

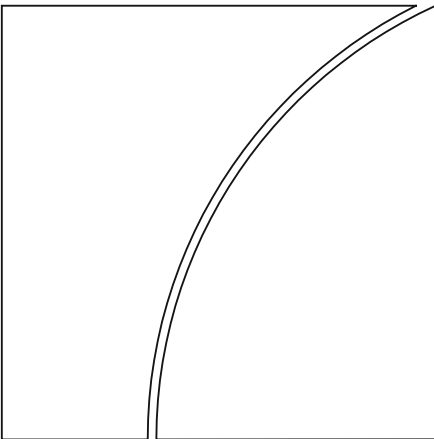
Basel Committee on Banking Supervision

Working Paper No 27

Impact and implementation challenges of the Basel framework for emerging market, developing and small economies

Prepared by the Basel Consultative Group

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Contents

- 1. Executive Summary 1
- 2. The Basel III capital framework..... 5
- 3. The Basel III liquidity framework..... 9
- 4. OTC derivative market reforms 12
- 5. Sovereign exposures..... 14
- 6. Domestic systemically important banks 15
- 7. Cross-border supervisory colleges..... 16

Impact and implementation challenges of the Basel framework on emerging market, developing and small economies

1. Executive Summary

1. **The Financial Stability Board (FSB), in collaboration with standard-setting bodies (SSBs) and international financial institutions (IFIs), has been monitoring the effects of regulatory reforms on emerging markets and developing economies (EMDEs).** Following the study by the FSB and IFIs in June 2012, and while fully supporting the implementation of the agreed regulatory reforms to achieve a safer financial system, the G20 encouraged the FSB (in coordination with SSBs, IFIs and national authorities) to continue assessing the potential unintended consequences on EMDEs and providing policy advice to mitigate them.

2. **An update of the 2012 study was published by the FSB in September 2013.**¹ The main takeaways of this report were:

- **EMDEs continue to indicate that several regulatory reforms could have potential adverse implications.** These include Basel III capital and liquidity requirements, OTC derivative market reforms, policy measures for G-SIFIs, and structural reform initiatives. Many of these reforms are in the initial stages of implementation and their full impact on EMDEs is yet to be seen.
- **EMDEs continue to be concerned about deleveraging by internationally active banks.** That said, differences in macroeconomic conditions and the relative health of home country banking systems are reported to have been the main drivers of differences in foreign bank lending to EMDEs. There are also concerns about potential impact on the liquidity of EMDEs domestic sovereign bond markets.
- **EMDEs are particularly concerned about the Basel III liquidity standards.** Many banks in EMDEs are expected to meet the minimum capital requirements. However, the Basel III liquidity framework is expected to lead to implementation challenges for EMDEs due to the limited availability of high quality liquid assets and difficulties in calibrating the framework to suit practices of smaller banks and small jurisdictions.
- **The implementation of reforms in EMDEs needs to be sequenced taking into account several factors.** These include: (i) adequacy of supervisory resources; (ii) the need for intensive cross-border cooperation and information sharing to avoid potential inconsistencies in national initiatives (such as the structural constraints imposed on bank business models), and (iii) the needs and the structure of the EMDEs financial systems. Indeed, given that the structure and characteristics of financial systems across EMDEs are very diverse, some aspects of the new standards are not necessarily applicable nor a priority for many EMDEs.

3. **IFIs and the Basel Committee on Banking Supervision (BCBS) are increasingly focusing on the implementation of Basel III reforms.** IFIs continue developing additional guidance and identifying good practices of reform implementation for EMDEs, monitoring these issues in the context of their surveillance work, and providing technical assistance to evaluate the adequacy and sequencing of the

¹ Financial Stability Board, *Monitoring Note on the Effects of Regulatory Reforms on Emerging Market and Developing Economies*, September 2013, www.financialstabilityboard.org/2013/09/r_130912/

regulatory reforms. The Basel Committee is monitoring the timely adoption of Basel III standards, its quantitative impact on banks and the consistency of implementation among its members.

4. **The BCBS also expanded its outreach and consultation across jurisdictions on the impact of Basel III, and the Basel framework more generally.** The Basel Consultative Group (BCG),² the main outreach group of the BCBS, established a work stream to identify the impact of BCBS standards implementation on emerging market, developing and small Economies (“EMDEs and small economies”).

5. **This report presents the findings and recommendations of the BCG** (summarised in [Table 1](#)). Broadly, the BCG would like to highlight the increasing importance of defining an “internationally active bank” as being the primary target of implementation of reforms. This is particularly important given the complexity of reforms and the reinforcement of the proportionality concept in the 2012 Basel Core Principles.³ The report is divided into six sections. The sections focus on issues and BCG recommendations related to the Basel capital and liquidity framework, including issues voiced by smaller jurisdictions focusing on financial services (Sections 2 and 3), OTC derivatives reforms (Section 4), banks’ sovereign exposures (Section 5), domestically important banks in EMDEs and small economies (Section 6), and cross-border supervisory colleges (Section 7).

