

Jones, Emily

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Global banking standards and low income countries: Helping or hindering effective regulation?

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Global Banking Standards and Low Income Countries: Helping or Hindering Effective Regulation?

Emily Jones



The
**Global
Economic
Governance**
Programme



Global Banking Standards and Low Income Countries: Helping or Hindering Effective Regulation?

Emily Jones¹

Abstract

Should Low Income Countries (LICs) adopt new global banking standards? The global financial crisis stimulated a series of reform initiatives to strengthen financial regulation, including a new set of global banking standards (Basel III), which all countries are being encouraged to adopt. This paper scrutinises a relatively thin body of scholarly and policy research to establish what we know about LICs and global banking standards and propose a future research agenda.

Two findings stand out from this analysis. First, there is a high level of concern in the scholarly and policy literature about the appropriateness of Basel standards, particularly Basel II and III, for countries with nascent financial sectors. Second, despite these concerns and minimal participation in relevant decision-making processes, many LICs are going ahead to implement the latest standards. Strikingly, available data suggests that low-income and lower-middle income countries are just as likely to implement Basel standards as high and upper-middle countries. There is a pressing need for more in-depth research on the economics and political economy of global banking standards and LICs and I propose an agenda for future research.

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¹ Deputy Director, Global Economic Governance Programme, University of Oxford. Comments welcome: emily.jones@bsg.ox.ac.uk. Thanks to Max Watson, Taylor St John, Geoff Gertz, Ranjit Lall, Tu Anh Vu Than, Que Giang Tran Thi, and Alexandra Zeitz for comments on earlier drafts

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1. Introduction

In the wake of the recent financial crisis, the largest players in the global economy agreed a series of regulatory reforms to repair and regulate their own financial systems.² While many regulatory initiatives are national or regional in character³, reforms are also being pursued at the international level. Central to the international reform efforts are Basel III capital and liquidity standards, which aim to tighten banking standards across the world to ensure that the global financial system is more resilient.⁴ Although these standards are voluntary, all countries are encouraged to adopt them.⁵

There is an urgent need to examine the implications of new standards on Low Income Countries (LICs). LIC financial markets are deepening rapidly and foreign bank participation is increasing. While closer regulatory integration is imperative, LICs have financial systems which are very different to those of more advanced developing countries. Yet to date, no initiative exists to examine the impact of global regulation on LICs, nor how it is that LICs can harness and influence emerging global standards so that they support inclusive development and remedy structural inequalities, at both the national and regional level.

In recognition of the increasingly global reach of Basel standards, there have been a series of initiatives to consider the possible 'unintended consequences' on developing countries. In 2010, G20 leaders asked the Financial Stability Board, World Bank and International Monetary Fund to study the consequences of new global financial regulations for emerging and developing countries.⁶ To date these discussions have focused on the most advanced and largest emerging and developing countries such as Eastern Europe, China, India, and Brazil. Precious little attention is being paid to the specific interests of LICs.

This paper is a first step in examining the interface between global financial regulation and LICs. It scrutinises a relatively thin body of scholarly and policy research to establish what we know and proposes a future research agenda. More specifically, it asks three questions: (1) How much influence do LICs have over the development of global banking standards? (2) To what extent are LICs implementing global banking standards and why? (3) How appropriate are global banking standards for LICs terms of improving the stability and resilience of their financial systems and fostering inclusive growth?

Low Income Countries (LICs) are poorest in the world in terms of income per capita. Thirty-six countries are currently classified as LICs (see Appendix 1) and they are home to more than ten per cent of the world's population.⁷ Although LICs play a marginal role in international finance, international finance and the rules that govern it have major ramifications for LICs.

