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The Implementation and the Consequences of Basel II

Some global and comparative aspects

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Abstract

The paper deals with the implementation and the consequences of Basel II. It addresses the questions of why and how Basel II is implemented differently in different countries and world regions. In order to deal with these questions a global overview of the processes of implementation is provided. Furthermore, some selected regions and countries such as the CEE and the SEE region, as well as Russia, Slovenia and Albania are analyzed in more detail. Adopting a political economy perspective it is concluded that the unequal implementation of the new Basel Accord mainly is mainly explained by the specific structures of the different national financial sectors and by different interests and uneven processes shaping the implementation of the new regulations.

> “…[G]lobal implementation of Basel II will be uneven and […] only a minority of countries will meet the schedule in the Revised Framework, including the January 2007 starting date.” (Cornford 2006: 11)

1. Introduction

The central aim of the paper is to analyse how and why the new global financial regulations in the banking sector are applied differently in different countries and regions. These questions are answered by analyzing the implementation of Basel II in different cases and comparing them within a larger framework. The paper starts with a brief analysis of the making of the global rules and their supposedly uneven impact on different types of countries, namely developing countries[1] on the one hand and industrialized countries on the other hand. In addition, a short overview of the different forms and processes of implementation of the new Accord is provided. Based on this, some selected cases are analyzed in more detail.[2] In particular the following questions are addressed. Firstly, when and how Basel II is implemented and what are the differences compared to the official Accord. Secondly, what are the reasons for deviations from the official accord? Thirdly, what are the implications of Basel II on the banking sector (e.g. differentiating large and small banks), credit lending and pricing, and specific sectors of the economy such as SMEs. Fourthly, how will banking regulation develop further? Which tendencies are observed? Finally, some general conclusions are drawn from a comparative perspective.

2. Basel II: The rules and their making

In June 2006 the Basel Committee on Banking Supervision published the comprehensive version of the Basel II accord. There are basically two approaches to Basel II: the Standardised Approach and the IRB-Approach (Internal Ratings Based). Regarding the IRB-Approach we have to distinguish between Foundation and Advanced IRB-Approach. In the Standardized Approach the risk weight for the RWA (risk weighted assets) calculation is given by the national regulator. In the Foundation IRB only the PD (probability of default) is estimated by the bank whereas in the

[1] According to Maurer (2007: 6f.) broadly three groups of countries in the developing world may be distinguished: First, developing countries in Sub-Saharan Africa and Asia, which are still working on the implementation of Basel I. The second group comprises Caucasus, Northern Africa and Middle East. These countries will keep the Basel I rules for calculation of the credit risk but will adopt the standards for transparency (Pillar III) and regulatory supervision (Pillar II) according to Basel II. Countries in the CEE and SEE region are expected to implement Basel II completely.

[2] Two case studies based on questionnaires were conducted. One was done in Slovenia with a special focus on the Slovenian banking sector. The second had a broader framework and focussed on the CEE and SEE countries. The questionnaire was distributed by Raiffeisen International within its network.

Advanced IRB-Approach all risk parameters (PD, LGD, CCF and EAD) are estimated by the bank itself.

The IRB will be used mainly by larger and internationally active banks. The Advanced IRB will be implemented only by few banks. In most emerging markets the Standardized Approach will be implemented. The calculation of RWA and minimal capital requirements represents pillar I of Basel II. In Pillar II the Supervisory Review Process is regulated. It is important that this process is harmonized in order to create comparable competitive conditions. Pillar III refers to market discipline and sets out a framework for public disclosure and tries to encourage safe and sound banking practices through effective disclosure. Effective disclosure is essential to ensure that market participants can better understand banks' risk profiles and the adequacy of their capital positions.