Main findings and recommendations

Table 1

Background	Key recommendations by the BCG
Basel capital framework	
Basel 2.5 led to increases in RWA for trading exposures in the financial markets of EMDEs and small economies; while criteria for estimating RWA exposures is decided by parent banks and home-country supervisors.	Request for further BCBS guidance on the treatment, at consolidated level, of subsidiaries’ local sovereign exposures denominated and funded in local currency and Assess whether to re-evaluate consolidation practices.
Implementation of Basel III will generate a need for capital replenishment - In particular, the requirement that all Tier 1 and Tier 2 instruments have a “point of non-viability clause”. If the clause is triggered, supervisors may face potential governance issues when conversion brings in shareholders that may not be fit and proper.	EMDEs and small economies should strengthen legal and institutional arrangements to enable issuance of capital instruments. Define <i>a priori</i> criteria for non-viability trigger and ensure supervisory powers for case-by-case decisions.
When adopting Basel II and III, some banks may not reveal and recognise all potential risks associated with their balance sheets and could be tempted to put pressure on supervisors to approve IRB approaches/internal models when both the bank and supervisor are not ready.	EMDEs and small economies should set priorities for ensuring the robustness, reliability, and transparency in the adoption of Basel standards, including the Basel Core Principles; Communicate that: (i) decisions on the pace of implementation need to consider

² BCG members are: Austrian Financial Market Authority, Bulgarian National Bank, Comision Nacional Bancaria y de Valores, Mexico, Czech National Bank, Dubai Financial Services Authority, National Bank of Georgia, Central Bank of Hungary, National Bank of Kazakhstan, Bank Negara Malaysia, Reserve Bank of New Zealand, Financial Supervisory Authority of Norway, Superintendencia de Banca, Seguros y AFP, Perú, Bangko Sentral ng Pilipinas, Polish Financial Supervision Authority, Qatar Financial Centre Regulatory Authority, Bank of Thailand, Central Bank of Tunesia, Central Bank of West African States, International Monetary Fund, Islamic Financial Services Board, World Bank, Association of Supervisors of Banks of the Americas, Group of Banking Supervisors from Central and Eastern Europe, Group of International Financial Centre Supervisors, Executives’ Meeting of East Asia Pacific Central Banks; and Financial Stability Institute (BIS). In addition, some Basel Committee members are also represented on the BCG.

³ Basel Committee on Banking Supervision. *Core principles for effective banking supervision*, September 2012, www.bis.org/publ/bcbs230.htm

Main findings and recommendations

Table 1

Background	Key recommendations by the BCG
	particular characteristics of banks and banking systems, as well as supervisory constraints and (ii) Basel II and Basel III standards are designed primarily for large internationally active banks in BCBS member jurisdictions.
The role of the supervisor is key to implement the capital conservation and countercyclical buffers. Supervisory powers to restrict profit distributions in the event of non-compliance with these buffers and modalities to activate various triggers are still lacking in some EMDEs and small economies.	Adequate supervisory powers should be encouraged in EMDEs and small economies.
A mechanistic implementation of the countercyclical capital buffer (ie sole dependence on a credit-to-GDP ratio) could have negative consequences.	EMDEs and small economies should improve their understanding of credit cycles; Request for examples provided by the BCBS on the use of macro-prudential tools (such as sector-specific counter-cyclical buffers), which can enhance banks' resilience to credit booms.
Basel liquidity framework	
Implementation of the liquidity coverage ratio (LCR) will be challenging for many EMDEs and small economies.	QIS for EMDEs and small economies; Creation of a dedicated unit in supervisory agency to facilitate LCR implementation.
Enhanced liquidity requirements are encouraging groups to hold liquid reserves at the parent level, but it is unclear when and how these reserves should be made available; deposits placed at a parent bank by foreign subsidiaries could become subject to bail-in arrangements; operations undertaken by banks in IFCs incur a higher liquidity charge; banks may be "compartmentalising" their different operations, which may weaken the ownership chain and the availability of group liquidity and capital support .	BCBS Guidance and/or Best Practices requested to: (a) give greater encouragement to home supervisors to reach understanding with banks and host supervisors on how and when reserves can be made available; (b) allow greater flexibility for the treatment of non-retail deposits; and (c) encourage agreement on likely resolution scenarios in advance.
OTC derivative market reforms	
The impact of OTC derivatives reforms in EMDEs and small economies varies widely depending on financial market characteristics and stage of development. The cost of creating certain financial market infrastructures might not be justified in these jurisdictions.	Reforms should be implemented sequentially in non-BCBS jurisdictions; Endorse an explicit reference to thresholds of proportionality.
Sovereign exposures	
The Basel III framework continues to provide for national discretion in giving preferential treatment to sovereign exposures, which could lead to an excessive build-up of such exposures.	Request for BCBS to consider approaches that give due regard to sovereign exposure risks, preferably on a globally consistent basis.
Domestic systemically important banks	
Domestic systemically important banks (D-SIBs) could be perceived as "too big to fail".	Host supervisors should consider bank-specific recovery and resolution plans.
In systems dominated by foreign banks, intra-group capital flows could emerge.	Need for close coordination between home and host supervisors on phasing in capital requirements for D-SIBs.
Parent banks of subsidiaries classified as D-SIB in host jurisdictions may seek to circumvent the higher loss absorbency requirements.	Host supervisors should (i) increase powers over branches; and (ii) deter regulatory circumvention through the conversion of subsidiaries into branches.