² (Woods 2010, Helleiner and Porter 2010)

³ Including the Dodd-Frank Act in the United States, the Vickers Report on banking reform in the United Kingdom, and the Liikanen Report on banking in the European Union

⁴ (Hildebrand 2012, Lall 2012)

⁵ (Byres 2013)

⁶ (FSB 2011, FSB, IMF, and WB 2011)

⁷ Total LIC population 847 million; GDP \$501 billion <http://data.worldbank.org/income-level/LIC>

LICs typically have relatively small, underdeveloped economies and low levels of financial development, yet they are increasingly integrated into the global financial system. For instance, many LICs have a foreign bank share of above 80 per cent, and, particularly where countries are reliant on exports of minerals, international financial flows are large relative to GDP.⁸ While LIC economies proved to be less affected in absolute terms by the recent global financial crisis than many more developed countries, their relatively high poverty levels and constrained government budgets mean that their governments and citizens are less able to absorb and respond to crises, rendering them particularly vulnerable. (For an overview of financial markets in LICs see Annex 2)

Global regulatory standards loom large on the agenda of LIC regulators. Although Basel standards were initially intended for implementation in the most advanced economies, greater emphasis is now placed on worldwide implementation, particularly in the aftermath of the global financial crisis. LIC regulators confront pressing questions including about the extent to which they should implement the most recent standards at home; the spill-over effects on their jurisdictions that stem from implementation by other countries; and the effort they should invest in trying to shape the global regulatory agenda.

Global Financial Regulation and LICs: Striking the Right Balance

Like other countries, LICs have a common interest in ensuring a robust global financial system. What is less clear is the extent to which it is desirable to have a single set of harmonised and detailed rules that are enforced globally, as opposed to a set of global principles that regions and countries agree to adopt and implement locally.

As finance is highly mobile across countries, a system of regulation that is purely national or regional in nature will always be at risk of arbitrage by internationally active financial firms. For this reason there is strong justification for decisive action at the global level. However financial markets are heterogeneous as are the policy objectives, regulatory approaches and supervisory capacities of governments. These differences are particularly sharp among countries at very different levels of development: advanced industrialised countries have deep, diverse and complex financial markets while LICs typically have shallow financial sectors that are dominated by banking. Relative to other developing countries LICs are highly dependent on foreign capital, more reliant on international currencies for domestic financial transactions, have weaker institutional structures, and face greater supervisory capacity constraints.⁹

Global financial governance faces the challenge of striking the right balance between harmonisation and flexibility, designing institutions that are sufficiently similar to prevent regulatory arbitrage yet sufficiently flexible to respond to different national contexts. The first Basel standards, created in the 1980s, were based on a model of home-country regulation, carried out in accordance with a global set of principles, coded into a set of voluntary standards that were then applied at a national level in the G10 countries.¹⁰ The global financial crisis has shown the limits to such an approach, and there are, rightly, calls for a

⁸ (Claessens and Van Horen 2014)

⁹ (FSB 2012, FSB, IMF, and WB 2011, Beck, Todorov, and Wagner 2013)

¹⁰ (The Warwick Commission 2011)

more robust set of global regulations. However regulators, particularly from developing countries, are keen to stress that ‘one size doesn’t fit all’.¹¹

Five Key Findings

Five key findings emerge from the analysis in this paper. First, *the evidence base is very weak*. We only have patchy data on the degree to which Basel standards are being implemented by LICs. Moreover, as the data we have is largely derived from LICs reporting their implementation in Financial Stability Institute (FSI) surveys, there is the likelihood of a reporting bias towards countries that are implementing Basel standards. There is relatively little evidence on the impact of Basel standards on the financial sectors of developing countries, and while there are some country-level studies, to date we have no systematic analysis of the impact on LICs. The analysis we have provides plausible inferences on the impact we might expect, but is a long way from providing concrete evidence on which LIC regulators can make informed policy choices.

Second, *LICs play a very marginal role in decision-making over global standards*. LICs are not formal members of the groups that decide global banking standards, namely the Financial Stability Board and Basel Committee on Banking Standards. In the past five years, greater efforts have been made to consult with non-member jurisdictions including through the creation of Regional Consultative Groups (RCGs). However membership is far from universal and falls well short of formal representation and influence over the standard-setting process. In 2010, a taskforce was established to identify financial stability issues of particular relevance to emerging and developing economies but only one LIC is included.¹²

Third, and strikingly, the data we do have on implementation suggests that *low-income and lower-middle income countries are just as likely to implement Basel standards as high and upper-middle countries*. More precisely, among non-member countries that responded to FSI surveys, the data suggests that there is effectively no difference in the rate of adoption between countries at varying levels of development: 68 per cent of low-income and lower middle-income countries reported that they had either partially or fully adopted Basel II, compared to 71 per cent of high income and upper middle income countries. Similarly, 32 per cent of low income and lower middle-income countries reported that they had taken steps to implement Basel III, compared to 36 per cent of high income and upper middle-income countries.

