Growth Research Programme

Navigating global banking standards in developing countries

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Key messages:

1. **Designed by a group of developed and major emerging countries**, the so-called Basel global banking rules have also been adopted by non-members.

2. **There are two main drivers for the adoption of Basel II and III rules.** First, for politicians to signal openness to inward investment; and second, to facilitate outward investment by international banks.

3. **It is important that the Basel Committee on Banking Supervision, the Financial Stability Board and International Financial Institutions encourage financial rules that are appropriate for developing countries.** This can be achieved through better engagement with developing countries during the standard-setting process.

This brief summarises and sets in context the results of the DEGRP-funded research project 'Navigating global banking standards.' With a focus on low- and middle-income countries, the project examined why countries adopt global banking rules which are designed to enhance global banking stability, but which may not be appropriate to the context of the poorest countries.

The project was led by Professors Emily Jones and Ngaire Woods (Blavatnik School of Government, University of Oxford), and Professor Thorsten Beck (Cass Business School, University of London) and included at least 10 researchers from a variety of countries.

The issue: identifying and adopting appropriate banking rules

Financial rules are required to govern the global banking sector. They make financial markets more resilient and stable, while simultaneously reducing the incidence and impact of financial crises. Global banking rules have been designed in various phases by a range of developed and emerging countries, starting with the Basel I standards of 1998, which were quickly met with critiques. These were followed by reforms and the agreement of the more complex Basel II standards in 2005, before, eventually, the Basel III rules, agreed between 2010 and 2014, after the global financial crisis (see Box 1).

The poorest developing countries are both directly and indirectly effected by global banking rules. The financial health of banks is central to the global economy and hence the poorest countries through economic spillovers. International banks also operate within countries that are not part of the membership that set banking standards. Research shows that poorer non-member countries are adopting global banking standards, and there are some important questions surrounding this trend:

- Why are poorer countries adopting such standards?
- Are global banking standards appropriate for non-members and, if not, what can be done to make them more appropriate?

Significant research efforts have been undertaken since the early 2000s by researchers such as Stephany Griffith Jones, Avinash Persaud and Helmut Reisen, responding to Latin American and Asian financial crises. Since the turn of the decade, following the global financial crisis, DEGRP has stimulated a body of research on Basel banking rules. Gottschalk (2010) points to a range of challenges for poor countries in adopting banking rules, including: designing a framework for capital adequacy; regulating foreign banks; and addressing supervisory gaps, such as a lack of counter-cyclical tools or capacity to address currency mismatches.

Building on earlier work, a comprehensive assessment by DEGRP researchers highlights a range of challenges facing developing countries (Gottschalk, 2010; Beck and Tyson, 2018):

- Banking rules are too complex, requiring capacities or data which are either costly or very difficult to obtain;
- Macro-prudential standards require regulatory capabilities and resources that are often unavailable;
- Assessing credit risk requires credit rating agencies which may not be available;
- Some important risks (such as foreign currency lending) may not be covered by the rules, yet they can be important for poor countries;
- Tight application of Basel III rules on credit risk may lead to a reduction of banking portfolios in poorer countries and weaker sectors;
- Certain Basel III financial risks may not be relevant for poor countries;
- Official banking rules can lead to the possible emergence of shadow banking.

Box 1. The Basel Committee on Banking Supervision and Basel rules

The Basel Committee on Banking Supervision (BCBS) is the primary global standard-setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. It comprises 45 members from 28 jurisdictions, consisting of central banks and authorities with formal responsibility for the supervision of banking business. The jurisdictions represent major advanced and emerging economies.

Additionally, the Committee has nine observers, including central banks, supervisory groups, international organisations and other bodies. Non-members do not set standards, but the Basel Consultative Group (BCG) helps to deepen the Committee's engagement with supervisors around the world on banking supervisory issues.

The Basel Committee has overseen a series of Basel banking rules:

Basel I: the first Basel Capital Acord was established in 1988, covering credit risk by setting minimum capital requirements. Some amendments on market risks were incorporated in 1997.

Basel II: the second agreement and subsequent changes were agreed between 2001-2004, covering minimum capital requirements, supervision and the transparency of banks.

Basel III: a third set of standards were launched between 2010-2014, responding to the global financial crisis and addressing systematic risks and pro-cyclicality, including through higher and more qualified capital requirements.

Basel IV: the banking industry has begun to discuss this informally, focusing on new measures of risk assets.

Sources: Bank for International Settlements; Griffith-Jones and Ocampo (2019).

