THE IMPACT OF REGULATORY REFORMS ON EMERGING MARKETS

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I. Executive summary

1.1 One result of the global financial crisis was the launch of a far-reaching agenda for the reform of financial services regulation, with a multitude of changes at global, regional and national levels. This transformation of the regulatory framework for banking is only partially implemented, and it is still too early to determine the full consequences for the business models and economics of banking. The resulting impact on the provision of finance and hence the broader impact on economic growth and job creation are only just beginning to be understood.

1.2 Given that most of the regulatory policy focus has been on the advanced economies, the effects of the changes for emerging markets are even less clear. However, it is inevitable that these markets will be affected: directly via local implementation of the international reforms; indirectly as international banks in advanced economies change their business models in response to the new regulatory landscape; and as a result of the knock-on impact of deleveraging in the advanced economies.

1.3 Continued economic growth in emerging markets is clearly vitally important to the overall health of the global economy. Given the challenges faced by the advanced economies, global economic growth is fragile and depends critically on sustained and robust growth in emerging markets. Understanding the impact of the regulatory reform agenda on these markets is therefore very important.

1.4 The impact and trade-offs of regulatory change may be very different for emerging markets than for the advanced economies. The international regulatory reform agenda has been driven primarily in response to the problems encountered in the advanced economies during the global financial crisis. Emerging markets are typically very different in terms of the health of their banking systems, the development of their capital and broader financial markets, and in the financial needs of the broader economy, given the pace and stage of economic growth and development. Consequently, it may be that some regulatory changes aimed at curbing problems in developed financial markets may not be appropriate for emerging markets where starting positions and dynamics are different.
1.5
As a snapshot, the table below highlights some of the key consequences:

<table>
<thead>
<tr>
<th>IMPACT ON BANKS OPERATING IN EMERGING MARKETS</th>
<th>Rising cost of finance</th>
<th>Liquidity constraints possible where regimes have been developed that do not match emerging market practices. Rising cost of capital leading to increased cost of credit and scarcity in some markets.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reduced availability of credit due to deleveraging</td>
<td>As banks in advanced economies delever, sell assets and focus on their home markets it is possible there will be a negative effect on emerging markets.</td>
</tr>
<tr>
<td></td>
<td>Fragmentation of finance</td>
<td>Policies including extra-territorial legislation and structural reform of banks could lead to a fragmentation of international finance.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IMPACT ON GROWTH IN EMERGING MARKETS</th>
<th>Trade and commodity finance</th>
<th>Capital and liquidity treatment could lead to reduced availability.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment and infrastructure</td>
<td>Liquidity rules could reduce the availability of long-term financing which would have a particularly negative impact on emerging markets that have particularly acute needs for new infrastructure.</td>
</tr>
<tr>
<td></td>
<td>Risk managment</td>
<td>Some regulatory approaches, such as the use of some hedging techniques to reduce capital requirements, seem alien to emerging markets.</td>
</tr>
<tr>
<td></td>
<td>Impact on development of financial markets</td>
<td>Risk that focusing on the policy response to the financial crisis will stop efforts to develop financial markets in emerging countries.</td>
</tr>
</tbody>
</table>

Figure 1. Table of key impacts from regulation
II. Introduction

2.1 Following the financial crisis in 2008 G20 leaders agreed a far-reaching series of actions to reinforce financial stability. The task force welcomes the determination of G20 governments to implement fundamental reforms such as Basel III on a consistent international basis. Additional measures are being taken at a regional level and by national governments, especially in the advanced economies, to supplement the core international standards being developed and implemented under the leadership and guidance of the Financial Stability Board (“FSB”) and the Basel Committee of Banking Supervision (“BCBS”). Some countries have also sought to implement the international agreements well ahead of the agreed timetables.

2.2 Emerging markets have different challenges and priorities to advanced countries. The banking sectors in these countries are often fundamentally different in nature and sophistication. Financial markets are often far less developed, so capital markets represent much less of an alternative to bank credit. In advanced economies, dealing with the ‘too big to fail’ problem and managing an orderly deleveraging process loom large as regulatory priorities. In many emerging markets, there is typically much greater emphasis on the role of banks in supporting economic growth and job creation given that capital markets are often underdeveloped, and these banks are also increasingly competing with advanced market banks on the international stage. In this context it is particularly important to ensure that they are healthy and able to deliver sustained levels of credit for investment in emerging markets. In facilitating the global trade and investment flows that underpin global growth, all banks have a role to play, but international and regional banks clearly play a particularly important role in this respect.

2.3 We take as given that healthy banks are a prerequisite for healthy economies, and that the health of banks depends in part on the health of the economies in which they operate. Moreover, we take it as axiomatic that healthy banks benefit from strong and effective regulation. Equally, banks will only be healthy where they continue to remain attractive to investors and are therefore able to secure the funding and capital they need to support their customers and clients. The fundamental changes that are happening to banks’ business models and economics, as a result of regulatory reform will undoubtedly have a significant impact on the cost and availability of credit in all markets. Banks in emerging markets play a particularly crucial role in supporting economic growth and job creation given that capital markets are often underdeveloped, and these banks are also increasingly competing with advanced market banks on the international stage. In this context it is particularly important to ensure that they are healthy and able to deliver sustained levels of credit for investment in emerging markets.

2.4 This paper highlights some specific areas where the task force believes policymakers should give greater consideration to the impact of the reform agenda on economic growth in emerging markets. We focus on the extent to which policy changes, largely driven by

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1 For example the Independent Commission on Banking and bank levy in the UK, Dodd Frank in the US and proposed structural reforms in France.

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2 Three of the five largest banks in the world by market capitalisation (as at the end of 2009) were Chinese (while a fourth—HSBC—has extensive links to China); and 7 of the top 20 banks (by market capitalisation) were in emerging market economies. Emerging market banking systems are thus important not only from a national systemic perspective, but now also globally.
the advanced economies, might not match the needs, characteristics or capabilities of emerging markets. The regulatory reform agenda should aim not just to reinforce financial stability, which is obviously a top priority, but also to protect and enhance the role and effectiveness of banks in supporting economic growth and job creation. Moreover, the regulatory reform agenda must be responsive to the differing needs of countries at different stages of economic and social development.