Main findings and recommendations

Table 1

Background	Key recommendations by the BCG
<i>Cross-border supervisory colleges</i>	
Supervisors from EMDEs and small economies are not likely to be included in core supervisory colleges.	Introduce a mechanism to ensure all relevant jurisdictions are invited to colleges; Sign an MoU before granting a banking license to a cross-border institution; Define a set of minimum information to share; Supervisors should have the power to require capital for entities in their jurisdiction and to require a restructuring of the financial group.

2. The Basel III capital framework

Background

6. **In response to the global financial crisis, the BCBS introduced two sets of reforms to the international capital framework for banks.** The “Basel 2.5” package of reforms, issued in July 2009,⁴ included measures to strengthen the trading book capital requirements under Basel II and enhance the three pillars of the Basel II framework. Basel III⁵ introduced changes to the Basel II capital framework by raising the quality, consistency and transparency of the capital base, enhancing risk coverage, implementing a supplementary limit on leverage, and addressing cyclical capital requirements. Most of Basel III relates to Pillar 1 measures, but there are also implications for Pillar 2 (supervisory approach) and Pillar 3 (disclosure and market discipline).

7. **The Basel Consultative Group (BCG) believes that implementation of Basel 2.5 and Basel III will be challenging in EMDEs and small economies.** In particular:

(a) **While Basel 2.5 capital requirements should increase resilience of banks against losses in the trading book, two issues arise:**

- *The criteria for estimating risk weighted assets (RWA) for exposures in host-countries are decided by parent banks and home-country supervisors.* Hence, the highest credit quality risk for a host-country local bank (domestic sovereign debt) could be transformed, through the process of balance-sheet consolidation, into a parent bank’s foreign sovereign-risk exposure. A foreign sovereign-risk exposure denominated in foreign currency is assigned a much higher RWA than a domestic sovereign exposure denominated and financed in local currency.
- *Basel 2.5 produces significant increases in the RWA for trading exposures in the financial markets of EMDEs and small economies.* Basel 2.5 exacerbates global banks’ costs of trading exposures to EMDEs and small economies, when global credit ratings are used to assess their foreign sovereign exposures. Higher capital charges will also be particularly significant for sovereign domestic debt held by large subsidiaries of global banks because their risk positions may increase the capital requirements for concentration risks.

(b) **While most EMDEs and small economies will not have great difficulties in complying with the new definition of capital in Basel III, there could be several implementation challenges:**

- *The eligibility criteria for Tier 1 and Tier 2 are non-trivial.* This applies in particular to the requirement that all these instruments have a “point of non-viability clause,” that is, all regulatory capital instruments should be able to absorb losses in the event that the issuing bank reaches a point of non-viability. In addition, once the clause is triggered, supervisors may face potential governance issues when conversion brings in shareholders that may not be fit and proper. More broadly, the change of ownership structure may have implications for the viability of the institution going forward.
- *The deduction of Deferred Tax Assets (DTA) proposed by Basel III seems to weigh relatively more in EMDEs than in advanced economies.* This may be partly due to provisioning and accounting

⁴ Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010, www.bis.org/publ/bcbs189_dec2010.htm

⁵ Basel Committee on Banking Supervision, *Revisions to the Basel II market risk framework – updated as of 31 December 2010*, February 2011, www.bis.org/publ/bcbs193.htm

legal frameworks, eg forward looking provisions frequently are not recognised by tax authorities and generate DTA.

