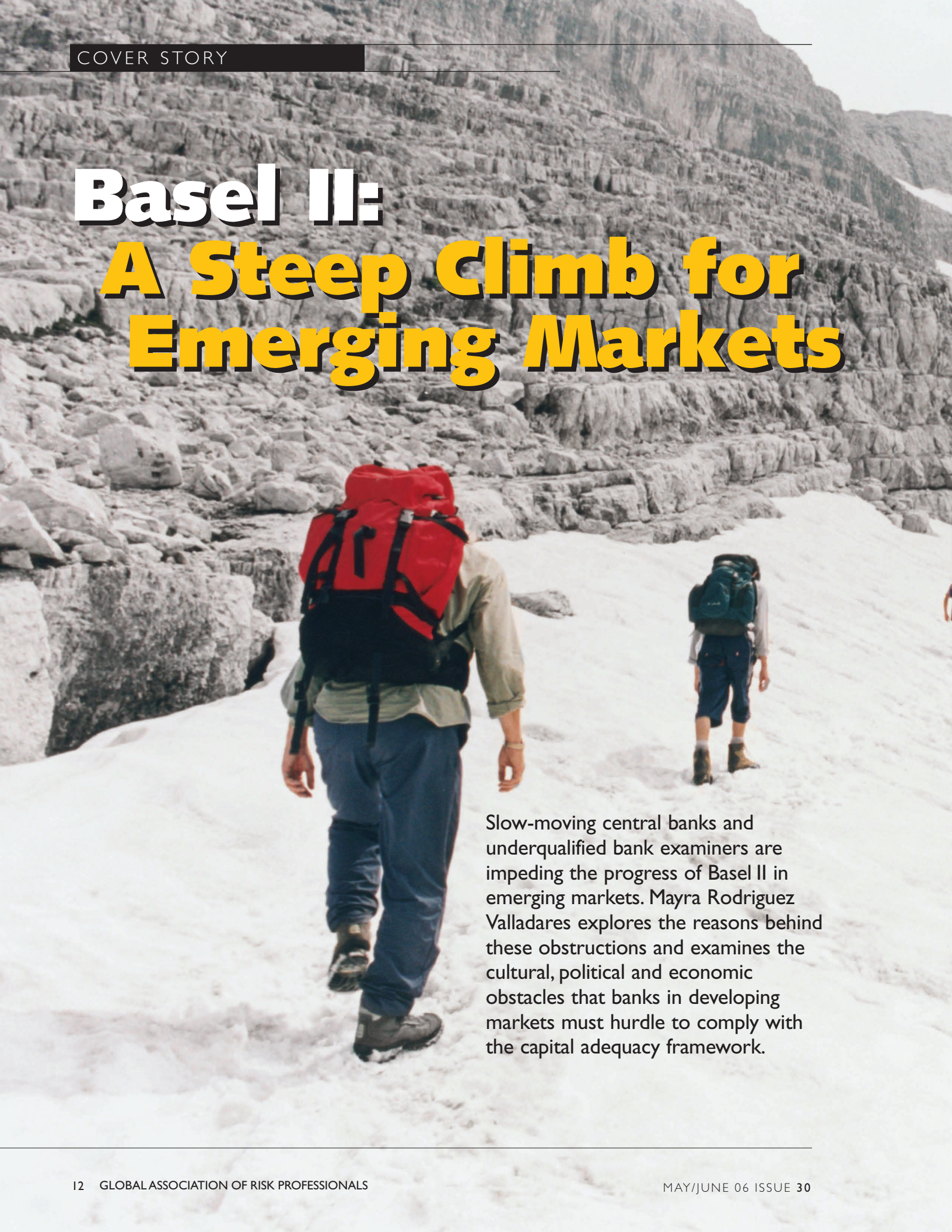


Basel II: A Steep Climb for Emerging Markets

A photograph of two hikers with large backpacks walking on a snowy mountain trail. The hiker in the foreground is wearing a red backpack and a green jacket, while the hiker in the background is wearing a blue backpack and a grey jacket. The trail is a mix of snow and rocky terrain, with a steep, rocky mountain face in the background.

