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Emerging Countries and Implementation

Brazil's Experience with Basel's Regulatory Consistency Assessment Programme

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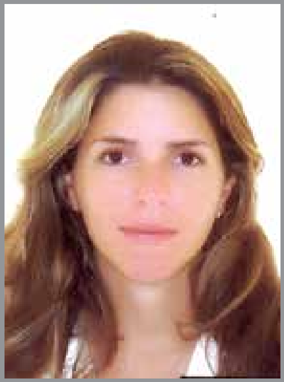
About the New Thinking and the New G20 Project

The project aims to promote policy and institutional innovation in global economic governance in two key areas: governance of international monetary and financial relations and international collaboration in financial regulation. Sponsored by CIGI and the Institute for New Economic Thinking, the project taps new research and next-generation scholars in the emerging economies, linking them to established networks of researchers in the industrialized world. The objective over the longer run is to create a more permanent and self-sustaining research network that will provide a continuing stream of new ideas, sustain international collaboration and integrate researchers from the emerging economies into global policy discussions.

Miles Kahler and Barry Eichengreen (principals in the original project) recruited C. Randall Henning (new principal, American University) and Andrew Walter (University of Melbourne) to lead two research teams devoted to macroeconomic and financial cooperation and to international financial regulation. Gathering authors from eight countries, the project consists of 11 CIGI papers that add to existing knowledge and offer original recommendations for international policy cooperation and institutional innovation. CIGI will also publish the final papers as an edited volume that addresses the global agenda in these issue-areas.

About the Author



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Acronyms

BCB	Central Bank of Brazil
BCBS	Basel Committee on Banking Supervision
CRA	credit rating agency
FSAP	Financial Stability Assessment Programme
FSB	Financial Stability Board
FSF	Financial Stability Forum
G7	Group of Seven
G20	Group of Twenty
GFC	global financial crisis
IMF	International Monetary Fund
PRB	Peer Review Board
RCAP	Regulatory Consistency Assessment Programme
ROSCs	Reports on the Observance of Standards and Codes
SIBs	systemically important banks
SSBs	standard-setting bodies

Executive Summary

As part of a major effort to level the regulatory playing field among internationally active banks, the Basel Committee on Banking Supervision (BCBS) established the Regulatory Consistency Assessment Programme (RCAP) in 2012 to evaluate the consistency and completeness of Basel standards. The enlargement of international financial standard-setting affiliation opened the doors to the increasing participation of emerging markets in the financial regulation reform agenda. In spite of this, important challenges remain in terms of legitimacy, transparency and accountability for principal international standard setters as well as concerning the effective contribution of emerging economies. Recent Brazilian experience with RCAP points to some of the gaps that must be filled in order to serve the interests of a broader range of actors in the international regulatory landscape.

Opening the Basel Doors

The reform of financial regulation is a top priority on the public policy agenda for both advanced and emerging economies (Helleiner and Pagliari 2011). In 2009, the BCBS opened its membership to key emerging markets to encourage international participation in the Basel rule-making process and commitment to implementation of its standards.

One distinctive feature of the 2008 global financial crisis (GFC), which set it apart from other major crises in the previous three decades, was that it originated internally from within the centre of the system (Trichet 2010). Ultimately, the crisis was a failure of major economies and global institutions to recognize and effectively address emerging flaws in global financial markets and institutions. In the first meeting of the Group of Twenty (G20) leaders in 2008,[1] participants recognized that insufficient and inconsistent coordinated policies led to the crisis, and committed themselves to achieve the necessary cooperation (Bernes 2013).

Following the transition from the Group of Seven (G7)to the G20 as the primary forum for international economic coordination, the expansion of both membership and range of competencies consolidated the Financial Stability Board (FSB)[2] position as a major actor, together with the International Monetary Fund (IMF), in charge of strengthening the international financial architecture and global financial stability (Crockett 2010).

Other international standard-setting bodies (SSBs), such as the aforementioned BCBS and the International Organization of Securities Commissions, restructured their governance structures and broadened their membership to reflect a shifting economic order post-GFC. The importance and inevitability of this measure is attested to by the expectation that even the quota-based decision-making process at the IMF,[3] which still favours the American and European members, will possibly change in the near future (Eichengreen 2009). Going forward, the success of these financial regulatory efforts will depend on the complete and globally consistent implementation of international policies, which is increasingly the focus of public and financial industry attention (FSB 2011).

The first attempt in this direction was the IMF-World Bank's Financial Stability Assessment Programme (FSAP), introduced in the wake of the Asian crisis of the late 1990s. As the forerunner in the field of economic policy oversight, the IMF faced significant problems regarding the establishment of the surveillance function under Article IV of the IMF Articles of Agreement. Both the FSAP and the Reports on the Observance of Standards and Codes (ROSCs) were usually conducted under the technical assistance function of the IMF and so originally

1 The G20 Washington Summit on Financial Markets and the World Economy took place on November 14-15, 2008.

2 In 1999, the G7 set up the Financial Stability Forum (FSF) as a body to bring together central banks, regulators and finance ministries to monitor the health of the international financial system. The FSB was established in 2009 as the successor to the FSF and assumed a key role in promoting and coordinating the financial reforms.

