ARE THE BASEL BANK REGULATIONS GOOD FOR DEVELOPMENT?

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New Rules for Global Finance

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1. It is very sad when a developed nation decides making risk-adverseness the primary goal of their banking system and places itself voluntarily on a downward slope, since risk taking is an integral part of its economic vitality, but it is a real tragedy when developing countries copycats that and falls into the trap of calling it quits.

2. In his book “Money: Whence it came, where it went” (1975), John Kenneth Galbraith speculates on the fact that one of the basic fundamentals of the accelerated growth experienced in the western and south-western parts of the United States during the past century was the existence of an aggressive banking sector working in a relatively unregulated environment. Banks opened and closed doors and bankruptcies were frequent, but as a consequence of agile and flexible credit policies, even the banks that failed left a wake of development in their passing.

3. Few things can be so relevant to the financing of development as the regulations that are being applied to commercial banks. Unfortunately, as the world has been quite infatuated with the banking regulations emanating from Basel ; as they seemingly kept the bank crisis at bay so efficiently –although some of us believe they seemed more destined to stop the small tremors than to help to avoid the big quakes, or what in recent Alan Greenspan terminology would amount to a lack of "benevolent turbulence"– there has been no room to question the basic principles of the regulations, much less so from the perspective of developing countries that "needed" to be "saved" from their recurring bank crises.

4. As a former Executive Director at the World Bank (2002-2004) who tried to voice this issue frequently, among others at an ECOSOC-Bretton Woods-WTO meeting at the UN in April 2004, I can testify to the difficulties.

5. Some specific problems, such as the possible reinforcement of the pro-cyclicality of bank lending, and some specifics of the Basel II reforms such as its high costs, which could give the larger banks a comparative advantage, have been recorded as discussed, though resulting in nothing special of practical consequence. We should also comment that it is a bit surrealistic to debate the Basel II reforms without ever having entered into and much less exhausted the discussions on the fundamental principles imbedded in Basel I, which clearly contain the genesis of a series of factors that could affect the financing of development.

6. The recent financial turmoil that has cast some serious shadows on some of the Basel operational methods, for instance the high reliance on credit rating agencies, can perhaps now provide us with the opportunity to ask and debate "Are the bank regulations coming out from Basel truly compatible with the best interests of developing countries?" It is in this vein that we would like to start by raising the following issues:

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[1] Presented at the High-level Dialogue on Financing for Development at the United Nations, New York, October 2007, by Per Kurowski as a member of New Rules for Global Finance (www.new-rules.org). For further information you can contact Per Kurowski at perkurowski@gmail.com, www.subprimeregulations.blogspot.com/.

Current regulatory arbitrage favors risk adverseness

7. The bank regulations that come out from Basel are almost exclusively against-risks-at-any-cost driven and so they completely ignore the other two major functions of banking systems, namely to help generate growth and to distribute opportunities.[2] The fact that in a developing society there are some risks more worthy to take than others is completely ignored in the minimum capital requirements ordained by Basel. The argument that "a stable banking system is critical to the long-term growth of an economy" is repeated like a mantra with no consideration of the stage of development and circle of growth in which a country finds itself.

8. Credits deemed to have a low default or collection risk will intrinsically always have the advantage of being better perceived and therefore being charged lower interest rates, precisely because they are lower risk. But, the minimum capital requirements of the Basel regulations, by additionally rewarding "low risk" with the cost saving benefits resulting from lower capital requirements, are unduly leveraging the attractiveness of "low risk" when compared to "higher risk" financing.

9. Allow us to illustrate this central argument in a very simplified way. Under the current Basel I Standardized Approach, a low risk corporate loan (rated AAA to AA-) requires a bank to hold only 20% of the basic 8% capital requirement, meaning 1.6 in units of capital, while a much riskier loan (rated below BB-) requires it to hold 150% of the basic 8%, meaning 12 units of capital. If the current cost of capital for the bank is 15%, then the bank's carrying cost for the low risk credit is 0.24% (8%*20%*15%) while the bank's carrying cost for the high risk credit is 1.80% (8%.150%*15%), thereby producing an additional cost of 1.56% that must be added on to the normal spread that the market already requires from a high risk compared to a low risk loan in a free market.

10. The extra Basel spread on risk makes it more difficult for higher risk borrowing needs to have access to credit from the commercial banks. In a developed country this might not be so serious because there are other alternative sources, but in a developing economy this is fatal, as the commercial banks frequently represent the only formal and supervised source of finance.

11. And of course the Basel effect does not limit itself to the extra carrying cost. From the perspective of the balance sheet we see that each unit of bank capital can sustain 62.5 units of low risk lending but only 8.3 units of high risk lending, and since bank capital itself is more scarce in a developing country, this also induces channeling of local savings increasingly towards the low risk side of the economy.