The internationalization of financial markets in general and the increasing international activities of banks demanded a co-ordinated approach to regulation in order to disincentive regulation arbitrage and to provide a so-called level playing field. While Basel I was implemented already in the 1980s, a substantial reformulation of the rules was agreed upon on an international level in 2005. The Basel Committee for Banking Supervision at the Bank for International Settlements was the official institution pushing forward the new regulations. The Basel Committee consists of representatives of some core OECD countries. Hence, on the formal level interests of these richest countries in the world were transmitted directly into the process of decision-making. On an informal level mainly large-scale US-based but also large European banks were the driving force behind the reformulation of the new regulations (Bieling/Jäger 2008).

Although Basel II was agreed upon by the Basel Committee backed by the major OECD countries it is argued that it contains several shortfalls regarding the situation in the OECD countries themselves which become striking in the context of the unfolding sub-prime mortgage crisis in the US. Hence the new Basel Accord is criticised for its incompleteness:

> "The risk-focused Basel II bank capital adequacy rules, designed by the Basel Committee as an upgrade of the simpler capital standards that since 1988

> have underpinned the solvency of the world's banking system, are largely silent on liquidity risk." (Keefe 2007a)

In addition, Sheila C. Bair, Chairman of the Federal Deposit Insurance Corporation in the US, argued that the models which are at the core of Basel II and are applied by financial institutions and credit rating agencies failed to predict the fallout from the meltdown in the subprime market:

> "Models are a helpful risk management tool, but they are not always a reliable predictor of credit responses; and they should never be expected to predict the effects of a sea change in lending products." (Bair, quoted in Keefe 2007b)

In the non-OECD world further considerable problems are discussed. Although Basel II was established mainly by OECD countries the new regulations are supposed to be adopted in the rest of the world. This is not unquestioned. In the following we analyze the question whether Basel II as a "one size fits all" approach adequately addresses the needs of different countries. In particular, regarding development countries this is frequently doubted. Among others, general doubts are expressed very clearly by Jonathan Ward:

> "For developing countries, there is obligation without representation – a governance gap. The international regulatory framework is more nearly a colonial regime than official rhetoric admits. Developing countries cannot be expected to comply in good faith. The governance problem would matter less if the new accord were suitable for application in developing countries. It is not." (Ward 2002: 57, quoted in Metzger 2006: 139)

In general, it is argued that Basel II causes problems for developing countries because it is more difficult for them to reach the high technical standards which banks but also regulatory institutions are required to provide.

Furthermore, Stephanou and Mendoza (2005: 26ff.) list a variety of additional problems related to the implementation of Basel II: The upgrading of the supporting financial infrastructure –bank supervision, functioning of the financial system, Pillar 2 and 3– requires changes in the legal and judicial framework. The development of a credit rating industry requires reporting and controlling departments of companies, strong accounting and external auditing rules, credit bureaus etc. In addition, a catch-up in the field of risk management as applied in developed banking systems seems required. This implies a fundamental change to the way many banks in developing countries are actually managed. Local banks are assumed to adopt less sophisticated approaches and attract riskier assets because of their inability to properly differentiate and price risk. While under Basel I sovereigns are risk weighted with 0%, in the Basel II framework the risk weight depends on the rating of the sovereign. Insufficient discriminatory power of rating systems may also cause a retreat of the banking sector from some types of business. This implies a limited access to financial services for some parts of the economy such as SMEs and lower income groups. On the contrary, the price for debtors with a very good rating will fall and they may obtain better access to financial services (Maurer 2007).

