Anita Angelovska-Bezoska: Financial regulation, implementation and transition effects on emerging market economies

Speech by Ms Anita Angelovska-Bezoska, Vice-Governor of the National Bank of the Republic of Macedonia, at the Fourth OMFIF Main Meeting in Europe, Ankara, 5–6 September 2013.

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Since the onset of the global financial crisis the financial regulatory overhaul has been put high on the policy agenda with the aim of increasing the resilience of the banking system and thus promoting global financial stability. Stronger banking system will be better placed to absorb financial or economic shocks and prevent transmission of these shocks to real economy. The regulatory reform basically addresses the lessons learned from the crisis that insufficient capital and liquidity buffers, non-adequate on and off-balance sheet risk coverage and excessive leverage can undermine the stability of the financial system leading to contraction of the economic activity that can further aggravate the financial instability and require public sector intervention to avoid full-blown banking crisis. In this vein the reform will undoubtedly contribute to creating more sound and resilient banking system that is a key for sustainable growth. For the emerging world, even more so amidst less developed capital markets, as an alternative source of growth funding.

However, during the process of transition, given the still rather weak economic recovery, the reform may have some negative implications for the financial markets, credit activity and growth dynamics. The fact that these reforms were primarily tailored to the specifics of the more advanced economies (AE), where the financial crisis, originally rooted from points to a possibility of ***asymmetric effects*** for advanced and emerging economies (EE) during the transitional process. As EE's and AE's economies intrinsically differ in terms of the level of financial and economic development, it is to be expected for the financial regulatory reform to have asymmetric impact on both groups of countries. Possible, unintended adverse impact on emerging market might occur, both through the ***direct channel*** of transmission (via the direct implementation of the new regulation), but also through the ***indirect channel***, as the foreign banks in the emerging market change their behavior in response to the new regulatory standards. The deleveraging process is one of the well known indirect impacts, with large consequences, particularly in the emerging Europe.

As the international regulatory reform process is very complex, some of the measures have long sequencing of implementation, and for some of the reform areas there are more observations and analyses to be done to define the final contours of the new financial system, more precise assessment of the impact seems challenging. Nevertheless the qualitative assessments and quantitative impact studies converge toward the understanding that the global regulatory changes will impact the availability and cost of funding in the EM in transition period. The financial structure in the EE is rather simple, and dominated by the banking system, the retrenchment of credit financing might impair growth prospects and the potential for job creation in the emerging markets.

Although the reforms process is quite comprehensive and there are probably many channels through which it can translate to the EE, still there are some key channels that I would like to highlight.

The first point of transmission refers to Basel III capital requirements. To provide adequate coverage of banks' risks exposure with capital, focus is placed on enhanced risk coverage (especially trading book), higher quality and quantity of the regulatory capital, and constraints on leverage. Overall, it appears that banks in emerging markets are well capitalized with relatively low reliance on hybrid capital instruments, with traditional business and no significant exposure to risks related to trading book, so significant direct impact of the new capital requirements is not expected. But the indirect effects are perceived as important, with possible adverse impact on the access to financing and the growth potential. Some of the important ***indirect implications*** are very well being pinpointed by the IMF (April, 2013) in its scrutiny on impact of the global regulatory changes on the CESEE countries.

– ***The new capital requirements require balance sheet rebalancing of internationally active banks, i.e., increase of the capital or reduction in risk weighted assets.*** Given the still slow recovery process that would be an obstacle for faster increase of capital (through reinvested earnings or new capital injections) this may have implications for the availability of finance. One related issue is the exclusion of ***minority stakes*** from consolidated group capital and its implications for the process of deleverage as well as for the development and liquidity of local equity markets (change in the nature of acquisitions).

– "***Retrenchment in specialty finance*** due to higher risk weights for certain finance instruments would be particularly harmful to the growth outlook of the region. Some of the sectors most exposed to the retrenchment process are specialty finance lines, particularly infrastructure finance and ***trade finance***. ***Infrastructure finance*** is characterized by long maturities, heavy use of syndication, and dependence on long-term dollar funding that makes it particularly exposed to deleveraging"

– ***Cost of finance*** – "The cost of finance in the region could increase due to inherent inconsistencies in the treatment of sovereign exposures at the solo and consolidated levels. Host supervisors typically apply low risk-weighting for exposures to the host sovereign. However under the forthcoming set of EU regulations, higher risk weights on these exposures could result in a higher cost of finance in the host jurisdiction".