3 Unlike the BCBS, the IMF is not a selective club. Instead, it is a truly international organization with solid institutional foundations and universal membership.

they did not constitute formal obligations for members (Lastra 2006).

Before the GFC, the FSAP process was weakened by the refusal of the United States and other important countries such as China to participate. In 2010, assessment under the FSAP became a mandatory part of Article IV surveillance, and in 2013 the list of jurisdictions covered was expanded to 29. For all other IMF members, participation in FSAP exercises remain voluntary. However, even if implementation is made universal and compulsory, concerns remain unresolved. The IMF lacks the powers of an international supervisor that could intervene if national authorities showed complacency in face of its warnings (Avgouleas 2012).

Historically, implementation of international financial standards derived from the BCBS was agreed based on best efforts and only among a narrow membership (Goodhart 2011). The lessons of the recent financial crisis have underscored the need for full, timely and consistent implementation of these standards so that a clear shift toward enforced adoption of common standards has been observed. Nevertheless, the procedure for addressing the consequences of non-compliance is far from clear.

In spite of the general trend toward a more intrusive international oversight of national regulatory frameworks, it still cannot be established that these new arrangements — as currently designed — will be implemented effectively. There has always been a persistent unwillingness or inability to rely on hard measures to ensure thorough compliance with recommendations. International divergence regarding implementation has often been considerable, with implicit agreement among major countries not to go too far into the details of national implementation (Walter 2008).

The prominent illustration is that the United States, which was once a customary deviant, was expected to lead by example, but it was constrained by strong internal opposition to international interference (Walter 2010). From the perspective of emerging countries, deviance generally relates to a regulatory design that does not take into account their idiosyncrasies (Chwieroth 2015) and their own pattern of reform that preserves their future growth.

The objectives of this paper are threefold. First, it investigates the prospects for regulatory coordination that encompasses the effective involvement of emerging countries in the international financial fora. The paper explores if and how this proposed regulatory architecture may allow for more flexible and less-biased rules for financial systems, while at the same time supporting consistent implementation and harmonization.

Secondly, the paper assesses the BCBS's strengths and the challenges regarding implementation through the Brazilian experience with the RCAP process. As a leading emerging economy, the case of Brazil raises interesting issues worth mentioning: potential intended and unintended consequences of international harmonization; divergence among SSBs; and prospects for incorporating national concerns in the Basel and other SSBs rule-making process.

Finally, the paper concludes that the increasing importance of emerging markets — in particular to the restoration of economic growth and in international regulatory affairs — is just the first stage. Legitimacy, transparency and accountability are necessary components of more symmetric and democratic global governance. From the emerging market position, resources and articulation are among the further enhancements needed.

Emerging Markets: Trends and Challenges

Emerging economies substantially differ in economic terms, levels of development, legal and institutional structures and other factors that affect their reform priorities and the ways in which their financial systems are impacted (FSB-IMF-World Bank 2011). Among other features, emerging markets may be characterized by the dependency on foreign funding, the relevance of international capital flows through foreign direct investment and financial markets and their relative dependency on bank-centric financial systems and trade finance. In addition, they have fewer resources for coping with financial crises, in particular systemic crises, and have a limited ability, or face higher costs, to borrow in international financial markets, any of which constrain their capacity to pursue counter-cyclical policies (Khan 2013).

Evidence from the IMF and World Bank past assessments, including findings from FSAP exercises, indicate that authorities in emerging markets are making significant efforts to align their supervisory and regulatory framework with international standards. Since the GFC, reforms put in place to adopt sound macroeconomic measures and strengthen financial sector supervision improved legal frameworks for supervision, induced overcompliant capital ratios well above the minimum requirement, enhanced prompt corrective action schemes and established more robust bank resolution schemes (Caruana 2010).

Emerging economies also benefitted during the financial crisis from reliance on stable internal funding and foreign liquidity as well as from residual exposure to mortgage-backed securities. The latter was due to the high returns derived from traditional banking operations as well as to conservative rules limiting bank exposures to complex and opaque products.

In the aftermath of the crisis, financial reform was not as high a priority on the political agenda of emerging markets as in developed countries. Emerging markets continued to grow at a higher speed than advanced economies, relatively unaffected by the US and European economic downturn. With much higher levels of capital allocated by banks, these economies avoided the critical phase of the cycle and sustained growth for a while.

Most of the international financial reforms have been designed to respond to public pressure in developed economies and are aimed at strengthening their financial systems. Some regulatory policy measures are perceived to be a driver of deleveraging, in particular in Europe, where authorities have substantially increased capital requirements as a way to restore confidence in the banking sector. While prudential adjustments are necessary, drastic changes in the financial and economic order may have direct and indirect impact for emerging countries, not only through more restrictive banking regulations but also through cross-border lending, foreign investments and global demand.