Moreover, the new regulations are supposed to affect international lending to developing countries in an uneven way. As Basel II is assumed to lead to an increased spread of interest rates according to the rating, this will negatively affect emerging market economies and many firms located there as they are usually perceived as more risky. Banks are expected to change their strategies by concentrating on lower risks. Both tendencies have been confirmed recently by an empirical research in the case of Austrian banks (cf. Jäger/Redak 2007) and are expected in development countries too (cf. Chandrasekhar 2008, Maurer 2007). In general, pro-cyclical effects of Basel II are supposed to more seriously affect countries with bank-based systems compared to countries with market-based financial systems (Heid 2007: 3898). With regard to transition economies and the developing world the cyclical rating of countries by globally active rating agencies is considered to be a serious additional problem (Sinclair 2005)[3]. As Basel II requires to apply (cyclical) ratings for determining minimum capital requirements already existing cyclical inflows and outflows of capital are expected to be more pronounced as Martina Metzger notes:

> "Another result of more risk-sensitive capital requirements consists in the credit crunch once a crisis is on the brink to break out. […] During the crisis year 2001 [in Argentina] the ratings deteriorated in only six months from BB- to CCC+. Under the old capital accord mandatory capital requirements had

[3] Ocampo et al. (2007: 56f.) argue that the risk weights in the IRB-approach do not consider portfolio effects caused by diversification into developing countries and therefore require a too high level of regulatory capital leading to a further exacerbation of cyclical effects.

> been struck at eight per cent although credit institutions voluntarily increased their reserves in expectation of the default. According to Basel II minimum capital requirements would have to be increased to from eight per cent to twelve per cent under the standardised approach and jump from 12.35 per cento to 47.04 per cent under the IRB foundation approach which all internationally active banks will apply in the future. If banks are forced to increase their minimum capital requirements to such an extent only in a couple of months then it is not far from the mark to expect that the credit crunch will not only affect a country in crisis, in example Argentina, but also debtors which are seeking to roll-over an already existing credit or trying to raise a new loan exactly during the time of the other country’s crisis. Therefore, Basel II can be expected to enforce the typical boom-bust cycles and accelerate contagion.” (Metzger 2006: 144f.)

Nevertheless, some developing countries such as Chile or Singapore have rather high and stable ratings. For this small group of countries, Basel II is assumed to have minor or even positive effects as long as their economies are perceived as stable. Furthermore it is expected that internationally operating banks applying an internal ratings based approach will focus on low risks in developing countries while local banks adopting mainly a standardized approach will tend to have higher risks in their portfolio. This is supposed to result in relatively higher profits for international banks, making them even more competitive and reducing the market share of domestic banks and a concentration of ownership. Due to higher refinancing costs the competitive disadvantage of domestic banks in developing countries is assumed to be stronger if market transparency is increased (cf. Metzger 2006: 147).

Notwithstanding this, it is likely that many less developed countries will implement Basel II rather soon due to the pressure of financial industry. In general, Basel II forms part of a broader process of market-oriented financial regulation and, hence, liberalization (cf. Chandrasekhar 2008). In addition, national regulators receive support from the World Bank and the IMF (cf. Stephanou and Mendoza 2005: 30ff.). In sum, Basel II is supposed to reduce capital flows to the global South and will lead to considerably stronger cyclical effects in developing countries due to higher volatility of cross-border lending[4]. Concerning the financial sector, internationally active banks mainly adopting the IRB-approach are supposed to benefit at the cost of domestic banks adopting the standardized approach. Hence, Basel II seems to be mainly favourable to internationally active banks, most of them located in OECD countries, at the cost of higher financial instability. Griffith-Jones and Persaud therefore argue in favour of a Basle Committee more open to the global South:

> "A Basel Committee with appropriate representation from the world economy would result not just in a fairer but also in a more stable financial system, with welfare-enhancing effects for all." (Griffith-Jones and Persaud 2004: 11)

3. The national implementation of global rules and expected effects: a general overview

Basel II is not internationally binding but has to be transposed into national regulation. According to a study conducted by the Financial Stability Institute (FSI) in 2006, around 100 countries in the world announced that they were willing to adopt Basel II between 2007 and 2015, although often in a specifically adapted and gradual way. These 100 countries mainly comprise the OECD countries, the G20 and middle income countries. Among the group of the G20 almost all countries, maybe with the exception of China, are supposed to be willing to implement the rules on the national level. It is concluded that:

> "The vast majority of low income countries are adopting the 'better wait' and gradual approaches, in face of the huge challenges posed by Basel II" (Gottschalk/Griffith-Jones 2006: 10).

