

Effects Of Global Economic And Financial Reforms On Developing Economies: A Reassessment

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ABSTRACT

This paper aims at creating the necessary awareness that could bail out developing economies from continuous living in squalor. It highlights the major global economic and financial reforms as championed by the Basel III standards stipulated by Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), which G-20 instigated. The paper presents a brief history of what led to Basel III standards and the lessons from it. It presents the Basel III global capital adequacy requirements and the relativity of the reforms to developing countries' banking institutions. In conclusion, suggestions are made on what the way forward ought to be for the developing countries. Summarily, there is the view that economic and financial reforms should not hamper, but enhance economic growth in the developing countries. Hence, the need to end the stunting roles that local economic and financial regulators play to compare with their peers in the developed economies.

1. INTRODUCTION

The cause of the global economic and financial reforms, of which impacts are being deliberated today, is the recent global financial crises (GFC). In turn, the causes of the GFC could not be divulged from failure of some advanced countries' monetary policies to contain local financial imbalances, flaws in global financial regulation and supervision, weak global financial architecture, and global financial imbalances (Morgan and Pontines, 2013).

As one of the causes of the GFC, the group of thirty (G-30) identified gaps and weaknesses in the coverage of prudential regulations and supervision of the global financial system (GFS). Secondly, the group identified lapses in the quality and effectiveness of prudential regulations and supervision. Thirdly, G-30 identified lapses in transparency, risk management, and corporate governance of financial institutions.

The G-30 constitutes core professionals experienced in economic and financial management in Europe and America. The group made some corrective recommendations to fix the identified lapses in 2008. Later, the group of 20 came into the scene. The G-20 is made up of financial experts in economic and financial management in Europe, America, Asia and South Africa.

The G-20 has since 2009 London summit been trying to fix the identified problems. The group has come up with Basel 1, Basel II and Basel III Accords. All sum up to establishing minimum standards for financial institutions' resilience globally, so as to prevent a recurrence of GFC.

2. THE REFORMS

Basel I focused on setting minimum standard of capital adequacy requirements for financial institutions as stipulated by the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FAB).

Basel II focused on aligning risk management with capital adequacy requirements for financial institutions as stipulated by the FSB. Basel III on its own focuses on strengthening the quantity and the quality of banks capital to improve their resilience and avert crises. Its focus on this dimension led to the introduction of capital adequacy ratio (CAR), liquidity coverage ratio (LCR) in the short run, and the net stable funding ratio (NSFR) at the long run. Please see annexure 3.

In the words of Morgan and Pontines, the financial regulatory issues already finalized include the requirements for greater quality and quantity of capital, minimum liquidity requirements, leverage ratio, standards for over the counter derivatives markets, surveillance on and regulation of systemically important financial institutions, and compensation for compliance. Other issues debated include strengthening oversight on shadow banking, credit rating agencies, compliance with international accounting standards, development of macro-prudential frameworks and tools, and adherence to international supervisory and regulatory standards.

Basel III mandates increases in the minimum common equity capital ratio of banks from 2% to 4.5%. It increased minimum Tier 1 capital ratio from 4% to 6% in year 2015. Tier 1 capital includes deferred tax assets, mortgage servicing rights, and shares of financial institutions. Not that alone, Basel III rules introduce a capital conservation buffer that would start in 2016. This buffer is expected to be 2.5% by the year 2019. All these aim at increasing the resilience of banks during periods of crises as witnessed between 2007 and 2009 in US. Kindly see annexure 1.

Apart from Basel Accords, there is the Volcker Rule that was enacted in 2010 by US Dodd Frank legislation. Volcker Rule proscribes banking institutions from acquiring or retaining ownership interest in, or sponsoring a private equity or hedge fund in the US.

3. THE REFORMS' ASSESSMENT

The innovations to financial stability and trade growth should be highly commended. The CAR put a floor under banks capital adequacy. This is a key micro-prudential tool introduced in Basel III reforms. It impacts on the quantity and quality of capital that banks should hold to absorb losses. It is therefore a primary regulatory tool. Dewatripont and Triole (1993), as cited by Kasekende et al, stated that CARs are theoretically justified as a micro-prudential tool. The reason is that CARs serve as incentives to banks. It aids banks abstinence from taking excessive risks that could jeopardise the worth of their assets' portfolio.