2.5
Although we use the term “emerging markets” as shorthand throughout this paper, we appreciate that these markets have as many differences between them as with developed markets. However, what they share is an imperative on economic growth, a need for greater financial inclusion and relatively less developed and less liquid financial markets. In Figures 1 to 6 in this paper we have separated out G7 markets and emerging markets constituting the 10 largest emerging market countries by GDP (Brazil, India, Russian Federation, Mexico, Turkey, Indonesia, Poland, Saudi Arabia, Venezuela and Argentina). Where listed, China has been categorised separately because its size and characteristics are so different.

2.6
This paper addresses: first, the impact of regulation on banks operating in emerging markets, particularly in terms of cost of finance, deleveraging and fragmentation; second, the consequent impact on growth in emerging markets; and finally, some proposed steps to address these issues. Appendix A sets out some thoughts on the differences between emerging and developed markets.

III. Impact on Banks Operating in Emerging Markets

3.1
The full impact of current reforms is not yet clear. As they are only partly implemented, some details are still to be worked out, and there are still uncertainties about the approach and timeline for full implementation. In theory, only those countries that are members of the BCBS\(^3\) need to implement Basel III. Some BCBS member countries may delay implementation; equally some emerging markets that are not members of BCBS may choose to develop similar regimes. However, it is clear that banks in advanced economies will need to change their business models significantly to meet the new regulatory requirements and that this is likely to result in:

i. increasing cost of finance;
ii. significant deleveraging (at least for certain activities or assets); and
iii. fragmentation of the international banking model (driven by a combination of concentration on home markets, forms of “ring-fencing” and the extra-territorial impact of domestic legislation).

Rising Cost of Finance – Liquidity

3.2
Inadequate liquidity regulation in advanced countries undoubtedly contributed to the financial crisis. The Basel III liquidity regime introduces two requirements:

3 BCBS members are Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.
the Liquidity Coverage Ratio (“LCR”) and Net Stable Funding Ratio (“NSFR”), which are designed to prevent the failures experienced during the crisis. These changes to liquidity rules are likely to have a powerful impact on both advanced and emerging economies; although not necessarily in the same ways.

3.3
Many emerging markets had already established robust regulatory regimes for liquidity, learning the lessons from previous financial crises. There is a lack of clarity about how the Basel III regime will work in these markets, not least since they operate different banking models. Over and above the differences of individual countries and regions within the emerging economies group, there are some issues arising from the new regulation that are common to most of them.

3.4
The Basel III requirement under the LCR to hold very high quality liquid assets within buffers poses particular problems for some emerging markets. Emerging markets issue significantly less sovereign debt than advanced economies (see Figure 2) and some do not have enough sovereign debt in issue to enable their banks to meet the buffer requirements of the new Basel rules. Taking the alternative of making central bank placements will increase the cost of liquidity and thus increase the cost of finance. Alternatively, emerging markets might issue more sovereign debt so their banks can meet the liquidity requirements. Given the sovereign debt issues in the West it would seem a strange outcome for regulatory policy.

3.5
In some emerging markets, banks may be able to increase their holdings of highly rated liquid assets from other countries. As advanced sovereigns continue to face ratings downgrades, we expect banks to target alternative high grade assets for such purposes, increasing demand for securities from stronger emerging market sovereigns such as Abu Dhabi (AA), China (AA-) and Qatar (AA). The availability of such paper is likely to be very limited, so banks will look at sovereign backed entities from these jurisdictions. However, holding liquidity buffers in foreign securities, however highly rated, is far from perfect for liquidity buffer purposes, given foreign exchange and country risks.

Figure 2. Central government debt (% of GDP)

![Figure 2: Central government debt (% of GDP)](image)

Source: The World Bank
3.6
Another way to meet the LCR liquid asset buffer requirement is to hold high quality non-sovereign instruments, such as covered or corporate bonds. These can comprise up to 40% of the buffer and are subject to haircuts. However, in most emerging markets such instruments are in scarce supply. Covered bonds are insufficiently developed as an asset class. Highly rated corporate paper will not be available in sufficient quantities, partly because overall corporate bond issuance is much more limited (as Figure 3 below indicates) and partly because of rating constraints. To qualify for the LCR liquid asset buffer, corporate bonds are subject to minimum credit rating requirements, which are capped at the rating of the country. Yet many emerging markets are rated lower than the minimum standards required by the LCR.

3.7
Such issues about the appropriateness of the LCR for emerging markets are not limited to the definition of the buffer, but also affect the treatment of liabilities. For example, not all countries operate deposit insurance schemes, yet the Basel III liquidity regime identifies deposit insurance as a key criterion to classify deposits as stable. In such cases the depth of relationship between the bank and the client and the channel by which the deposit has been gathered could be a better indicator of deposit stability under stressed conditions.

3.8
The ongoing review of the LCR, covering both the definition of eligible assets for the liquid asset buffer, and the treatment of different classes of liabilities, thus needs to take full account of emerging market considerations.

3.9
The NSFR looks even more problematic than the LCR. The European Banking Authority (“EBA”) estimates that European banks alone will face a shortfall against the NSFR of around €1.9trn, which is around 75% of the size of the European senior debt market. This obviously represents a significant challenge for European banks as they also seek to meet the other challenges of a distressed economic outlook. This is also likely to be extremely demanding for emerging market banks, partly because of the limited depth in local funding markets and partly because of the resultant stress on global funding markets. The current review of the NSFR needs to consider emerging market concerns.

3.10
In addition to the direct impact of the Basel III liquidity regime on emerging market banks, there is likely to be a powerful indirect impact as banks in advanced economies, and particularly Europe change their business models in response to the regulatory requirements. Areas like project finance are likely to be particularly affected, given the long tenor of the assets, and the extent of international bank involvement in providing such finance. This will have a direct impact on infrastructure development in emerging markets. Nomura concludes that the Basel III liquidity regime

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4 Eurozone and Basel III – Fears for Tears, Nomura analyst note, 4 May 2012

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![Figure 3. International Bonds and notes ($) / GDP Year 2010](image-url)
“…has the potential to markedly alter global asset allocation decisions, the conduct of central bank monetary policy and the shape of global yield curves.”