The second channel of transmission is related to the Basel III liquidity framework. As learned from the crisis that adequate capital is necessary, but not sufficient, the Basel III introduces internationally harmonized liquidity standards promoting internationally leveled playing field. The introduction of the Principles for Sound Liquidity Risk Management and Supervision (Sound Principles adopted in 2008), Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), undoubtedly address the prior inadequate liquidity regulation, which contributed to the crisis. The impact of the new regulation for sure will be felt in AE and EE, but most probably the nature of it will be different. Most of the EE's have already established sound regulatory regimes for liquidity, as a response to the previous financial crisis within this group. But, despite the fact that the level of liquidity per se should not be a problem there are additional dimensions through which the new liquidity regulation impacts the EE's.

– The Basel III liquidity framework asks for very specific features of the ***high quality liquidity assets***, which does not always properly reflect the structure, the depth and the liquidity of the financial markets in the emerging markets (tighter criteria compared to the existing ones in national regulations). This mainly refers to ***government bonds***, being treated as highly liquid assets. Most of the emerging markets do not have deep and developed government securities markets, which imply very limited availability of these assets, as a basis for fulfillment of the liquidity requirements***-"highly marketable"*** which is ***more restrictive than the eligibility criteria for central bank refinancing operations*** (and central bank liquidity is the most reliable form of liquidity). The options for investing in foreign securities might be

viable, but at the same time it also increases the exposure to foreign exchange risk. Some of the countries might opt for the central bank placements as an alternative, but this is also seen as a solution, which increases the cost of liquidity and hence, increases the costs of finance. The problem of limited availability of proper assets also holds for ***corporate bonds***, which should have a proper credit rating and certain liquidity features to qualify for the LCR. This is difficult to be fulfilled in countries with thin financial markets, and with sovereign and hence corporate credit rating usually bellow the Basel III requirement. So measures that restrict banks ability to finance bond holdings may hamper the further development of the local capital markets. One remaining issue is the interaction between the LCR and the provision of central bank facilities (The Basel Committee committed to work on this during 2013).

– The second "dimension of problems" arises from the calculation of the NSFR that requires shift from short-term to more stable funding of assets and business activities. Banks would have to extend the maturity of funding sources (long-term securities or extend the maturity of loans) or convert long-term loans to short-term loans with negative implications for the effects for the growth. Extension of the maturity of the funding structure would also imply higher ***cost of financing***. Within the emerging markets, the main concerns arise from the mismatch between the funding that is actually being stable in some of the EE's and the funding that is defined as a stable one within the Basel III regulation. Some of the examples that we can run through are countries like Saudi Arabia and South Africa, where the deposits of the public sector entities and the wholesale funding are the most stable one, but are not treated as such within the new regulatory framework.

The above can be considered ***as direct impact of transmission*** of the new liquidity framework to the EE's, but ***the indirect impact*** should not be neglected at all. The new liquidity rules will probably change the assets structure in the balance sheets in some of the large banks in the AE's. In a world of rapid financial integration, many of these banks have subsidiaries in the emerging world and if the liquidity is managed on consolidated level, this can imply possible liquidity shortages in the host country. ***The treatment of intra-bank exposures*** may pose challenges especially in the emerging markets where banking systems rely markedly on the parent funding (intra-bank funding will be treated as funding from external third parties and their maturity will have to be extended – netting out at consolidated level is not allowed). Other question is the ***treatment of liquidity transfer restrictions***. Excess liquidity in one entity would not be recognized when calculating the consolidated LCR if there is a reasonable doubt about the availability of such liquidity (due to ring-fencing measures, non-convertibility of domestic currency, foreign exchange controls etc.).This may lead to fragmentation of the liquidity management, replication of the treasury operations at decentralized level with cost implications.