- *Implementation of Basel III will generate a need for capital replenishment.* Reasons for this include: (i) banks in EMDEs and small economies inevitably need to issue additional capital given their relatively fast economic growth and the pivotal role played by banks in funding; (ii) higher minimum regulatory capital requirements at the international level will likely lead to banks in EMDEs and small economies building up capital to maintain buffers against a relatively higher degree of macroeconomic and market volatility, and (iii) internationally active banks often use the sovereign credit rating of the host jurisdiction as the credit ceiling or the risk floor for all the exposures incurred by their subsidiaries - EMDEs and small economies with lower credit ratings could thus find their banking system with higher capital levels than in advanced economies, regardless of whether banks in the latter are more exposed to other systemic risks.
- *The supervisory powers to implement the mandatory capital conservation and countercyclical buffers will be essential to ensure effective implementation.* In addition, there are complex issues related to the interaction of these buffers and additional buffers that might have been required by supervisors under Pillar 2. Furthermore, the countercyclical buffer could have negative consequences stemming from the limited understanding of credit cycles and the complexities involved in setting such a tool. In many EMDEs and small economies, a mechanistic application of the recommended methodology (measuring excessive growth on the basis of deviations from the long-term trend of credit relative to GDP) may not be adequate. It is recognised that the standard allows for some flexibility (including the use of sector-specific indicators). However, admitting other types of indices in an emerging market context might be difficult, especially if the framework is not explicit about what flexibility entails. In an EMDE context, supervisory powers tend to be more limited and not easily given by legislators.

(c) Banks in EMDEs and small economies could move to the IRB approaches without being ready and respond to higher capital requirements by not revealing and recognising all potential risks associated with their balance sheets. The higher requirements may create an incentive for banks to use the advanced risk measurement techniques under Basel II to achieve lower implicit risk weights with the same balance sheets, and put pressure on supervisors to approve such practices even if a bank is not ready (eg by citing reputational concerns). This could put somewhat arbitrary cushions against expected and unexpected losses. In addition, an incorrect or manipulative use of IRB methods and accounting rules could weaken consistency and comparability due to excessive variation in risk measurement without better management of the underlying risks.

Recommendations by the Basel Consultative Group

8. **In order to deal with the challenges of implementing the Basel 2.5 and III capital framework the BCG recommends the following:**

- **Basel 2.5:** The Basel Committee could issue specific guidance for the appropriate use of local and global credit ratings and the risk assessment of sovereign exposures (denominated and funded in local currencies) booked in foreign subsidiaries. When consolidating parent banks and subsidiaries' balance sheets and assigning RWAs, guidance is needed on practices regarding the risk-weighting, at the consolidated level, of foreign subsidiaries' risk exposures – both the currency denomination of assets/liabilities and the legal differences between a parent bank's assets/liabilities in an overseas branch from those of a subsidiary should be taken into account. In addition, the Basel Committee should re-evaluate the circumstances in which it may be appropriate to deduct an entity from regulatory capital rather than consolidate its exposures. The latter can be particularly important for structurally separated entities that are systemically important and have limited intra-group exposures.

- **Difficulties associated with the deductions and eligibility criteria for Tier 1 and Tier 2 instruments under Basel III:** EMDEs and small economies may need to implement changes to their legal frameworks. In the case of the eligibility criteria for Tier 1 and Tier 2 instruments, the national legal and regulatory frameworks should be consistent to ensure that the non-viability clause is effective. While the criteria driving the trigger for conversion/write off can in principle be set out *a priori* in broad terms (allowing for better pricing of the instruments and helping reduce market uncertainty and the legal risk to supervisors), the decision as to whether a bank can continue on its own will ultimately always be a judgment call. As a result, supervisors need to be given sufficient powers to be able to make such decisions.
- **Capital conservation buffer and counter-cyclical buffer:** The restrictions on the distribution of profits in cases of non-compliance with these capital buffers should be automatic and imposed on banks through requirements set forth by national legislation. Such supervisory powers to restrict profit distributions and modalities to activate various triggers are still lacking in some EMDEs and small economies. Such powers should be provided to supervisory authorities. Supervisors also need to assess if the Pillar 2 add-ons could safely be drawn down in times of crisis. If this is not the case, such add-ons should be considered a minimum requirement for the bank. With regard to the countercyclical buffer, supervisors should use the flexibility provided in the framework to use judgement and/or undertake a comprehensive analysis to improve the understanding of credit cycles rather than mechanically relying on credit to GDP de-trending. In addition, examples of other macroprudential tools (such as sector-specific counter-cyclical buffers) that could be used to enhance banks' resilience to credit booms should explicitly be set out in Basel standards.
- **The need to replenish capital:** EMDEs and small economies need to take actions to cultivate domestic markets for the issuance of structured capital instruments, including: (i) having in place legal and institutional arrangements to enable the issuance of Basel III recognised capital instruments; (ii) defining *a priori* criteria for the triggering of the point of non-viability, which may help boost market confidence and acceptance for issuance of structural capital instruments.⁶ If foreign bank subsidiaries operating in EMDEs and small economies issue capital and this is included in the consolidated group's capital, authorities may need to impose certain regulatory requirements to avoid capital being used to cover losses of parent banks. Enhanced communication between home and host regulatory needs to be encouraged and should cover, among other issues, regular information sharing of the performance of related parent banks and subsidiaries and related resolution plans.
- **Establish priorities for progressive movement to more sophisticated approaches within the Basel framework (eg IRB approaches):** Supervisory authorities should ensure robustness, reliability, and transparency of prudential outcomes from the adoption of Basel standards, including the Core Principles for Effective Banking Supervision ("Basel Core Principles"). In this context, Pillar 3 should be seen as a tool for meeting the needs of investors and counterparties. Decisions on the pace of the implementation would need to consider particular characteristics of banks and banking systems, as well as supervisory constraints. For example, some countries

