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Reform of the global regulatory regime for emerging markets: Some thoughts

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Key points

1. Involvement of emerging world in global regulation key

2. Zero compliance needed since new global regulation will affect the emerging world

3 .First key channel is on level and volatility of credit

4. Second is through foreign banks operating in emerging markets' financial systems

5. Where are heading? Some looming risks

1. Involvement

1. **WIDESPREAD PRESENCE FROM EMERGING MARKETS NEEDED**

   Specially in the ad-hoc decision making bodies for regulatory reform
   BIS committees are a very good example

2. **ALSO VEHICLES TO LOOK FOR CONSENSUS AHEAD OF INTERNATIONAL MEETINGS**

   G20 is a good example. Korea set a great example last year. Mexico should follow next year.

2. Zero complancency needed

1. **Emerging countries may feel SAFE in the light of new higher capital requierements**
   - **Their capital ratios are higher than developed countries and**
   - **In many cases their capital is good quality**

2 **However, they will CLEARLY be affected by banks in the developed world sclambling for capital**
   - **Many emerging Asian economies –specially the poorest - need to bancarize further (credit still low) so capital needs will be huge but…**
   - ***Constrained by their less developed local financial markets and scarcity of capital internationally***
   - ***Foreign banks still playing an important role (cross-border and/or local operations)***

3. Different channels for Basel III to affect emerging markets

1. **BBVA Research has its own model to estimate the impact of Basel III on emerging markets (theoretical and empirical)**

Main findings

2. **Higher capital requirements have a NEGATIVE impact on credit and the efficiency of banks, which is HIGHER in emerging markets**
3. **Higher liquidity requirements have a NEGATIVE impact but SLIGHTLY MITIGATED in the case of emerging economies**
4. **Emerging economies are CLEARLY MORE SENSITIVE to changes in the credit channel. Since they generally have less opportunities to raise non-bank finance (from capital markets) either domestically or internationally**

4. Why worry about impact on credit in emerging markets?

- (Level of) credit growth still crucial for economic growth

- The more so the least developed the banking system

- Countries like Indonesia, Argentina and Uruguay have very low credit to GDP: bancarization needed to grow faster!

- **Volatility of credit to increase**
    - **Scarcity of capital globally can create rapid shifts in mood and, thereby, BOOM AND BUSTS in certain asset classes**
    - ***Emerging markets probably need countercyclical tools more than others!***
    - **Dynamic provisioning in my view that abrupt changes in LTVs ratios (affordability issues need to be considered)**

4. What about the role of foreign banks in emerging countries

1. Foreign banks (virtually all from developed countries) relevant through CROSS-BORDER OPERATIONS and LOCAL ACTIVITY (branches or subsidiaries)
2. Cross border operations as much as 2 trillion USD and known to be very volatile (Asian crisis is a good example)
3. Local operations mainly through subsidiaries but some branches (specially US banks)

   Branches generally more volatile than the latter since their funding less local/retail

4. Subsidiary model in our view SUPERIOR for several reasons
   - It creates natural firewalls in the event of a crisis.
   - Decentralised management of liquidity and capital allows for a proper evaluation of country risk and reduces moral hazard

5. Where are we heading? Looming risks

1. **Ever more complicated regulatory regime**
   - **How can smaller banks follow?**
   - **Shall we end up with ever larger banks?**
     - **Even if SIFIs need more capital, they may also have more room for regulatory arbitrage and too large to fail not avoided**
2. **Constraints to raise capital make it harder for foreign/private banks and easier for state-owned banks**
   - **Is that the banking system we want?.**
     - **Previous crises offer lessons about the risks of having the state allocating credit**
3. **Two things we seem to be forgetting in our pursuit of stricter regulation**
   - **Rules can be irrelevant if there is no inforcement: Importance of supervision**
   - **The world is always more globalized, even financially. We need to think about cross-border crisis resolution as soon as possible**

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