The other micro prudential tool introduced in Basel III is that of liquidity requirements. Basel III introduces LCR and NSFR. The use of retail deposits in funding assets used to dominate the practice of banking in developing countries. The practice is inferior to the use of wholesale funds. With Basel III liquidity ratio requirements, banks in the developing countries would have to switch to the use of wholesale deposits in

funding their assets. Hence, as financial structures develop in the developing economies and continually get more integrated into the GFS, it becomes more imperative for banks in developing economies to engage the use of wholesale deposits sourced from both local and foreign sources. It is in view of this that Basel III introduces the LCR and the NSFR.

The LCR is more sophisticated than the liquidity assets ratio that banks in developing countries use to cover partial withdrawal of deposits. LCR requires banks to hold adequate high quality liquid asset to cover all possible sources of liquidity pressures over a 30-day period, under stressed conditions. The reason for this is that wholesale deposits constitute a much less stable source of funds than retail deposits. The effect of the introduction of LCR and the NSFR is that their adoption would influence the zeal and confidence in developing countries' banks to take on wholesale foreign deposits, as they got integrated into the GFS, thereby increasing their capacity.

4. MACRO PRUDENTIAL POLICIES

4.1 COUNTER - CYCLICAL CAPITAL

One should note that a lesson learnt from the occurrence of the GFC is that micro prudential policies alone could not take care of the malfunctioning of the existing financial system, due to the negative externalities that aggravate systemic risks. Hence, when individual financial institutions (protect their own solvency) complying with micro prudential regulations; there is the need for macro prudential policies to guide the institutions in order to avert systemic instability.

It is in consideration of the fact that micro prudential regulations coupled with deposit insurance rules and central banks regulatory facilities could not prevent GFC that Basel III introduced some macro prudential measures. There is the introduction of counter-cyclical capital buffer. This buffer is at 2.5% of Risk Weighted Assets. The intent of this is to contrite excessive credit growth that would have manifest by the pro-cyclicality of foreign capital inflow.

4.2 PRO - CYCLICAL CAPITAL

Apart from the counter-cyclical measure that was introduced, Basel Accords introduced pro-cyclical measure. This aims at dampening cyclicality of the minimum liquidity requirements, while promoting stronger forward-looking provisioning against expected loan loss. This at the same time introduces capital conservation.

In the words of Calice, countries could alleviate the pro-cyclicality of CAR by having two levels of regulatory capital: the officially disclosed minimum and an extra cushion. The officially disclosed minimum would be enforced, while the extra cushion would be raised during periods of sustained growth, but reduced during

downturns. Such an arrangement would base on clear rules, so as to promote transparency, credibility, and protect supervisors from undue political and lobbyist pressures.

4.3 RE-ASSESSING THE IMPACTS

The innovations to financial growth and stability are highly commendable. Moreover, as good as the requirements and stipulations are, there are associated costs, even though there are benefits. Besides, there are some suspected flaws, which necessitate re-assessing the effects of these reforms. To some school of thought, these notable flaws probably stem from the inability of the G-20 to have some representatives of developing countries as members. Although three consultative documents were reportedly circulated by G-20 soliciting comments throughout year 2010, data collected through these documents have proved inadequate. One wonders the extent of participation of Asian and African developing countries financial representatives in the survey.

It is no news that Basel III requirements have been able to strengthen the resilience of banks globally. The fact remains that the associated costs of such benefit on real outputs are more negative on the developing economies than on developed economies. CAR and liquidity requirements reduced the lending ability of banks globally. Yet the ability to secure requisite finance is crucial to the emergence of the developing countries. Not only was the supply of trade finance reduced, long-term loan-able funds increased in costs.

Morgan and Pontines state that a number of potential problems, which Basel III generated for Asian economies are been identified. These include among others restricted lending and reduced economic outputs, increased cost of capital, and the possibility to constrain issuance of convertible bonds.

In the words of Pietro Calice (2010), the financial sector in most African countries differs substantially from those in industrialised countries. Yet, some of these countries already had undergone all-inclusive banking reforms. Hence, the sector was adequately capitalised prior to Basel III standards. Besides, with much smaller banking structure and less developed capital markets, African banking interests and needs are different. The global economic and financial reform agenda ought to note and consider this.