⁶ Basel Committee on Banking Supervision, *Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee*, January 2011, www.bis.org/press/p110113.htm

The Annex of the press release states: "The trigger event is the earlier of (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority." Several BCG members believe that the flexibility afforded under the current approach is needed to take into account the different legal environments and practices across jurisdictions.

have considered the adoption of a more rules-based approach to Pillar 2 requirements as a way forward amidst the presence of legal frameworks which significantly limits supervisory powers. When considering the capital framework for smaller and less sophisticated banks, authorities should be aware that Basel II and Basel III standards are designed primarily for large international banks operating in BCBS member jurisdictions. However, when the majority of the banking sector is owned by these large institutions, supervisory authorities in EMDEs and small economies should build relationships with the home authorities of their largest banks and, upon agreement with the home authority, participate in relevant discussions on model validation within supervisory colleges.

3. The Basel III liquidity framework

Background

9. **The liquidity coverage ratio (LCR) is designed to improve banks' resilience to short-term liquidity shocks through holding a reserve of high quality assets (HQLA).** Together with the Net Stable Funding Ratio (NSFR), the LCR is part of the first internationally agreed liquidity framework. Previously, national practices and experiences of liquidity requirements differed. Nevertheless, many countries, including some EMDEs and small economies, had developed approaches based on the concept of banks holding stocks of liquid assets to withstand stressed periods.

10. **The BCG believes that implementation of the new liquidity framework will be challenging for some EMDEs and small economies.** In particular:

- **Despite the emphasis on diversification, concentration risk, particularly to sovereign debt (a "Level 1" asset), can easily emerge.** The LCR requires banks to hold a diversified portfolio of HQLA that can be liquidated in a stress event to cover the outflow of liabilities, but the room for diversification will be limited in many EMDEs and small economies with limited access to other HQLA than sovereign debt. Furthermore, yields on HQLAs will typically be lower than other securities, implying a cost to banks' profit margins. Where strategies based on broadening the asset pools are used to address scarcity of eligible HQLA (eg greater use of "Level 2" HQLA such as corporate debt), greater volatility in market risk and increased exposure to credit risk may be introduced.
- **For some EMDEs and small economies, the LCR may increase foreign currency risk if banks meet LCR shortfalls in domestic currency with foreign currency assets.** Currency convertibility in the LCR framework for dollarised countries needs further guidance. It is questionable, for example, whether it is prudent to allow surplus in dollar LCR to cover a shortfall LCR in the domestic currency and vice versa. Also, while Basel III does not require the LCR to be met currency by currency, monitoring and reporting of relevant currencies forms part of the LCR framework and banks may feel under pressure to meet the LCR in all individual currencies, thus increasing demand for foreign currency HQLA. This may in turn affect the price and availability of such assets.
- **Banks in EMDEs and small economies generally rely heavily on deposits for funding, putting a premium on applying appropriate run-off rates to deposits.** For example, banks in Malaysia, the Philippines or Saudi Arabia enjoy very high levels of deposits, over 80% of their total funding. Broadly this funding pattern reduces the HQLA requirement but close attention needs to be paid to the breakdown of deposits to ensure low run-off rates are suitable and reflect local conditions.
- **Enhanced liquidity requirements are encouraging groups to hold liquid reserves at the parent level, but it is unclear when and how these reserves should be made available to subsidiaries and branches.** Authorities who are part of the Global International Financial Centres Supervisors (GIFCS) group have expressed concerns that: (i) parent regulators could (*in extremis*) require parent banks to prioritise the home need for liquidity; (ii) deposits placed at a parent bank by foreign subsidiaries could become subject to bail-in arrangements; (iii) operations undertaken by banks in GIFCS jurisdictions incur a higher liquidity charge, which

does not reflect their more stable nature at the point of origination,⁷ and (iv) bank structures may change in response to measures that ring-fence core activities and require “living-wills”. As a result, banks may be “compartmentalising” their different operations, which may weaken the ownership chain and the availability of group liquidity and capital support.