Although the new Accord initially was intended to be applied to internationally active banks only already on a very early stage of negotiation, the European Commission made clear that it was willing to apply the rules to all banks within Europe, irrespective of their size. On the 30th of June 2006 the European Commission published the new framework for capital requirements (Capital Requirements Directive – CRD). This transposes the regulations into European law. The new

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[4] It may be doubted whether focusing on capital inflows (e.g. in the form of bank loans) is an adequate approach to foster economic development. In a historical perspective, development strategies aiming at a surplus in the trade balance and a corresponding deficit in the capital account seem to be more promising strategies for late industrialisation (cf. Priewe/Herr 2005).

European framework consists of two directives: the directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and the directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

Although this was heavily disputed, Basel II has become the only binding rule for all banks within Europe in 2008. Following intensive internal discussions the US finally decided to implement Basel II for the 15 to 20 largest banks only by 2009. While large banks claim that this late date for implementation causes a relative competitive disadvantage to them the supervisors argue that they intend to proceed cautiously in order to prevent a sharp decline in banking capital which might be caused by the new regulations. All the other banks should be subjected to so-called Base 1A regulations in order to avoid too complex reporting and supervision (Keefe 2007a).

Among the developing world regions Latin America is characterized by relatively well developed national financial systems. Chile has probably the most advanced financial sector. Hence it is willing to adopt Basel II and the consequences of the adoption are supposed to be rather minimal (cf. Betancour et al. 2006). On the contrary, countries such as Venezuela or Ecuador having a relatively low country rating are supposed to be affected negatively by Basel II (cf. Powell 2006). Hence, those countries are much more hesitant to implement the new regulations. In the context of weak financial markets this seems reasonable. Moreover, official commitments to implement Basel II should not be taken too seriously:

> "… [I]t should be mentioned that even though many countries say they will implement Basel II quite soon […], *in practice they often postpone several times actual implementation*." [5] (Griffith-Jones 2007: 8).

Taking into account the obstacles described above, it may be doubted whether developing countries should hasten to implement Basel II although they often seem to be forced to do so:

> "In light of the current level of discord, there is no reason why countries outside the G-10 and particularly LICs should be pressured to implement Basel II. Notwithstanding this and the fact that the Basel Committee itself recommends a measured, sequenced approach to many non-G-10 countries, as does the IMF, it will be seen below that a vast majority of countries world-

[5] Italics in the original.

wide intend to implement Basel II at some point soon partly because they may feel explicit or implicit pressure to do so coming from international consultants, rating agencies and large international banks when these are active in their countries." (Griffith-Jones 2007: 7)

4. Flashlights on some selected cases

This section of the paper focuses on SEE and CEE countries in general, and Slovenia, Albania and Russia in particular. These transition countries depict several differences. Regarding GDP per capita, Slovenia comes rather close to the average of the OECD countries. While Albania has a GDP comparable to the average less developed countries Russia is located in between.

4.1. The CEE and the SEE countries

In the case of the CEE and the SEE countries it is necessary to distinguish between members of the EU and non-EU members. The first group has to follow the EU directives und time-frameworks when transposing the regulations into national law. In case of the non-EU members there is no direct legal regulation forcing them to implement Basel II but it is likely that they will follow the final Basel II accord set up by the Basel Committee. While the implementation of the Standardized Approach will not be too difficult, implementing the IRB-Approach is rather challenging. In order to obtain higher profits, large banks are supposed to be in favour of the implementation of the IRB-Approach because QIS-studies have regularly shown that under the IRB-Approach less regulatory capital is required.

