# Why Basel III matters for Latin American and Caribbean financial markets

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It is a great pleasure to address this high-level meeting. I would like to thank our co-hosts, the Association of Banks of Supervisors of the Americas and the Financial Stability Institute, for the opportunity to give the keynote address to you. I would also like to express my appreciation to the Superintendency of Banks of Guatemala for hosting us here in Antigua and for its kind hospitality.

The topic of today's meeting is "The emerging framework to strengthen financial stability and regulatory priorities in the Americas". This title is full of promise, as it suggests that we are making progress in addressing the problems that have gripped the global financial system and that there is interest in discussing the potential implications of the regulatory reforms for Latin America and the Caribbean, which I will refer to as LAC.

In my remarks today, I will first reflect on the way LAC financial markets have sailed through the recent global storm. I shall then spend most of my presentation in answering the question: why does regulatory reform III matter for financial markets, including those in less affected regions? During the last part of my talk, I will share my thoughts on some of the practical challenges associated with Basel III implementation in the region.

## I. Latin American and Caribbean financial markets and the recent financial crisis

In general, the LAC region demonstrated a high degree of resilience during the 2007–09 financial crisis and this year's turbulence in the European financial markets. According to recent estimates, LAC's average GDP growth rate fell by about 6.7 percentage points from 2007 to 2009. However, this decline was no larger than that in leading emerging countries in Asia, and much smaller than the 13 percentage point decline experienced by eastern Europe. Not only did the LAC region begin to recover ahead of developed nations, but it is also expected to get back in 2011 onto the path of economic activity on which it was travelling before the crisis.[1] Despite this positive outlook for the LAC region, I acknowledge that the global crisis had different economic impacts, and that prospects differ across countries depending on the strength of their macroeconomic policy frameworks and the nature of their external linkages. In spite of this diversity, a common factor during the recent

1 World Bank, *Globalized, resilient, dynamic: the new face of Latin America and the Caribbean*, October 2010.

financial crisis across the region has been the ability of financial systems to remain sound despite the global crisis and resulting recession in several industrialised countries.[2]

One of the key reasons behind this financial sector resiliency are the reforms put in place by many LAC countries over the last decade to adopt sound macroeconomic measures and to strengthen financial sector supervision. The strengthened regional prudential frameworks could be characterised by, inter alia, improved legal frameworks for supervision; banks operating with capital ratios well above the minimum requirements; enhanced prompt corrective action schemes; and more robust bank resolution schemes. In addition, the LAC region benefited during the crisis from reliance on stable domestic funding and appropriate foreign currency liquidity risk management,[3] as well as from low direct exposures to private mortgage-backed securities. The latter is a reflection not only of the relatively high returns from traditional banking operations but also of the implementation of regulatory frameworks strictly limiting bank exposures to complex derivatives and structured finance.[4]

## II. Basel III – an opportunity to further enhance the resilience of the Latin American and Caribbean financial markets?

Against this backdrop of efforts to strengthen banking supervision that made the financial sector resilient to a global crisis, one might wonder whether the work taking place in Basel in response to the crisis is really relevant for the LAC financial markets. In a word, the answer is yes, there are valid lessons for all of them.

My view is that Basel III, defined as the enhanced Basel II capital framework and the new global micro- and macroprudential banking standards, could help to strengthen financial systems in the LAC region even further. There are at least five arguments justifying this claim.

***First, Basel III will provide a good platform to continue to enhance risk management, disclosure and supervisory practices in the LAC region.***

Some of you, including those who have been making important efforts to move to Basel II,[5] may be wondering about the wisdom of my first argument in the light of the criticism that Basel II has received in the wake of the financial crisis. Forgive me for being very blunt, but I do not believe that Basel II contributed to the recent crisis for two reasons. First, the crisis manifested itself in 2007 on the basis of imbalances that had built up prior to the implementation of Basel II. Second, many countries that have adopted Basel II did so in 2008 or later. The crisis came too soon for Basel II to be credibly held responsible.