Following public demand, policy makers in countries most affected by the crisis retained a tough approach on regulating banks, and proceeded as quickly as possible, mostly driven by domestic political motivations (Singer 2004).[4] Other countries grow increasingly afraid that the much-anticipated unintended consequences may be closer than ever. While the former see international coordination as counterbalancing internal pressures, these other countries tend to take a different path. As long as national context and interests are increasingly dissimilar, incentives for cooperation tend to weaken.

Design and implementation of balanced global standards depend both on the cost-benefit analysis of regulatory options and on the balance of power among member jurisdictions within international policy forums (Simmons 2001). Emerging markets have the potential to alter the dynamics of post-crisis negotiations and facilitate the attainment of more balanced decisions.

At this early stage, new entrants have to date supported majority decisions instead of avoiding blocking negotiations. Eventually, regulators in emerging markets will be expected to help shape an international and harmonized regulatory landscape, advocating their standpoint whenever necessary.

Participation in the international regulatory process entails material benefits for emerging economies. It may enhance their credit standing and market attractiveness and the reputation of their financial systems. Nonetheless, these countries must be prepared to evaluate regulatory options against the social and private compliance costs associated with commitment to adopting international financial regulation. Additional challenges to regulators remain in terms of independence and powers as well as concerning availability of information, tools and human resources. This concern is becoming more critical as the Basel framework becomes more complex.

4 For instance, before the GFC, British regulators imposed the lowest possible burden and cost on the financial industry. After the crisis, they became substantially tougher.

Basel Timeline

The creation of international prudential regulatory standards has taken place in a slow and disorderly fashion since the mid-1970s in conjunction with the globalization of financial markets. In December 1987, the Group of Ten signed the first Basel Accord on the international convergence of capital standards. Known as the 1988 Accord — or the Basel I Accord — this was the first internationally agreed regulation to set minimum risk-adjusted capital requirements for international banks, a direct product of international financial integration (Kapstein 2006).

In fact, during the 1982 debt crisis prior to the 1988 Accord, financial institutions significantly raised systemic risk and limited regulators' capacity to prevent arbitrage opportunities. This reinforced well-known financial industry market failures and encouraged policy makers to embark on a wave of mutually beneficial international regulations. The main goal was to stop international banks from evading more strict national rules.

In a different context from the one that brought about Basel I, in 2004 the BCBS adopted a significant review of the 1988 Accord — named Basel II — with the aim to encourage the banking industry to implement stronger risk management practices. While many of the key elements of Basel I were maintained, the 2004 review incorporated a major change in the way risks are assessed. This new set of recommendations allowed risk to be measured under proprietary methods, thus relying upon banks to largely self-monitor their own risk-taking strategies. National supervisors were left with the challenging task of reinforcing internal risk evaluations by assuring minimum compliance to nationally incorporated standards. The resulting complexity prevented effective oversight and enforcement and, to a certain extent, promoted regulatory arbitrage by banks.

In 2008, before Basel II could be fully implemented by member jurisdictions, the most severe financial crisis since 1929 occurred. A new wave of regulatory responses led to a comprehensive revision of the previous accords. Known as Basel III, this new set of recommendations required banks to issue more and better capital against their risk-weighted assets than under Basel I and II (BCBS 2010). But complexity remained and even increased. The perception of an excessive and unbalanced regulation was widespread and its effects have already been felt including in the decreased size of banks' balance sheets and lower leverage. Alongside the supervisory surveillance and enforcement challenges, many other aspects added to the increased complexity (Haldane 2011).

In the wake of the GFC, public interest in the regulation of banks and other financial firms became substantial. Intricacies regarding the enforcement of international financial regulations increased, in particular in the presence of overregulation. As a result, policy oversight demands effective incentives to promote compliance. Despite maintaining voluntary commitments and principle-based philosophy in the rule-making process, focus has shifted to monitoring, assessing and reporting on the implementation of agreed reforms to ensure that jurisdictions live up to their commitments (FSB 2011).

International Standards Nature, Compliance and Implementation

Implementation covers the period from the development of an international policy standard via changes in laws and regulations at the national level to market participant engagement, oversight and enforcement by jurisdictions.

An international policy standard is generally in the form of soft law, defined as a set of commitments made by negotiating parties that are not legally binding. This is the primary mechanism used in international deals among financial regulatory authorities. Soft law may affect policy development and practice precisely because it exercises an informal and flexible influence that encourages, through self-executing treaties or international agreements, otherwise reluctant jurisdictions to consider and eventually adopt policies and strategies that they would resist if required to do so by law.

