



# **Impact of Basel II on Macro-Prudential Risks in Emerging Markets: Implications for Surveillance**

**R. Sean Craig**  
**Monetary and Financial Systems Department**  
**International Monetary Fund**

Presented for Conference on  
**Basel II: The International Banking System at the Crossroads**  
June 1-3, 2004

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## **Overview of the Presentation**

- Nature and sources of macro-prudential risk
- Role of international banks in emerging markets
- Macro-prudential effects of Basel II
- Potential for risk transfer from international to emerging market banks
- Requirements for effective surveillance
- Responses to Basel II
  - Strengthening the financial infrastructure
  - Scope for using prudential tools

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## Sources of Macro-Prudential risk

- **What is macro-prudential risk?**
  - Is in addition to traditional bank level credit risks
  - Arises from collective action of many banks
- **Sources of macro-prudential risk**
  - Pro-cyclicality of credit and asset prices
  - Common banking system exposures
  - Weaknesses in the financial infrastructure
- Monitored using FSIs that aggregate bank data

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## Risks from Pro-Cyclicality of Credit

- **“Excessive” pro-cyclicality exacerbates credit risk**
  - Real estate and asset prices driven up by rapid credit growth
  - Collapse in prices and collateral values can trigger losses
  - Rapid credit growth results in hidden asset quality problems
- **Bank risk management and supervisors may not address macro-prudential risks**
  - Aggregate effect of banks prudent behaviour adds to cycle
  - Supervisors may focus only on individual bank soundness

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## Risks from Common Bank Exposures

- **Banking systems become more vulnerable to shocks**
  - Common market exposure causes markets to become illiquidity when many banks try to reduce exposures at the same time
  - Credit crunch when banks cut lending together
- **Dollarization** results in a common bank FX exposures
  - Reflected in balance sheet miss-matches in corporate sector
  - International banks contribute to risk by lending in dollars
  - Originates in fundamental lack of policy credibility

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## Risks from Weaknesses in the Financial Infrastructure

- Banks have common dependence on infrastructure
- Rate of **BCP non-compliance** (in percent) in Table points to areas where infrastructure needs strengthening
- BCP Preconditions not rated so use Codes and Standards

	Core Principle	Developing countries	Emerging Markets	Industrial countries
BCP 6	Capital Adequacy	55	39	6
BCP 13	Risk Management	75	18	6
BCP 20	Consolidated Supervision	58	39	2
BCP 21	Accounting	78	15	7
BCP 22	Remedial Powers	65	26	9

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## Role of International Banks

- **International banks shape risks in emerging markets**
  - Direct credit exposures
  - Financial intermediation role
  - Providing access to global capital markets
- **Exposures large for emerging markets but small and diversifiable for international banks**
  - Bank risk management and supervisors lack incentives to respond to macro-prudential risk from aggregate exposures
- 1990s crises led to initiatives to limit risk (FSAPs etc)

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## Role of International Banks in Emerging Market Financial Systems

- Share of banks' FX credit is large (includes branches & subs)
- Local liabilities give banks major intermediation role
- low risk to G7 financial systems as exposure low share of equity

BIS banks' Role in Emerging Market Regions	Exposure/Domestic Credit	Exposure to Banks/Domestic Credit	BIS Local Liabilities/Total Liab.	G7 Bank Exposure/own Capital
Latin America	73	6	50	1.2
Emerging Europe	64	12	21	1.8
Middle East	28	9	7	1.2
Asia	18	4	9	6

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## Impact of Basel II: IRB and Standardized Approach

### Pillar I: Standardized Approach

- Risk weights aligned with bank capital using ratings from rating agency or from supervisors:
- Contributes to pro-cyclicality as agency ratings are pro-cyclical

### Pillar I: IRB Approach

- Risk weights set by internal rating model are pro-cyclical when banks base them on current risk not risk over the cycle
- Banks ignore aggregate effect of synchronized rating changes



## Impact of Basel II:

### Pillar III and Supervisory Review

#### Pillar III: market discipline

- Enhances disclosure to give markets data for discipline to work
- May not address pro-cyclicality in pricing of credit
  - Markets are much better at pricing “relative” risks than the overall level of risk in financial systems
  - Global liquidity conditions determine level of interest rates

#### Supervisory Review

- Supervisor validation of internal models key to IRB
- narrow focus on individual bank models could allow “too much” variation in ratings over the cycle, exacerbating pro-cyclicality
- Should supervisors consider aggregate effect of IRB?



## Risk Transfer from International to Emerging Market Banks

- **Basel II will affect banks differently:**
  - International banks use the IRB approach
  - Emerging market banks adopt the standardized approach
- **IRB approach gives higher risk weights to risky emerging market exposures than standardized approach so**
  - International banks cut emerging market exposures sharply
  - Effect magnified as IRB approach does not allow capital relief when risk is lowered by diversification
- **Emerging market banks may take over exposures**
  - Increasing exposure concentration and macro-prudential risk

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## Results from the QIS Point to Potential for Risk Transfer

- IRB International banks reduce RWA (credit risk) by enough to reduce capital but still raise capital ratio
- Emerging market banks take on credit risk but sharply raise capital so capital ratio rises

(percentage point Change in)	Standardized Approach: emerging markets banks	IRB Approach for large international G10 Banks
Capital Ratio	12	3
Risk Weighted Assets	2	-7
Capital	14	-4

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## Insights from the QIS

- **International banks reduce credit exposures**
  - Very rough estimate of 7 percentage point cut in exposure to 40 emerging market countries is \$120 billion
- **Emerging Market banks take on more credit risk**
  - but rise in capital could increase bank soundness
  - Key questions: can banks raise this capital?
  - Could banks take on credit risk before increasing capital?
- BCBS could use unpublished QIS data to do much more detailed assessment of potential for risk transfer

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## Basel II Challenges for Surveillance

- **Enhanced Surveillance key to identifying risks by**
  - Monitoring risk transfer to emerging market banks
  - Detecting weaknesses in the financial infrastructure
- **Basel II could weaken surveillance by making data less comparable between banks (so can't aggregate data)**
  - IRB banks define their own different risk weights
  - Ratings agencies give same credits different ratings
- **Solution**
  - Require all banks to report under standardized approach
  - More disclosure so data are comparable under approach

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## Responses to Reduce Basel II Risks

- Enhance BCPs so surveillance can assess preconditions
- Use assessments to target improvements in infrastructure
- Deepen cooperation between developed and emerging market country authorities to monitor risk transfer
- Assess use of prudential tools to address to M-P risks
  - Supervisors could take pro-cyclicality risk into account
  - Examine scope for using ex-ante general provisioning (e.g. Spanish dynamic provisioning model)
  - Clarify how capital ratios should be adjusted to limit macro-prudential risks from Basel II (e.g. risk transfer)