Rising Cost of Finance – Capital

3.11 The greatest impact of the Basel III capital requirements is likely to fall on advanced economy banks. Many emerging market banks were, in the past, better capitalised though banks in advanced economies have significantly increased levels of capital over the last few years. International banks active in emerging markets may have to change their strategies and business models as a result. Figure 4, below, shows how these trends have changed. (China has been separated due to its size and differing characteristics from other emerging markets.)

3.12 A number of emerging markets operate effective and interventionist macro-prudential regimes. Basel III gives little consideration to the benefits that this can bring from a financial stability perspective. Effective macro-prudential regulation embeds a degree of safety in the overall regulatory regime which means that additional capital requirements may offer less incremental benefit.

3.13 A number of assessments have been conducted on the additional costs of the Basel III capital requirements and the impact these will have on economic growth and credit supply in advanced economies. Less attention has been given to the impact on emerging markets. However, the World Bank estimates that an increase in capital ratios in advanced economies of 2% could reduce GDP growth by 0.3% in emerging markets with large banking flows.

3.14 The G20 has commissioned the FSB, World Bank and International Monetary Fund (“IMF”) to undertake an analysis of the impact of the regulatory reforms on...

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5 The Institute of International Finance undertook an assessment of the cumulative impact of the regulatory reforms whilst the BCBS Macroeconomic Assessment Group (“MAC”) has considered the impact of implementing Basel III.


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Figure 4. Tier I capital ratio (%) trend over time: G7 vs Emerging market countries

![Graph showing capital ratio trend over time](image-url)
emerging markets. Some research has also been carried out by the private sector (as shown in Box 1).

**BOX 1**

**Impact of Financial Regulation on Emerging Countries**

In March 2011, BBVA Research released an impact study of financial regulation on emerging countries. The paper analyses the potential impact of a higher level of capital and liquidity of banks on the credit penetration and the economic development in emerging countries. To do so, it employs an econometric exercise in two stages. In the first stage, it estimates the impact of capital and liquidity on the quantity and the price of credit. In the second stage, it quantifies the impact of credit and its price on the GDP per capita, which permits to channel the impact of higher capital and liquidity requirements on the real sector. In summary, the effects of increasing capital and liquidity levels are stronger in emerging economies than in developed ones in terms of credit over GDP. The results show that if capital over assets increases by 20% the impact over GDP per capita would be -1.6% for the whole sample and -2.5% for emerging countries. In turn, if liquid reserves over assets increase by 20%, the effect over GDP per capita would be -0.4% for the whole sample and -0.5% for emerging economies.

Results: aggregation of the channel of the banking credit and the channel of the net interest margin

| EFFECT ON THE GDP PER CAPITA OF A 1% INCREASE IN THE FOLLOWING VARIABLES: |
|-----------------|-----------------|-----------------|-----------------|
|                  | Total Low interval | Total High interval | EMES Low interval | EMES High interval |
| Bank capital to assets ratio | -0.02 | -0.08 | -0.04 | -0.13 |
| Bank liquid reserves to bank assets ratio | -0.1 | -0.02 | -0.01 | -0.02 |
| Capital and liquid reserves | -0.03 | -0.10 | -0.04 | -0.15 |

*Using values of 2008. Source: BBVA Research (March 2011)*

The BBVA research does not focus on the reasons behind the greater impact of capital and liquidity on emerging markets. However, there could be several reasons for this differentiated impact, for example, the scarcity of capital, the need for more capital relative to assets consequence of a higher credit risk in emerging markets. In terms of liquidity, given the less developed nature of financial markets in these countries, the banks might have to maintain higher amounts of liquid assets.

Emerging economies face a challenge that is different to that of more advanced countries, and are seeking sustained growth in a long-term perspective to bring their average income into line with developed economies, develop their financial systems, and, at the same time, extend access to financial services to the poorest segments of the population.

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9 A 1% increase in both capital and liquid reserves causes a decrease in GDP between 0.04% and 0.15% in emerging economies and between 0.05% and 0.10% for the whole sample.

3.15
As banks consider the additional prudential requirements, they are also acutely aware that they need to offer requisite returns for investors, not least so they can secure the additional capital and funding they need to meet new regulatory requirements. Figure 5 shows that return on equity has fallen below cost of equity for G7 banks and therefore they face considerable pressures to overcome these trends. Some banks in developed countries have taken radical steps to restructure their businesses, often exacerbating the reductions in capital deployed to emerging markets. Others meanwhile, may have been able to maintain lending in their host markets in emerging economies, especially if they were able to secure a higher return in these markets.

The BIS Quarterly Review in December 2008 concluded that "A robust finding is that deterioration in banks’ health and stresses in mature interbank markets from the early 1990s to mid-2007 consistently led to slower growth in international credit to emerging markets."

3.16
In addition to the core Basel III measures on capital there are a number of other changes to capital regulation that have an impact on emerging markets. For example, implementation of Basel 2.5 is generating considerable deleveraging of trading positions by advanced economy banks, affecting liquidity in emerging markets and the development of their financial markets.

3.17
Furthermore, authorities in the advanced economies are now developing bail in tools for ensuring that banks are easily resolvable in a crisis. These moves are welcome, but as the FSB and BCBS seek international consensus it is important they consider whether the reforms proposed will be appropriate for emerging economies, given the differing structure and characteristics of their bank funding markets and the state of development of their capital markets.

Figure 5.
Return on equity and cost of equity for G7 and emerging markets, 2007 and 2011

Source: PwC analysis
3.18
More generally, in designing and implementing counter-cyclical capital buffers, it is important to recognise the significant differences between the required rates of credit growth in advanced and emerging markets. Advanced markets, with more mature economies, should not need anything like the pace of credit growth we would expect to see in emerging markets, to support continued rapid economic growth and social development. As a result, what might appear an unsustainable level of growth in an advanced market may be much lower than the optimal level in a growing emerging market with far lower levels of credit penetration (see Figure 6).