A main corollary for institutional arrangements in international regulation is the respect for national sovereignty. However, cooperation implies that national authorities should make compromises, giving up something in order to pursue a common approach to a single problem. They are expected to sacrifice their autonomy up to a certain level in order to reach enhanced harmonization (Bradlow 2010). Cooperation is a result of both the willingness and ability to surrender national-oriented policies in favour of global objectives. While the general effect is most likely positive, the changes could well threaten all sorts of domestic interests.

Soft law tends to be used in situations where national authorities are unable to agree on a set of measures, while leaving implementation optional for those who do not wish to be bound by mandatory conditions. They are successful strategies for international standard setters to use when faced with resistance from some jurisdictions that are likely to block policy proposals. But this same flexibility of soft law reinforces challenges to attain effective harmonization through implementation by members.

Equally important is the non-discriminatory principle, according to which international deals must ensure that jurisdictions are treated in the same way as long as they share similar conditions.[5] In this sense, dissimilar jurisdictions must be handled differently. At a minimum, this requires all international governance institutions to understand the social and economic impacts of their recommendations on each member jurisdiction and, eventually, in a broader perspective.

Non-discrimination may take the form of principles-based text rules, proportional judgments and explicit national discretions. International bodies resort to such mechanisms to secure rapid and comprehensive agreement and commitment. Nonetheless, rule-making flexibility encourages interpretation and harmonization problems while leaving wide space for regulatory arbitrage.

In this sense, various mechanisms have been put in place to ensure the implementation of international financial standards and policies and to monitor and review their effectiveness. They encompass the already-established IMF-World Bank FSAP and ROSCs, thematic and country peer reviews performed by the FSB, progress reports and other monitoring and review processes carried out by the BCBS and other standard-setting instruments.

Assessment mechanisms vary in terms of their intensity. At one end, there are mechanisms built for exchanging and disseminating information with no collective scrutiny or analysis of the self-reported information. Other mechanisms incorporate an evaluation process, wherein information provided by national authorities is subject to varying levels of scrutiny and analysis.

The strictest level of scrutiny tools consists of an independent assessment of compliance with an international financial standard. Under such an assessment, experts evaluate to what extent a jurisdiction has effectively implemented that standard, and identify weaknesses so that the jurisdiction can be subject to corrective measures through moral suasion by the authorities (FSB 2011).

In acknowledgement of the importance of implementation, in 2012 the BCBS established the RCAP. The purpose was to ensure the consistent implementation of the Basel III framework across jurisdictions, and thus to contribute to global financial stability.

The program entails two distinct but complementary work streams, one to monitor the timely adoption of Basel III standards and another to assess the consistency and completeness of the standards and the significance of any deviations in the regulatory framework. The RCAP monitoring and assessment of risk-based capital regulations covers implementation of Basel II and III, ensuring that relevant Basel standards are introduced into domestic laws and regulation on a timely basis. The first assessments were carried out both on a jurisdictional

5 The non-discrimination principle is a contentious subject. Recently, the FSB announced the "Total Loss-Absorbing Capacity" proposal to end the risk to the public purse from bank failure. Banks headquartered in emerging markets were initially exempt due to different market conditions and "deposit-based business models." Nevertheless, the exemption was not extended to subsidiaries of global systemically important banks (SIBs) in Brazil in spite of the same conditions.

as well as on a thematic basis. In the second half of 2013, the monitoring progressively expanded from capital standards to include new thematic standards relating to leverage, liquidity and the higher loss absorbency requirement for globally SIBs.

Macroeconomic Stability and Regulatory Evolution in Brazil

Brazil's long-standing legacy of high and unstable inflation continues to have an important impact. The system is still characterized by low domestic savings, high interest rates and short duration equilibrium, which limits capital market and business development. Fiscal responsibility legislation, the inflation-targeting regime and a flexible exchange rate have all contributed to a significant improvement in macroeconomic stability in recent years. But reforms, in particular those to improve public services, required prolonged constraints in Brazilian investment and expenditure capacity.

In August 1994, the Central Bank of Brazil (BCB), by means of Resolution 2,099/1994, established the methodology and instructions for the calculation of the required regulatory capital, initiating the adoption of the Basel I Accord in the Brazilian financial system. Back then, Brazil was neither a member of the BCBS nor was it home to any bank that would be considered internationally active.

Moreover, an effective implementation of the global regulatory agenda can only take place if there are strong regulatory regimes and adequately staffed regulators with the appropriate levels of expertise. Most emerging markets face capacity and resource constraints that hamper their ability to implement the internationally agreed reforms. In Brazil, public administration reforms followed macroeconomic stabilization and only recently has it been possible to hire and retain qualified staff.

These circumstances still prevailed when Brazil opted to implement the new structure of capital recommended in Basel II. In view of the many challenges faced in both macroeconomic and financial areas in that decade and before, the BCB adopted the more simplified approach prescribed by the BCBS to calculate the capital required to cover credit and market risk, including a series of adaptations to the Brazilian financial environment, such as the non-reliance on assessments from credit rating agencies (CRAs). These circumstances explain, in principle, many of the differences between Basel II recommendations and the text in the Brazilian regulation.