12. In Basel II, while the "Internal Ratings-Based Approach" provides a much more refined instrument for assessing risks it creates even more bias against risk, much the same as a health insurance scheme is able to offer more differentiated rates the more they know or think they know about the expected health prospects of their clients. We should not ignore that the finance of development requires the current generation to be willing to share in the risks of the future so as to help the society and coming generations to progress. In this respect the Basel risk adverseness could be described as a baby-boomer generation's invention to assure that their savings are there when they need them, with little consideration to what might come after.

[2] http://www.bis.org/publ/bcbs107.htm

13. By adding on a new layer of sophistication and digging deeper in the hole created by Basel I, Basel II will ironically increase the possibilities of new systemic risks and make the fight against the risks targeted by the Basel Committee even more difficult. This particular problem lies outside the context of this paper but for those interested we refer to the Statement number 160 of the Shadow Financial Regulatory Committee, March 2000,[3] where they propose instead the more logical route of harnessing more market discipline by using subordinated debt to make capital requirements more risk sensitive.

14. We are by no means implying that the risks in lending should be taken lightly, but since development normally does not make a living in the land of low risks, much the contrary, this regulatory arbitrage of overly benefiting risk adverseness, and adding on costs, is very costly for development. In short, Basel provides economic signals for maintaining the status quo rather than fostering development.

15. In this respect, and since the current Basel II proposals do contain much that could stimulate the banks to better quantify and manage risk, an alternative that could perhaps provide some of the benefits with less regulatory-ordered bias would be to require a flat percentage of assets as the capital requirement for the banks but forcing them to report to the market a Basel-calculated minimum capital, thereby allowing the market participants, investors or depositors, to price in their views on the differences between these two figures. Going this route would also diminish the quite dangerous possibility that the markets begin to believe that the Basel minimum capital requirements constitute a perfect risk equalization machine among banks with totally different risk structures.

16. As much of the risk management used by Basel is based on the analysis of old data, so as to establish loss probabilities, we also need to acknowledge the fact that a desired future does not stand on past statistical data, much less in the case of developing countries where that past statistical data refers precisely to what should be avoided in the future, and bears little relevance to what needs to be done.

17. But again we wish to make absolutely clear that this is NOT a proposal to abolish the Basel minimum capital requirements outright, but rather to study its other social costs in order to contain these or develop alternative methods that better balance the different societal objectives for the banks.

Current regulatory arbitrage leads to risk hiding

18. An excessive anti-risk bias will naturally stimulate risk hiding. Let us not forget that the need for assets to be qualified as more or less risky is exactly the reason why the credit rating agencies were so much empowered that now we also have the credit rating agencies bias risk, which already helped to create the sub-prime mortgages debacle.

19. One of the dangers for a developing country, where regulatory weaknesses might be more easily exploitable, is that the banks deviate all assets that in their opinion carry a lower capital requirement than what the regulator-credit rating agencies order into other formal or informal places of the market, while loading up their balance sheet with assets for which the risk/capital

[3] http://www.aei.org/publications/pubID.16542/pub_detail.asp

allocation seems a bargain; giving new meaning to the Thomas Gresham's principle that states that "bad money drives out good money."

20. The mentioned risks are clearly not limited to developing countries and we can find a discussion of it in the context of developed countries in a speech of Alan Greenspan on "The Role of Capital in Optimal Banking Supervision and Regulation"[4] in 1998.

Excessive empowerment of new participants

21. Credit rating agencies. The Basel I Standardized Approach regulations led to the credit-rating agencies substituting for some of the traditional in-house credit analyst departments in local banks which, for better or for worse, had allowed credit analysis to be more colored by local factors. This has affected the whole credit environment, and the recent drive towards "development banks" and the establishing of the micro credit institutions can be seen in great part as efforts to satisfy needs created by the Basel inspired bank regulations.

22. It is indeed very difficult for developing countries to understand how authorities that have frequently preached to them the value of the invisible hand of millions of market agents can then go out and delegate so much regulatory power to a limited number of human and very fallible credit-rating agencies, especially as this must surely be setting us up for very serious new systemic errors.

23. Powers to the Supervisors. The Basel II "Internal Ratings-Based Approach" returns much of the credit analysis to the banks themselves, where it belongs, but in doing so it generates a series of new hands-on activities for bank supervisors who will need to consent, concur, approve and what have you, and which can only create new sources of distortions. In this respect suffice it to read the book by James R. Barth, Gerard Caprio, Jr. and Ross Levine, "Rethinking Bank Regulations: Till Angels Govern" [5] to reflect on the possible consequences.

We need much more research

24. When looking at how consumer credit is growing fast in so many developing countries, mainly because it can be more easily packaged (or camouflaged) as a low risk operation while traditional entrepreneurial credits barely skimp along, it would be natural to ask whether this could not be the direct result of the Basel regulations.

