



Could the medicine harm the patient's friend?

Or the unintended consequences of new financial regulation for poor developing countries

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The financial system is undergoing the biggest transformation in at least a generation. Under the combination of new data points generated by the crisis, the experiences of those active in the market and the slew of new regulations and supervisory structures being introduced the financial system will be transformed beyond recognition.

Many of the changes, especially the new regulations being enacted will overall make the financial system more stable. This is not just good for the OECD and G-20 countries driving these regulatory changes but also good for the smaller developing countries that are not part of the process. This is because financial instability, in particular international financial instability has a particularly damaging effect on poor countries.

That having been said, these changes, by virtue of changing the whole financial landscape, are also likely to have a number of unintended consequences on poor and/or small developing countries that do not have a seat around the G-20 table.

Some of these unintended consequences would be benign, but some others are likely to have a negative footprint on these countries. DfID has a duty to bring these to the attention of the international community in general and the G-20 and the UK treasury in particular.

This report is an effort to map out the potentially negative macro level consequences of changes to the financial system and regulation on developing countries. It does not focus on the positive aspects of these changes.

The two biggest channels of impact on developing countries are 1) how these changes impact the interaction of developing countries with the financial system and 2) how they impact the domestic financial systems within these countries

This work is being by Re-Define in co-operation with DfID and GTZ.

The financial crisis – some lessons for the G-20

- The quality and quantity of capital was too low – No shock absorption capacity – Need to increase quality and quantity of capital
- We had just in time liquidity – which disappeared into a liquidity black hole – No resilience in the system – Need to introduce liquidity buffers
- There were too many Too Big (or complex or interconnected) to Fail Institutions – Posing systemic risk – Need mechanisms to tackle them
- There was an excessive focus on soundness of institutions – No mandate to look at systemic risk build up – Need to have institutions looking at systemic risk and mechanisms to tackle this risk
- The financial system is inherently procyclical - but regulations amplified this – New regulations have to be explicitly countercyclical
- Many important institutions (the so called shadow banking system) were poorly regulated and critical markets such as derivatives were non transparent – this led to an unseen accumulation of risks in the system – new regulation must be comprehensive and cover all key markets, institutions and jurisdictions – A need to expand the perimeter
- International co-operation was very poor – this meant that many risks fell between regulatory gaps and that problems in cross border financial institutions were poorly handled – there is an urgent need to revise and strengthen the framework for the management and supervision of cross border financial institutions and strengthen international regulatory co-operation
- The financial system was full of mis-aligned incentives which led to conflicts of interest and excessively risk taking behaviour – this contributed to the build up of risk which precipitated the crisis – incentive system including that for traders and credit rating agencies need to be urgently revamped
- Investors were often sold inappropriate products or products and money from bank depositors was used to speculate – governments had to step in to protect depositors and to a lesser extent investors to stave off a total collapse in confidence – Increased protection for depositors and investors

Some asymmetries faced by developing countries in International Finance

Developing countries have faced a mostly unfavourable international finance landscape which is characterized by the following asymmetries where DCs are on average in a weaker position compared to their developed country counterparts

The fear is that the crisis and the response to it could amplify these

- Procyclicality of finance– DCs have less capacity to tackle it (less fiscal capacity)
- High volatility of finance – DCs have lower resilience to this
- DCs have a high susceptibility to episodes of 'sudden stop'

- DCs face high spreads – which make external finance for DCs expensive
- DC finance has a shorter tenor – which expose the countries to rollover risk and maturity mismatches
- DCs often have a high exposure to international banks – both in the form of foreign bank lending in the DC as well as DC syndicated loans from foreign banks
- DCs are mostly unable to issue liabilities in their own currency – FX mismatch
- DC markets and financial systems are smaller – can be overwhelmed by exogenous factors.
- DC markets are less liquid – so they have to pay a higher liquidity premium
- DC markets are less transparent – so investors demand a higher premium
- There is a high level of volatility in commodity prices – which affects developing countries to a greater degree
- DC have much lower supervisory and regulatory capacity
- On average SSA had a savings investment gap of more than 10% of GDP. This understates the need for external funds since investment rates were only 28% and perhaps need to be closer to 40%. Low income countries continue to be heavily dependent on external finance
- It is estimated that developing country incomes are 25% lower as a result of the banking and currency crisis they have faced in the past quarter decade

Some first order impacts of the crisis on Developing Countries

Reversal of the positive shocks of 1) easy financing 2) high commodity prices and 3) high remittances

- Sudden reversal of portfolio finance flows
- Collapse in DC stock markets
- Pull back of bank finance
- Big increase in DC risk spreads
- Sudden drying up of liquidity in DC markets
- Steep and sudden fall in exchange rates
- Drying up of trade finance
- Steep fall in commodity price indices
- Stagnating migrant remittances
- ODA stagnation

How will the financial system change as a result of the crisis?