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[2] IMF, *Regional economic outlook, western hemisphere: heating up in the south, cooler in the north*, October 2010.

[3] J Caruana, "Financial globalisation, the crisis and Latin America", speech at the XLVI Meeting of Central Bank Governors of the American Continent and LXXXVII Meeting of Central Bank Governors of Latin America and Spain, May 2009.

[4] This section draws from: A C Porzecanski, "Latin America: the missing financial crisis", Studies and perspectives, ECLAC Office in Washington, October 2009; R Rennhack et al, "Global financial regulatory reform: implications for Latin America and the Caribbean (LAC)", *IMF Staff Position Note*, July 2009; and IMF, *Regional economic outlook, western hemisphere: stronger fundamentals pay off*, May 2009.

[5] Seventeen countries in the Americas and eight in the Caribbean intend to adopt Basel II by 2013–15. See FSI, "2010 FSI survey on the implementation of the new capital adequacy framework", *FSI occasional papers*, no 9, August 2010.

Having said this, as part of the lessons learned during the recent crisis, the Basel Committee has strengthened Basel II to capture significant risks within its Pillar 1 (minimum capital requirements) framework, such as exposures related to the trading book, complex securitisations and off-balance sheet vehicles. Although these changes are particularly relevant to LAC countries with significant over-the-counter (OTC) derivatives markets, I would like to draw your attention to two areas of the revised Basel II rules that have received much less attention but that are extremely important: the revisions to the supervisory review process (Pillar 2) and the work to enhance disclosure practices at banks (Pillar 3).

Regarding Pillar 2, the Basel Committee has raised the bar for the supervisory review of risk management practices. The purpose of this Pillar 2 supplemental work is to address the flaws in some banks' risk management practices that were revealed by the crisis, which in many cases were symptoms of more fundamental shortcomings in governance structures at financial institutions. The areas addressed by the extended guidance include:

- improving firm-wide governance and risk management;
- capturing the risk of off-balance sheet exposures and securitisation activities;
- strengthening valuation processes for financial instruments;
- designing and implementing sound stress testing programmes;
- managing risk concentrations more effectively; and
- aligning incentives to better manage risk and returns over the long term, including compensation practices.

Another area of Basel Committee work that has received relatively little attention is focused on improving transparency in the financial markets. In this area, the revisions to Pillar 3 seek to improve disclosures related to securitisation, off-balance sheet exposures and trading activities. In addition, the Basel Committee is requiring that banks disclose all elements of the regulatory capital base, the deductions applied and a full reconciliation to the financial accounts. I believe that these new disclosure requirements will help to harness market discipline from bank equity and bond investors to the supervisory effort to strengthen banks' balance sheets.

Looking at areas for further improvement in LAC banking regulation and supervision identified by the Financial Sector Assessment Program, the IMF[6] has cited the need to improve adherence to the Basel Core Principles, to enhance risk-based supervisory capacity, to make consolidated supervision more effective, to improve disclosure of information and to better assess the risks arising from the growing derivatives markets.[7] Comparing these areas with improvements in Basel III, particularly its revised Pillars 2 and 3, leads me to the conclusion that Basel III provides a good platform to continue to improve LAC countries' prudential frameworks.

***My second argument is that the enhanced capital requirements and new liquidity standards will contribute to making LAC financial systems even more resilient.***

There is broad agreement that the depth and severity of the crisis were amplified by weaknesses in the banking sector such as inadequate quality and low level of capital, excessive leverage and insufficient liquidity buffers.

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6 Rennhack et al (2009).

7 See the table in the Annex for more detailed information on the growth of OTC derivatives daily turnover in selected Latin American countries according to the latest BIS Triennial Survey data.

So what has the Basel Committee done in response? To begin with, it has strengthened the ***definition of capital*** by raising the quality of the capital base. A key element of the new definition is the greater focus on common equity, the highest-quality component of a bank's capital. The Basel Committee has adopted a stricter definition of common equity and is requiring regulatory capital deductions to be taken from common equity rather than from Tier 1 or Tier 2 capital, as is currently the practice. As a result, it will no longer be possible for banks to display strong Tier 1 capital ratios while holding limited common equity.

