the financial institutions in their respective countries. Responses fell into three groups: small EU banks and banks in the US, Basel II countries, and Greater Asia countries (Exhibit 2). Banks in the US and small EU banks believe the Basel III framework would penalize their operations. However, the new framework would not affect operations in those countries where Basel II has been adopted. Bankers in China, Hong Kong, and India deem Basel III rules beneficial for their operations.

The US may face implementation difficulties as it still operates on Basel I standards. The new regulation will hit small EU banks because they will not be able to raise additional capital due to the fact that they do not have ready access to capital markets.[8] Thus, it could be expected that smaller players in the EU may have to restructure and merge to form stronger institutions.

Asian banks may not be negatively affected because their capital ratios are already higher than those proposed by Basel III[9]. Furthermore, Asian banks have large deposit bases and thus will not be impacted by the liquidity requirement. Some respondents believe that stability in the Asian financial system, especially in China and Hong Kong, coupled with a

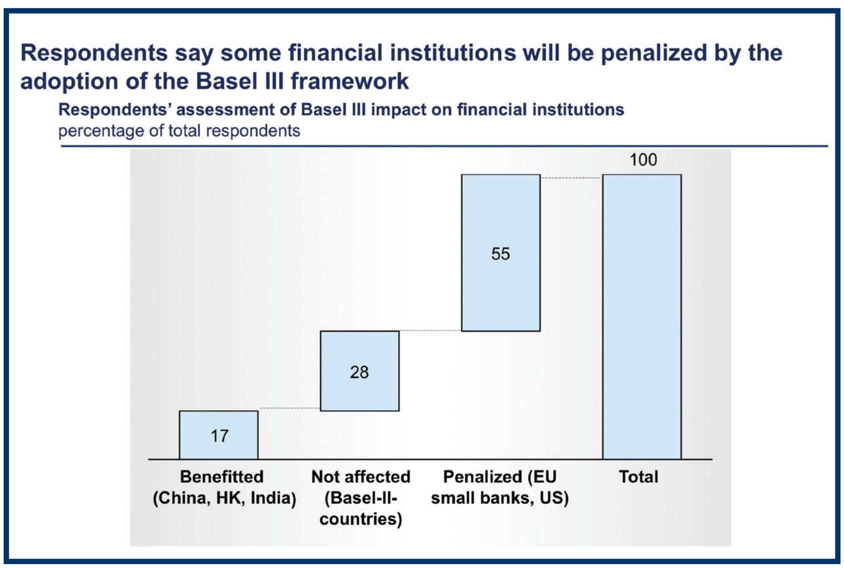

Exhibit 2: Effects of the Basel II Framework

6. The respondents of the survey were divided into three groups: emerging markets, developed economies and multilateral organizations. (International Monetary Fund, The World Bank).

7. Härle, P. Lüders, E. Pepanides, T. Pfetsch, S. Poppensieker, T. Stegeman, U. *Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation*. McKinsey & Company. Nov 2010.

8. Brandeis' survey interviews; Peters, J. *Basel III Around the World*. Morningstar Institutional Equity Research. 14 April 2011.

9. Ibid.

strong banking system could offer them the opportunity to emerge as a major capital source for capital-intensive projects around the world.[10]

3. The survey also revealed a number of concerns regarding Basel III implementation. These include:

- Challenge of implementation across countries
- Risk of small EU banks being crowded out
- Challenge of adjusting risk models
- Potential difficulties with raising capital
- Unequal compensation packages in cross-border institutions

4. Virtually all respondents had similar understandings of the meaning of macro-prudential policy. In their own words, these are "actions and instruments aimed at the entire financial system which serve to limit the risk of financial distress…thereby limiting the real output loss of the economy…by stabilizing the system as a whole, not individual institutions." However, respondents diverged in their operational definition of financial stability and its measures (Exhibit 3).

The majority of respondents consider general and system-wide risk metrics as measures of macro-prudential stability. A smaller subset equally identified credit growth or credit/GDP ratio, asset prices, and leverage ratios as appropriate measures of financial stability. There was a split between the views of multinational and national stakeholders. Multinational institutions suggested that leverage and system-wide risk metrics are the core of the operational definitions of financial stability. National central banks and commercial banks said that the definition of financial stability should include credit as a share of GDP and asset prices.

This divergence implies different approaches in the measurement of financial stability by international regulators, national regulators and commercial banks. Moreover, such differences in approach may contribute to an overall inequality in the way commercial banks and domestic and international regulators operate. In order for the macro-prudential policy to be effective, key stakeholders should agree on how to evaluate outcomes of prudential measures. Our survey shows that such an agreement does not exist.