The growth impact of the regulatory changes is of large importance for the emerging markets, as they aim towards financial inclusion, development of financial markets, long-term sustainable growth and real convergence to the more AE's. Two of the most important points which have been extensively discussed in the growth context are the regulatory impact on ***trade and long-term infrastructure finance***. ***Trade finance*** has been considered as the most important facilitator of the trade flows in part of the emerging markets and hence as an important growth factor within this group of countries. Some of the estimates point to a figure of 80–90% of the world trade being reliant on some form of trade finance, like trade credits or insurance/guarantees. Some of the products like the Letters of credit have been widely used in the emerging markets and some of the estimates indicate around 55% of all letters of credit to be related to export activities, indicating the relative importance of trade financing in export facilitation and growth performances. Trade finance is particularly considered to be important for SME, as an easy and chip access to financing, as it is structured and self liquidating. Despite the large importance and the low riskiness, the new Basel rules treat the trade finance in more conservative way, which might reduce the availability of trade finance, increase its costs and thus impair the export and growth

prospects of the emerging markets. Albeit some amendments to the Basel rules in this area were done in October 2011, still there are views that they are relaxed asymmetrically, only for the importers, and as such they do not bring benefit for the emerging market exporters, where the problems might stem from. ***Longer-term infrastructure finance*** is also treated as important enhancer of the infrastructure project in the emerging economies, and crucial for enhancement of their structural competitiveness. The reforms of the regulatory framework, pose challenges in this respect as they might ask for a balance sheet rebalancing towards more liquid assets, which can reduce the availability of infrastructure finance. In addition, the implementation of NSFR increases the costs of infrastructure financing as it asks these types of assets to be covered with longer term and more expensive funding.

Albeit there are many other angles within the new regulatory reform which have been discussed in light of their consequences to the EE's (for instance policy measures for dealing with systemically important banks, the impact of some other national and regional reforms[1], the two above elaborated dimensions of the Basel III, seem to depict, or to be a good represent of what the main impact boils down to. Rising cost of finance, restrained credit availability and more conservative treatment of some of the forms of financing, crucial for the growth of EE's are the most important consequences being discussed, which should be seriously addressed.

As for the quantitative impact studies, they do indicate a growth impact of the new regulatory changes, though with varying intensity. While BIS Macroeconomic Assessment Group finds rather modes effect, assessment of the International Institute of Finance and some assessments of the banking industry point to a non-negligible growth effects. A BBVA[2] research, conducted in early 2011 estimates the impact of higher liquidity and capital requirement on the quantity and price of credit, and hence its impact on the GDP per capita. The estimation results point to a larger effect of the regulatory changes on the GDP per capita of the emerging markets, compared to the one in the more advanced countries. The results show that an increase in the capital to assets ratio by 20% reduces the GDP per capita by 1.6% for the whole sample, and by 2.5% for the emerging markets, while the increase of the liquid reserves to assets ratio by 20% adversely impacts the GDP per capita by 0.4% and 0.5%, respectively. Another research, conducted by the International Institute of Finance (IIF), a private sector institution, in 2011, finds pronounced net cumulative impact on economic activity of the proposed financial sector reforms (both, CAR and LCR) estimating that the level of GDP will be 3.2% lower than it would otherwise be after five years with an output loss of 0.7% per annum. On the other hand, the analysis conveyed by the Macroeconomic Assessment Group (MAG), which was set up by the BCBS and FSB in 2010 with a purpose of assessing the macroeconomic effects of the new Basel III proposals suggests a modest impact on aggregate output of the transition towards higher capital and liquidity standards. According to MAG's assessment results, a 1 percentage point increase in the target ratio of tangible common equity (TCE) to risk-weighted assets is estimated to lead to a decline in the level of GDP by a maximum of about 0.19% from the baseline path after four and a half years (equivalent to a reduction in the annual growth rate of 0.04 percentage points over this period). Regarding the tighter liquidity requirements (modeled as a 25% increase in the holding of liquid assets, combined with an extension of the maturity of banks' wholesale liabilities) MAG's estimations point to a median increase in lending spreads of 14 basis points and a fall in lending volumes of 3.2% after four and a half years. This is estimated to be associated with a median decline in GDP in the order of 0.08% relative to the baseline trend. An IMF study dating as of February 2012, reports similar results to MAG's research, finding that in the absence of any monetary policy response, a permanent synchronized global increase in capital requirements for all banks by

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[1] For instance the EBA requirements and the Volcker Rule, within the Dodd-Frank Law in US.

[2] Banco Bilbao Vizcaya Argentaria.

1 percentage point would cause a peak reduction in GDP of around 0.5 percentage points, of which around 0.1 percentage point would result from international spillovers. Their findings show somewhat higher losses in EMEs as compared to AEs (0.74 percentage point loss in GDP in EMEs as compared to 0.46 percentage points in AEs) due to higher estimated spillover effects.