The crisis will have a long term impact on the financial system and the main channels for this impact are

- The 'data point change' where the data points generated by the crisis will affect behaviour
- The 'mindset change' where the experience of having lived through the crisis would affect the behaviour of actors
- The 'regulatory change' where the plethora of new regulations being adopted will bring about the biggest changes in finance in a generation
- The 'supervisory change' where new supervisory structures as well as more intense supervision will affect both financial markets and institutions
- The 'benchmark change' where even countries and market segments not directly affected by the crisis would feel the pull and push of the new policy focus and regulations

Some expected changes to the financial system

Below are the main changes that are likely to come about as a result of the new data points that have emerged with the crisis

- New extremes of price changes including for developing country assets will change their risk / return profile
- New extremes of volatility for developing country assets will also change their risk / return profile
- New degree of high correlation between developed and developing countries so diversification benefits undermined
- Simultaneous falls in currencies and asset prices amplify losses so developing country assets may look less attractive
- So developing country investments may not qualify as being safe even when fundamentals are sound
- The overall risk premium is set to rise
- The pricing for credit risk is set to increase
- The pricing for liquidity risk is set to increase

Some other changes to the financial system

- Actors will become more conservative and risk averse
- They will not trust numbers completely
- Anything that is far from the mainstream or less transparent, more unknown, complex or less liquid will be penalized

- Decoupling myth busted and actors will not believe in it again
- Regulatory changes are discussed in detail below, supervisors are likely to become much stricter in enforcing regulation, amplifying its effects and are likely to move in the direction of stability in the trade off between say stability and access
- Even if developing countries are not obliged to adopt the G-20 regulatory changes for their domestic financial systems, the new benchmarks set by G-20 regulation as well as the change in regulatory philosophy and policy is likely to pull DC domestic regulation in the same direction

The likely impact of these changes

While each of the channels in the previous slide can have a profound impact on the financial landscape in their own right, the likelihood is that they would all act in the same direction and that the cumulative effect of these might be enormous

- Higher cost of capital and credit
- Higher risk aversion
- The price of liquidity will be higher
- Diversification scepticism
- Lack of transparency will be penalized
- Limited availability of finance sector capital
- Interactions with jurisdictions and markets and actors with less onerous regulations would be penalized
- Possible fragmentation of international financial flows and institutional structures
- Greater possibility of risk i.e. currency risk, rollover risk, commodity price risk etc ending up being borne by developing countries which do not have the capacity to carry such risk
- More stringent and onerous regulation for developing country domestic financial systems which may be inappropriate for them

The Channels of impact on Developing Countries

There are two main channels through which these changes will impact DCs. The first is how they impact the interaction of the international financial system with DCs and the second how these affect the working of the financial sector within DCs.

This paper concentrates on the first with a forthcoming sister paper for GTZ focuses on the second

- How these changes affect global financial stability, risk aversion, cost of capital, liquidity premiums, commodity price volatility, and investment strategies, and risk management systems. While many of these effects will apply across the spectrum, some of the changes are likely to have asymmetric impacts on developing countries.

- How these changes affect the availability of capital to the financial sector within DCs, the regulation and supervision of DC financial systems and the change in the behaviour of financial actors within DCs

Relevant regulatory changes that are happening

- Increasing Capital Adequacy
- Introducing Minimum Liquidity Coverage Ratios
- Tackling Procyclicality in the Fin System
- Introducing Prudential Norms for Systemic Risk
- Tackling Too Big to Fail Institutions
- Improving Derivative Market Operation
- Improving Cross Border Supervision and Regulation
- Expanding the Perimeter of Regulation
- Reforming Incentive Structures
- Improving Consumer and Investor Protection

