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# The New Basle Capital Accord and Developing Countries

## Issues, Implications and Policy Proposals

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**Abstract**

This paper argues that, if implemented in its current form, the new Basle Capital Accord will adversely effect developing sovereigns, corporates and banks wishing to borrow in international markets. This impact will result from the major banks' lending patterns being altered by the adoption of internal ratings based approaches, leading to a significant reduction of bank, and/or a sharp increase in the cost of international borrowing for many developing countries. Greater use of banks' internal risk management systems is also inherently pro-cyclical and therefore likely to amplify the economic cycle, thus increasing both the frequency and scale of crises.

Keywords: risk-management, internal-ratings, pro-cyclicality, net impact

JEL classification: F34, G18, G21



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## Introduction

Since the Asian crisis of 1997/8 bank lending to developing countries has fallen sharply to the extent that it has become negative. In June 1998 loans outstanding to developing countries totalled US$924 billion, however, by December 2000 this had fallen to US$753 billion: this represents an annual decline of –7.9 per cent.[1] It is in this context that the implications of the new Basle Capital Accord for developing countries should be assessed. In particular, the fear that the new Accord may further discourage lending is of great concern.

It is clear that banks have become highly risk averse *vis-à-vis* developing and emerging economies. However, this increased awareness of the particular risks posed by these types of borrower mirrors a more general trend towards ever-greater appreciation of the need for accurate risk assessment. This trend, with a growing focus on efficiency in all parts of the banking business, has, in part, been a response to competition from non-bank financial institutions. These institutions are not subject to the same regulatory constraints as banks, a situation that, for some, has placed the banks at a competitive disadvantage. Consequently, given the fear that business will migrate from the regulated (bank) sector to the unregulated (non-bank) sector, banking regulators have come under pressure to act.

It is argued that the 1988 Basle Capital Accord has forced banks to hold levels of regulatory capital that do not correspond to actual risks, as measured by the banks' own internal models.[2] This situation has created perverse incentives leading to distortions in lending practices. In particular, capital requirements for lending to highly rated borrowers are in excess of that which the banks would choose to hold – putting them at a commercial disadvantage with respect to non-bank institutions. Recognising these trends, the Basle Committee has proposed a new Capital Accord with a strong focus on aligning regulatory capital requirements with actual risks.

Whilst the effects on developing countries are clearly not central to the new proposals, it seems likely that, as with the 1988 Accord, significant impacts will be felt. This paper will outline those areas with the highest potential impact – in both a positive and negative sense – before concluding with some policy recommendations aimed at maximising the former, minimising the latter and avoiding a *net* negative impact.

## 1 The new Basle Capital Accord

Although the proposed new Basle Capital Accord is to be built on 'three mutually reinforcing pillars', it is likely that the changes proposed to the measurement of credit

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1 An alternative way of viewing this is to examine banks' net exposure to developing countries in terms of assets and liabilities. Banks' exposure peaked in 1997 with a net credit position of US$147 billion. Since then, however, net claims on developing countries have fallen by a staggering US$292.8 billion so that, by 2000, banks had become net debtors to the tune of US$145 billion (Lubin 2001).

2 See the Bank of England Spring *Quarterly Bulletin* (2001), for example.

risk (under Pillar 1) will have the most far-reaching implications for both developed and developing countries alike. Consequently, it is this aspect of the new Accord that shall be focused on in this paper.

The proposals envisage three possible approaches to the measurement of credit risk, with increasing degrees of complexity. These are the standardised approach and the foundation and advanced internal ratings based (IRB) approaches. The new system proposed in the standardised approach addresses many of the concerns raised by developing countries about the 1988 Accord. In particular the removal of the OECD/non-OECD distinction and the reduction in the incentive towards short-term lending are positive proposals. Also, the removal of the sovereign ceiling will be of benefit to highly rated banks and corporates in less highly rated countries, regardless of OECD membership. Overall, therefore, the proposals should, as envisaged, more closely align capital requirements with actual risk.

The proposed use of external credit assessment institutions (ECAIs) has been criticised in some quarters. Whilst we have some misgivings on this issue, these are primarily of a practical nature and need not prove insurmountable.[3] Therefore, on balance, the proposals contained in the standardised approach are to be broadly welcomed. Unfortunately, however, the standardised approach cannot be viewed in isolation: in our judgement the IRB approach, if implemented in its current form, would have negative implications for developing countries. Consequently, the net impact of the new Accord on developing countries is likely to be determined by the extent to which the IRB approach comes to dominate the banking industry’s relations with the developing world.