Slow-moving central banks and underqualified bank examiners are impeding the progress of Basel II in emerging markets. Mayra Rodriguez Valladares explores the reasons behind these obstructions and examines the cultural, political and economic obstacles that banks in developing markets must hurdle to comply with the capital adequacy framework.

While many financial institutions in the developed world have made significant strides in preparing for Basel II, banks in emerging markets are lagging significantly behind. Central banks in these developing markets, in particular, have been reluctant to change and have been slow to adopt risk-based supervision as the process by which they supervise and examine commercial and investment banks. Moreover, emerging markets' bank examiners — the risk professionals who are responsible for assessing the ability of individual banks to identify, monitor, measure and control risks —

are often underqualified and undermotivated.

Economic crises of the last two decades in Latin America, Asia and Russia have exposed significant weaknesses in emerging markets' financial systems. So it is crucial for banks in these markets to comply with the vigorous requirements of the three pillars of Basel II¹ for the sake of economic growth and stability.

But whether central banks in emerging markets choose to comply with Basel II is a question of individual national policy rather than of the Basel Committee's timetable. The last significant survey that attempted to evaluate emerging markets' Basel II readiness was conducted by the Financial

Stability Institute and the Basel Committee on Banking Supervision (BCBS) in 2004. The objective of this so-called "Basel II Implementation Assistance Questionnaire" was to identify Basel II implementation plans and to determine corresponding capacity-building needs in the non-BCBS supervisory community.

The questionnaire was sent to 115 jurisdictions in Africa, Asia, the Caribbean, Latin America, the Middle East and non-BCBS Europe, and responses were received from 107 jurisdictions. While a majority of emerging markets responded that they are adopting Basel II, the time schedules for the implementation of the accord varied dramatically (see Figure 1, left).

We should know more about the progress emerging markets have made with regard to Basel II in the near future. In the winter of 2005, BCBS distributed its Quantitative Impact Study 5 (QIS 5) globally. This study should reveal more updated Basel II data, painting a clearer picture of whether emerging markets' banks have made significant progress with their implementation plans. The BCBS plans to release data and analysis from QIS 5 later this year, but it has not specified an exact date.

Which emerging markets countries will be able to actually meet all of the requirements of Basel II is yet to be determined. However, analysts and investors can better understand the readiness of specific countries by exam-

Figure 1: Banking Sector Assets

Expected to be Subject to Basel II (weighted average)

Regions	Type*	by end of 2006	2007-2009	2010-2015
Africa	Locally Incorporated	53%	60%	81%
	Of which:			
	foreign controlled	3%	6%	10%
	foreign incorporated	5%	5%	6%
	Total	58%	65%	87%
Caribbean	Locally Incorporated	0%	12%	15%
	Of which:			
	foreign controlled	0%	11%	13%
	foreign incorporated	0%	11%	11%
	Total	0%	23%	26%
Latin America	Locally Incorporated	19%	83%	93%
	Of which:			
	foreign controlled	15%	27%	29%
	foreign incorporated	0%	2%	2%
	Total	19%	85%	95%
Middle East	Locally Incorporated	13%	76%	79%
	Of which:			
	foreign controlled	0%	13%	14%
	foreign incorporated	6%	13%	13%
	Total	19%	89%	92%
Non-BCBS Europe	Locally Incorporated	73%	84%	89%
	Of which:			
	foreign controlled	21%	27%	27%
	foreign incorporated	5%	5%	5%
	Total	78%	89%	94%
Asia	Locally Incorporated	25%	59%	60%
	Of which:			
	foreign controlled	7%	8%	8%
	foreign incorporated	13%	13%	13%
	Total	38%	73%	73%

* Foreign controlled are incorporated by locals, but foreign entities own 51% or more of the bank

Source: Summary of responses to the Basel II implementation assistance questionnaire about the implementation of the new capital adequacy framework in non-Basel Committee member countries, Occasional Paper 4, August 2004.

ining the following key factors:

- **Macroeconomic stability.**
- **Capital markets development.**
- **Openness of banks to foreign investment and activity.**
- **Central banks' focus on risk-based supervision.**
- **Capacity of bank examiners.**
- **Banks' risk management processes and systems.**

Macroeconomic Factors

Since 2003, emerging markets have improved in many areas, boasting lower inflation, declining fiscal deficits and increasing exchange-rate regime flexibility.