In further work for DEGRP, Griffith-Jones and Gottschalk (2016) suggest there is a balance between inclusive growth and implementing standards. Implement few rules and the financial sector risks becoming unstable, which can lead to unpredictable financial crises. However, implement the rules aggressively and there is little to no scope for a dynamic financial sector to support real growth. Hence, the adoption of Basel banking standards and, more generally, financial regulation are issues of critical importance for development.

The DEGRP research

Aims

The DEGRP project investigated three interrelated questions:

1. To what extent are bank regulators in developing countries (outside the countries that are a member of the Basel Committee on Banking Supervision) adopting international banking standards such as Basel I, II and III?

2. What political economy factors explain the variation in adoption across countries?

3. Do regulators in developing countries have flexibility in adopting banking standards and what reforms are needed to the process of designing and implementing international banking standards?

Methods

The team used several methods and combined quantitative analysis with in-depth case studies across various countries in Africa, Asia, and Latin America (Angola, Bolivia, Ethiopia, Ghana, Kenya, Nigeria, Pakistan, Rwanda, Tanzania, the West African Economic and Monetary Union (WAEMU), and Vietnam).

The quantitative research assembled a dataset of Basel adoption in some 100 non-members of the Basel Committee in 2008. The dataset was used in regression analysis to explain the adoption of Basel banking standards.[1] The quantitative findings have been written up in a journal article (see Jones and Zeitz 2017).

There are also in-depth case studies of 11 countries across three regions. These studies review the literature and undertake semi-structured interviews with regulators, bankers and financial experts. These case studies are outlined in working papers (e.g. Upadhyaya, 2017) and in a forthcoming book edited by Emily Jones (forthcoming, 2019). There are also a range of published journal articles: see Knaack (2017); Jones and Zietz (2017); and Jones and Knaack (2019).

The project team have also summarised the findings and policy implications of their work in several policy briefings (see Jones *et al*., 2018a, b and c).

Findings and recommendations

The project's findings can be grouped into three areas:

1. Describing the adoption of banking rules;

2. Understanding the reasons behind adoption and;

3. Suggestions for improving the process of setting banking standards.

[1] Data will be available shortly from: https://www.geg.ox.ac.uk/project/developing-countries-navigating-global-banking-standards

1. The adoption of Basel II and III rules is widespread – but selective – in non-member developing countries

There is widespread variation in how many and which components of Basel standards financial regulators in non-member jurisdictions adopt and implement. The first set of Basel rules have been adopted widely globally, even by non-members who had zero influence over how they were designed. Some 125 countries had implemented these standards by 2005. Jones and Zeitz (2017) show that selected components of Basel II rules are implemented in more than half of the non-members of the Basel Committee.

Referring to data from the Financial Stability Institute (FSI) at the Bank for International Settlements (BIS), Beck *et al*. (2019) argue that 90 out of 100 surveyed non-member jurisdictions have implemented Basel II at least partially or are in the process of doing so. Furthermore, 81 jurisdictions reported they have begun to implement at least one component of Basel III.

However, the adoption of components of Basel II rules by non-members relate to standard approaches to credit, markets and operational risk. Less than 20% of non-members adopt banking standards that rely on internal bank models to assess risk. Thus, research shows that developing country regulators take a selective approach towards the adoption of Basel rules, taking into account their technical capacities.

2. A complex interplay between regulators, politicians, and domestic banks shape the adoption of Basel standards

It is not immediately clear why so many non-members adopt global banking standards, especially considering the multiple challenges faced by developing countries during implementation. With this in mind, the DEGRP project sought to unpacks the drivers behind adoption. This examination is based on case studies and regression analysis, using data from the FSI, and covers 115 Basel II standard adopters from 2008 and 100 Basel III standard adopters from 2015.

The research identifies several reasons for why non-members may adopt banking standards. First, politicians that promote the implementation of Basel II and III banking rules wish to signal their openness to foreign investment and the establishment of financial hubs. Secondly, countries that host international banks may foster Basel II or III standards to reassure regulators in home countries. The researchers argue that banks in Nigeria have championed Basel adoption at home, which subsequently helps expansion abroad.

Thirdly, adopting international standards can facilitate cross-border discussion between supervisors regarding the operation of foreign banks in their jurisdiction. Fourthly, countries tend to respond to peer pressure to adopt global standards, becoming convinced of their appropriateness and effectiveness. Finally, the researchers argue that technical advice from the International Monetary Fund and the World Bank can, in some cases, encourage countries to adopt Basel II and III.

The project argues that the primary reasons behind the adoption of Basel II and III rules are for politicians to signal openness to investment into their jurisdictions, and for them to facilitate outward investment by international banks from their jurisdictions. However, it must be noted that global banks and international financial institutions exert less direct pressure on domestic stakeholders than previously assumed.