The publication of the Basel II recommendations in 2004 coincided with positive assessments of Brazilian banks' capabilities by the regulation and supervision team at the BCB. This led to a decision to improve regulation to be more in line with the BCBS recommendations and to implement Basel II in full, including the possibility of using internal models. Yet, in some critical aspects, regulators opted to retain a local approach, as was the case of the foreign exchange and fixed interest rate capital requirement, which proved to be more risk-sensitive and conservative than the Basel standardized models. Furthermore, the Basel II standardized methodology for calculating capital for market risk was adopted for exposures to risk factors not yet covered by Brazilian regulation (for example, including exposure in foreign currency coupon rates, price index coupon rates, interest rates coupon rates, equity and commodities).

Following Brazil's admission as a member of the BCBS in 2009, several additional rules were published by the BCB with the aim of obtaining a higher level of convergence between domestic practices in banking regulation and supervision of the BCBS's recommendations. As a G20 country, Brazil is firmly committed to implementing Basel III as agreed by members of that forum. The Brazilian Basel III capital regulations were published in March 2013 with additional regulations. Some important amendments were issued in October 2013 to clarify and improve the risk-based capital framework based on recommendations of the RCAP exercise.

The Brazilian RCAP

The Brazilian RCAP exercise consisted of a comprehensive evaluation of domestic regulations in order to test adherence to the risk-based capital standards under the Basel framework. This was done in two steps: validation of all the required provisions that have been enacted; and consistency verification of any material differences between national regulations and the internationally agreed capital standards.

The RCAP team selected bank-level capital ratio and exposure data for the six largest banks in Brazil covering approximately 80 percent of banking system assets (as of March 2013), which were identified on grounds of domestic significance and regional and international exposure. The international activities of Brazilian banks are still limited compared to those of major banks in Asia, North America and Europe, and operations are less complex when compared with those of large banks from developed economies.

Brazil was considered to be overall a compliant jurisdiction with its capital standards aligned with the international agreed minimum requirements established by the BCBS (BCBS 2013b). Brazilian regulations were largely compliant in only three specific areas: standardized approach to credit risk, capital buffers and Pillar 2. These findings indicated that all provisions of the Basel framework had been satisfied with compliant ratings, which confirmed there were no differences that could materially impact financial stability or disrupt the international level playing field.

Basel III was first adopted in Brazil in March 2013, when the principal regulations were introduced. Following the RCAP exercise, a set of amendments was published on October 31, 2013, which played a significant part in the overall positive outcome of the assessment. Some of the revisions came into force from November 2013 and others became effective from July 2014.

The BCB has adopted recommendations from the RCAP team to complement and clarify certain items of its regulations. These adjustments represented not only a further step toward international convergence, reinforcing the traditional conservatism of Brazilian regulation, but also proved to be an important output of the assessment process itself.

The tailoring of Basel standards often resulted in banking regulations that were more conservative relative to the Basel minimums in many areas and less conservative in others. The BCBS emphasizes that areas of "super-equivalence" are not taken into account for the overall assessment of compliance, suggesting that such extra stringency may be unnecessary.

It is generally conceded that implementation of international standards may require adjustments to reflect local circumstances. But the extent and the direction to which deviations should be taken into account is an unresolved question. Some elements are considered sufficient at the supervisory level or deemed not applicable due to residual cross-border exposures, specific local business practices or the absence of more sophisticated financial products in the local market. Other aspects have supported more stringent regulations for legitimate reasons. In this regard, the BCB adapted specific areas of the Basel framework during implementation, while respecting international standards as a floor for the local requirements.

Super-equivalence and the Flexible Level Playing Field

Some important aspects of the Brazilian regulation remained different from the Basel standards, not only to reflect local circumstances, but also to express national regulatory judgments. The scope of application is one significant example of super-equivalence of Brazilian regulation in response to principles of non-discrimination.

The focus of the Basel framework is on internationally active banks. Jurisdictions are left to evaluate the precise application of this tenet to their own banks. If a narrow definition was to be applied, the RCAP materiality assessment should, in principle, find no relevant example of Brazilian banks within this designation due to the residual proportion of international assets and liabilities they hold.

However, Brazilian prudential regulation applies to all banks, not only those with international operations. It is designed to ensure there is no competitive advantage, or conversely, no competitive disadvantage for foreign banks in comparison with domestic national counterparts. But among different jurisdictions, the precise scope of application can vary substantially.

As a matter of comparison, the US financial regulation agency's framework for capital requirements applies differently to banking organizations based on their size and international activity. The US approach to the Basel standards resorts to the concepts of "core banks" and "non-core banks" to which different regulatory requirements apply. While this approach may give rise to discriminatory practices toward international peers operating in the country, the US framework responds to proportionality concerns, avoiding excessive regulation where considered unnecessary (BCBS 2014). In contrast, in the European Union and in Brazil a common set of standards is applied to all banks.