Despite these improvements, emerging markets still face a number of economic challenges. For example, to prevent capital outflows, developing countries have been compelled to raise their interest rates to keep pace with recent interest rate hikes in the US and Europe. These interest rate increases have made it difficult for both companies and individuals in emerging markets to borrow funds, and this potentially threatens the growth of these countries.

Developing countries must also hurdle obstacles presented by Basel II. Pillar I of the accord raises regulatory capital requirements for higher risk asset classes — including emerg-

One last factor worth considering is oil prices. High oil prices have prevented some countries — such as Saudi Arabia, Russia, Nigeria and Venezuela — from undertaking significant macroeconomic reforms. If global interest rates were to increase significantly and oil prices were to start declining, many emerging markets would suffer.

Signs of Progress

The development of local currency bonds has been one recent sign of progress in emerging markets. These markets, in fact, are increasingly relying more on local currency debt issues and less on foreign exchange issues — i.e., local authorities and investors are demonstrating more and more faith in instruments developed in emerging markets.

Local currency debt issues have in fact been part of the largest emerging market countries, such as Brazil, Mexico and Russia. However, a lot more investor confidence needs to arise before more countries can issue local currency debt more frequently.

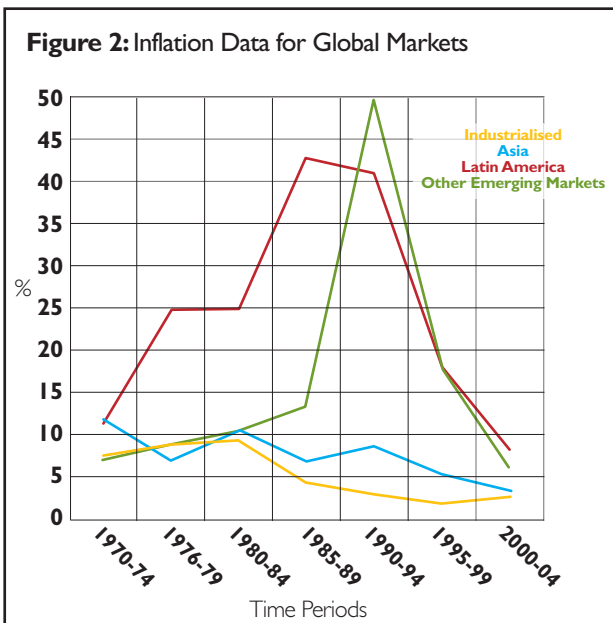
Further development of local currency bonds will be beneficial for emerging markets, because it will help corporations raise capital and will provide useful traded benchmarks for banks and investors. Local currency bonds will also help commercial banks develop useful reference assets that are imperative for the development of credit derivatives.

In the name of progress, in addition to establishing local currency bonds, emerging markets need to open up their banking systems to foreign banks. As noted in July 2004 by the Working Group of the Committee on the Global Financial System,³ the entry of foreign banks into major emerging market financial systems brought many benefits, such as “improved management and technical skills, greater capital backing for the risk-taking of financial intermediation ... and greater diversity in the channels of intermediation.”

Today, fearing competition, local emerging market banks too often fight vehemently against the entry of foreign banks. For example, the current environment of high oil price has led many countries — including Russia, Venezuela, and, most recently, Bolivia — to undertake measures to restrict foreign participation in that sector. But if they want to move forward, emerging markets must try to prevent the trend toward nationalization from extending into the financial services sector.