But better capital is not enough. As the financial crisis painfully revealed, we need more capital in the banking sector. Therefore, another important element of Basel III is an increase of the ***minimum common equity requirement*** from the current 2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. In addition, factoring in the capital conservation buffer, which I will discuss in a moment, brings the total common equity requirement to 7%.

An additional key element to the regulatory capital framework is the introduction of an internationally agreed ***leverage ratio***, which will serve as a backstop to the risk-based capital requirement. The use of a supplementary leverage ratio will help contain the build-up of excessive leverage in the system. It will also serve as an additional safeguard against attempts to "game" the risk-based requirements and will help address model risk.

In terms of liquidity risk, the Committee has proposed global minimum liquidity standards to make banks more resilient to potential short-term disruptions in accessing funding and to address longer-term structural liquidity mismatches in their balance sheets. The ***liquidity coverage ratio*** will require banks to have sufficient high-quality liquid assets to withstand a 30-day interruption of funding in a scenario that is specified by supervisors. This is complemented by the ***net stable funding ratio***, which is a structural ratio designed to address maturity mismatches over a longer-term horizon.

To sum up, my second message today is that there are fundamental changes taking place in the prudential approach to bank capital and liquidity. These changes respond to weaknesses manifested in the recent financial crisis but, due to their structural nature, have worldwide application and value in helping to enhance the resilience of the financial systems everywhere, including financial systems in LAC.

***My third argument is that implementing a macroprudential approach to regulation and supervision will be particularly useful in improving the oversight of system-wide risks in LAC countries.***

While stronger individual banks typically lead to a stronger banking system, this firm-specific approach by itself is not sufficient. This is because the risk posed to the system could be greater than the sum of the risks faced by individual institutions, as was particularly evident during the financial crisis that started in 2007. Therefore, we at the BIS believe that two broad macroprudential measures must be pursued to effectively limit system-wide risk. The objective of the first set of measures is to reduce procyclicality, that is, the financial system's tendency to amplify the ups and downs of the real economy. The objective of the second set of measures is to strengthen the resilience of the entire banking system by taking account of the interlinkages and common exposures among financial institutions, especially those deemed systemically important.

As mentioned, an essential element in addressing system-wide risk is the build-up of buffers in good times that can be drawn down in periods of stress. To help achieve this, Basel III will require banks to hold a ***capital conservation buffer*** comprising 2.5% of common equity. This serves as a buffer precisely because it can be used when losses mount. However, as a bank's capital levels move closer to minimum requirements, discretionary distributions will be progressively constrained. These distributions include dividend payments, share buybacks and bonuses. Retaining a bigger proportion of cash flow during a downturn will help ensure that capital remains available to support the bank's ongoing business operations and lending during the period of stress.

In addition, the Basel Committee has proposed a ***countercyclical buffer*** which would be imposed when, in the view of national authorities, aggregate credit growth is so rapid as to be building up system-wide risk. The countercyclical buffer would be as large as 2.5 percentage points of risk-weighted assets. Conversely, the buffer would be released on the basis of the judgment of the authorities and could help absorb losses. This would help reduce the risk that available credit is constrained by regulatory capital requirements.

Taken together, the capital conservation and countercyclical buffers have been designed to mitigate procyclicality and increase banking sector resilience.

Under the Basel III Framework, it has also been agreed that systemic banks should have loss-absorbing capacity beyond the common minimum standards. The Basel Committee and the Financial Stability Board (FSB) are developing a well integrated approach to systemically important financial institutions (SIFIs) which could include some combination of capital surcharges, contingent capital and bail-in debt. In addition to these higher loss absorbency capacity measures, the FSB has stated that it expects policy towards SIFIs to include:

- the capacity to resolve national and global SIFIs without disruption to the financial system and without taxpayer support;
- increased intensity of SIFI supervision; and
- a peer review process to promote consistent national policies in this area.