Effects of increasing capital adequacy

- Higher minimum capital adequacy requirements will squeeze credit availability across the spectrum and is likely to increase the cost of capital as well as credit
- Since DCs are more dependent more capital and credit poor and are more dependent on external finance flows, they are likely to be more strongly impacted
- This impact will be felt most directly through two channels initially
- 1) Reduced availability and higher costs of cross border bank finance including syndicated loans and the disbursement of credit by foreign banks
- 2) Potential problems DC based financial institutions might face in raising equity to meet (exceed) new capital adequacy benchmarks especially given that many DC equity markets are shallow
- Developing countries and their companies have on average lower ratings – so have higher risk weights and would be penalized disproportionately when risk weighted capital requirements increase

The effects of the introduction of minimum liquidity ratios

- As funding liquidity is regulated tightly, maturity mis-matches are penalized and minimum liquidity coverage ratios are introduced the price of liquidity will increase significantly

- This immediately means that DC markets which are usually smaller and less liquid will be penalized by international investors so will have to pay an even higher premium to attract investments
- It also means that the already short tenor of loan and bond debt made available to DCs would shrink causing DCs to have to bear higher maturity mis-matches and rollover risk
- At first glance many developing countries retain minimum liquidity ratios and if anything their banking systems have excessive liquidity
- However, just as they do now, many DC financial institutions may hold proportionately higher liquidity reserves even as the minimum benchmark is increased further reducing the availability of long term domestic financing in developing countries

Tackling procyclicality in finance

- A less procyclical financial system would benefit all countries especially DCs but ...
- In order to achieve this outcome regulators are contemplating introducing countercyclical capital buffers and/or ex ante reserve requirements as well as improve accounting practices
- Problems are likely to arise when home country business cycles for international banks are out of sync with host DC credit cycles as is likely to happen often
- This would reduce policy space and have the potential to add another channel of exogenous shocks to DC economies

Prudential norms to tackle systemic risk

- A whole slew of measures including extra capital requirements that increase with systemic risk, leverage caps, limits to maturity mismatches etc are being considered
- Since most developing countries are not likely to be systemically significant large cross border institutions, it is likely that the rising capital requirements would be determined mainly by home country conditions and built up of systemic risk.
- However these would undoubtedly affect the behaviour of banks in host developing countries as well as their behaviour in the cross border lending market
- Capping leverage is likely to reduce overall credit availability in the financial system. However, under capped leverage, banks might find it more appealing to invest in riskier assets such as developing country loans/bonds in order to seek a higher return.
- Penalizing maturity and currency mismatches is likely to penalize developing countries which are far more likely than OECD countries to be faced with such situations

Tackling too big to fail institutions

- Regulators are discussing either breaking up too big to fail banks or penalizing them for being too big.

- It is mostly these large international banks that have the biggest presence in developing countries either through their subsidiaries or branch network or through their significant role in the cross border loan market
- Tackling these institutions might disproportionately hurt developing countries
- Faced with either the possibility of becoming smaller or increasing their capital, some of these institutions might choose to shut down or scale back their developing country operations
- These institutions will be made to write 'living wills' so they can be wound down without market disruption but at this stage it is unlikely that much attention would be paid to their overseas operations in developing countries many of which may not be systemically significant enough to be on the radar screen of the home regulators

Improving Derivative Market Operation

- There is a push for OTC derivative standardization and on exchange trading – developing countries likely to have less standard risks since the markets are not large enough for these to have been standardized yet. So, it is possible that the risk hedging options for developing country entities might be reduced.
- There is push for derivatives, including OTC derivatives to be cleared and settled centrally – This is likely to draw the derivative markets in and inhibit the development of derivative and supporting market infrastructure development in small developing countries
- There is an ongoing discussion on introducing derivative haircuts and margining requirements – This might disadvantage developing country governments and entities which are less sophisticated and may be shut out of hedging markets
- There is an ongoing discussion on capping naked positions for commodity derivatives – Many such as UNCTAD believe that speculation in these markets contributed to high volatility and prices in commodity markets so action on this front could help reduce volatility and extremes in commodity markets
- Ignoring developing country perspectives in derivative regulation might reduce the scope for risk currently borne by developing countries such as weather risk, commodity price risk, currency risk etc to be dispersed to those better equipped to bear it

Improving cross border supervision and regulation

- There is a discussion on improving cross border supervision and regulation
- In developing countries foreign banks constitute a significant share of banking activity - 40%-50% being fairly typical
- While few developing country financial institutions or financial actors have a significant presence in developed markets OECD country banks and increasingly other financial institutions have a substantial and increasing presence in developing country markets. Similarly an increasing number of OECD country institutional investors are very active in the capital markets of developing countries.