Fourth, there is a *high level of concern about the appropriateness of Basel standards, particularly Basel II and III, for countries with nascent financial sectors*. While LIC regulators welcome the objectives of Basel III, particularly its emphasis on macro-prudential regulation, there are clear shortcomings. Six stand out: (1) new capital adequacy ratios in Basel III may lead to a reduction in finance in priority areas, such as SME financing; (2) adverse effects may arise from the implementation of liquidity standards including on long-term finance; (3) inappropriate design and gaps in the Basel III framework may lead systemic risks in LICs to be inadequately addressed (4) the Basel III framework fails to provide the incentives and institutional mechanism for greater home-host cooperation, undermining the regulation of international banks operating in LICs; (5) although Basel III sets up mechanisms for the

¹¹ (Byres 2013)P2

¹² (FSB, IMF, and WB 2011), see Annex 1 for list

resolution of globally systemically important banks, this doesn't solve bank resolution challenges in LICs; (6) Basel III may distort the regulatory agenda in LICs, diverting scarce resources away from the regulation of the non-bank financial sector, including micro-finance.

Fifth, irrespective of the merits and demerits of the standards, *LICs face major implementation challenges due to regulatory weaknesses and gaps in financial infrastructure*. These are particularly acute for implementing the more advanced approaches to risk assessment in Basel II, and the macro-prudential approach of Basel III.

The paper is structured as follows. **Section two** gives an overview of global banking regulations and their evolution since the late 1990s, particularly in light of the financial crisis (this section can be skipped by readers familiar with Basel standards). **Section three** examines the representation and voice of LICs in global decision-making. **Section four** sets out what we know about the levels of implementation of global standards by LICs and, in light of concerns about their appropriateness and major implementation challenges, examines the reasons why many LICs still seek to implement them. **Section five** examines the evidence on the appropriateness of global standards for LICs, highlighting the main areas where global standards are criticised for failing to reflect their needs. **Section six** looks at the specific challenges LICs face in implementing global standards.

In terms of sources, as there are no studies that focus exclusively on the impact of Basel standards on LICs I have drawn on studies that examine global standards either from the perspective of all developing countries or from the perspective of sub-Saharan Africa. As 25 of 48 African countries are LICs, and these 25 countries account for two-thirds of all LICs, I have relied particularly heavily on the Africa-based studies. As there is heterogeneity among LICs, the analysis and argument should be duly treated with caution.

2. The Evolution of Global Banking Standards

Global banking standards are embodied in the Basel 'Core Principles for Effective Banking Supervision' and four agreements that set out specific standards (see Table 1). Standards are voluntary and national regulators can exceed these minima at their discretion. The evolution of the Basel standards has been a reactive process, with newer standards often aimed at addressing the pitfalls and gaps of previous sets of standards. Understanding the core features of these various sets of Basel standards is important as banking regulation in LICs is invariably based on them.

The existing evidence (discussed in detail in Section 4) suggests that most LICs are focused on implementing the Basel Core Principles and Basel I standards. However a substantial number of LICs have already moved to Basel II and the majority has indicated a clear intention to do so in the near future. A few LICs have started to implement Basel III.

Table 1: Core Features of Basel Standards

Standard	Core Principles (revised 2012)	Basel I (1988)	Basel II (2004)	Basel 2.5 (2009)	Basel III (2010)
Core Attributes	29 principles covering: (1) Supervisory powers, responsibilities and functions; (2) Supervisory expectations of banks	Agreement to apply common minimum capital standards to banks. General requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets	Pillar 1: minimal capital requirement; Pillar 2: supervisory review process. Pillar 3: market discipline. Greater use of assessments of risk provided by banks' internal systems as inputs to capital calculations	Strengthened treatment for securitisations in Pillar 1 (in wake of financial crisis). Modest changes to Pillars 2 and 3.	Aims at higher quality core capital, limits off-balance sheet activities of banks via special purpose entities, and seeks to institute new measures to prevent systemic short-term illiquidity