Risk-Based Supervision: A Must

Increasingly, emerging market central banks are realizing that they must improve their banking supervision practices by adopting a risk-based supervision approach. This entails hiring bank examiners who can properly assess the quality of a bank's risk management process of identifying, mea-



Source: International Monetary Fund staff calculations, 2004²

ing markets. These requirements will alter developed banks' lending patterns to emerging markets. And the growth potential of corporate and household sectors in these markets could be negatively impacted by the combination of higher interest rates and changes in lending patterns.

sure, monitoring and controlling risks. However, this is easier said than done.

A major cultural change that needs to take place in most emerging market central banks is that senior management must make it clear to middle management that training personnel in the risk-based supervision process is a key priority. To achieve this, banks must close up the chasm that exists between middle managers and bank examiners.

Due to the hierarchical nature of most central banks in emerging markets, middle managers tend to be middle aged and very reluctant to change. Hence, middle managers exert enormous influence on what bank examiners — who tend to be younger and much more open to the idea of adopting risk-based supervision — write about their findings after a bank examination.

In one central bank where I worked, examiners complained that middle managers would often make them change aspects of their reports that delineated bank weaknesses, because middle managers did not want to “hurt the feelings” of the banks. Indeed, attempting to exert influence on central bank managers in emerging markets — where the members of the financial community tend to know each other very well — is anything but uncommon. Demonstrating this point, one bank examiner once relayed to me the following story: “When I examined the bank, it was in terrible shape; by the time my report was edited by middle management and given to senior management, it was rated a good bank.”

On a more positive note, according to the International Monetary Fund (IMF),⁴ emerging market central banks have made significant strides implementing the Basel Core Principles since 2002. And most key emerging market central banking and treasury authorities believe that improving bank supervisory practices is definitely in their own long-term interests.

What’s more, according to the aforementioned Basel II questionnaire, more than 90% of banking assets in the emerging markets are expected to be covered by Basel II by 2010. However, given the challenges that central banks are encountering on the road to Basel II compliance, these expectations seem quite unreasonable.

Bank Examiners: Underqualified

Emerging market banks’ ability to comply with Basel II will depend largely on whether central banks adopt risk-based supervision as the approach to supervising and examining banks. Logically then, central bank examiners have to undergo rigorous training to understand risk and to be able to conduct risk-based supervision examinations. This remains one of the central banks’ greatest challenges.

According to the Bank for International Settlements (BIS), 9,400⁵ supervisors worldwide are expected to need training on Basel II-related topics. But many emerging mar-

ket central banks lack training manuals for risk-based supervision and examination of banks. In the central banks where I have worked, in fact, I have seen anything from manuals that have not been updated in 15 years to manuals that are lacking significant sections on the various financial risks — especially market risk.

Risk-based supervision manuals provide detailed instructions on the uniform procedures that central bank examiners must follow. So bank examiners employed by central banks that do not have such manuals are at a serious disadvantage.

The examiner recruiting process at most central banks in emerging markets is another obstacle blocking the path to improved bank examiner capacity. Traditionally, central banks have hired accountants to be bank examiners. These individuals rarely have essential knowledge about how economics and politics affect market and credit risk, and even fewer understand the interconnectedness of financial risks across different banking functions.

What’s more, emerging market central banks have been very hesitant to employ bank examiners with knowledge of political risk, economics, financial instruments or business — even though hiring individuals from those backgrounds and placing them in teams with accountants would create an interdisciplinary approach to analyzing the causes of various financial risks that arise across different banking functions.

Importantly, senior and middle managers must support examiners when they critique banks’ risk management process. At one central bank where I worked, bank examiners were significantly harassed by bankers when they gave a bank a negative rating; more shockingly, the next day an entire floor of the bank was mysteriously set on fire.

Risk Management Processes and Systems

The robustness of risk management processes and systems at emerging market banks is critical to the success of their Basel II implementation projects. Unfortunately, banks in many of these markets lack the proper motivation to enhance their risk management infrastructures.