3.19
Banks in some emerging markets have tended to operate with levels of capital above those held by advanced economy banks in earlier years, to maintain an “emerging market premium”. However given that Basel III now requires all banks to hold higher levels of capital, and that banks operating in the emerging markets have demonstrated their strength through the crisis, the rational for holding such an increment seems questionable. The latest analysis from PwC (figure 4) shows that G7 banks are now operating on levels of Tier 1 capital similar to emerging markets. However, this does not mean these countries should automatically seek to match the levels currently being maintained by the G7 banks. As the BBVA research highlights (see Box 1, above) the economic impact of increasing capital is likely to be most acutely felt in emerging markets.

Reduced Availability of Credit Due To Deleveraging

3.20
International banks are being forced to make choices about the allocation of capital between countries and activities. There is a danger that mandatory requirements for capital in the ‘home’ markets of advanced economy banks leads to a reduction in capital allocation to other countries. The approach taken with the recent EBA stress tests is an illustration, with European banks required to meet the new 9% Core Tier 1 requirement without reducing lending in the EU.

Figure 6. Domestic Credit/gdp average

<table>
<thead>
<tr>
<th>Year</th>
<th>Emerging market countries average</th>
<th>G7 average</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2006</td>
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<td>2010</td>
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</tbody>
</table>

Source: The World Bank
Evidence to date suggests that deleveraging and asset sales could for many banks come at the expense of non-core markets, which for advanced economy international banks will invariably mean emerging markets. However, there are steps that can be taken to address these issues. For example, the Vienna Initiative, originally launched in 2009 at the height of the global financial crisis was designed to help maintain financial sector stability in emerging Europe by encouraging cross-border banking groups to maintain their exposure to the region as a whole and to maintain adequate solvency levels for their subsidiaries. A new phase has been required in 2012 as a response to renewed risks to the region stemming from the international environment.

Fragmentation of Available Finance

3.22
Continued growth in international trade flows is critically important for emerging and developed markets alike. A number of factors could well reduce the ability of international banks to facilitate these flows:

3.22.1
Some banks, especially those that have received equity investment from governments, have come under considerable political pressure to ensure that financing is primarily provided in their home markets. This may come in the form of explicit pressure to reduce commitments to non-core markets, or in the form of politically agreed lending targets for domestic sectors, which could well have much the same effect.

3.22.2
Structural reforms and other regulatory disincentives to cross-border activity are creating new impediments to financing international trade and investment flows. As a result of reforms to bank structures in the advanced economies (e.g. the Independent Commission on Banking in the UK, the Volcker rule in the Dodd Frank legislation in the US), as well as changes to large exposure limits and cross-border booking requirements, it seems very likely that we will see increasing fragmentation in international banking. This could have a profound impact on many emerging markets, which are often reliant on international banks and financing, given the limited depth and development of their domestic financial markets. This is likely to have a significant impact on the pricing and availability of some aspects of financing, including trade finance and project finance, as well as affecting the ability of these markets to absorb financial shocks. Measures such as the regime for Global Systemically Important Banks (“G-SIBs”) further incentivise banks to constrain their cross border activities – as the methodology carries a 20% weighting for cross-border activities in the analysis.

3.22.3
The extra-territorial impact of national policies could have a significant impact. In the aftermath of the financial crisis, G20 policymakers agreed to co-operate on developing consistent reforms. However, some countries have embarked on national reforms with potentially significant extra-territorial effect, such as Dodd Frank, which could have the effect of limiting the sovereignty of emerging markets in developing their own regimes and restrict access to US markets. For instance, Dodd Frank requires that all swaps with US companies and US banks must be transacted out of a swap dealer that is registered and regulated by the Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”). A foreign bank would have to register as a swap dealer with the CFTC before it can trade with US companies and US banks on swaps (subject to very limited exceptions). The most likely choice of entity registration for the foreign bank would be its home country head office where the global swaps businesses are centrally booked and managed. Under Dodd Frank, the SEC and CFTC would then have regulatory
oversight over the foreign bank home country entity, and this may subject the entity to duplicative and inconsistent regulatory requirements and potential tension with home country regulators. The UK bank levy is another example, since this is applied to a UK domiciled bank’s global liabilities, not just those in the UK. (Further examples are set out in Appendix B.) Emerging markets that weathered the crisis well are thus experiencing regulatory intervention in their banking systems due to the extra-territorial impact of policies from the advanced economies that experienced far greater failures.

3.22.4
Recovery and Resolution Plans ("RRPs") are an extremely valuable component of the overall regulatory reform agenda, but could have a damaging impact on international banking and emerging markets in particular, if home regulators of internationally active banks take too parochial an approach. In developing effective resolution regimes, it is essential that home supervisors collaborate with the key host supervisors of an internationally active bank, including those in emerging markets, focusing on resolution techniques that are aligned with firms’ structures, in particular whole firm resolution techniques such as bail in. Assessment of the adequacy of bail-in-able liabilities should be on a consolidated basis as part of the Pillar 2 process. There should be a clear understanding of how home regulators would carry out their coordinating responsibilities with their host counterparts.

IV. Impact on Growth in Emerging Markets

4.1
The previous section considers some of the challenges banks operating in emerging markets face as they seek to grapple with the regulatory reform agenda. The next section considers how the regulatory pressures affecting banks in emerging markets could feed through into the different financing needs of businesses and thus economic growth and job creation.

Trade and Commodity Finance

4.2
Trade and commodities are key to economic growth in many emerging markets so trade finance and commodity finance therefore have a vital role to play in improving the current global economic outlook. At a global level, trade finance supports $14-16trn of trade annually. It is particularly relevant to emerging markets given the role that export related businesses play in their economic development and also because of the higher take up of documented trade finance in these markets. Products like Letters of Credit ("LCs") are much more widely used in Asia and emerging markets than the advanced economies, with both SMEs and much larger companies in emerging markets using LCs in their day to day export and import activity. Over 55%\(^\text{12}\) of all LCs are for exports from Asia, Africa, the Middle East, Central and Latin America showing the importance of trade finance as an important source of credit for these growing markets.