The third point of transmission relates to development of financial markets EE's. The development of deep domestic financial markets can improve the economy's ability to absorb shocks and manage financial risks. These benefits to financial stability complement the critical role that capital markets play in efficient resource allocation and in reducing over-reliance on the banking sector for the mobilization of savings and financial intermediation. Additionally, diversified financial markets provide investors with alternative asset classes in times of financial stress. However, developing such markets is a long-term process that requires proper planning, appropriate prioritization and decisive action in several successive stages.

Divert efforts from further development of financial markets

Financial markets in EE's have become more interlinked within the local and global financial systems, but they are still shallow and prone to sudden price movements and greater disruption that may undermine confidence in their integrity. ***It is therefore important that the ongoing fundamental reforms in emerging financial markets continue and that these longer term priorities are not forgotten as a consequence of predominant focusing on the policy response to the financial crisis and on the accomplishment of the international regulatory reform agenda.*** In this sense, a decisive action is needed to develop a domestic investor base, address market illiquidity, and improve key aspects of market infrastructure in order to mitigate risks to emerging economies' financial stability. Ultimately, development of bond markets, money markets and government securities markets is the optimal route for further progress on this front. The assistance of international partners in this area is of a key importance and should not be neglected in conditions of growing challenges of different size and shape on both sides.

Loss of diversification benefits

Another important drawback in this regard is the initiated process of deleverage of western banks, their more pronounced concentration on home markets and the general fragmentation of international banking model that could deplete the financial markets of EE's, slow down the process of their regional integration and globalization and will eliminate the potential diversification benefits for their investors.

Incentive for further development of shadow banking

Extremely high capital and other requirements may drive banking activity into institutions or financial arrangements that are not regulated as strongly, often referred to as "shadow banks." This is especially pronounced in EE's where required credit growth rates to support continued rapid economic growth and social development are much higher compared to advanced economies (AE)[3]. There is near universal agreement after the financial crisis that the shadow banking sector is potentially capable of creating massive problems and triggering a future crisis. Therefore, there is much discussion on how to control those institutions and

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[3] According to Financial Stability Board's monitoring report on global shadow banking ("Global Shadow Banking Monitoring Report 2012", page 4, paragraph 5): "After the crisis (2008–2011), the shadow banking system continued to grow although at a slower pace in seventeen jurisdictions (***half of them being emerging markets and developing economies undergoing financial deepening***) and contracted in the remaining eight jurisdictions"..

types of transactions. Determining appropriate capital adequacy standards for the shadow banking system will indeed be a key challenge in an effective redesign of the regulatory system. A related challenge is to ensure that tighter capital standards for banks and other highly regulated entities do not result in their simply shifting activity to less regulated areas, including off-balance-sheet activities such as structured investment vehicles. This would simply encourage more risk taking and raise systemic risk as well, since many off-balance-sheet activities could end up being effectively on-balance sheet at times of crises. However, the truth is that we are far from completely figuring out how to control these institutions and types of transactions and it is unlikely that there will be an approach clever enough to provide the same level of systemic protection in regard to shadow banks as there will be for highly regulated entities.

Conclusion

When scrutinizing the impact of the regulatory changes on the EE's, ***there are no doubts that the reform process is an important qualitative step forward for the overall financial industry*** and its implementation will mean more stable financial sector, lower probability of financial crisis and less "headaches" for the authorities responsible for macroeconomic and financial policies. Yet, apparently, ***there are many angles within the new regulation which should be further well screened and assessed in terms of their potential adverse impact***, especially in emerging markets due to different challenges. And as the EE's are currently the main engine of growth in the world economy, and the economic prospects of the advanced world are highly conditioned on the economic health of emerging countries, it appears that this is a question of a mutual interest. Improving the home-host cooperation to avoid conflicts of interest between home and host supervisors may also help in mitigating the possible adverse effects.

What I have talked above, for sure does not exhaust all the issues, but I think it gives a map of the main points which are being heavily discussed, as they can possibly impair the financial and economic prospects of the EE's. By now, many shortcomings of the reforms have been identified, and efforts for addressing some of them have already been made. But, the timeline of the financial regulatory changes is rather long. Hence, a continuous discussion on the characteristics of the proposed financial reforms is of a great importance. Discussions and forums in this area can help for a timely identification and removal of the possible weaknesses that can easily evolve into causes of a next (global) financial crisis.