Given that numerous central banks still have not adopted risk-based supervision, the majority of financial institutions in the emerging markets do not feel compelled to have strong risk management committees and systems that focus on identifying, measuring, monitoring and controlling risks firmwide.

While key risks such as market, operational, liquidity and legal risks are important in all financial institutions, it is credit risk that is at the heart of Basel II. Though this is important to all banks, it is particularly key in emerging markets, where banks are being exposed to higher and higher levels of credit risk as they enter into new lending activities.

The underlying risk of lending, of course, is incorporated into Basel II/Pillar 1 regulatory capital requirements. To meet these requirements, banks should have good data collection systems in place; unfortunately, such systems are noticeably absent in many emerging markets banks.

Data collection systems provide banks with the information necessary to assess default probabilities. They also come in handy for banks that calculate value-at-risk (VaR). While banks in the developed world and some in emerging markets use VaR, the majority of emerging market central banks and commercial banks do not use

collection systems.

The knowledge and ability to use credit derivatives to hedge credit risk is yet another challenge facing emerging markets banks. As you can read in Figure 3 (left), some emerging market countries have tackled the credit derivatives challenge more successfully than others.

The Bottom Line

Emerging markets banks' ability to comply with Basel II has significant implications not only for the financial systems of those countries, but also for the rest of the international banking community. We only need to look at the crisis of the late 1990s to remind us of the interconnectedness of global trade and finance.

The risk management discipline required by Basel II should strengthen each and every emerging market, regardless of its current level of banking sophistication. At this stage, however, it is clear that the implementation of Basel II in emerging markets countries will take quite a bit longer than the BCBS originally anticipated.

While there has been progress in many emerging markets in terms of their macroeconomic development, the unwillingness of central banks to convert to a risk-based supervision model and the lack of strong capacity among bank examiners will continue to thwart effective implementation of Basel II for the next few years at least.

However, there is hope for the future. International aid organizations — such as the United States Agency for International Development — are funding financial stability and development projects in emerging markets. These international aid organizations must work closely with the BIS to improve the capabilities of emerging market bank examiners and to help central banks transition to risk-

Figure 3 Use of Credit Derivatives in Emerging Markets

Most Liquid	Less Liquid	Sporadic Aivity
Argentina	Bulgaria	Chile
Brazil	Croatia	Ecuador
Colombia	Korea	Ivory Coast
Mexico	Peru	Kazakhstan
Philippines	Thailand	Lithuania
Russia		Morocco
South Africa		Romania
Turkey		Tunisia
Venezuela		

Source: BIS and Federal Reserve Bank Triennial Surveys, 2004

this measure or similar ones to measure or to try to control risk. Usually, VaR is “passed over” by banks because they either do not have personnel who understand how to calculate VaR or they do not have the necessary data

FOOTNOTES:

1. Basel II comprises three interrelated and reinforcing pillars. Pillar I aligns minimal capital requirements to banks underlying risks. Pillar II allows central bank supervisors and examiners to evaluate each bank's assessments of how they identify, measure, monitor and control risks. Pillar III recognizes the power that market discipline has to influence banks in establishing prudent risk management.
2. Industrialized nations include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK and US. Asia includes China, India, Indonesia, Korea, Malaysia, Philippines and Thailand. Latin America includes Argentina, Brazil, Chile, Colombia, Dominican Republic, Mexico, Peru and Venezuela. Other emerging markets include the Czech Republic, Egypt, Hungary, Poland, Romania, Russia, South Africa and Turkey.
3. The Committee on the Global Financial System is a central bank forum for the monitoring and evaluation of broad financial market issues with the aim of developing appropriate policy recommendations to support the central banks in the fulfillment of their responsibilities for monetary and financial stability. The committee emphasizes assisting the G10 central bank governors in identifying, evaluating and responding to threats to the stability of financial markets and the global financial system.
4. Financial Stability Institute Occasional Paper No. 4, July 2004.
5. “Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries,” BIS, August 2004.

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