## 2 The IRB approach

Perhaps the most significant changes proposed under the new Accord relate to the greater use of banks' internal risk management systems. The rationale behind these moves is that greater sensitivity to the measurement of actual risk will enable banks to more accurately price and provision for risk. This would enable the banking system to function more efficiently and reduce perverse incentives created by the existing Accord. The result, it is hoped, is for a sounder, more efficient banking system that functions better for the benefit of all concerned. This argument is based on the benefits that would result from a more efficient allocation of resources at the microeconomic level. However, while this may be true at the level of individual banks, it fails to take account of the potentially negative macroeconomic, systemic implications of the proposals. From the perspective of developing countries there are two major areas of concern.

### 2.1 Cost and quantity of lending

It seems probable that one impact of the new Accord will be an increase in the quantity of loans to borrowers rated above BBB and a fall in loans to borrowers rated below BBB. Given that the majority of the latter borrowers are in the developed world, they

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[3] For a more detailed discussion of these issues contained in a longer paper see IDS finance website, http://www.ids.ac.uk/ids/global/finance/intfin.html.

are likely to see a reduction in overall levels of lending from internationally active banks. What lending does occur would be concentrated in highly rated sovereigns, corporates and banks. Patricia Jackson, Head of the Bank of England's Financial Industry and Regulation Division puts it thus: 'For any bank, the effect of the internal ratings approach on required capital will depend on the risk profile of its particular book – high risk books will demand more capital than currently and low risk books less'.[4]

A number of independent studies have attempted to assess the likely impact on the cost of borrowing for low rated borrowers. Some have suggested alarming increases in the costs of borrowing, to the extent that developing countries would be effectively excluded from international bank lending.[5] Other research, which also predicts a sharp rise in the cost of lending to lower rated borrowers, has not found increases of the same magnitude.[6] The different approaches, however, all point to a significant rise in the cost of lending to low rated borrowers. Indeed, this problem is also cited in the recent submissions to Basle by a number of major international banks, some of which argue that the calibrations used by the Basle Committee are too conservative and therefore produce capital requirements, particularly for low rated borrowers, that are in excess of those produced by their own, internal models. For example, Citigroup argues that: '…under the new Accord, the calibration of capital causes regulatory minimum capital requirements to increase to inappropriately high levels when compared to existing rules or internal risk models'.

Similarly, Credit Suisse Group contends that: 'The calibration of high- risk grades in the IRB sanctions SMEs and emerging markets. Their access to capital from large institutions will be made significantly more difficult'.[7]

The Basle Committee appears to have largely accepted this point. Ongoing work is attempting to ensure that the regulatory capital curve is flattened sufficiently to align it with the economic capital models employed by the major banks – two issues arise here. First, some have argued that concerns over the impact of the new proposals on the cost of bank lending are misplaced. Whilst it is not disputed that capital requirements for lending to lower rated borrowers will rise under the IRB approach,[8] the suggestion is that banks price loans off their own internal models, rather than on the basis of capital requirements. Consequently all the new Accord will do is bring regulatory requirements into line with existing practice. However, whilst this may be so when the regulatory capital required is *below* that which banks would choose to hold, if, as in the current proposals, the regulatory requirements are *above* those indicated by the banks own models, it would be liable to force them to increase the cost (and/or reduce the quantity) of lending to lower rated borrowers.

4 Bank of England (2001).

5 Reisen (2001).

6 Powell (2001).

7 See 'Comments received on the Second Consultative Package', http://www.bis.org/bcbs/cacomments.htm.

8 The fact that capital requirements overstate the risk for high rated borrowers is a major impetus behind the new proposals. However, if these requirements are to be lowered *and* the overall level of capital in the banking system is to remain fixed at 8 per cent, then requirements at the low rated end must rise.

Second, even if the IRB curve is brought into line with those produced by banks' internal models, is this a realistic assessment of the risk posed by developing country borrowers? In the absence of robust, long-term historical default data for all classes of borrower (certainly an issue in developing countries), 'risk' can be viewed as the quantification of expectations. The high levels of uncertainty that this situation produces creates strong incentives to herd, with developing countries periodically going in and out of 'fashion' (as is currently the case). Thus, it can be argued that market perceptions of the risk posed by developing countries is often overstated, sometimes understated, and rarely objectively justifiable by economic fundamentals. Given the fact that developing countries face this very different lending environment from developed world borrowers, there would appear to be a case for formally recognising these differences and developing a distinct approach to regulatory capital. The Basle Committee has apparently conceded that there may be a case for devising a separate curve for SMEs, and is currently working on this issue. Therefore, if it is argued that SMEs should be treated differently, due to their distinct risk profile and importance as an engine of economic growth, a similar argument can be made in the case of developing countries.