Moreover, in the perspective of some school of sort, macro prudential measures as proposed in Basel III would not likely be sufficient to mitigate systemic risks in Africa. According to the school, even thou macro-prudential regulations are relevant to Africa, the ones proposed in Basel III do not address perfectly the systemic threats from foreign capital inflows mediated through the banking system. Kasekende et al submitted that African countries need a wider array of instruments, such that could restrict large loan concentration and foreign exchange exposures.

Kasekende et al declare that even though the CARs aim at strengthening the resilience of banks against insolvency, there are other approaches that could have been strengthened by regulations, which reduce the risk factors in banks accumulation of assets. Alternatively, there could have been regulations that could raise

the share of risk-free assets in banks' total asset portfolio, relative to risky assets. Yet the efficacy of a given minimum statutory CAR depends on the risk factor in the composition of banks asset portfolios.

Further faults were found in CAR in that it is doubtful if the minimum global standard approach could protect banks in such a volatile environment as in developing countries. In addition, reference was made to the prevalence of non-performing loans in Africa. In 2009, for instance, banks non-performing loans ranged between 2 to 19% as a share of total loans, with an average of 9%. This is said to be three times as the level in advanced economies in 2009.

Kasekende et al therefore suggest that CAR ought to be supplemented with regulations that reduce risk factors (like restrictions on large loan concentration, insider lending, and foreign exchange exposures). In addition are such regulations that raise the share of risk free assets in the total portfolio (e.g. government securities or banks reserves held by the central banks).

While assessing the Basel III's introduction of counter-cyclical capital buffer of 2.5% of Risk Weighted Assets, Kasekende et al considered it too low. The buffer is said to be too low to contain excessive credit growth in African banking systems and could therefore be ineffective. A reason adduced to this is that the cause of credit growth in developed economies, which informed the postulation of 2.5% of risk-weighted assets (RWA), is quite different from the causes of credit growth in Africa.

Kasekende et al identified five main sources of credit growth or crunch in Africa. These include volatile external capital inflows or financial distress in cross border banks, unexpected economic upturns or downturns, credit concentrations or contractions in dominant sectors of the economies, distress of systemically important financial institutions, and hybrid of the combination of any of the four sources.

Carauna (2010) as cited by Kasekende et al stated that direct credit curbs and loans to value ratios have been in use in East Asia, to dampen the pro-cyclicality of credit, before the introduction of Basel III standards. Yet, a fixed percentage of total outstanding loans are being set aside by banks in some African countries as an element of expected loss in their provisioning requirements.

Nevertheless, one should note that the systemic risks that do emanate from external capital flows are not tackled in Basel III Accords. Equally is the issue of cross-sectional aspects of systemic risks. Basel Accords failed to address the issue of untoward large credit exposures of banking system that exist in not well-diversified economies. The effect of this cannot be divorced from the practice of shadow banking, which is inimical.

Conclusively, Kasekende et al highlighted that African banks face greater risks relative to their counterparts in advanced countries. Besides, loans issued by African banks are less diversified. Yet, weaknesses in the African legal system impede loans recovery.

Moreover, while Bernabe and Jaffar (2013) argue that banks in developing countries could meet with the set CAR through issuance of new shares, retained earnings and reduced loans, Kasekende et al counselled more progressively. Kasekende et al counselled that African banks should not increase their CAR by reducing their RWA, so as not to jeopardise economic growth. Rather, the banks could increase their CAR through retention of their earnings, without having to reduce lending. One wonders if the retained earnings would not have affected the paid out dividends that equity holders would have invested in probably juicier investments.

Moreover, Nnadozie (2011) posit that Basel regulations ought to base on global coordination, rather than the imposition of some regulatory standards by the developed countries on the developing countries. He expresses concerns about the instability of Euro and the US dollars, which could trigger further instability in the GFS. In his words, the EU and the US that are primary issuers of reserve currencies have already experienced serious debt problems.

Nnadozie notes that the gap between the G-20 pronouncements and what is now being implemented is quite wide and becoming wider as years moved farther away from the immediate post crises period. According to him, in question is the capacity of many banks in developing countries to compete with bigger and more established international banks.

Apart from Basel Accords, there is the Volcker Rule that was enacted in 2010 by the US via the Dodd Frank legislation. Volcker Rule proscribes banking institutions from engaging in proprietary trading. Under the rule, banks are prohibited from acquiring or retaining ownership interest in, or sponsoring a private equity or hedge fund. In addition to this, the rule outlaw banks from underwriting shares and from any market making activities (Morgan and Pontines).