I would like to applaud the progress made in several LAC countries to require stricter capital ratios, in some cases well above the international norms, particularly for their largest banking institutions. Also, it is important to recognise the efforts of some countries to address procyclicality through dynamic provisioning and similar approaches. Having said that, I am confident that the macroprudential measures included in Basel III will promote an even better handling of systemic risk in the region.

***My fourth argument is that the Basel III framework, particularly its macroprudential overlay, will reduce opportunities for capital arbitrage in certain areas and promote a level playing field.***

Foreign-owned banks and cross-border flows play an important role in the LAC region. Foreign banks have a significant market share in most countries. The bulk of foreign banks' lending in 2010 was disbursed through local affiliates, mostly subsidiaries. As a result, one might conclude that it matters little whether parent banks implement Basel III, since local subsidiaries of foreign banks must comply with host country regulations. However, foreign banks' cross-border lending to non-banks can be relevant.

To deal with these instances, a reciprocity agreement is imbedded into the operation of the proposed Basel III countercyclical capital buffer. Consider the case of a country in the region receiving strong capital inflows and experiencing rapid credit growth and buoyant asset prices. Before Basel III, any tightening in capital required of locally incorporated banks would lead to the objection that foreign banks could lend to firms from offshore without being subject to the more rigorous capital requirements. With Basel III, however, internationally active banks would be required by their home regulators to calculate the countercyclical capital buffer add-on for exposures to the country whether booked in the local subsidiaries or offshore. This example highlights how Basel III hardwires home-host supervisory coordination into the rules in an unprecedented manner. This reciprocity will make for an even playing field for domestic and foreign banks operating in your markets.

As a concrete example,[8] the rapid growth of private credit in Mexico in the late 1980s and early 1990s – even from a low base (Graph 1 in the Annex) – would have sent up a warning signal under Basel III (Graph 2 in the Annex). This, in turn, would have called for higher capital against risk-weighted Mexican exposures (Graph 3 in the Annex). This countercyclical capital buffer would have had to be held against claims on Mexico, whether held by Mexican-owned banks, Mexican-incorporated subsidiaries of foreign banks or foreign banks booking loans to Mexican obligors outside the country. Such extra capital might not have prevented the tequila crisis, but it could only have made it less costly in output and unemployment.

***My fifth argument is that we should learn from past crises to reduce the likelihood and impact of future ones.***

We all have a lot to learn from both the recent and past financial crises. History has shown that crises have emanated from all regions of the world and have a range of causes. None of us knows what the source of the next crisis will be or where or when it will take place. What we do know, however, is that in a dynamic, ever changing global economy, there will be future crises and they will be hard to predict well in advance. We also know, in light of the way the LAC region has weathered the recent global crisis by learning from its past crises, that taking advantage of these events to strengthen macrofinancial fundamentals pays big dividends.[9]

## III. Practical issues related to Basel III implementation

Now that I have stated the reasons why I believe Basel III matters for the LAC region, allow me to share my thoughts on some of the practical implications related to Basel III implementation.

All the measures I have described are expected to increase the resilience of banks, but only if they are effectively implemented and enforced at the national level. To achieve this, there are at least four elements that national authorities may want to keep in mind when implementing Basel III.

The first is to have a ***well thought out and clear strategy to move to Basel III***. In this regard, let me mention that Basel Committee members have agreed on transitional arrangements for implementing the new standards that ensure compliance while supporting the ongoing economic recovery in Europe and the United States. As such, national implementation for Basel Committee member countries will begin on 1 January 2013; it will be incremental and is expected to reach the final level on 1 January 2019. Consequently, there is enough time within this schedule to design a Basel III strategy that relies on:

- first, assessing the implications of the Basel III reforms for the local banking system. This requires comparing the strength of the current regulatory and supervisory baseline with the Basel III requirements. An important part of this assessment should involve analysing the potential impact of Basel III on individual banks and the financial system as a whole. In order to have a wider perspective on these potential

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8 See M Drehmann, C Borio, L Gambacorta, G Jimenez and C Trucharte, "Countercyclical capital buffers: exploring options", *BIS Working Papers*, no 317, July 2010; and J Caruana, "Macroprudential policy: could it have been different this time?" speech at the People's Bank of China seminar on macroprudential policy, in cooperation with the International Monetary Fund, Shanghai, 18 October 2010.