Recommendations by the Basel Consultative Group

11. **The LCR demands careful planning and dedicated resources.** Transition to the LCR, which is relatively more sophisticated than most existing Basel methodologies, could pose a substantial challenge for many countries. In this context, further guidance by the Basel Committee will be important to ease transition for EMDEs and small economies. More specifically, authorities may wish to consider the following issues when implementing liquidity standards:

- **Jurisdictions must determine the scope of LCR coverage.** For internationally active banks in BCBS member jurisdictions, the LCR is mandatory. For the more advanced banks in EMDEs and small economies where a similar methodology already exists, there is considerable value in implementing the LCR and applying it to banks that have material cross-border activities. For jurisdictions where an LCR-like rule does not exist and cross-border activities are minimal, the aim should be to move to the LCR framework gradually to give banks time to improve their capacity. During this transition, consideration should be given as to whether the LCR parameters are sufficiently stringent or need to be tightened as appropriate to the local context.
- **Jurisdictions should assess national discretions and the options for Alternative Liquidity Approaches (ALA) in the context of their own systems.**⁸ A first step is to understand the availability and characteristics of liquid assets and the liquidity characteristics of banks’ sources of funding. The pros and cons of the ALA options must be carefully assessed. The flexibility the LCR framework offers in terms of the ALA and national discretions should enable an orderly transition based on careful consideration of QIS information and stringent application of criteria for ALA treatment. Nevertheless, the Basel framework provides stringent criteria and processes for jurisdictions to be qualified for the ALA treatment, including periodic self-assessment and independent peer review. EMDEs and small economies should strive to adhere to these as much as possible.
- **It is advisable for supervisors to monitor the LCR by currency and jurisdiction irrespective of the importance of foreign currency in banks’ balance sheets.** Such information allows the supervisor to identify any potential currency mismatches and to consider the liquidity risk in foreign currencies.
- **A quantitative impact study (QIS) to design the LCR appropriately for EMDEs and small economies.** The QIS should provide granular data, such as amounts of different types of HQLA that banks hold, or banks’ ability to categorise deposits based on their stability. Fluent two-way communication mechanisms with the banks, such as workshops, are recommended to ensure that banks’ understand the standard, and authorities understand the banks’ capacities so that adjustments to local standards, criteria, haircuts and run-off rates can be made where appropriate.

⁷ Banks in GIFCS jurisdictions raise deposits locally, which are then lend to central treasuries in banking groups; this operation is typically treated as wholesale funding at the home level, thus incurring a higher liquidity charge.

⁸ The LCR framework includes three options to address an insufficient supply of HQLA (“Alternative Liquid Asset Treatment”).

- **Organisationally, a dedicated unit in the supervisory agency will smooth LCR implementation.** Involvement of regulatory and supervisory staff will provide breadth of knowledge and experience and should remain a stable contact point for the banks, providing control, expertise and communication.

12. **The BCBS should further encourage home supervisors to reach understanding with banks and host supervisors on how and when liquidity held centrally should be made available to subsidiaries and branches.** This is particularly important when the home country supervisor has not adopted a single point of entry resolution scheme. Absent such understandings, there may be a need for host supervisors to require subsidiaries and branches to retain minimum liquidity at the local level. In terms of supervision and resolution, the BCBS should encourage a wider sense of continuing responsibility for group-wide banking operations. Market-wide solutions like those adopted in EU should be explored and could help avoid home supervisors to retrench and become more inward looking. In addition:

- **Bail-in arrangements:** home and host supervisors are encouraged to agree on likely resolution scenarios in advance. While host supervisors could insist on bank deposits of subsidiaries at their parents being secured, this is not conducive to orderly group-wide resolutions.
- **Treatment of non-retail deposits:** a more flexible treatment should be allowed to reflect the nature of the underlying depositors, which would reflect the reality of the business model and support the continued diversification of funding. In addition, with respect to the liquidity framework, the Basel Committee should place an even stronger emphasis on consolidated supervision by the home supervisor while maintaining close communication with the host supervisor.

4. OTC derivative market reforms

Background

13. **In an effort to improve OTC derivative markets, G20 leaders agreed on a set of reforms in late 2009.** The reforms aimed at ensuring that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. OTC derivative contracts would have to be reported to trade repositories and non-centrally cleared contracts would be subject to higher capital requirements.

14. **EMDEs and small economies play a relatively minor systemic role in global OTC derivatives markets, and an even smaller role in the global credit derivatives market.** That being said, globally important financial institutions do play a key role in the host markets of many EMDEs and small economies, and hence cross-border issues are critical to help improve over-the-counter derivatives markets.

15. **The impact of OTC derivatives market reforms in EMDEs and small economies varies widely given differences in financial market characteristics and the stage of financial development.** The dividing line in the more difficult reform issues is between major financial centres and all other jurisdictions, not necessarily between advanced and other economies. While reforms are most advanced in the major financial centres, as they are the primary home jurisdictions of the most significant OTC derivatives markets, reforms will likely: (i) increase the cost of entities that need derivative hedging vehicles and, (ii) limit the amount of bespoke transactions for entities operating in EMDEs and small economies, where bespoke transactions might be more prevalent (particularly for small-and medium-sized businesses).