- That is why changes to regulations that deal with the cross border provision of financial services are of special relevance to developing countries because these new rules could significantly impact the nature of their financial sector even though they do not have a seat around the table of policy makers formulating these rules.
- Of special relevance, for example, is whether there is regulatory pressure that changes the current mixed branch/subsidiary model in one direction or the other. The main distinction between these is that branches of foreign banks are not required to adhere to local standards of capital adequacy nor maintain ring-fenced local buffers of capital whereas subsidiaries are required to have their own in country capital base. The other big difference is that the main supervision of branches is done by the home country and of subsidiaries by the host country. On other issues such as maintaining liquidity buffers etc, the host country supervisors have some discretion over making branches adhere to some standards.
- It has been shown that foreign banks respond to conditions both in their home as well as host countries with the collapse of foreign bank lending in the 4th quarter of 2008 being a case in point
- Typically, many of these institutions can be quite large from the DC perspective but the DC's share of their global portfolio tends to be much smaller so small changes in the behaviour of such large financial institutions can affect DCs but DCs have an asymmetrically low influence on their operations
- Between 1/2 and 2/3 of foreign bank lending in DCs is subsidiary based so these have to apply host country rules and home country prudential rules apply only to domestic not global operations so changes in home country regulations are unlikely to directly affect DC operations
- However, new proposals call for more effective x-border supervision to prevent regulatory arbitrage so home country requirements are much more likely to impact host country operations than in the past.
- The tightening of home country regulations would lead to curtailment of credit growth in host countries and could possibly even lead to the retreat of some Financial Institutions from DCs at least in the short run
- Cyclical variations in prudential norms in the home country would be transmitted into home country operations though the business cycles between the two are not likely to be in sync and this has a potential to create economic disturbances
- Colleges of supervisors do not include many of the Developing Countries in which cross border institutions operate since they are too small to be systemically significant. This reduces their influence over FIs operating in their territories.
- The problems noted with cross border subsidiaries are much more stark when foreign banks operate as branches
- And the issue of home country conditions affecting credit growth and behaviour in DCs is the strongest when cross border loans are considered

- The tightening of home country prudential norms is likely to have a significant and negative impact on the availability of credit in DCs through branches and cross border lending
- Moreover the introduction cyclically adjusted prudential norms in home countries is likely to transmit home country economic fluctuations to DCs through the channels of cross border branch operation as well as cross border bank lending
- Trade financing is too dependent on cross border banking and is likely to suffer as a result
- There will most likely be a shift towards the subsidiary model away from the branching model for cross border bank operation. While it is likely to increase developing country policy space and reduce the threat of cross border contagion, it might lead to some institutions deciding to get out of developing country operations if they are no longer able to move capital around 'efficiently'

Other issues in cross border banking

- What is the liability and coverage of the host and home country deposit insurance agencies?
 - Developing countries typically have fewer resources to provide deposit insurance so there may be a significant difference between the host country insurance offered by domestic banks and subsidiaries and the home country higher insurance offered by branches which might create a competitive disadvantage for domestic institutions
- What is best mode for information sharing between home and host country supervisors?
 - While there is a discussion for establishing colleges of supervisors and other mechanisms for better information sharing – the fact that information sharing depends on relationships and trust means that developing countries which are only integrating recently are at a sharp disadvantage.
- What is the standard for dealing with weak foreign bank branches and subsidiaries?
 - Developing countries suffer from the dual problem of both having smaller fiscal capacity to provide resources that may be needed for Prompt Corrective Action in the event of a bank failure or fiscal bailouts in the event of a systemic crisis as well as face a higher likelihood of both individual bank failure and a systemic crisis. So given their high exposure to international financial actor presence developing countries are at a sharp disadvantage as long as there is a lack of clarity regarding cross border arrangements for failed banks.
- How to best deal with institutions which are not systemically important in their home countries but have systemic relevance in the host country?
 - One of the key reforms being discussed in the international financial system now is that of subjecting systemically significant firms to higher prudential standards and tighter supervisory regimes. This raises a crucial and as yet unanswered question for how to best regulate financial institutions that are systemically significant only in their host market.

