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# Asian Banking: Moving Beyond Basel III

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Asian banks are well capitalized and many Asian jurisdictions have moved beyond Basel III – with higher capital requirements and ahead of the January 2015 deadline.Indeed, nearly half of all jurisdictions currently implementing Basel III are Asian. Adhering to Basel III ahead of others raises questions about a level playing field for Asian banks, especially since Basel III was largely designed to address the crisis-related problems of the more advanced and sophisticated financial markets. Asian banks are still retail deposit-based, and less reliant on wholesale funding. Many Basel III rules on liquidity, risk weights and overall leverage ratios are still being finalized, and the real effects of Basel III on Asian bank lending could be clouded by the current environment of ample global liquidity. As growth expands, the need for additional capital increases could be substantial. Hence, Asian policymakers need to balance growth with regulation in a judicious manner without negative implications on Asian systemic stability. This requires:

- Exercising judicious national discretion in tailoring Basel III implementation that is risk-appropriate for individual economies. The aim is not to selectively implement prudential rules, but to focus on risk exposures that are different for each country, while minimizing unintended consequences.

- Seeking alternative ways to strengthen growth and fund debt, for example, by improving financial infrastructure and supporting capital market deepening to increase equity financing.

- Reducing over-reliance on bank credit by promoting long-term institutional investors to finance Asia's long-term development.

- Looking beyond Basel III to address emerging risks from shadow banking and the impact of volatile capital flows, as well as the implications of "mobile" money creation outside of the regulated financial system.

- The aim is not to dilute prudential regulations, but to ensure that the complex Basel III regulations are fit for purpose, and commensurate with the different stages of development and risks in Asia.

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## INTRODUCTION

On a quantitative and qualitative basis - in terms of capital adequacy, liquidity and risk exposure - Asian banks currently have stronger financial positions than many banks in the advanced countries.

As of August 2013, 25 Basel Committee members, nine of which are from Asia, have or are in the process of implementing Basel III, while two have draft rules in place[1]. A Financial Stability Institute survey of 100 non-Basel Committee regulators shows that a further 26 (with 16 from Asia) are in the process of implementation. Amongst the first and second batch of those economies complying with Basel III capital requirements, Asian jurisdictions would account for nearly half by number.

Indeed, some jurisdictions in Asia have moved beyond Basel III to introduce standards that are more stringent than Basel III, requiring domestic banks (which have systemic importance) to hold more capital than specified under Basel and ahead of the Basel Committee's January 2015 deadline. While Asian banks are not capital-constrained in the immediate term, their ability to support growth and credit demand may be impaired in the medium term as credit demand continues to expand in Asia, underpinned by ongoing economic development and infrastructure financial needs.

Furthermore, since the Asian financial crisis, Asia-Pacific economies have been at the forefront of experimenting with different macro-prudential policies and tools that work in conjunction with the Basel III prudential rules in order to safeguard their financial systems from both internal fragilities and external shocks. These have varied from calibrating Loan-to-Value ratios (Hong Kong and Singapore), varying reserve requirements (China and South Korea), exchange controls (Malaysia), land supply measures (Singapore) and stress tests (Australia).

Recent Bank for International Settlements (BIS) research suggests that the Basel III regulations will not increase the cost of bank credit, or reduce access to trade credit or project finance. As many Basel III requirements on liquidity, risk weights and overall leverage ratio are still being formulated, however, their full impact on Asian bank credit remains unclear. The real effects of Basel III on bank lending could also be disguised by the current environment of ample global liquidity.

It is also important to note that Basel III is only the first of a raft of regulations that will impact the global banking industry, including Asia. These include the U.S. Dodd-Frank Act, which has extra-territorial implications, the U.K. and EU financial tax proposals, while new regulations on the shadow banking industry are still under discussion. The full implications of all of the proposed regulatory changes on the global economy have not been calculated.

Asian economies are undergoing very different stresses and challenges from those of the advanced financial markets because many of the Asian financial systems are still relatively less developed and depend more on retail deposits rather than wholesale funding, which is one of the areas of focus under Basel III. Basel III also deals mostly with stability within banking institutions, whereas systemic risks can arise from the interconnectivity and interaction with shadow banking institutions, volatile capital flows on asset prices and the impact of the real economy (such as structural adjustments and technology) on bank portfolios and funding models.

Thus, Asian regulators need to focus on a much wider range of policy tools than just implementing Basel III requirements.

[1] *http://www.bis.org/publ/bcbs260.pdf*

## BEYOND BASEL III: THE IMPORTANCE OF REGULATORY DISCRETION

Concerns have been raised about the unintended consequences that may arise from the implementation of Basel III standards, including the potential impact on the real economy. This underscores the need for the reforms to be implemented cautiously, as national implementation of global standards should reflect domestic realities and circumstances.

The risk is that if Asian growth falters because of credit constraints, this will impact global growth and declining growth will affect Asian credit exposures. Judicious exercise of national discretion among Asian regulators is therefore important in tailoring Basel III implementation that is fit for purpose for Asian economies. The aim is not to dilute prudential rules but to focus attention on risk exposures (that are different for each country), and minimize unintended consequences.

As Asia continues to lead global growth, its demand for credit will escalate beyond the funding capacity of Asian banks under Basel III capital rules. Based on three high-level scenarios – Slow World Growth, New Normal or Global Recovery – the Fung Global Institute's (FGI's) estimates[2] indicate that the Basel III capital requirements may restrict loan growth across Asia to 2017. The shortfall in Tier I Capital for Asian banks could range from US$250 billion (Slow Growth) to US$1 trillion (Global Recovery) by 2017.