16. **The cost of creating certain financial market infrastructures, where annual turnover is relatively low, might not be justified in EMDEs and small economies.** Nevertheless, some EMDEs and small economies are considering creating a local CCP, while many others seem to be focused on creating or designating a trade repository as the most important element of their OTC derivatives market reform goals. However, the cost of creating certain financial market infrastructures, where annual turnover is relatively low, might not be justified in EMDEs and small economies. Where a business case is not present for designing a new financial market infrastructure, this type of reform initiative might be introducing new risks rather than eliminating existing risks. Even though the benefits of increased centralised clearing generally outweigh costs due to a lower frequency of financial crises⁹, this might not be the case in localised situations where trade volumes do not justify the CCP existence.

17. **Infrastructure costs would be minimised by allowing market participants to report their OTC derivative transactions to a foreign trade repository.** Data protection concerns, however, will need to be addressed before embarking on this strategy. Moreover, if an EMDE/small economy designates a trade repository outside its own jurisdiction, it will expect the reporting to be two-way and require the trade repository to communicate macro-economic data and fully honour information requests for investigations. The various indemnification provisions regarding data protection currently being debated for trade repositories (which receive and share information with outside parties) is an example of the complexity in these cross-border arrangements, and highlights an issue and a risk that must be resolved prior to moving forward with centralised data sharing.

⁹ See the “Macroeconomic impact assessment of OTC derivatives regulatory reforms”, Bank for International Settlements Macroeconomic Assessment Group on Derivatives, dated August 2013.

Recommendations by the Basel Consultative Group

18. **Relevant reforms should be sequential in nature.** Simultaneous reform initiatives between major and minor financial jurisdictions will only lead to inefficiencies of infrastructure design and incompatible operating information systems. Agreements should first be reached between major financial jurisdictions on cross-border reporting for internationally active banks involving data fields, data flows and data security at major CCPs and trade repositories before other jurisdictions begin designing systems to match those requirements. It is also important to endorse an explicit reference to thresholds of proportionality, and possible *de minimis* rules, with respect to mandatory central clearing and reporting. While this sequential reform effort might delay the global readiness of all OTC derivatives markets, it should not have any material impact on reducing global systemic risks as the overwhelming percentage of OTC notional values are traded via the major financial centres.

19. **With a small number of large intermediaries providing the majority of global client clearing, authorities need to ensure that appropriate regulatory and supervisory safeguards are in place to address potential intermediary concentration or access issues.** This is particularly important for jurisdictions with smaller OTC derivatives markets where authorities have noted that participants in their markets are likely to have access to central clearing for certain products only through client clearing arrangements.¹⁰

¹⁰ See the "OTC Derivatives Market Reforms. Seventh Progress Report on Implementation". Financial Stability Board, 8 April 2014.

5. Sovereign exposures

Background

20. **The Basel III framework generally provides preferential treatment of sovereign exposures.** This has a risk of reinforcing the links between sovereign and banking sector stresses, as became apparent in the recent global financial crisis. In addition, as jurisdictions may exercise national discretion to assign a zero-risk weight for domestic sovereign exposures under the capital framework, there could be further incentives for banks to hold domestic sovereign exposures.

21. **The buildup of sovereign exposures on the balance sheet of banks is a relevant concern for EMDEs and small economies.** In line with the development of domestic capital markets, sovereign debt in EMDEs and small economies is increasingly being funded in domestic currencies. However, domestic bond markets in EMDEs and small economies are still under development, thus limiting the ability of banks to diversify their assets. This poses several challenges, including for the implementation of the LCR. Addressing banks' sovereign exposures is particularly pertinent for those EMDEs whose economies are dollarised, are members of currency blocks, and/or issue a significant amount of sovereign bonds denominated in foreign currency.

Recommendations by the Basel Consultative Group

22. **Several principles can guide the approach aimed at limiting excessive accumulation of sovereign exposures spurred by market and regulatory incentives.** While the authorities must recognise that banks have legitimate motivations to hold sovereign exposures, the approach needs to: (i) differentiate among types of sovereign debt held by banks; (ii) be tailored to country specific circumstances; (iii) consider potential unintended consequences; and (iv) be supported and informed by a robust analytical framework. As a start, jurisdictions should require scenario-based stress tests for sovereign credit events, supported by reverse stress testing and sensitivity analyses.

23. **Potential menu of approaches to address sovereign risk build-up includes:** (i) sovereign risk capital buffers, such as incremental capital charges on sovereign exposures under Pillar 1 or concentration charges under Pillar 2; (ii) more robust and consistent cross-jurisdictional application of the Pillar 2 supervisory review process to address risks associated with excessive concentration; (iii) a limit on the size of sovereign debt exposures, possibly as a percentage of total assets or capital, and (iv) supply-side measures to promote sovereign risk diversification, such as vehicles or funds for sovereigns to collectively pool liabilities, as well as initiatives aimed at developing domestic and regional bond markets.