Basel I and the Basel Core Principles

The central bankers of the G10 countries (who comprised the Basel Committee on Banking Standards) agreed the first set of global banking standards in the 1980s. Basel I standards, as they became known, were directed at the small number of large internationally active banks that competed across the G10 countries. The standards were designed to eliminate unfair competitive advantages resulting in differences in regulatory regimes. Although Basel I was never intended to apply to banks in other jurisdictions, or even to domestic banks in G10 countries, by the early 1990s more than 120 countries had adhered to Basel I or stated an intention to do so.¹³

The main feature of Basel I was a set of minimum capital requirements, based on a ratio of capital to risk-weighted assets of 8 percent. The intention was to ensure that individual banks held sufficient assets to address the operational risks they faced without requiring government intervention. Under Basel I, assets were risk-weighted according to the identity of the borrower. Government bonds, for example, had a 0% risk weighting, while traditional corporate loans had a 100% risk weighting, so that capital constituting the full 8% of the value of the loan must be held against it. Unlike later versions of the Basel Standards, Basel I only dealt with credit risk, the classic risk in banking of a debtor defaulting on his loan.¹⁴

Basel I was complemented by the 'Core Principles for Effective Banking Supervision', which were issued in the late 1990s and have been updated regularly since. These 'Core Principles' set out wider supervisory 'best-practice' and are used as a benchmark for assessing the quality of countries' supervisory systems, including by the International Monetary Fund (IMF) and the World Bank, in the context of their Financial Sector Assessment Programmes.¹⁵

¹³ (Stephanou and Mendoza 2005)P3

¹⁴ (Lall 2009)

¹⁵ (Brummer 2012, Helleiner, Griffith-Jones, and Woods 2010)

By the late 1990s, there was widespread recognition that Basel I was not having its intended effect, largely because the rules for assigning risk were too crude. The rules created incentives for regulatory arbitrage, leading banks to reduce their holdings of less profitable assets whose risks were overestimated in Basel I and to replace them with more profitable assets whose risks were underestimated.¹⁶ Because there were no rules for banks' securitization exposures, banks also moved assets off the balance sheet through securitization. As a result, overall capital levels in the banking system, which had risen sharply after Basel I came into effect in the early 1990s, started to decline.¹⁷

Basel II

In the late 1990s, the Basel Committee set out to revise Basel I. The new set of standards, Basel II, specified more refined minimum capital requirements (pillar 1). In addition, it provided national supervisors with guidelines on regulatory intervention (pillar 2) and created new information disclosure standards for banks (pillar 3). A major difference between Basel I and II was that banks were, for the first time, permitted to use their own models to estimate various aspects of credit risk under the 'advanced-internal ratings based' (A-IRB) approach. As only the largest banks had the institutional capacity to do so, smaller banks had to adopt the 'standardized approach' specified under Basel II, essentially a more refined version of Basel I which linked more fine-grained risk categories to external credit ratings provided by commercial rating agencies.¹⁸

The shortfalls of Basel II rapidly became clear. Even at the time Basel II was agreed, studies predicted that permitting the largest banks to use the A-IRB approach would lead to a dramatic *drop* in the levels of capital they held. For instance, one study found that under this approach average capital levels in American banks would fall by 18-29%, with some seeing reductions of more than 40%, under this approach.¹⁹ Large financial institutions also gained significant competitive advantage over smaller institutions. A 2006 study showed that smaller banks using the standardized approach would experience a 2 per cent *increase* in overall capital requirements, reducing their profitability, causing a loss of market share, and making them more vulnerable to takeovers.²⁰

Basel II also fell short of its promise to take a more 'comprehensive' approach to addressing risks. The new standards covered securitization and tackled market risk (the risk of losses in on and off-balance sheet positions arising from movements in market prices). However, provisions for risks associated with the trading book (as opposed to their banking books, where banks keep assets that they intend to hold to maturity) were conspicuously absent, and the treatment of new risks that the Basel Committee did address was considerably watered down during the regulatory process. Banks were eventually allowed to use their own models to determine capital charges for market risk, and, similarly, in the area of asset securitization, A-IRB banks were given permission to use their own estimates of the risk parameters for unrated exposures and liquidity facilities.²¹

¹⁶ (Cornford 2010)