Expanding the Perimeter of Regulation

- To hedge funds and private equity would increase systemic stability but might make them cut back on their recently increasingly important role in supplying credit and equity investments in developing countries
- There is a strong focus on not leaving any jurisdiction out of the regulatory loop
- A number of developing countries developed offshore financial centres were often used for regulatory as well as tax arbitrage
- The opportunities for these are being throttled under new initiatives against tax havens and making regulation comprehensive.
- So those developing countries that depended on fees from offshore finance are already under fiscal stress which is likely to get worse
- This will be amplified by the fact that investors and banks will be ever more concerned by the size of the tax payer base who could back up the financial system so as to guard against the risk of an Iceland like situation
- All these factors together will lead to a substantial retrenchment of business from offshore financial centres to larger onshore centres which are mostly developed countries such as the US, UK, Switzerland etc

Reforming credit rating agencies

- These may become more conservative and penalize poor developing countries
- They have already said that they would penalize ratings which could be unstable through the cycle – many low income countries would fall under this category

Improving consumer and investor protection

- A kneejerk reaction might lead to governments in rich OECD countries tightening the criteria for retail, pension fund and mutual fund investments which might penalize low rated and risky developing countries

Other potential impacts of the set of new regulations

Potential effects of cumulative capital charges

- Higher quality of capital
- And higher minimum capital ratios
- Plus countercyclical capital buffers
- With perhaps ex ante loss provisioning
- And higher systemic risk capital charge on large institutions
- Combined with higher trading book and securitization capital

- May put a credit squeeze
- Which would disproportionately impact LICs

Potential effects due to flight to safety

- Increasing depositor protection thresholds
- More lender of last resort capacity
- Greater fiscal capacity in OECD countries
- Stricter regulation of financial institutions
- Increased supervisory capacity
- Might all lead to chronic flight to safety from developing countries
- Or worsen acute capital flight in the event of economic or financial uncertainty

Potential higher agglomeration flight

- Institution of centralized counterparty clearing
- And greater exchange trading
- Combined with the natural advantage of OECD countries with higher liquidity
- And bigger markets
- Might lead to flight of financial transactions to OECD country centres to take advantage of agglomeration effects

Effects of greater focus on Market Integrity, Tax flight and Anti Money Laundering

- More stringent market integrity legislation is on the way
- There is also a renewed focus on taxation issues
- Anti Money Laundering legislation continues to be a major area of focus
- Taken together the three could put less sophisticated LICs at a disadvantage
- OECD financial regulators could penalize interaction with jurisdictions that do not make the cut

Ever higher standards, even when they may not be appropriate

- Pushed by the comprehensiveness principle
- And efforts to reduce regulatory arbitrage
- Adopted by the G-20 - would put pressure other developing countries to conform to the new accords, regulations and standards

- The refocusing of FSAPs towards G-20 priorities would also contribute to the pressure
- Even when such actions are not in the best interest of low income countries and are being developed without proper consultation with them
- As has long been clear to financial and development experts, adopting international financial sector standards can be very challenging for developing countries in terms of capacity as well as appropriateness.
- LICs might feel pressured to extend standards to microfinance or other parts of the domestic financial system for which it is not appropriate

Some possible ways forward

- Include Low Income Countries in discussions
- Special and Differential Treatment for LIC financial regulation
- Compensatory financing facilities for losses
- Greater IFI capacity and Guarantees
- Basel III Accord – Include diversification benefits for investing in developing countries etc
- Include LIC voices in Supervisory Colleges
- Basel lite, Liquidity lite – Less onerous and simpler capital and liquidity accords for LICs
- Greater focus on domestic resource mobilization – savings mobilization in particular
- Developing regional financial markets
- Doing an impact analysis of the financial crisis and financial regulation
- “regulators are to avoid potentially adverse effects on other countries” – G 20
- A greater need for crisis management mechanisms
- Keeping the access vs. stability debate alive – often there is no trade-off but sometimes there is
- For LICs not to have a kneejerk reaction to reforms nor succumb to pressure to follow the west
- Keep the FSAPs for LICs – Start new program for G-20 and developed economies
- Non Systemically important financial systems
- Tiered approach to domestic regulation
- Capital account liberalization revisited
- Possible alternative frameworks to securitization to increase lending in developing countries