Different preferences and regulatory options embodied in national legal systems generate different observance costs and risks to financial stability that go beyond the internationally agreed minimum requirements. There are a number of areas where this prevents further harmonization at the global level.[6] This is not necessarily an issue if legitimate reasons support distinct approaches.

Credit Ratings and Divergent Trends

Areas where the Basel standards are not consistently applied in the BCBS's opinion have been subject to the materiality-prioritizing approach. In making the assessment, the RCAP team takes into account the current and potential future impacts of the gaps identified, and applies their expert judgment based on the local structure, appropriateness of the regulations and consistency across other assessments under the RCAP.

Overall, for Brazil's standardized approach toward credit risk, the potentially material deviation in nature and extent relates to the decision not to refer to external credit ratings. The component was therefore assessed as being largely compliant with the Basel III framework. Under the Basel standardized approach, risk weights for claims on sovereigns, public sector entities, banks, securities firms and corporations are linked to external credit assessments. The Brazilian regulations do not employ external credit ratings, and instead apply an alternative simpler methodology that, despite being more prudent, is not as risk-sensitive as those of the Basel framework.

Moreover, the BCB gathers a large amount of data at the level of individual loans made by Brazilian banks through its credit registry. This system was created in 1997 and includes data on all outstanding loans (99 percent of individual loans and the remaining one percent in aggregate). This information is used by national supervisors and banks to supplement the simpler flat risk weights employed in the Brazilian regulations.

Despite the limited experience of CRAs in assessing Brazilian issuers and issues and the higher capital requirements derived from the approach currently adopted, for the RCAP team there was a chance for the Brazilian conservatism to be reversed in a stressed scenario. They assessed the component as potentially

6 As an example, the framework for resolution of financial firms has long been thought as inherently national for years. Harmonization efforts in this field are relatively recent and reform prospects are still uncertain.

material with respect to large corporate exposures and claims on banks with an original maturity of more than three months.

This result was at odds with a key aspect of the financial reform agenda: to reduce reliance on CRAs and enhance the capability of the banks, market participants and institutional investors to make their own risk assessments. The mechanistic use of external ratings for capital regulation and for investment decisions is among the main criticisms that emerged from the financial crisis. The FSB reinforced the need to reduce reliance on CRAs, but the references to them can still be found in a number of different regulations, in particular the Basel III capital and more recently in liquidity standards.

Recognizing the conflicts of interests' pro-cyclicality effects and systemic disruption related to the use of external ratings, the US Dodd-Frank Act of 2010 banned references to credit rating assessments in the American regulatory norms. The Brazilian rule is therefore consistent with the US approach, as well as with the stated FSB directive of eliminating mechanistic reliance on credit ratings. However, these factors were not taken into account in assessing the component.

Specific issues relating to emerging markets arise from the difference in the interpretation of the implementation of the rules guiding the use of credit rating grades, while others come from the perception that credit ratings do not accurately reflect the creditworthiness of sovereigns and firms and thereby overstate the risks of operating in emerging economies (FSB 2012).

Some emerging countries expressed concern over the use of global credit ratings and their effects on lending and balance sheet management decisions of internationally active banks when considered on a consolidated basis. One possible unbalanced cost for emerging economies relates to the country ceiling, a common feature in CRA's global scales.

As a result of the mechanistic Basel recommendation to rely solely on external credit ratings in the standardized approach to credit risk measurement, international banks still use global ratings to measure risk and assign capital for their foreign operations. These global ratings do not typically allow a local borrower to have a rating higher than that of its sovereign, regardless of the creditworthiness of that borrower. In the process of consolidation, the parent bank typically requires more capital irrespective of whether that exposure is denominated and funded locally. As a result, global credit ratings do not always reflect current creditworthiness and therefore overstate the risks of operating in emerging jurisdictions. Ultimately, the consequence of such treatment will be passed on to the local borrower through higher interest spreads.

Feedback Channels: The Scope of Consolidation Case

The Brazilian regulations are applied at the consolidated level in line with the Basel framework. As previously mentioned, the majority of banks operating in Brazil are headquartered in the country and those subsidiaries of international groups must comply with capital requirements at a sub-consolidated level. However, the national regulations do not require calculations based on a separate test for capitalization on a stand-alone basis, so the issue was left out of the assessment in the current round.

Theoretically, the absence of sub-consolidated or stand-alone calculations may preclude the scope of application from assessing whether individual entities or subgroups within a wider and internationally active banking group are adequately capitalized under the standardized minimum capital ratios.

To date, Basel standards have not yet set out clear criteria on how they should be applied to each bank within an internationally active banking group or when the entities themselves are not internationally active. Practices seem to differ across member jurisdictions, and further work is underway.