¹⁷ (Lall 2009)

¹⁸ (Lall 2009)

¹⁹ (Lall 2009) (FDIC 2004)

²⁰ (Lall 2009, Basel Committee on Banking Supervision 2006)

²¹ (Lall 2009)

There is credible evidence that intense and timely lobbying by large financial institutions resulted in Basel II's bias toward large international banks. During the negotiating process, other stakeholders, including small banks in advanced economies and some banking representatives from large developing countries (such as India and South Africa) voiced concerns about potentially adverse impacts of Basel II. They were particularly critical of the incorporation of the A-IRB approach on the grounds that this would unduly advantage large international banks. However their objections came very late in the day and had little influence over the negotiations.²²

Basel 2.5 and Basel III

The financial crisis, which began in 2008, led to further reform. Basel 2.5 was agreed in 2009 and was a 'stop-gap' measure aimed at addressing the key failings of Basel II that had been starkly revealed during the crisis, namely that the capital charges for the risks banks run in their trading books were far too low, creating massive arbitrage opportunities.²³ Under Basel II, credit items were weighted less strictly if held in the trading book, on the assumption that they are easy to hedge or sell. However the financial crisis revealed that banks declared a trading intent on positions that proved difficult or impossible to sell quickly. The incentives toward a trading book allocation acted powerfully for credit assets, which proved impossible to sell or hedge quickly when the crisis struck, originating losses well in excess of the related capital charges.²⁴ In addition, risky assets were shifted off the balance sheet, securitized in the form of special investment vehicles, and then put back on the balance sheet in the form of triple A-rated securities that did not need any capital.²⁵ Under Basel 2.5, the Basel Committee increased the capital required for trading book and complex structured products (securitizations and resecuritizations).²⁶

In 2010, further reforms were agreed under Basel III, which sought to address wider problems associated with pre-crisis supervision. A major problem revealed by the crisis was that supervision and regulation were based on a micro-prudential approach, focusing on limiting the risks in an individual institution, but this did not necessarily limit the risk to the financial system as a whole.²⁷ Indeed, many argue that an exclusive focus on micro-prudential regulation *contributed* to the crisis because it encouraged homogenous behaviour (with everyone selling at the same time or buying at the same time), exacerbating risk at the systemic level. In the words of the Warwick Commission, micro-prudential regulation "in the name of transparency, risk-sensitivity and prudence" led to "increasing homogeneity of market behaviour and as a result increased systemic fragility".²⁸

Another shortcoming was that this prudential approach was 'siloed', with different approaches for the regulation and supervision of banks, insurance and securities, and an absence of oversight at the systemic level. As deposit-taking banks were more heavily

²² (Lall 2009)

²³ (Adair Turner et al. 2010)

²⁴ (Turner 2009) argued that the leniency of the trading book treatment contributed significantly to the excessive leverage with which many banks entered into the crisis.

²⁵ (Beck 2011)

²⁶ (Caruana 2010)

²⁷ (World Bank 2013b)

²⁸ (The Warwick Commission 2011) P16

regulated, this led to the rapid growth of the shadow-banking sector. Moreover, regulation was overly focused at the national level and when crisis struck, cross-border regulatory cooperation broke down.²⁹ Finally, implementation of the rules was constrained by the capacity and incentives of regulators and supervisors. Even in the advanced economies, resources were stretched as financial institutions, instruments and regulations became more complex, and regulators faced conflicts of interest, or found it hard to withstand pressure from industry.³⁰ To address these shortcomings, Basel III introduced macro-prudential regulations for the first time and sought to improve the quality of micro-prudential regulation.³¹

Strengthening capital adequacy requirements is a major element of Basel III and it has both micro- and macro-prudential elements. To reduce the riskiness at the level of individual banks, Basel III seeks to increase the *quality* of capital held. Greater focus is placed on common equity (the highest-quality component of a bank's capital). Under Basel II banks had to hold at least half of their regulatory capital (8 per cent of all risk-weighted assets) as Tier 1 capital and half of Tier 1 capital had to be common equity (i.e. common equity had to be 2 per cent of total risk-weighted assets). Under Basel III, the overall minimum remains at 8 per cent but there is an increase in the minimum common equity requirement from 2 per cent to 4.5 per cent of total risk-weighted assets. In addition, the definitions of common equity and Tier 1 capital have been tightened.³²