The more stringent Basel III requirements for liquid assets may also trigger unintended consequences in terms of reallocation of funds at the sectoral level that penalize bank lending for trade finance, small and medium sized enterprises (SMEs) and infrastructure projects – all critical to Asia's future growth. For example, the requirement on a higher level and quality of equity capital will squeeze banks' capacity to lend to SMEs. Since SME lending tends to carry higher risk than corporate lending, it will be impacted through higher capital requirements. FGI estimates that the return on equity (ROE) for SME lending will be reduced by about 3 percentage points under Basel III regulations.

Furthermore, the new leverage ratio treatment (still under discussion) may lead to a significant increase in capital requirements, thus driving up the costs of conducting trade finance business. Although the Basel Committee revised the Basel III framework for trade finance instruments in 2011 by waiving the one-year maturity and the sovereign floor, the credit conversion factor (CCF), which was raised to 100 per cent from 20 per cent in Basel III (for the calculation of the leverage ratio), remains unchanged after the revision.

Since the Asian financial system is bank-dominated, infrastructure financing is still largely provided by the banking system. Banks may be disincentivized to hold such long-term assets under Basel III, given the higher capital and Net Stable Funding Ratio (NSFR) requirements. Banks will need to fund these on average with longer-dated sources of funding which is more expensive. Moreover, the type of collateral, for example, land, that supports this type of funding is often subject to heavy haircuts. FGI estimates that the ROE for project finance may decrease by about 5 percentage points under Basel III regulations. This could impact infrastructure investments for Asian economies that, according to the Asian Development Bank (ADB)[3], need more than US$8 trillion in infrastructure investments to 2020.

The need for regulatory discretion is particularly important since:

- The advanced economies are adopting different implementation phases with different interpretations and treatments for Basel III. For example, the European Parliament had

[2] *FGI-Stamford Advisory. 2013. Hong Kong. Working Paper on Asia and Basel III. http://www.fungglobalinstitute.org/*

[3] *ADB, 2013. Strategy 2020 Midterm Review. Manila. http://www.adb.org/about/strategy-2020-mid-term-review*

recognized the low-risk and self-liquidating nature of trade finance and approved exemptions to the Basel III rules, which effectively enable EU banks to offer trade finance at lower cost. If Asia adheres strictly to Basel III, this raises the question of whether a level playing field exists for Asian banks and those operating under different markets.

- Basel III is designed essentially for global systemically important banks or national banks with nationally systemic international exposure. This does not fit the description of most Asian banks in emerging markets. It is not meaningful from a global perspective to require a small economy with a relatively less globalised banking system to adopt highly complex financial regulations. The scarce resources should be used more appropriately for domestic development.

- Asian regulators need to strike an appropriate balance between reduction of risk and the availability of credit finance to meet the long-term funding needs of SMEs, trade finance and infrastructure funding.

It is important to highlight that the aim is not to dilute prudential regulations, but to ensure that the complex Basel III regulations are fit for purpose, and commensurate with the different stages of development and risks within Asian economies. Indeed, Asia needs to look beyond Basel III as the region confronts emerging risks associated with shadow banking, volatile capital flows and mobile money. These are less institution-based risks that Basel rules address, but represent greater system-wide and interconnectivity issues that require more holistic solutions.

## ALTERNATIVE SYSTEM STABILITY MEASURES

Given the priority that Asia accords to sustained growth through continued access to credit for trade finance, SME and project financing, regional authorities should consider alternative mechanisms to secure such financing. For instance, in trade finance, where the experience of credit losses is relatively low, central banks can offer a rediscount facility to assist banks to lend for trade financing. Export-Import banks (EXIM banks) can also cover a proportion of the credit risks. These backstops would not only reduce the risk weights on trade finance, but also minimize disruptions during a crisis.

To support lending to SMEs, the ministry of finance, or credit guarantee corporation, can also create a special scheme (for example, the Enterprise Finance Guarantee and Funding for Lending facilities in the U.K.) for SME financing on preferential terms. Tax incentives can be given to private equity or venture capital funds to inject capital and expertise to promising SMEs and reduce their leverage or debt burden.

On project/infrastructure finance, the solution lies in institutional innovation to diversify the Asian financial system. This is especially the case in developing asset securitization via long-term institutional investors, such as pension and wealth management funds and insurance companies, to reduce the maturity risk profile of project financing and decrease the risk weight for banks.

The fact that the banking system in many Asian economies accounts for over 60 per cent of the financial system assets underscores the need to diversify the financial system in order to reduce over-reliance on the banking sector, which has an inherent maturity mismatch. Active development of long-term institutional investors would reduce the maturity mismatch, and provide more sustainable, long-term funds for long-term development. The fund management industry, specifically, can help deepen the equity cushion of enterprises, thus increasing their ability to take on debt and active impact investment, which would also strengthen the enterprise sector.

## CONCLUSION

Basel III is a strong step forward in the global efforts to minimize banking risks. As different jurisdictions have adopted different phases of implementation and national treatments, this means that a level playing field and the consequences on different economies are unclear. There is a further risk that one-size-fits-all rules may add to systemic fragility because it is the diversity of systems that adds to overall global systemic stability. It is the willingness to experiment with different types of macro-prudential tools and structural reforms in combination with Basel III rules that holds the key to addressing the different conditions and risks confronting national regulators.

Going forward, Asian regulators can do more to balance financial regulation and real sector needs. The implementation of Basel III in Asia needs to be placed in a proper context to ensure that the new standards are calibrated so that they best fit domestic conditions. To achieve financial system stability, there is a need to look holistically at real sector imbalances, monetary and fiscal policies, and the interconnectivity and feedback mechanisms between the financial system (including shadow banks) and the real economy as a systemic whole. The use of alternative mechanisms to backstop trade finance, SME and infrastructure financing may also be useful to secure Asia's future growth, as are longer-term measures to improve financial infrastructure and diversify the Asian financial system.

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