Feedback Channels: Interpretative Issues and the Bottom-up Improvements

As the implementation process advances, differences arise due to interpretative issues on the capital standards. In March 2014, the BCBS agreed that a system should be put in place in order to help address the interpretative aspects of Basel III standards, thus avoiding inconsistencies and improving the RCAP process.

The BCBS's Peer Review Board (PRB)[7] noted that a few issues would benefit from the views of the relevant policy and expert groups. It was also felt that as other Basel III standards come on stream (liquidity, leverage and SIBs), interpretative issues could arise and so the implementation and policy work streams should closely coordinate and establish an ongoing feedback loop.

A preliminary list of issues identified by the RCAP jurisdictional assessments was produced together with proposals that could be taken into account by the policy development group of the BCBS and other relevant groups as well as by each RCAP team for a better understanding and prioritization of the issues.

Feedback Channels: RCAP Assessment Guidance and Improved Transparency

From 2013, the BCBS secretariat has been developing proposed guidelines for RCAP teams (BCBS 2013a). These guidelines include quantitative benchmarks, which aim to assess both the materiality gaps between local rules and Basel standards and the assignment of grades with regard to key components of the capital standards and overall implementation.

The guidelines are based on the principle that wherever relevant quantitative data is available, RCAP teams should make use of it. The guidelines also provide benchmarks for translating team

7 The PRB consists of the chairman of the BCBS, the chairman of the Supervision and Implementation Group, and the secretary general of the BCBS. The PRB is supported by the head of Basel III Implementation at the BCBS Secretariat.

calculations into materiality assessments. Where data is not available, the guidelines state that RCAP teams should keep the same benchmarks in mind as they frame their judgments on specific gaps and grades.

While focusing on benchmarks, the guidelines are not meant to force RCAP assessments to become mechanical exercises. Indeed, RCAP teams are expected to apply regulatory and supervisory common sense as they use it. They should feel free to adapt it as needed, provided that their adjustments are described and explained in the RCAP report. In fact, the assessment process should avoid excessive quantification where the prospective materiality of gaps or uncertain quality of the data would not justify the burden on banks to estimate the necessary data points. On the other hand, quantitative benchmarks and aggregation processes add transparency and objectivity that could be useful to future assessments.

In areas where quantitative evidence is lacking or data is of doubtful relevance or quality, judgment will be crucial where the assessment team believes it is appropriate to take local circumstances into account or even when gaps are potentially, although not currently, material. In these cases, the RCAP team would be expected to adopt a conservative view.

Conclusion

Democratization of the governance of SSBs and the strengthening of compliance processes of international standards are among the main regulatory innovations post-GFC. Building trust relies on consistent implementation of agreed common standards and on the recognition that regulations will need to take account of each jurisdiction's own circumstances.

By ensuring that regulations issued by BCBS members comply with international requirements, the RCAP exercise is an essential step toward promoting full and consistent implementation. It is the baseline for enhanced confidence in regulatory ratios and for a more level playing field among institutions and jurisdictions.

The dialogue during the assessment process and the preliminary recommendations from RCAP teams play an important role in the implementation process. Be it to complement or clarify national regulations or to promote more structural changes, adjustments following the assessment demonstrate members' willingness to adjust national regulations when there are compelling reasons to do so. These adjustments represent not only a further step toward international convergence but also prove to be an important output of the assessment process itself.

Important challenges remain in terms of legitimacy, transparency and accountability to principal international standard setters as well as in terms of an effective financial integration of emerging economies. Brazil's recent experience with RCAP points to some of the gaps that institutions of international financial governance must be able to fill in order to serve the interests of a broader range of actors in the international regulatory landscape.

In a world where financial crises are cross-border by definition, all jurisdictions should be increasingly engaged and be granted the opportunity to effectively contribute to the establishment of a new prudential environment. They should also be engaged to establish consistency in assessment methodologies as well as in other compliance exercises.

Jurisdictions have different views as to whether the pace and location of major reforms entail intended or unintended consequences. The deleveraging process in major economies and the use of country ceilings in external credit rating assessments point to legitimate concerns in relation to home bias, either in the design of the reforms or in the way that they are implemented in other jurisdictions. Substantive legitimacy implies a widening of scope for assessing regulatory externalities. Ultimately, feedback channels from the past RCAP exercises could safeguard non-discriminatory principles in future standards and help to enhance the Basel legitimacy.

In addition, the rationale for adopting particular governance mechanisms within those prescribed by international organizations must be made public as far as possible. The public should be able to hold institutions such as the FSB and the BCBS, as well as their member jurisdictions, accountable for their decisions and commitments to produce timely and balanced decisions. Internal governance formalization such as the establishment of the BCBS's PRB and the publication of the RCAP assessment guidance are positive steps to reconcile these gaps.