However, it is not clear why Volcker Rule exempts US government securities from the prohibition against proprietary trading as cited in Morgan and Pontines. The rule is therefore perceived by some quarters as being discriminatory relative to other securities. Baxter (2012), as cited by Morgan and Pontines, asserts that such a rule could hinder banks liquidity and financial market development in developing countries.

Besides, Dodd-Frank mandates the US Commodities Futures Exchange Commission to impose extensive regulation on OTC derivatives. These would significantly increase transaction costs. With such, Baxter, as cited by Morgan and Pontines, stated that in any transactions involving non- US counterparties, the entities involved would face double regulation.

Should Basel Accords be to favour only banks' resilience without considering the extent of negative impacts it has on GDP growth rates in the developing countries? These and more related questions are what regulators in developing countries should consider to rethink their position. It should be at the back of their minds that developing countries were not adequately represented in reaching the Basel Accords because of the failure of

their countries GDP growth to meet certain standards. Therefore, considerations relative to promoting GDP should be sacrosanct.

Nevertheless, one should note the problems that cross border banking could pose for banks' regulation. There are systematically important financial institutions (SIFI), which have major market share among banks in the developing countries. The imposition of CAR on SIFI to ensure their resilience may prove to be highly counterproductive. Yet, coordinating supervision between home and host regulators of these SIFI may prove difficult.

It should be noted that Basel Accords do not state any regulation on external capital inflows. Yet, from macro-prudential view, the non-core liabilities, which pose the greatest risk, are short-term foreign currency liabilities. They could expose banks to credit risk, liquidity risk, and exchange rate risks (Kasekende et al).

Meanwhile, it is disturbing that some regulators in Africa appear not satisfied yet with the minimum standards set and thereby agitating for further increases, their Asian counterparts are saying the Basel set standards are too high. The Asians claim that such set standards could contrite investible funds in the developing and emerging market economies. One should note that the set standards are not even static, but annually increases in phases.

This perception corroborates studies done by the FSB and the BCBS (under the auspices of G-20), and IIF among others. Their findings are that bringing the global common equity capital ratio to the Basel agreed minimum and conservation buffer would result in a decline in real outputs growth rate. The IIF's position on this is that the Basel III standards would cut economic growth in Japan, US, and Euro zone by three percent within the timeframe of five years (Bernabe and Jaffar).

One should note that even though the three studies used different models, they arrived at the same conclusion. To buttress it, study done by the organization for economic cooperation and development (OECD) did not disprove. They all conclude that banks' higher capital requirements would lead to cumulative reduction in GDP.

Realising that the above four studies based their findings on developed economies, Morgan and Pontines cited Parcon –Santos and Bernabe (2012) and Bernabe and Jaffar (2013) to present the effects of the Basel Accords on the economic growth of two developing countries: Philippines and Malaysia respectively. The two found that an increase in capital requirements of the banking institutions led to drops in real GDP of the two developing economies. Please see annexure 2.

5. CONCLUSION

In conclusion, banks' regulators in Africa ought to cultivate the habit of acting on scientifically researched facts rather than on mere perceptions. Acting on scientifically proven facts would yield more credible positive impacts than actions that base on mere perceptions.

Besides, there appears the need for financial experts from purely developing countries (a semblance of G-30) to collaborate. They supposed to meet, deliberate, agree, and present financial policy statements, in conformity with Basel Accords, but which are pro GDP growth.

If such a semblance group is continental, for instance, members would have known the peculiarities of their countries financial economy. Hence, the task of fine tuning global reforms that could impede sectoral growth would be complementary and be wholesomely progressive.