\(^{12}\text{SWIFT MT 700 data from "SWIFT Watch"} \)
4.3 Trade finance is particularly important for SMEs and smaller corporates, as it is an easier and cheaper way for them to borrow than other debt funding because it is more structured and self liquidating. This is particularly relevant to SMEs, because their higher risk profile would otherwise mean higher capital requirements, more expense for the banks and additional costs for customers.

4.4 Trade finance plays a crucial role in supporting real economic activity yet poses minimal risks to financial stability and made no contribution to causing the global financial crisis. An example would be an LC to facilitate import/export business. Such deals are short-term, with an average tenor of between 90 to 180 days with very low default rates (around the 0.1% mark). Across the industry default rates for import LCs sit at 0.077% with a loss rate of only 0.007%. The highest default rate for trade finance products is seen in export loans to corporates, with a default rate of only 0.290%.

4.5 Trade finance therefore seems exactly the type of product policymakers should support, given its role in supporting economic growth and its limited credit and liquidity risk characteristics. Unfortunately, this perspective is not reflected in the current Basel III regulatory proposals. In fact the combined impact of Basel II and Basel III on trade finance is very significant and out of all proportion to the limited risks these activities pose. As a result the task force has concluded that policymakers should seek to make the following changes:

4.5.1 Capital - A waiver of the one year maturity floor for Trade Loans and Receivables and agreement that there should be a harmonised approach to implementation. Creation of a Trade specific Asset Value Correlation (“AVC”) or risk curve and a harmonised approach to implementation.

4.5.2 Liquidity - A defined liquidity requirement for Trade Contingents (LCs and Trade Guarantees) based on data from the International Chamber of Commerce. Recognition of Trade Finance inflows from corporate counterparties at 100%. The Basel III rules prescribe that inflows from exposures to Financial Institutions are recognised at 100% during stress – i.e. that 100% would repay on maturity - whereas only 50% of inflows from corporate clients are recognised. Given the unique characteristics of trade finance, it would be much more logical if inflows on both corporate and financial institutions were recognised at 100%. Capping inflows at 50%, and therefore adding a liquidity buffer cost to the business, puts pressure on the viability of export/import financing and thus may lead to banks pulling back – rather than growing – this key source of economic growth.

4.6 In October the BCBS announced some proposals to improve the capital treatment of trade finance. The announcement was strangely asymmetric in that it only affected LCs for imports to low-income countries ("LCIs"), and not exports from LCIs. As such, it seems to benefit exporters from advanced economies over emerging market exporters.

4.7 If banks do not supply trade finance, then the practice will move into unregulated shadow banking or disappear altogether - both unattractive outcomes. There is already considerable evidence that banks have and may continue to dramatically contract this relatively low margin form of lending.13

4.8 Commodity finance faces many of the same issues as trade finance in general, not least because trade finance

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13 According to data from Dealogic in Q1 2012 trade finance figures were down 18% year-on-year. Activity also fell to 173 deals, down 39% on Q1 2011 when 282 deals were completed.
plays a significant role in facilitating cross-border flows of commodities. With Dodd Frank and Basel III some banks have threatened to exit commodity finance altogether. The predominantly USD nature of this business is an added complexity for banks without access to sufficient USD funding.

**Investment and Infrastructure**

4.9
Many emerging markets have significant demand for infrastructure finance. International financial institutions provide a particularly important role by helping to finance large scale infrastructure projects in emerging markets (see Figure 7).

4.10
We welcome the review that is to be undertaken to consider the impact of the liquidity requirements in Basel III. Although we are supportive of effective liquidity regulation it is essential that the impact on key activities such as infrastructure investment is not negatively affected. Taken together, it is likely that the liquidity requirements will make project finance a less attractive proposition for banks. In particular, the NSFR is likely to mean that it will be more costly to initiate project finance, even when debt would be subsequently restructured. The NSFR rules require banks to match long-term obligations with long-term funding which will increase the cost of liabilities to fund infrastructure finance. There are already signs that project finance is starting to reduce. In Q1 2012 project finance funding reduced significantly (according to Dealogic, funding in Asia (excluding India) fell 32% to $10.2bn,

Most trade and project finance, going from advanced markets to emerging markets, comes from Europe and Central Asia

Figure 7.
Origin of Trade, Project and Commodity finance form advanced markets\(^1\) into emerging markets

\(^1\) Advanced economies are those classified ‘high income’ by the World Bank

Source: Dealogic
in Middle East/Africa it fell 21% to $3.5bn and in the Indian sub continent it fell 58% to $13.1bn). Whilst some of this fall can be accounted for by other macro-economic developments, it is likely that at least some of this decline is a direct consequence of increased capital and liquidity requirements. If this is the case it is likely that key infrastructure projects will become more difficult to fund (and most likely more expensive) at a time when there is a need for significant infrastructure investment both in emerging and developed markets. This situation could be compounded as European banks seek to either delever or sell assets and/or move out of project finance because it has comparatively low margins and they face increased profitability pressures. It is likely that there will need to be fairly radical changes in the way these projects are structured for continued funding to be available.

4.11
It is not clear whether institutional investors may cover some of the financing gap if banks are to reduce the amount of project finance they offer. In emerging markets, however, institutional investors tend to be relatively underdeveloped, while foreign investors generally shy away from illiquid, long-term investments in these countries. There may be few private sector options available if both foreign and domestic banks withdraw to some extent from project finance. The OECD is currently working on these issues and more generally on the promotion of long-term and infrastructure investment. It could be invited to deliver a report to the 2013 G20 Summit.

Risk Management

4.12
Some of the requirements set out in Basel III appear to have been written with a bias towards the banks in advanced markets, and investment banks in particular. An example is the Credit Valuation Adjustments (“CVA”) capital charge for counterparty credit proposed in Basel III.