From the emerging countries' perspective, resources and articulation are the main challenges to be addressed. With a more diverse range of economic, institutional and social arrangements, emerging countries are not yet sufficiently prepared to preclude advanced countries from enforcing their will on matters of common relevance. To do so, they need better mechanisms for articulation on global financial governance matters.

Emerging countries should reach out for a set of mutually acceptable and achievable short-term reforms, focusing on those areas that can result in real gains and accelerated reform opportunities that are consistent with their vision. This will require ongoing dialogue and cooperative relationships to deepen and enrich their contacts with each other, with SSBs and with international financial institutions.

A number of initiatives have already been taking place in this area. For example, the regional consultative groups established by the FSB and the Basel Consultative Group, charged with monitoring the effects of the implementation of Basel III, opened new opportunities for dialogue. Going forward, more vehicles and processes are needed to ensure that emerging countries are appropriately consulted and that their views are adequately taken into account. New spaces in the international arena are to be developed. The future is yet to come.

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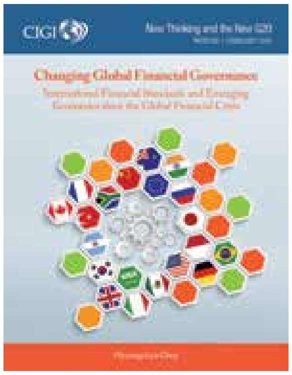

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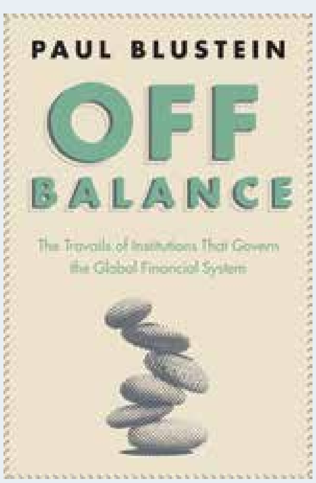

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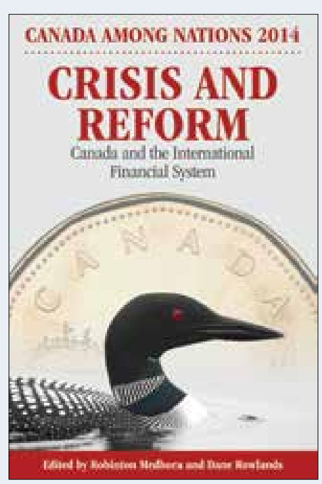

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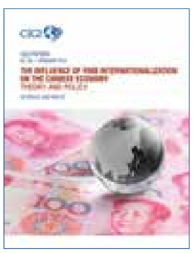
The International Capital Market Association (ICMA) has recently published proposed standard terms for new, aggregated collective action clauses. Concurrently, the ICMA released new model wording for the pari passu clause typically included in international sovereign bond contracts. These announcements and the commencement of issuance of bonds with these clauses are an important turning point in the evolution of sovereign bond markets.



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Completing the G20's Program to Reform Global Financial Regulation

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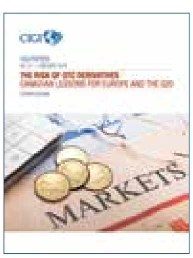
Malcolm D. Knight

The measures regulators have largely agreed on for a strengthened and internationally harmonized financial regulatory regime, which were endorsed at the 2014 G20 leaders summit in Brisbane, are a major step toward achieving a robust and less crisis-prone global financial system. There are, however, a number of specific measures that need to receive closer attention in order for the G20 leaders to declare their reform program a success. This paper discusses what policy makers and regulators should focus on in 2015 and why closer international cooperation in implementing regulatory reforms will be essential for success.



The Risk of OTC Derivatives: Canadian Lessons for Europe and the G20

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Chiara Oldani

Over-the-counter (OTC) derivatives played an important role in the buildup of systemic risk in financial markets before 2007 and in spreading volatility throughout global financial markets during the crisis. In recognition of the financial and economic benefits of derivatives products, the G20 moved to regulate the use of OTC derivatives. Attention has been drawn to the detrimental effects of the United States and the European Union to coordinate OTC reform, but this overlooks an important aspect of the post-crisis process: the exemption of non-financial operators from OTC derivative regulatory requirements.

The Trade in Services Agreement: Plurilateral Progress or Game-changing Gamble?

CIGI Papers No. 53
Patricia M. Goff

Trade analysis in the current moment is understandably focused on mega-regional negotiations, but plurilateral talks also deserve our attention. Plurilateral negotiations leading to a Trade in Services Agreement (TiSA) is the focus of this paper. Barriers to trade in services are distinct and their removal consequential; thus inviting careful consideration and, ideally, public debate. This paper seeks to illuminate developments in negotiations toward the plurilateral TiSA. Just as it has become commonplace to ask whether regional agreements advance economic and political agendas, so is it useful to explore the promise and peril of plurilateral agreements such as TiSA.

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The Centre for International Governance Innovation is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

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