### 2.2 Pro-cyclicality

One of the most significant charges levelled at the new proposals is that they will exacerbate pro-cyclical tendencies within the banking system. The drive for risk-weights to more accurately reflect probability of default (PD) is inherently pro-cyclical in that, during an upturn, average PD will fall – and thus incentives to lend will increase. Conversely, during a downturn, average PD will increase (due to more difficult economic circumstances) and, in consequence, a credit crunch may develop with all but the most highly rated borrowers having difficulty attracting funds. In addition, deteriorating economic conditions would cause existing loans to 'migrate' to higher risk categories, therefore raising overall capital requirements and further deepening the downturn. The Basle Committee has recognised this concern in the Second Consultative Package, but argues as follows: 'The Committee has also considered the argument that a more risk-sensitive framework has the potential to amplify business cycles. The Committee believes that the benefits of a risk-sensitive capital framework outweigh this concern'.[9]

However, as is the case with much of the new Accord, the trade-offs in terms of costs and benefits are viewed primarily in terms of their impact on the major banks. For the developing world, it is likely that they will feel the costs disproportionately (reduced lending coupled with increased frequency and scale of crises) while simultaneously attracting few of the benefits. If we assume that financial crises are connected with the business cycle, and accept that developing countries are disproportionately affected by such crises, it becomes clear that developing countries have more to fear from an amplified business cycle than the developed world. Given that influential voices in the latter are expressing real concern about the impact of increased pro-cyclical pressures, developing country fears are certainly not misplaced.

The Basle Committee seems to have also accepted the validity of this criticism. The next consultative document is likely to include a variety of measures to combat pro-

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9 Overview of the New Basel Capital Accord, p.8, para. 40.

cyclicality. However, the important question to be asked is whether the concrete measures to be proposed will be meaningful enough to offset the potentially negative effects of increased pro-cyclicality? Moreover, to what extent will *any* measures be able to offset the inherent pro-cyclicality of a market sensitive framework, while still maintaining increased overall risk sensitivity: a central aim of the new Accord?

## 3 The net impact on developing countries and policy proposals

Whilst the proposals contained in the standardised approach are *broadly* to be welcomed, in that they address many of the concerns expressed in developing countries about the existing Accord, the introduction of IRB approaches has very problematic implications. If, the negative impact of the IRB approaches outweigh the positive impacts of the standardised approach, from a developing country perspective, then the new Accord will merely serve to give with one hand only to take (more) with the other. However, the systemic implications of greater risk sensitivity in lending patterns are likely to impact upon developed and developing countries alike - although more so on the latter given the smaller size of their economies *vis-à-vis* international capital flows. It is therefore crucial that the trade off between microeconomic allocative efficiency and macroeconomic systemic stability is more clearly thought through. Specifically, it is not clear that what is good for individual banks is necessarily good for the stability of the international financial system in general nor the economic prospects of the developing world in particular.

Our policy proposals can be summarised as follows.

- Early adoption of the IRB approach is likely to have significant, and possibly unintended, consequences and we therefore recommend further postponing its implementation to allow for further research.
- If, however, the IRB approach is to be implemented in something like its current form, it is essential that regulatory requirements are lowered for low rated borrowers to *at most* the levels suggested by the banks' own models. That is, the IRB curve should be flattened significantly.
- Serious attention should be given to counter-cyclical mechanisms that might mitigate the pro-cyclical elements of the IRB approach. One such measure that is gathering increasing levels of support is the Spanish provisioning approach: the practical workings of this mechanism should be empirically researched to ascertain the feasibility of extending such a system internationally.
- The possibility of a separate curve, similar to that under consideration for SMEs, should be fully investigated. From a global perspective, developing countries could be as much an 'engine of growth' as SMEs are at the national level. Also, the risk profile of developing countries is distinct from that of developed world borrowers and this difference could be recognised in a different approach to capital requirements.
- The improvements contained within the standardised approach should be developed to further reduce, if not eliminate, incentives towards short-term lending, and the number of risk buckets expanded to reduce regulatory biases towards lending to certain categories of borrower.

— One aspect of the standardised approach that has attracted much attention is the proposal to use external credit rating institutions to assign ratings. Given that international financial stability can be viewed as a public good, there is a strong argument for having a public element involved in credit rating. Of the major international financial institutions, the BIS has the best track record in terms of spotting potential crises as well as having financial stability as its' main objective, and would be well placed to fulfil this role.

## 4 Concluding remarks

The fact that the Basle Committee has decided to postpone implementation of the new Accord until after a further consultative package has been assessed is to be welcomed. Given the huge number of submissions in response to the Second Consultative Package, the varied and complex issues raised therein, and the vital importance of getting the Accord right, this is surely a sensible move. It is to be hoped that the concerns of developing countries are given sufficient weight in this process, which should be as transparent and open as possible. The 1988 Accord, devised with G-10 banks in mind, rapidly became the industry standard. Similarly, the new Accord, whilst not primarily aimed at the needs of developing countries, will have serious and unavoidable consequences for many developing and emerging economies. Given the crucial impor tance of ensuring a stable and suitable level of financing to facilitate much needed economic development in the poorer parts of the world, it is vital that these issues are seriously addressed so that a net negative impact can be avoided.

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