Jones (forthcoming, 2019) discusses how different groups of actors shape regulatory decisions that in turn result in varied uptake of Basel II and III, ranging from no implementation (e.g. in Ethiopia) to mock compliance (e.g. in Angola, Nigeria and Vietnam), or selected implementation (e.g. in Bolivia, Kenya, Tanzania) to ambitious implementation (e.g. in Ghana, Pakistan, Rwanda and WEAMU). The book goes on to identify four models of adoption: (i) policy-driven convergence (e.g. in Pakistan, Rwanda and Ghana); (ii) convergence driven by international institutions (e.g. in WAEMU); (iii) regulator-driven adoption (e.g. in Bolivia, Kenya and Tanzania); and (iv) policy-driven divergence (e.g. in Ethiopia). There are additional models for adoption used in Angola, Nigeria and Vietnam, which are outlined in Jones (forthcoming, 2019).

3. Policy implications for developing country regulators and international institutions

There are several briefings produced by the project that distil a set of clear policy messages. These messages are aimed particularly at policy-makers in poorer countries, who have the task of balancing the benefits and risks of adoption global standards. These messages are summarised below.

Firstly, regulators should consider the risks of overly ambitious implementation, instead using the flexibility of Basel II and III to select only appropriate components. A strong regulatory regime does not necessarily need to be a complex one. It is important to assess risks and available capacities before implementing Basel II and III rules comprehensively. One clear warning is that adopting tighter rules may exclude finance to certain sectors, while some rules can increase reliance on credit rating agencies. More regulation is not always better regulation when it comes to implementing Basel standards.

Secondly, regulators can tailor Basel implementation to the specific context of the jurisdiction. Some rules designed to cover specific risks are not relevant for the jurisdiction in question. Or, in some cases, the implementation of rules requires an institutional framework that does not yet exist. Countries should therefore focus on the components of Basel II and III that address the key risks in their particular banking sector. Countries can also adjust the weights of certain lending categories (e.g. for SMEs, as in the case of Philippines) to signal their importance.

Thirdly, adopting Basel standards is an adaptive process. Standards can be adjusted and rewritten for implementation, to ensure they are adapted to local circumstances. The researchers argue that regulators need to deepen mechanisms for learning from other regulators in similar South-South contexts, rather than looking only to international standard-setting bodies for advice. Such coordination could also lead to a consensus on changes to international standard-setting bodies.

The research also includes suggestions for IFIs and global standard-setters. Regulators in the poorest countries cannot afford to simply ignore global banking standards, yet they do not have direct influence over the setting of such standards. Developing countries must therefore selectively implement pre-existing rules.

Development considerations only occur at the margins of the regulatory debates at the Basel Committee. However, international bodies such as the BCBS, Financial Stability Board, IMF and World Bank can act to ensure the poorest countries implement rules that are appropriate to their context. This includes advocating for best-fit implementation and asking the BCBS to develop a proportional approach to the design and implementation of Basel standards, which includes greater meaningful input from low- and middle-income representatives.

Wider relevance

Findings published by the project, which fit into a wider body of research on financial sector development produced by DEGRP, have successfully contributed to several key policy and academic debates regarding global banking rules.

Firstly, the project has shown that global banking rules are a core development issue. Rules designed by richer countries have both direct and indirect consequences for development (see Te Velde, 2010; Rojas Suarez, 2018). The evolution of global banking standards has impacted low-income countries and the failure to adopt adequate global rules contributed to the financial crisis of 2007-2009. Furthermore, a fast imposition of higher capital adequacy ratios has led to a withdrawal of capital from developing countries (Te Velde, 2010). Developing an understanding of such rules is a major development need and should not be left to G20 countries or members of the Basel Committee alone.

Secondly, the research provides a better understanding of the setting of international economic rules and the manner in which poorer countries may or may not be included. As a comparison, research has shown that developing countries should not be ignored when designing trade rules at the World Trade Organisation (e.g. in the area of cotton subsidies), even though major powers such as China and the US drive the rule-setting process. However, in the field of global banking rules, poorer countries need to transition from being selective rule-takers to decision-makers in appropriate rule-making. This becomes increasingly relevant given the growing importance of non-member countries to international banking.

Thirdly, the project's findings contribute to the literature on the domestic political economy of adopting global standards, by examining the interplay between politicians, banks and regulators. While the literature on global banking rules is expanding, there is very little on how different actors – including banks, politicians, regulators and IFIs – engage with one another.

Finally, the research helps to unpack which components of Basel II and III are most relevant to poorer countries, and suggests more context-specific implementation. This provides a rich empirical context for further research, analysis and policy influencing work. Such work needs to be driven by the development concerns of the world's poorest countries, not just anxieties over the next global financial crisis.

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