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7. TABLES

Annexure 1: Timeline

Basel III: Global regulatory framework for more resilient banks and banking systems

Capital	2013	2014	2015	2016	2017	2018	2019
Min. Core Tier 1 Capital Ratio (% of RWA)	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer (% of RWA)				0.625%	1.25%	1.875%	2.5%
Min. Core Tier 1 plus Capital Conservation Buffer (% of RWA)	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from Core Tier 1		20%	40%	60%	80%	100%	100%
Min. Tier 1 Capital (% of RWA)	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Min. Total Capital (% of RWA)	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Min. Total Capital plus Capital Conservation Buffer (% of RWA)	8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Countercyclical Buffer	Range between 0-2.5% (common equity or other fully loss absorbing capital)						
Capital instruments that no longer qualify as Non-Core Tier 1 or Tier 2 Capital	Phased out over 10 year horizon beginning 2013 (reduction of 10% per year)						
Liquidity Standard							
Introduction LCR and NSFR*			LCR			NSFR	
Leverage Ratio							
Introduction Leverage Ratio						Leverage ratio	

Note: Italic numbers indicate transition periods and all dates are as of January 1st.

Reporting to supervisory authorities is expected by January 1, 2012 for both.

January 1, 2013 to January 1, 2017 – parallel run period.

Source: Accenture

Annexure 2: Studies on impacts of Basel III Capital adequacy and liquidity standards on GDP growth (percent points)

Study	Country	Methodology	Impact	Average	Cumulative	Average	Cumulative	Average	Cumulative
BCBS MAG (2011)	15 OECD Countries	Large scale macroeconomic models	Achievement of Basel III standard overtime	0.03	0.22				
		Reduced form models							
		Bank augmented DSGE models							
BCBS LEI (2010)	15 OECD Countries	Large scale macroeconomic models	One-percentage point rise in CAR;		0.09	0.08			
		Reduced form models	Meeting liquidity requirements						
		Bank augmented DSGE models							
IIF (2011)	US, euro area, UK, Japan & Switzerland	Banking sector model	Achievement of Basel III standard overtime					0.70	3.20
OECD, Slovik and Courneade (2011)	US, euro area, and Japan	IIF banking sector model and OECD macroeconomic model	Achievement of Basel III standard overtime					0.05 - 0.15	

IMF Roger and Vlcek (2011)	US and euro area	DSGE model with financial frictions and banking sector	Achievement of Basel III standard overtime	0.14	1.00	0.13	0.90	0.27	1.90
BSP Parcon-Santos and Bernabe (2011)	Philippines	Panel VAR model	One-percentage point rise in CAR	0.01					
Bernabe and Jaffar (2013)	Malaysia	Panel VAR model	One-percentage point rise in CAR	0.46					

Note:

CAR= Capital Adequacy Ratio; GDP= Gross Domestic Product; BCBS= Basel Committee on Banking Supervision; MAG= Macroeconomic Assessment Group; OECD= Organisation of Economic Cooperation and Development; DSGE= Dynamic Stochastic General Equilibrium; LEI= Long-term Economic Impact; IIF= International Institute of Finance; VAR= Vector Auto-regression

Source: As cited by Morgan and Pontines (2013)

Annexure 3: Basel III elements and key aspects

Basel III elements	Key aspects
Regulatory Capital	<ul style="list-style-type: none"> • Raising quality, consistency and transparency of the capital base • Predominant form of Tier 1 Capital must be common shares and retained earnings (common equity Tier 1, [CET 1]) • Deductions have been harmonized and generally applied at the level of CET1 • Tier 2 Capital instruments will be harmonized • Tier 3 Capital instruments will be eliminated
Risk Coverage	<ul style="list-style-type: none"> • Raising capital requirements for the trading book and complex securitizations • Capital requirement for counterparty credit risk (CCR) based on stressed inputs • Capital charge for potential mark-to-market losses (credit valuation adjustment, [CVA]) • Raising counterparty credit risk management standards (e.g. wrong way risk) • Strengthening standards for collateral management and initial margining • Establishing strong standards for central counterparties (CCP)
Leverage Ratio	<ul style="list-style-type: none"> • Introducing leverage ratio as a supplementary measure to the risk-based Basel II framework
Pro-cyclicality	<ul style="list-style-type: none"> • Dampening cyclicality of the minimum requirements (e.g. through-the-cycle parameters) • Promoting stronger forward looking provisioning (expected loss approach)* • Introducing capital conservation buffer • Introducing countercyclical buffer • Addressing systemic risk and interconnectedness (e.g. capital surcharge for SIFIs)*
Liquidity Standard	<ul style="list-style-type: none"> • Introducing liquidity coverage ratio (LCR) • Introducing net stable funding ratio (NSFR) • Introducing common set of monitoring tools

Source: Accenture