4.13
As a result of the way the CVA will be calculated it will be possible to reduce the CVA charge by using Credit Default Swaps (“CDS”) to hedge. This is likely to have two negative impacts for banks in emerging markets:

4.13.1 Unnecessarily increasing complexity. Whereas investment banks often seek to hedge out the counterparty credit risk component of a derivative transaction, most banks in emerging markets feel they exist to extend credit risk directly and are often already extending credit to their derivative counterparties, whether banks or corporates. Adopting the CVA approach entails deploying distinct methodologies for the credit risk for a loan and the credit risk relating to a derivative transaction for the same counterparty. For example, when a bank provides a currency hedge on top of a trade finance transaction, it will derive two different estimates of default risk, one based on the Advanced Internal Ratings Based (“AIRB”) approach (or Standardised or Foundation) and one on the CVA approach, which could well be very different. This will significantly complicate risk management and create the risk of regulatory arbitrage for no obvious benefit. Moreover, because they are derived from credit spreads, the CVA charge itself is likely to be both significantly higher than conventional credit analysis would imply, and considerably more volatile, particularly in emerging markets, where liquidity in the underlying instruments is often extremely limited. CVA charges will particularly penalise the lower-rated counterparties prevalent in emerging markets. Market analysts estimate that for emerging market banks capital requirements for derivative counterparties will increase by 2-4 times. This will inevitably increase the cost and reduce the availability of hedging instruments for emerging markets corporates and financial institutions.

4.13.2 Scarcity of appropriate CDS for CVA hedging. The CVA approach creates significant incentives to hedge through CDS. Yet there is a scarcity of single name
cds across emerging markets. Cds markets are extremely illiquid, especially in emerging markets, and single name cds are often only available in the five year maturity bucket and in USD. This will make hedging cva extremely onerous and difficult. Indeed the complexity of constructing hedges, taking account of maturity and currency differences, as well as the illiquidity of the underlying instruments, brings considerable risk. Because there will be so many dimensions of mismatch, such “hedging” could become more dangerous than not hedging at all.

4.14
Cva will impose significant costs on non-financial counterparts entering into derivatives contracts where they are not centrally cleared. These costs do not reflect the very limited systemic risk these activities pose to the financial system. As a consequence the cva capital charge is likely to impose unexpectedly high costs on corporates and project finance where derivatives are used to manage these risks.

4.15
We encourage policymakers to rethink the cva approach. It seems odd for the bcbs to mandate an approach designed for trading derivatives between sophisticated financial institutions, rather than the well-established credit risk approach used by commercial banks with their corporate clients, particularly when the risks of over-reliance on credit spreads and hedging through credit derivatives are well known. We welcome the European Parliament proposal to exempt some corporates from cva requirements, as part of the implementation of Basel III in the European Union. We believe the bcbs should adopt a similar approach for global application.

4.16
More generally, as governments seek to implement the g20 commitments on derivatives, including the creation of central counterparties and the cva approach however modified, it will be important to consider the ability of emerging markets to put in place adequate frameworks, especially where local financial markets are not highly developed and the infrastructure for central clearing and settlement agents may not be available. Policymakers should seek to establish realistic and consistent implementation timetables across jurisdictions, to ensure a level playing field and avoid market distortions and transition risks.

Impact on Development of Financial Markets

4.17
Significant empirical evidence shows that effective and efficient financial markets are an essential prerequisite for economic growth in emerging markets. Academic research shows that deeper financial markets provide greater financial stability, lower the costs of government financing and increase the financing options for businesses to grow.\textsuperscript{14} It is essential therefore that the momentum to implement reforms to create deeper financial markets in emerging markets is not lost as steps are taken to implement the g20-led regulatory agenda. The following issues should be considered:

4.17.1
Distraction – the needs of emerging markets are different. Many already had a safety first approach having changed their regulatory frameworks following previous financial crises, most notably the response to the Asian financial crisis in the late 1990s. However, there is a risk that the international regulatory reform agenda could divert effort from equally essential initiatives, such as developing deeper capital markets. Such fundamental reforms

\textsuperscript{14} The imf (Enhancing Financial Sector Surveillance in Low-Income Countries, April 2012) notes that “shallow financial markets tend to increase foreign exchange, liquidity management and concentration risks, posing risks for financial stability”. It adds that “well-developed financial markets and institutions can help dampen the negative impact that exchange rate volatility has on firm liquidity and investment capacity.” In markets that are not developed banks will tend to hold excess liquidity on their balance sheet because they are unable to “smooth their intraday liquidity to efficiently manage unexpected financing needs.”
would provide both greater financial stability (because markets would be deeper, more liquid and less volatile) and significant economic benefits. It is therefore important that these longer term priorities are not forgotten and that international partners continue to assist with the overall development of emerging market financial systems.

4.17.2
International USD liquidity – increasing fragmentation of international banking will likely lead to less liquidity and increased credit costs in USD. For activities such as trade and project finance which remain predominantly denominated in USD this could pose particular problems. As a result, we may see local banks increasing their use of local currency dollar swaps to access borrowing, which could potentially create further risks, or shifts away from the USD for such purposes. Ultimately, development of local currency bond markets is the optimal route for reducing emerging market dependence on international USD funding, underscoring the importance of continued progress on this front.

4.17.3
Loss of diversification benefits - a diversified banking market provides benefits from a financial stability perspective both for those in home and host countries. At a macro-level there is a risk that the deleveraging of international banks will lead to local concentration of banking models in emerging markets and for advanced banks a concentration of risk in home markets. As a result it may be more difficult for banks to cope when they are faced with financial stability risks. The financial crisis highlighted the benefits that well managed international banks can offer when providing credit into markets in which domestic banks may be overburdened. World Bank research\(^\text{15}\) suggests that during an economic crisis, international banks are an important source of market liquidity and credit to the economy. Domestically-focused banks are often compromised by a shock to the domestic economy, because their balance sheets will be concentrated on the local economy and markets.

4.17.4
Shadow banking – if the costs of credit provision are to increase significantly some elements of credit provision may migrate outside the regulated banking sector. It will be important for regulators to consider the risks that this may pose. In this sense, the work by the FSB and the EU Commission on shadow banking is essential to avoid stricter banking regulation leading to regulatory arbitrage and the channeling of financial flows through inadequately supervised and opaque segments of the financial system. It is also crucial to ensure the consistency in the regulatory treatment of shadow banking at all levels.

4.18
Finally, it is important to recognise the potentially profound impact of the action of central banks in the advanced economies on the emerging markets. Since the crisis, central bank balance sheets in the advanced economies have increased dramatically due to Quantitative Easing (by the US Fed, the Bank of England and the Bank of Japan) and the Long-Term Refinancing Operations of the European Central Bank. In the short-term these operations have clearly been important for securing financial stability in advanced markets. However, as their operation continues it will be essential to consider what impact they might have on the global financial system, especially emerging markets.