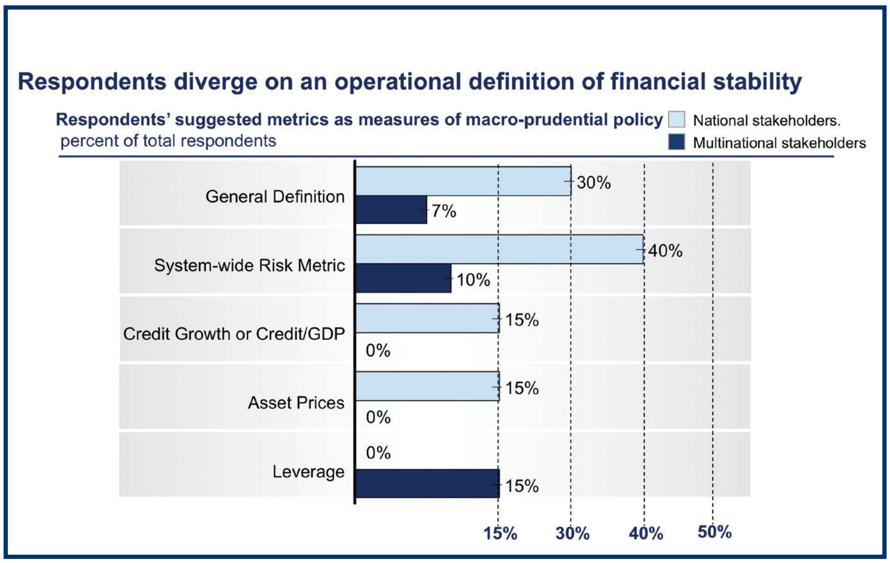

Exhibit 3: Respondents diverged in their operational definition

5. Respondents were asked to identify operational tools that would help achieve financial stability. The majority of respondents identified countercyclical capital ratios as a key operational tool. Liquidity ratios and loss provisions were among the most popular choices (Exhibit 4). Interestingly, financial systems with strong government ties see monetary policy tools and reserve rules as effective tools to achieve financial stability. Multinational institutions, on the other hand, propose stress tests, more rigorous surveillance of the financial system and more stringent loan-to-value ratios.

6. The majority of respondents in our survey agreed that Basel III would not achieve a level playing field among global financial institutions and systems. Among the reasons mentioned were:

10. Forchielli, A. Pagliarini, A. *Basel III: Implications for China Banks and Financial System*. Caixin Online. 30 Nov 2010.

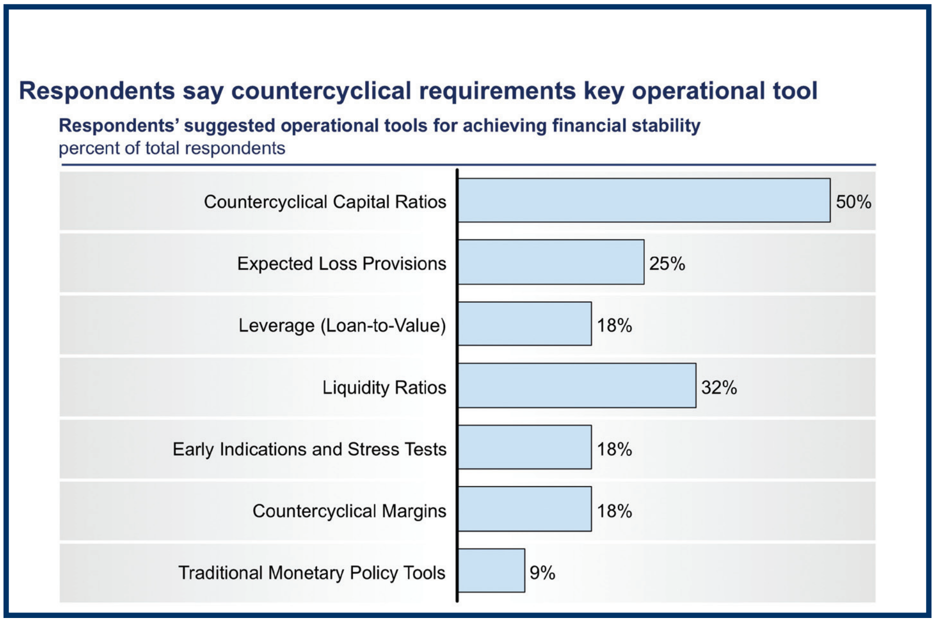

Exhibit 4: Operational Tools That Would Allow Financial Stability

- Basel III does not address the problem of large systemically important financial institutions (SIFIs).
- Basel III does not affect operations and excessive risk-taking activities in the shadow banking system. Moreover, the major global financial intermediaries may treat risk differently for a number of reasons, including the difference in the mentality of risk-taking.
- National regulatory systems differ greatly and any changes will be implemented differently.
- There are potential differences in the implementation of Basel III between the US and small EU banks and the rest of the world.
- Taxes, accounting and regulations differ among countries. Because banks in China are not commercial entities, for example, they are subject to different rules and have different risk-taking incentives than those in the US and EU.

A limited number of respondents suggested that the creation of a level playing field is not the goal of Basel III. This implies that different countries and institutions disagree on their understanding of the implied goals of Basel III. Financial regulations, experts argue, should serve as a "long-term trend reversal," rather than a quick-fix solution.[10]

Conclusion

The turbulence in financial markets resulting from the 2007/2008 financial crisis in the US revealed deficiencies in risk management mechanisms at financial institutions around the globe and exposed the limited capacity of governments to effectively supervise and regulate these institutions. Through a survey carried out by students at Brandeis International Business School, central bankers, policymakers in a subset of emerging and developed countries, and multinational financial institutions gave their views on the global financial regulatory framework of Basel III and the related concept of macro-prudential policy. Results from this survey lead us to conclude that the Basel III proposal will not provide the much sought-after level playing field. In summary, the survey revealed the following key messages:

1. Developed countries are more concerned about the liquidity requirements of Basel III, while emerging economies are more concerned with capital requirements.

2. Respondents among US banks and small EU banks said that the Basel III framework would penalize their operations. However, financial institutions in countries that had already adopted Basel II would not be affected by the new framework. China, Hong Kong and India would benefit from the implementation of Basel III.

3. Respondents diverged in their operational definitions of financial stability despite their similar understanding of the concept of macro-prudential policy. On the other hand, most respondents identified countercyclical capital ratios as a key operational tool for achieving financial stability.

11. Ibid.

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