6. Domestic systemically important banks

Background

24. **One of the responses to the global financial crisis was the emergence of the concept of systemically important financial institutions (SIFIs).** Global systemically important banks (G-SIBs) have been identified as institutions that can cause substantial cross-border repercussions and be a source of strong negative externalities. The new notion of domestic systemically important banks (D-SIB) is analogous to that of G-SIBs, but the D-SIBs framework focuses primarily on the impact that the domestic bank could have on the domestic economy. As in the case of the G-SIB, the regulatory framework of the D-SIB aims at reducing the probability of failure of these institutions and at mitigating the negative impact in case of failure.

25. **The implementation of the G-SIB/D-SIB framework has several challenges:** (i) moral hazard could increase if these institutions are perceived as “too big to fail”, particularly in small economies with few banks and a high ratio of them identified as D-SIBs; (ii) intra-group flows of capital could emerge in banking systems dominated by foreign-owned banks, and (iii) parent banks of subsidiaries classified as D-SIBs could have the incentive to circumvent this regulation, thus providing a competitive advantage to branches.

Recommendations by the Basel Consultative Group

26. **Addressing the challenges associated with the implementation of the G-SIB/D-SIB framework entails adopting mitigating measures on several fronts:** (i) the moral hazard related to owners and managers of a D-SIB could be mitigated by bank-specific recovery and resolution plans and by providing public assurances that “D-SIB status” is not equivalent to “too big to fail status”; (ii) the possibility of intra-group flows of capital could be mitigated by cooperation between the regulatory authorities and by an appropriate phasing in of capital requirements in home and host jurisdictions, and (iii) host authorities should strengthen their regulatory/supervisory powers over branches and deter the conversion of subsidiaries into branches if this is primarily driven by regulatory circumvention.

27. **Since the identification of D-SIBs is concerned primarily with domestic effects, local authorities should be given sufficient room to manoeuvre to develop their own methodologies reflecting conditions specific for local markets.** Nevertheless, the choice of indicators should respect the overall approach of the framework. In line with the principles set by the Basel Committee, the assessment of banks should be based on indicators that are in line with a “loss given default” concept rather than a “probability of default” concept.

7. Cross-border supervisory colleges

Background

28. **Supervisory colleges are a useful mechanism for systematically sharing information on international banking groups and the risks their operation may imply.** These colleges aim to provide the authorities with the tools and coordination mechanisms to properly manage and minimise the risks posed by a banking group with operations in multiple jurisdictions. However, they are not decision-making bodies and are not intended to replace the bilateral or multilateral relationship established between supervisory agencies and the responsibilities of each supervisor.

29. **As global bank operations in EMDEs and small economies tend to be relatively small compared to operations of the rest of the group, supervisors from these jurisdictions are not likely to be included in the core college.** This limits the information they get and their influence over home supervisors, thus creating significant challenges. This applies particularly to situations where the foreign operations of a bank are not regarded as systemic by the home supervisor, but are systemically important in the host country. Other aspects that may hinder effective supervisory cooperation include legal constraints for information sharing and lack of mandatory mediation processes for disagreements between supervisors.

Recommendations by the Basel Consultative Group

30. **To increase the effectiveness of cross-border supervision, the following actions are recommended.**¹¹

- **Supervisory colleges:** The Basel Committee should continue to encourage the enhancement of supervisory college structures to ensure that supervisors from relevant jurisdictions are invited to colleges. In this context, host supervisors should: (i) notify home supervisors when a banking subsidiary is important for the host's financial system; (ii) combine their efforts with other host supervisors to ensure a greater influence and voice in a college; (iii) sign a confidentiality agreement (at the request of home supervisors to the host supervisors), with home supervisors taking the lead in drafting a proposal of the college meeting agenda and distributing any documents to be discussed in colleges *ex-ante* (preparatory conference calls may also be useful); and (iv) ensure convergence of supervisory powers to improve coordination for an effective consolidated supervision.
- **Information sharing:** Home and host supervisors should: (i) sign an MOU before granting a banking license to any cross-border institution (a standardised MOU would facilitate this process); (ii) define the minimum amount of information that needs to be shared; and (iv) clarify who the supervisors of particular groups are, maintain close coordination between home and host supervisory teams and understand each other's supervisory frameworks. IMF Article IV and FSAP reports would help in this regard.

¹¹ The BCG recognises that several of these recommendations have been incorporated in the publication by the Basel Committee on *Revised principles for supervisory colleges*, June 2014, www.bis.org/press/p140626.htm

- **Cross-border supervision:** (i) Home authorities should provide host authorities with a detailed organisational structure of the banking group and inform about major regulatory reforms and/or implementation challenges in their jurisdictions; (ii) Supervisors must ensure that the parent and subsidiary meet all the international standards. To avoid regulatory arbitrage, they should have the power to require capital for entities in their jurisdiction, and to require a restructuring of the financial group, as deemed appropriate.