\(^{15}\) Foreign Bank Participation in Developing Countries, World Bank, August 2010
This paper is intended to start a discussion on the impact of the international regulatory reform agenda on emerging markets. It does not provide definitive conclusions, because the current indicators and data do not support this. The paper describes issues and potential unintended consequences arising from the regulatory reform agenda which the task force believes could be damaging to economic growth and job creation in emerging markets. Further work will be required by policymakers and industry participants to calibrate the likely impact of these changes and to define an appropriate policy response. In particular we recommend:

A FULL IMPACT ASSESSMENT - to assess the economic impact of the regulatory reform agenda on emerging markets, including both the direct effects of these markets seeking to comply with international requirements and the indirect impact via the responses to regulatory change of banks from advanced markets active in emerging markets. The focus of this work needs to be on the end users of bank products and services, and thus on economic growth and job creation.

A CONFERENCE OF GLOBAL LEADERS - including political, finance, business and regulatory leaders to consider the specifics risks posed to emerging market economies from the regulatory reform agenda.

A CLEAR ROADMAP FOR CHANGE - an international, consistent and harmonised approach to bank regulation is a worthy goal. However, it is important that this fully takes account of the very different states of banking models in advanced and emerging economies and the distinct financing needs of these economies, reflecting their stage of development. As a result, it may well be that some changes are required to be made to the international regulatory reform agenda, as currently defined, to mitigate unintended consequences on emerging markets, and to ensure it fits their needs in both substance and timing.

INFRASTRUCTURE IMPACT - the OECD is currently assessing the potential impact of the reduced financing for infrastructure projects and more generally on the promotion of long-term and infrastructure investment. It could be invited to deliver a report to G20 to set out options for avoiding a reduction in infrastructure financing, with a particular focus on emerging markets.
APPENDIX A: DIFFERENCES BETWEEN THE MARKETS
This appendix provides a high level overview of the differences firstly between the developed and emerging markets and then seeks to highlight the differences between the financial services sector in emerging markets as well.

**Differences Between Emerging and Developed Markets**

Generally advanced market financial services are more developed with deeper and more liquid capital markets. As a result the penetration of developed, predominantly advanced banks, into emerging markets is fairly high because they provide products and services that some emerging market domestic banks are unable to provide. The following pieces of data highlight the different characteristics:

a. Figure 7 highlighted the extent to which trade and project finance are supplied by advanced banks for emerging markets. These flows of investment are key for the development of these markets and in turn the sustained economic growth of these markets is key for advanced economies as they seek to escape current economic difficulties.

b. There is a close correlation between per capita income levels and the demand for financial services. The higher a country’s per capita income, the greater the need for sophisticated and developed financial markets. The regulatory needs of economies with relatively low levels of income are bound to be different.

c. Many emerging countries made more effective use, than their advanced economy counterparts in the period before the financial crisis, of macro-prudential measures which mitigated the risks of asset bubbles. The advanced economies can learn from these experiences.

d. Figures 8 and 9 from the Bank for International Settlement show some selected emerging markets and the extent to which they use credit from banks in advanced economies. Of course the amounts and the maturity structure will differ by markets so the pace of a withdrawal of credit could be very different and the impact on a host country is likely to be as a result of both the quantum and the pace of change. Equally because the concentration of foreign claims in the emerging markets differs so considerably the extent of the impact on emerging markets will be very dependent on the specifics of which developed market has been affected.

**Figure 8. Key creditors to emerging markets**

![Chart showing key creditors to emerging markets](chart)

1 Shaded area (lhs) plots total consolidated foreign claims (immediate borrower basis) on each emerging market region; in trillions of US dollars. Foreign claims include loans, debt and equity securities claims, but exclude contingent exposures such as credit commitments and guarantees. Lines (rhs) plot the share of total foreign claims on a particular region accounted for by banks headquartered in the countries shown in the legends; in per cent.

Source: BIS consolidated banking statistics

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**JP** = Japanese Banks
**DE** = German Banks
**FR** = French Banks
**IT** = Italian Banks
**AT** = Australian Banks
**ES** = Spanish Banks
**NL** = Dutch Banks
**US** = US Banks
**UK** = UK Banks
Difference Between Emerging Markets

1. The homogeneity of emerging market financial services sectors should not be over estimated. Differences include:

DIFFERENCES IN MARKET STRUCTURE
i. The breadth and depth of financial markets in emerging markets is significantly different to those in the advanced economies. As a result financing in emerging markets tends to be less focused on capital markets and has a much greater reliance on bank lending, often focused on debt solutions.
ii. The capability and capacity of regulators differs considerably across these markets.

DIFFERENCES IN THE IMPACT OF THE CRISIS EXISTED
FOR A NUMBER OF DIFFERENT REASONS:

i. Emerging market economies tend to have less developed capital and investment banking markets (with notable exceptions). As a result they avoided many of the issues that emerged during the crisis which related to complex structured products.

ii. Many of the emerging markets have less open financial systems (e.g. markets like South Africa continue to have capital controls) as a result they had less direct exposure to the crisis, although they did feel the secondary economic impact as global trade felt the impact of the crisis.

iii. Asian regulators had already made significant changes to their regulatory frameworks because of the Asian crisis in the late 1990s. In advance of the financial crisis many regulators in emerging markets had already required higher capital levels and had restricted portability of liquidity in banking groups. They also had demanding supervisory regimes which provided significant challenge to the management of financial institutions in their countries.

iv. Whilst the direct consequences of the financial crisis were comparatively limited for emerging market banks, these markets did feel the economic fallout from the crisis. The financial crisis had an impact on trade (including trade finance) and remittances for emerging markets. Both of these are important sources of economic growth.