To estimate the implications of Basel II on the banking sector in CEE and SEE countries a survey (questionnaire) was conducted by UAS bfi Vienna.[6] The participating countries were Poland, Hungary, Bosnia-Herzegovina, Romania, Kosovo, Slovakia and Slovenia. The business units involved were 7 banks and 2 leasing companies. The questionnaire was completed by the Risk Departments. In 2008 most firms have started to apply the Standardized Approach (SA) but they

[6] This questionnaire was distributed to Raiffeisen International subsidiaries in fall 2008, a few months before the implementation of Basel II in Austria (bank and leasing). 7 out of 15 firms returned a completed questionnaire.

intend to switch to the IRB-Approach in the future. Only Poland and Hungary have started right away with the IRB-Approach. Slovakia has started with the SA for Retail and Non-Retail beginning 2008 and will change to the Foundation IRB for Non-Retail in July 2008.

All but one of the financial institutions evaluated the impact of Basel II regulation on the banking sector in their country as positive. Some mentioned positive effects such as increased transparency, a “better” credit culture but also effectively lower capital requirements. Notwithstanding, some firms assumed higher capital requirements in the future. Furthermore, the too sophisticated regulations were criticised.

Neither in Bosnia-Herzegovina nor in Kosovo is it foreseeable that a national Basel II regulation is going to be implemented in the medium term. For two thirds of the firms Basel II was the trigger for the implementation of advanced risk management methods and techniques. In addition, two third of the firms will change the business policy regarding some of their clients due to Basel II (credit lending policy, prizing etc.). One bank mentioned that some segments will be closed down and the bank will focus on segments where despite an increased regulatory burden lending is still profitable.

4.2. Slovenia[7]

Slovenia is a member of the European Union and has implemented the two relevant EU directives. In the national banking law some discretion offered by the EU-directive has been utilised. Basel II regulation has been valid since 1st January 2007.

The Slovenian financial market is rather small and shared by 21 banks. The largest bank has a market share of around 32%. Like in many other CEE countries the banking sector is characterized by the presence of many foreign banks, and these international banks are the ones which will implement the more advanced approaches.

Comparing the Slovenian legislation to the Basel II Accord and the EU directives the differences are small. Most Slovenian companies are small and medium sized and therefore rarely have an external rating. According to the Capital Requirement

[7] The following analysis builds on the case study by Vita Jagric and Timotej Jagric (2008).

Directive, the Slovenian regulator has published procedures for recognition of ECAIs. The Slovenian regulator included other information like default definition, target PD for each class, significance level of default rate and so on.

A different treatment can be found in residential mortgage, where the Basel II accord allows the supervisors to increase the standard risk weight above 35% where they consider it necessary.[8] The Bank of Slovenia uses this possibility and assigns a higher risk weight if additional criteria are not met.

Regarding retail loans, there is a very strict definition in the Slovenian legislation. In Slovenia an individual retail exposure may not exceed 0.2 % of the total retail portfolio. This can be problematic for the Slovenian banks, because they are small and might have small retail portfolios. Such regulations do not exist in the Accord or the CRD respectively.

To examine the situation and mood in the Slovenian banking industry a survey was conducted in fall 2007. There was feedback from 8 Slovenian banks which have together a market share of 71%. The majority of the banks estimate the impact of Basel II as positive. Direct and opportunity costs are expected. One important impact of Basel II regulation in Slovenia is that most of the banks will develop advanced risk management techniques in order to apply the IRB-Approach. Only half of the banks estimate the help and cooperation with the Bank of Slovenia as good – additional effort by the Bank of Slovenia is expected.

Possible effects of Basel II on SMEs seem to be rather important, as 99.7% of all companies belong to this group. Therefore higher interest payments for SMEs could considerably affect the Slovenian economy in a negative way.

4.3. Russia[9]

Russia is not a member state of the European Union and is therefore much more hesitant to implement the new Basel II rules. For Russia, Basel II would imply a difficult harmonization of the domestic financial system with the standards of the EU but the requirements of Basel II cannot be neglected by the Russian banking

[8] Criteria of the accord to assign a risk weight of 35% to residential mortgages are: lending is fully secured by mortgage on residential property and there is a substantial margin of additional security over the amount of the loan.