9 Porzecanski (2009).

impacts, experience has shown that it is very helpful to take advantage of an open dialogue with other relevant national authorities and the domestic banking industry.

- second, identifying the skills, knowledge and experience needed for overseeing Basel III implementation. Investing in capacity-building to upgrade the skills of current staff and attracting qualified staff are very important components of any Basel III implementation strategy.
- third, establishing the domestic Basel III priorities. These priorities should be reflected in an implementation roadmap with specific target dates, which might be usefully published. The establishment of these priorities and their deadlines should also take into account any legislative changes as well as amendments to prudential rules and regulatory guidance needed to operationalise Basel III. And we should remember that the target dates are latest-possible deadlines, and that countries may decide to implement faster.

The second element that I suggest be considered in the Basel III implementation process relates to complementing the regulatory reforms with strong ***on-site supervision, ie within banks, together with external evaluation that incorporates the macroprudential focus***.[10] The success of Basel III, in my opinion, requires rigorous and strict oversight and enforcement. Here I am talking about revisiting the supervisory techniques in order to have a more intensive and effective presence at individual banks; conducting a more proactive dialogue with senior bankers with regard to business models, strategies and risks; and having broad powers for early intervention and prompt corrective action. Furthermore, a critical component of any supervisory framework should be the ability to combine a microprudential approach with a system-wide view of the industry with special focus on early detection of risks and imbalances.

This macro-/microprudential perspective brings me to my third element on Basel III implementation: the need to ***strengthen the domestic governance arrangements for financial stability***. To begin with, I believe a sound financial stability governance framework requires national authorities with clear mandates, operational independence, defined accountabilities, appropriate tools[11] and adequate resources. Building upon this solid foundation, we need pragmatic governance arrangements to achieve:

- Open communication and close cooperation between the supervisory, monetary and financial stability functions (or, if separated, the supervisory authority and the central bank). This should usefully allow for greater consistency between microprudential, macroprudential and monetary objectives, instruments and policies.[12] This consistency is particularly important as none of these can be conducted in a vacuum and they must support each other.
- Ongoing dialogue and cooperation among all relevant financial sector authorities. This relates to the increasing interconnections throughout the entire financial system and the need to have more consistent, and a much larger perimeter of, strong financial regulation and supervision.

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[10] Key elements of good supervision include being intrusive, sceptical, proactive, comprehensive, adaptive and conclusive. See J Viñals et al, “The Making of Good Supervision: Learning to Say No”, IMF Staff Position Note, May 2010.

[11] J Caruana, “The great financial crisis: lessons for the design of central banks”, speech at the Colloquium in Honour of Lucas Papademos, ECB, May 2010.

[12] C Borio, “Implementing a macroprudential framework: blending boldness and realism”, speech to the BIS-HKMA Research Conference on “Financial stability: towards a macroprudential approach”, July 2010.

Cooperation should be not only national but also regional and international.[13] Therefore, my final element for successful Basel III implementation is a renewed commitment to ***cross-border coordination*** among financial sector authorities. At the international level, I envisage a reinforced dialogue through effective supervisory colleges, as well as formal and informal mechanisms for information exchange and mutual assessment. Regional supervisory groups such as ASBA, the Caribbean Group of Bank Supervisors and the Central American Council of Supervisors, as well as meetings like this one, provide key forums for sharing practices and experiences, and promoting a consistent and mutually reinforcing Basel III implementation across countries.