2. The differences between developed and emerging markets and in particular the capacity of international banks and local banks in emerging markets is a key point. If emerging markets financial sectors were sufficiently developed, deleveraging or asset sales by non-domestic banks may not pose a problem, however where they are not, the impact is likely to be greatest.
Figure 9. Foreign claims on selected emerging markets

1 Shaded areas and dashed lines are billions of US dollars (lhs); solid lines are shares, in per cent (rhs). The sum of international claims (cross border claims in all currencies and foreign currency claims extended locally by foreign offices) and locally extended claims in local currency equals total foreign claims. Some reporting banking systems do not provide information on their local liabilities in local currency (eg Austria).

2 See footnote 3 in the text for a description on how this rate is calculated.

3 Share of short-term claims in total international claims.

Source: BIS consolidated banking statistics
APPENDIX B: EXAMPLES OF EXTRA-TERRITORIAL LEGISLATION
The following examples of extra-territorial legislation present particular challenges for emerging markets:

**Swap Dealer Registration Under Dodd Frank** – Dodd Frank requires that all swaps with US companies and US banks must be transacted out of a swap dealer that is registered and regulated by the Securities and Exchange Commission ("SEC") and Commodity Future Trading Commission ("CFTC"). A foreign bank would have to register as a swap dealer with CFTC before it can trade with US companies and US banks on swaps (subject to very limited exceptions). The most likely choice of entity registration for the foreign bank would be its home country head office where the global swaps businesses are centrally booked and managed. As a result, under Dodd Frank, the SEC and CFTC would have regulatory oversight over the foreign bank home country entity, and this may subject the entity to duplicative, inconsistent and contradictory regulatory requirements leading to tensions with home country regulators. This is a critical issue because US banks are a large part of the international market making community. Emerging market banks will either have to stop trading with US banks which will materially curtail liquidity in markets such as FX and interest rates or subject themselves to regulation by the US regulators in their home country.

**Volcker Rule** - The proposed draft generally prohibits US banks and non-US banks with a US presence and their affiliates from engaging in proprietary trading or sponsoring, or acquiring or retaining an ownership interest in a “private equity fund” or a “hedge fund”. To qualify for the Volcker exemption for a non-US bank under the proposed rule, a trade must be originated from outside the US by the non-US bank with a non-US counterparty, with all trade execution taking place outside of the US. To avoid triggering a Volcker violation, non-US banks are likely to be dissuaded from transacting with US banks and US counterparties and this will have severe implications to the liquidity in markets all across emerging markets. The Volcker Rule also exempts US government debt from the proprietary trading restrictions but does not exempt non-US sovereign debt. The implication is that US banks, as well as foreign banks that do business in US, would be restricted in trading non-US sovereign bonds. This may lead to increased borrowing costs for foreign governments, a potentially deep reduction in liquidity making the market for emerging market sovereign bonds less liquid and hence more volatile.

These problems will be further compounded if the European Union decides to undertake a structural reform in the European banking system which most probably would lead to changes to the existing European banking models (e.g. proposals for Volker like banking model. Such an approach would further complicate the international financial regulatory landscape.

**European Markets Infrastructure Regulation** ("EMIR") – EMIR is the legislation requiring that all eligible Over The Counter ("OTC") derivative transactions executed by firms within the European Union ("EU") are centrally cleared (subject to certain exemptions). EMIR asserts EU jurisdiction over any OTC derivative that has a material impact on the EU. This means the EMIR requirements apply upon any party to such a contract regardless of whether either party is based in any European jurisdiction. This rule may require a non-EU counterparty to clear contracts under an EU recognised clearing house and also under the home country clearing house due to the fact that the home country clearing house is not be recognised as an EU approved clearing house. Absent mutual recognition of non-EU clearing houses by EU authorities, emerging market counterparties trading with EU counterparties may face multiple or conflicting sets of EU and home country regulations on clearing, margin requirements and trade reporting.

**Markets in Financial Instruments Directive II** ("MIFID II")/Markets in Financial Instrument Regulation ("MiFIR") – MIFID II and MiFIR are the proposed revisions drafted by the European Commission to the original Market in Financial Instruments Directive ("MIFID") implemented in 2007 which governs the provision of investment services from within the European Economic Area ("EEA").

The current MIFID legislation does not apply to non-EU third country firms (i.e. firms not domiciled within
the EEA wishing to provide services to counterparties or clients within the EEA) the permissibility of such firms to provide services to any EEA countries is left to the national regulators. Accordingly there are differing standards throughout the EEA – in the UK for instance an exemption is provided for non-EEA affiliated firms to provide services to certain clients whereas in other jurisdictions e.g. France/Germany no such provisions exist but EEA firms can request the provision of services on a reverse enquiry basis.

MiFID II/MiFIR are proposing a harmonised third country regime which at best would seriously restrict the ability of non-EEA firms to transact with or provide service to their EEA clients. Emerging market firms (whether financial or corporate) may not be able to transact with an EEA firm to manage its EEA currency, interest rate or credit exposure and may remain unhedged. Alternatively, where it can find a provider outside the EEA the restricted liquidity will ensure that it incurs greater costs in the conduct of its business.

UK Bank Levy - the UK bank levy is applied on global consolidated balance sheets of UK banks and therefore has an impact on the cost of deposits not only in the UK but across emerging markets for those banks headquartered in the UK that have activities in these markets. The levy acts as a transfer of payments from emerging markets to a developed country but provides little benefit in the way of financial stability. We therefore caution against such approaches.

Foreign Account Tax Compliance Act (“FATCA”) – the extra-territorial nature of this US legislation to provide the US International Revenue Service (“IRS”) with tolls and powers to stop US taxpayers with offshore accounts from evading US tax poses many difficulties for banks. FATCA is intended to ensure that the US tax authorities obtain information on financial accounts held by US taxpayers, or by foreign entities in which US taxpayers hold a substantial ownership interest, at foreign financial institutions (“FFIs”). Failure by an FFI to disclose information would result in a requirement to withhold 30% tax on US-source income. The withholding requirements set out in FATCA would be considered illegal in some emerging markets as would the release of the personal data to US tax authorities. As a result there is anecdotal evidence that some non-US banks are choosing not to bank US clients because the global compliance will be so onerous and could be at odds with their local legislation. Whilst banks support efforts to ensure effective collection of taxation where such approaches are not reached through a treaty approach it can lead to significant implementation problems and can exclude emerging market banks from entering these markets.