[9] This part builds on the study by Grigori Feiguine and Tatjana Nikitina (2008).

industry. The Russian Central Bank has announced the adjustment of the Russian regulatory body to the rules of Basel II in 2008/2009 but the Russian banking industry is not ready for the implementation of the new standards. A modern financial infrastructure is missing, public influence is still very strong and sufficient transparency of the banking business is not guaranteed.

Notwithstanding these circumstances, Basel II may influence the competitiveness of the Russian financial industry in a positive way. It is expected that the implementation of Basel II will take a long period. Furthermore, a 10% increase of capital is expected because of operational risk and the poor quality of many debtors which are assumed to be assigned a risk weight of 150% in the Standard Approach. International banks will implement the more advanced approaches and will therefore obtain a competitive advantage compared to domestic banks.

Moreover, the Russian Central Bank is planning to increase the capital adequacy ratio from 10 to 12% to ensure a higher stability of the financial sector, while in the EU the capital adequacy ratio is still 8%. Due to this negative impacts on the Russian economy and the Russian banking sector are expected at least in the short-term. Although the large Russian banks intend to implement the Basel II standards, the current position of the Russian Central Bank regarding Basel II is still not clear.

4.4. Albania

Albania is one of Europe’s poorest countries characterized by a large informal economy. While other communist countries could catch up through reforms, Albania was thrown back again because of a Ponzi scheme in 1997. The Ponzi scheme was a fraudulent capital investment system, in which many Albanians lost their total savings. On important reason for the “success” of the Ponzi system was the poorly developed private banking sector.

Albania plans to implement Basel II as part of a medium-term strategy for the development, licensing and supervision of banks. Basel II should help to develop a proper banking industry. Fullani, central bank chief executive of Albania, said that his instituion aims to boost the banking system, mainly through the promotion of mergers and acquisitions and by providing incentives for the development of financial market segments. (Global Risk Regulator March 2007: 13). The focus is not on Pillar I (calculation of minimum capital requirements but on Pillar II (supervision of banks, proper risk management systems in banks) and on Pillar III (disclosure requirements).

A gradual approach to Basel II is desired (Fullani 2005). This should take the form of an interim standard between Basel I and Basel II that could offer banks some of the benefits of Basel II without causing to high costs. Increasing capital requirements due to the implementation of Basel II are expected (Global Risk Regulator March 2007: 13).

5. Conclusions

On a global level, it is striking that the USA, who first promoted the rules are very hesitant to implement them now. This stands in sharp contrast to the behaviour of industrialized countries in general and the European Union in particular but seems to be a rather common behaviour of developing countries. CEE and SEE countries which are EU member states will adopt Basel II in a rather similar way. Notwithstanding, the analysis of Slovenia –even being part of the Euro zone– shows some important deviations from the framework suggested by the European Union. Regarding the risk weights for residential property, some substantial changes are observable. Russia and Albania but also other middle and low income countries are much more hesitant to implement the new rules compared to EU member states. Nevertheless, as they have rather close ties with the EU, and (in the case of Albania) depict a high proportion of foreign bank ownership they seem to be more eager to adopt Basel II than other countries at a similar stage of development. Irrespective of likely problems such as increased advantages of foreign banks over local banks, increased volatility and worsening possibilities to finance SMEs and other economic sectors –which are considered risky but represent the backbone of many less developed economies– many countries are on the way to implement Basel II. Due to the pressure by the national and the international financial sector as well as by international financial regulatory institutions such as the IMF, many countries are trying to adopt at least adapted versions of Basel II despite these problems. As the official international rules have been negotiated without any relevant participation by less developed countries, an adaptation of the accord and a gradual implementation seems to match their realities better.

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