To conclude, let me reiterate that your efforts over the last decade to enhance the quality of banking regulation and supervision made the LAC financial systems resilient during the recent financial crisis. Basel III provides a very good opportunity to further improve the banking sector's ability to absorb shocks arising from financial and economic stress. However, the success of Basel III in improving financial stability requires active engagement of national supervisors in the process of effectively implementing and enforcing the new regulatory standards. The long-term benefits arising from strengthening financial stability and reducing the likelihood and severity of financial crises outweigh by far all the costs involved in effectively and consistently implementing stricter regulatory and supervisory standards around the world.

Many thanks for your attention.

[13] J Caruana, "Financial stability: 10 questions and about seven answers", speech at the 50th Anniversary Symposium of the Reserve Bank of Australia, February 2010.

# Annex

OTC foreign exchange and interest rate turnover in Latin America
Daily averages, in millions of US dollars

| Country | April 1998 | April 2001 | April 2004 | April 2007 | April 2010 |
|---|---|---|---|---|---|
| Argentina | 2,244 | | 696 | 1,113 | 1,613 |
| Brazil | 5,127 | 5,790 | 4,688 | 5,888 | 21,055 |
| Chile | 1,255 | 2,328 | 2,482 | 4,008 | 5,744 |
| Colombia | | 397 | 802 | 1,866 | 2,812 |
| Mexico | 8,839 | 8,960 | 16,664 | 18,233 | 18,411 |
| Peru | | 241 | 306 | 822 | 1,429 |
| **Total** | **17,465** | **17,716** | **26,637** | **31,930** | **51,064** |

Argentina did not report in 2001, and Colombia and Peru started to report in 2001.

*Coverage*

Market risk: foreign exchange and interest rate.
Instruments: currency swaps, forward rate agreements, foreign exchange options, foreign exchange swaps, interest rate options, outright forwards, spot.
Currencies: all currencies.
Maturity: all maturities.
Counterparties: reporting dealers, other financial and non-financial (local and cross-border).

*Definitions*

Turnover: absolute gross value of all deals concluded during the month, measured in terms of the nominal or notional amount of the contracts.
Reporting basis: locational, by residence of the reporting dealer.
Reporting dealer: financial institutions that are active in foreign exchange market and participate in the Triennial Survey.

*Valuation*

Aggregates are adjusted for local reporters' double-counting.

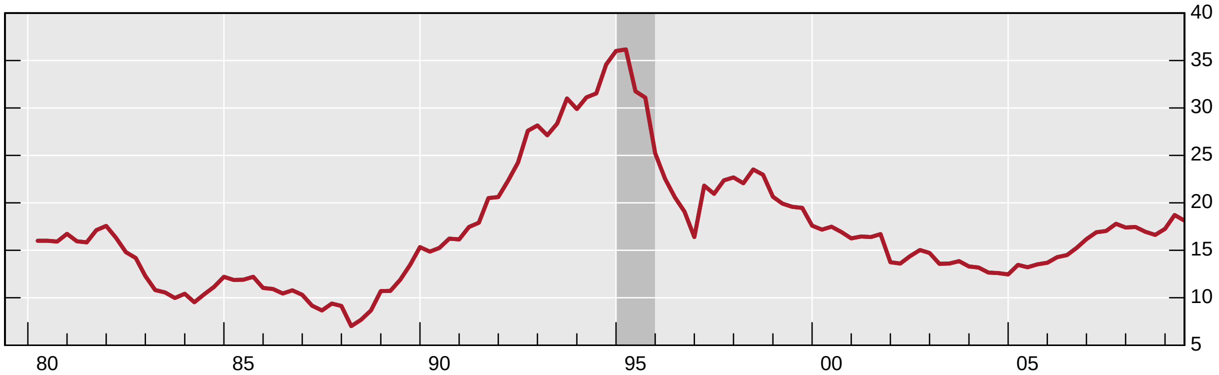
Preliminary results of the 2010 Triennial Central Bank Survey (www.bis.org/publ/rpfx10.pdf).

Source: BIS Triennial Survey.