25. Could Basel be hindering development finance? What are the consequences of regulatory arbitrated risk adverseness? Is Basel introducing a bias in favor of public sector finance? Could the paradox of the increasing net outward financial flows from developing to developed countries be in any way related to these regulations?

26. These are all vital questions but there seems to be no ongoing research to try to understand how global financial flows have been affected by the Basel regulations and by the use of the credit rating agencies. The topic seems almost taboo, but given the importance of banking

[4] Federal Reserve Bank of New York Economic Policy Review of October 1998.
[5] Cambridge University Press, 2006

regulations for the financing of development, we would urge giving more priority to the research of these issues.

Who is the lender of last resort?

27. One concern, much aggravated by the new Basel II regulations, is that the world might have been irrevocably placed on a route that leads it to end up with just a couple of big international banks. In such a case, if one of these banks that have captured a very large share of local deposits in a developing country runs into problems, who is the real lender of last resort? Is the European Central Bank, for instance, willing to furnish Latin American countries with at least a letter of intent to provide support if a European-owned bank runs into problems while working in Latin America? Clearly there is an urgent need for close international collaboration on this matter.

28. The issue of a possible tendency to have fewer banks, which would seem to imply that damages caused by an individual bank default could grow as a result of upping the ante, also raises the question of why this is not considered by Basel. If the Basel risk assessment methodology favors a diversification in the portfolio of a particular bank, then shouldn't society, and the lender of last resort, also apply this criteria to their own portfolio of banks? Is there not a need for an additional capital requirement based on the individual bank's market share?

What can be done?

29. There are no easy answers, but to discuss these problems openly and candidly is as good a start as any, and so therefore these questions and issues need to be brought to the forefront of the discussions, like for example:

30. Can and should the minimum capital requirements be supplemented or complemented in such a way as to neutralize the risk adverseness of current regulation by, for instance, providing an adjustment for credits destined to create jobs? If the bank regulators of the world insist on imposing the criteria of the credit rating agencies, should we development agents request the presence of our development rating agencies and distribution of opportunities rating agencies?

31. Instead of using the differences in the perceived risks of the credits to determine the formal capital requirements an alternative is to apply an equal percentage to all the assets of the bank but then having the banks to report something similar to a Basle risk valuation as an additional transparent information reference. Although this approach looks to incorporate a more holistic market view than the strictly risk related "subordinated debt route suggested by the Shadow Financial Regulatory Committee, there is nothing that stops it from being complementary to the former.

32. Some could argue that to rely on the markets is impossible in developing countries where markets are deemed to be non-existent or weak but the other side of that coin is that that constitutes precisely the reason for having to rely on whatever little market there is.

Who is debating?

33. Put together the chefs from many different countries and you might get a quite varied menu, but gather the brain-surgeons and there is not going to be a great deal of diversity in their opinions. One of the main problems in discussing the Basel issue, and more so of being able to introduce any changes, is the current lock-hold that central bankers and bank supervisors have on the debate. Sometimes it is argued that if developing countries are better represented in Basel, they will be better able to voice their development concerns, but if this representation of diversity is only to happen by convening experts from all around the world that profess the same principles and have the same mindset, then no matter where they come from, this will be a dead-end street.

34. The numerous comments made by Basel officials about the importance of not rushing the implementation of Basel II, would seem to indicate that experts from developing countries feel the pressure to be recognized as being just as up-to-date and risk-adverse as their peers in developed countries. This syndrome, that costs many developing countries dearly in many of their WTO negotiations, needs to be controlled by assuring the presence of professionals that have other interests beside bank regulations.

35. The World Bank, as a development institution, should have played a much more counterbalancing role in this debate, but unfortunately it has been often silenced in the name of the need to "harmonize" with the IMF. Likewise, the Financial Stability Forum is also, by its sheer composition and mission, too closely related to the Basel bank regulations to provide for an independent perspective, much less represent the special needs of developing countries. Therefore the introduction of independent development voices in the debate is absolutely crucial, and perhaps this could be arranged through a G77 or a G24 effort.

36. As evidence for the lack of inclusion of other points of view different from risk avoidance, let us just refer to the Policy Conclusion in the Report of the Secretary General on the International Financial System and Development dated July 6, 2007, where "surveillance" appears seven times and except for one reference to the development of the financial sector there is not a single word about development itself.

37. For the record, let us state that although we have made the above comments from the perspective of "finance for development," most of the criticism put forward is just as applicable to developed countries. In this respect it is interesting to note that in the United States there has been some serious questioning of whether those regulations are not too uniform as to be applicable to all of their banks.

38. To conclude, we wish to insist that no society can survive by simply maximizing risk avoidance; future generations will pay dearly for this current run to safety. So therefore, more than placing our trust in the banks' financial standing, we need to trust in what the banks do. Let us make certain our bank regulations help us to do just that.

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