

## **GENERAL PRINCIPLES FOR BASEL II IMPLEMENTATION IN EMERGING MARKETS**

This note sets out a number of principles that can be used to support debate between home supervisors of multinational banks and host supervisors in emerging markets, concerning the implementation of Basle II. The principles in question are listed and described briefly below. These could find expression in an agreement between national banking regulators and administered by the BIS.

### **PRINCIPLE 1: GRADUALITY & FLEXIBILITY**

The application of Basle II must be an unavoidable medium-term objective in all countries, but the initial situation may vary in terms of the degree of sophistication of banks, the quality of information, etc.

The timing of adoption is a sovereign decision of the regulators and supervisors in each country. Likewise, it is important to admit adaptations to local conditions in the different environments, and not to expect 100% readiness to tackle the implementation of the Agreement.

Therefore, it must be considered that decisions taken by home supervisors of foreign banks operating in these countries have an impact in the local financial system.

It would be advisable to reinforce this principle with the mutual recognition of progress made. Thus, if a national regulatory authority determines that banks under its jurisdiction may evolve from the standard model to the advanced model and that it, the regulator, has the capacity to validate advanced models, this should be considered by regulators of other countries for the purposes of supervising organisations that operate internationally.

### **PRINCIPLE 2: HOMOGENEITY**

To facilitate the implementation of the Agreement the major concepts (definitions of default, default probability, loss given default, etc.) must be consistent and must be respected utterly. Any local adaptations should be in the details.

Consistency of implementation (which is not incompatible with some degree of freedom) must stem from dialogue between emerging market regulators and supervisors and the Basle Committee. In this regard, home supervisors should play a significant role.

Attempts must be made to avoid various definitions. It makes no sense for local supervisors to use one set of definitions while at the same time different definitions are required by home supervisors. Developing databases with more than one definition is not only expensive but also tends in general to produce lower standards of information, possibly resulting in day-to-day management of organisations being separated from captured historical information. (1)

Assuring sufficient homogeneity should have advantages both for international banks with subsidiaries in the region and for home and host supervisors. For instance it could enable models to be validated almost immediately by one supervisor once another has given approval.

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(1) For instance the recovery procedures at financial institutions are in general closely linked to the local definition of default, so loss-given-default figures using non-local definitions are hard to interpret from the point of view of actual management of an organisation.

### **PRINCIPLE 3: MAINTAINING CAPITALISATION**

In many emerging countries current standards of capitalisation are high. This shows up in very high Basle ratios in comparison with developed countries (reflecting the higher level of risk in these countries).

In these cases the general principle of Basle II could be extrapolated to the different local financial systems. In other words the total capital requirements under Basle II can be kept similar to current levels.

This principle would eliminate some concerns about the New Accord, and would favour its implementation.

### **PRINCIPLE 4: NO DISCRIMINATION**

This principle is based on the idea that organisations which compete in the same markets should be subject to the same rules.

For instance, if local organisations in an emerging country have the possibility to adopt the standard Basle II model, then subsidiaries of multinationals in that country should be allowed to measure local capital requirements in the same way.

This principle means reciprocity of treatment so that regulators in each country acknowledge that an international organisation may have advanced models in one country and standard models in another, at least temporarily.

### **PRINCIPLE 5: INCENTIVES**

There must be medium-term incentives for organisations to tackle the developments needed to transit and to implement advanced models, and certainly to avoid disincentives.

Developing advanced internal models has major advantages for organisations in that it improves the risk management platform, and for supervisors in that they would thus obtain far richer information to carry out their mission.

For there to be incentives to use internal models one major requirement is to solve the confidence level problem. Thus, the confidence level implicit in models (99.9% related to an A- rating) is generally very demanding for these countries, so a solution would have to be found. (2)

Internal models and the consequent improvements in risk management must be a medium-term aspiration. However, it is also true that there is no need to rush: there are other matters that must be

solved first in some countries before these models can be fully developed, such as accounting and legal aspects, information platforms, cultural matters, etc.

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(2) The solution could be to provide lists of groups of countries according to sovereign ratings and to differentiate them based on confidence levels.

#### **PRINCIPLE 6: RECOGNITION OF DIVERSIFICATION**

Diversification must be recognised wherever it occurs, i.e. the lowest risk from diversification in an international group is found where risks are integrated, i.e. at parent organisation and/or consolidated level, and it makes no economic sense to distribute that diversification among subsidiaries.

This does not mean that diversification is not important to the local supervisor in the country where a subsidiary operates. On the one hand the subsidiary can be in turn a financial group which would have to take into account its own diversification. On the other hand the low level of recognition of diversification for international groups could affect the stability of financial flows to emerging economies, due to the impact that it might have on the capital required at parent organisation level.

#### **PRINCIPLE 7: SOVEREIGN RISK TREATMENT**

It is important to maintain the current treatment of sovereign risk as the lowest-risk investment alternative at local level. (3) Exemption of risk for the calculation of capital would apply to all options.

If this alternative is not selected, attribution of capital on the basis of sovereign risk could negatively affect the volatility of debt spreads and the stability of financing itself.

#### **PRINCIPLE 8: DISTRIBUTION OF RESPONSIBILITIES**

For the home supervisor of a financial group the most important thing is the capital at the parent organisation itself and the level of provisioning, while for the local supervisor the main points are the provisions set up and the capital of the subsidiary. In short, their interests converge, although with some nuances.

Once common criteria and principles of co-ordination are established this delimits the distribution of responsibilities between home and host supervisors.

There are clearly synergies between the jobs of the two groups of supervisors, and co-ordination to ensure the efficiency of the process is fundamental.

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(3) There may be private companies with lower credit risk levels (eg. because of payments made in dollars) but with far less depth than sovereign debt as an investment alternative.