Graph 1

**Private credit/GDP ratio in Mexico**

In per cent



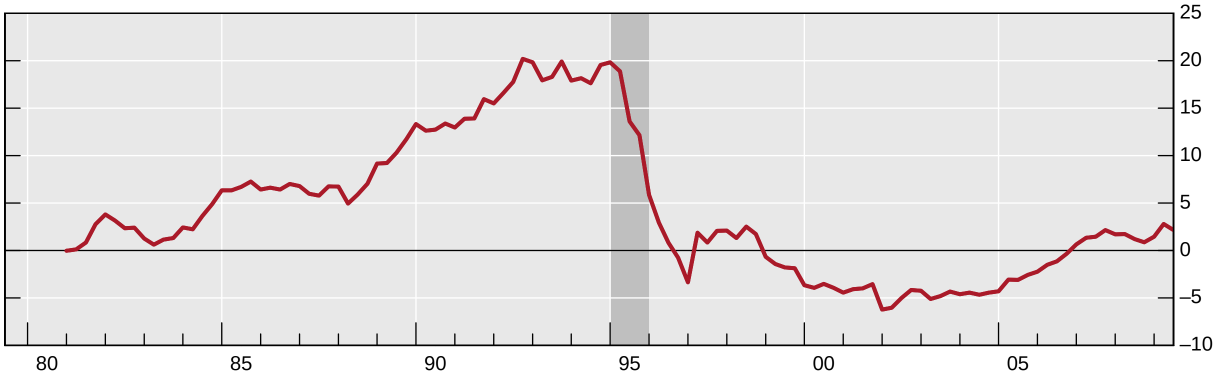

Vertical shaded areas indicate the starting years of system-wide banking crises.

Source: National data; BIS calculations.

Graph 2

**Credit gap in Mexico**

In per cent



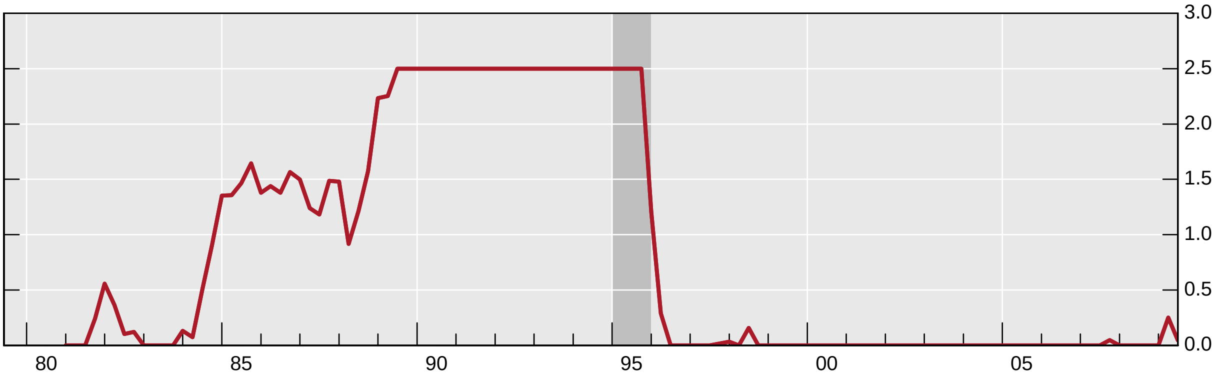

Deviation of credit/GDP from its one-sided long-term trend (ie a trend determined only from information available at the time assessments are made); in percentage points. Vertical shaded areas indicate the starting years of system-wide banking crises.

Sources: National data; BIS calculations.

Graph 3

**Countercyclical capital buffer: Mexico**

Percentage of risk-weighted exposure to Mexican obligors




The countercyclical buffer is 0 when the value of the credit/GDP gap is below 2, and 2.5 when it is above 10%; for gaps between 2 and 10% the buffer is calculated as 2.5/8 times the value of the credit/GDP gap exceeding 2%. Vertical shaded areas indicate the starting years of system-wide banking crises.

Source: BIS calculations.