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Debate organised around our study

Basel II – the current state of play; can the interests of developing countries be better protected?

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On May 11 the Basel Committee on Banking Supervision (BCBS) issued a press release to confirm that consensus had been reached on all outstanding issues surrounding the new Basel Capital Accord. However, we understand that this is not completely the case: many of the technical calibration details, which are clearly important to the impact the Accord will ultimately have, are yet to be finalised. This raises the possibility that it is still not too late for the BCBS to make changes to the Accord, if they can be persuaded that they are justified. Our concern throughout this process has been to ensure that the interests of developing countries are fully taken into account, despite the fact that they have no formal representation on the Basel Committee itself. It is encouraging that positive changes have been made in the final revision with respect to the treatment of project finance, so that much needed projects in the developing world are not prejudiced by overly high regulatory capital requirements. We would argue, however, that the BCBS needs to show the same flexibility in a far broader sense with respect to developing countries' treatment under the new Accord: it is hopefully not too late to make the modifications that we have proposed elsewhere, and summarise below.

The BCBS is to be congratulated on reaching this stage with only a relatively minor slippage in the final timetable. The Accord is intrinsically complex, and its complexity has only increased as the process has evolved. The Committee has focused on key issues, such as achieving the correct calibration in the IRB functions – a critical area for the Committee here is to maintain the overall level of regulatory capital in the system at 8%.

One of the key drivers of the reforms is to better align regulatory capital with risk. To this end, capital requirements for higher rated borrowers will fall significantly. An immediate corollary of this, however, is that in order to maintain the 8% overall level, capital requirements for lower rated borrowers will also rise significantly. Clearly developing and emerging economies contain a disproportionate number of lower rated borrowers, in comparison with the developed markets. It is not disputed, therefore, that – on average – regulatory capital requirements for emerging and developing country borrowers will increase significantly: the increase will, of course, be greatest for those borrowers with the lowest ratings.

The BCBS has argued that this will have little effect on the pricing and terms of lending, as banks price off their own economic capital models, rather than on the basis of regulatory capital. Consequently, it is argued, the reforms will merely bring regulatory capital into line with existing best practice. While it is true that some of the largest international banks do have an economic capital framework that is fully integrated into their systems and processes, it is not universally the case. Indeed, a recent survey of leading European banks by PriceWaterhouse Coopers found that only 10% of the banks surveyed had such a fully integrated system. For the others, it is the Basel process itself that is driving them to develop operational systems.

It seems highly improbable that these major shifts – wherein capital requirements for higher rated borrowers will fall substantially whilst those for lower rated borrowers rise sharply – will have no impact on either the pattern of lending to borrowers of different ratings or the pricing and terms of these loans. We fear that borrowers from emerging and developing economies will see the quantity of international lending to them fall, and the pricing of what lending remains deteriorate.

It is also argued that, even if there is some deterioration of the conditions facing lower rated borrowers, this is acceptable as it simply reflects a more accurate measurement of risk. However, this is not the case in an important aspect. We have undertaken empirical research to examine the impact on a bank's loan portfolio of international diversification. Our results clearly demonstrate that a bank with a portfolio which is diversified across both developed and emerging markets has a better risk/return trade off than one focused purely on developed markets. The most sophisticated international banks already incorporate this portfolio effect into their economic capital calculations. Unfortunately, however, Basel II will not take this important risk reducing factor into account, with the result that international diversified banks will have higher regulatory capital requirements than are objectively justified.

We therefore fear that incentives to lend to emerging and developing country borrowers – already low - will be further reduced by the failure to take account of the benefits of international diversification. This could have very negative effects on those countries growth, reducing the space for poverty reduction. There are two possible means by which international diversification benefits could be incorporated: first, the principle of international diversification could be directly incorporated into Pillar 1 of the Accord by means of an adjusting factor that would operate at the portfolio level; second, if this proved impossible the European Union could unilaterally incorporate this reform into the CAD3 legislation which is currently being negotiated and which will be discussed in the European parliament. At least Europe could provide a positive example to the world by approving an Accord that does not unfairly and inappropriately damage developing countries.