Capital adequacy requirements are also designed to reduce systemic risk. To complement the risk-based approach of Basel II, Basel III introduces a non-risk based leverage ratio, which is intended to put a floor under the build-up of leverage in the banking sector.³³ Basel III also seeks to reduce procyclicality and to take account of inter-linkages and common exposures among financial institutions. To this end, and in addition to the minimum capital requirements noted above, banks are required to hold a capital conservation buffer of 2.5 per cent (bringing the total common equity requirement to 7 per cent). The aim is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of stress without going below the minimum capital requirements.³⁴ Basel III also introduces a countercyclical capital buffer (0 to 2.5 per cent) designed to accumulate during periods of rapid aggregate credit growth if, in the judgment of the national regulators, growth is aggravating system-wide risk. Conversely, capital held under this buffer could be released during the downturn of the cycle.³⁵

In addition to revising and expanding capital standards, Basel III introduces the first-ever set of global liquidity standards. The financial crisis showed how quickly liquidity can dry up and how long it can take to come back. During the crisis, the banking system came under severe stress, forcing central banks to take action in support of both the functioning of money

²⁹ (World Bank 2012)

³⁰ (World Bank 2012)

³¹ For a useful discussion on the importance of macroprudential regulation see: (The Warwick Commission 2011)

³² (Caruana 2010)

³³ (Caruana 2010)

³⁴ (Caruana 2010)

³⁵ (Caruana 2010)

markets and, in some cases, individual institutions. The liquidity shortage was the result of excessive reliance on unstable funding of core (often illiquid) assets.³⁶

There are two new liquidity standards designed to achieve two separate but complementary objectives. The first is the Liquidity Coverage Ratio (LCR), which is intended to promote banks' short-term resilience to potential liquidity disruptions. It requires banks to hold an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet liquidity needs for a 30-day liquidity stress scenario. The LCR is intended to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill-over from the financial sector to the real economy.³⁷

The second minimum liquidity standard is the Net Stable Funding Ratio (NSFR). Still under consultation in January 2014, this requirement aims to reduce funding risk over a longer time horizon by reducing maturity mismatches, requiring banks to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress.³⁸

Aside from the core capital and liquidity standards the Basel Committee has agreed on other standards including capital frameworks for Systemically Important Financial Institutions (SIFIs).³⁹ Other issues being discussed by the Committee include cross-border resolution regimes for systemically important financial institutions, regulations to strengthen the regulation and oversight of 'shadow banking'; and steps to improve the over-the-counter and commodity derivatives markets so as to increase transparency, mitigate systemic risk and protect against market abuse.⁴⁰

Despite the laudable aims of Basel III and the tightening of regulations in some areas, it has been widely criticized for failing to go far enough. The head of the UK Financial Services Authority for instance, argued that at 7 per cent of risk-weighted assets, the Basel III capital adequacy ratio is far too low, and 15 to 20 per cent is needed to really reduce risk.⁴¹

As with Basel II, there is credible evidence that large financial institutions seized the negotiating agenda and succeeded in watering down many of the proposals. This included obtaining a reduction in the proposed minimum core Tier 1 capital ratio, and preserving the A-IRB approach to risk weighting.⁴² In addition, the measures will be phased in relatively slowly, only coming into effect in 2019.⁴³ Banks also lobbied hard on liquidity standards, and the Basel Committee revised the Liquid Coverage Ratio rules in early 2013 to amend the definition of HQLA to allow banks to use a broader range of liquid assets to meet the liquidity

³⁶ Just as banks may have private incentives to increase leverage, incentives arise for banks to expand their balance sheets, often very quickly, relying on relatively cheap and abundant short-term wholesale funding. Rapid balance sheet growth can weaken the ability of individual banks to respond to liquidity (and solvency) shocks when they occur, and can have systemic implications when banks fail to internalize the costs associated with large funding gaps. A highly interconnected financial system tends to exacerbate these spillovers (Basel Committee on Banking Supervision 2014)

³⁷ (Supervision 2013)

³⁸ (Basel Committee on Banking Supervision 2014)

³⁹ (Basel Committee on Banking Supervision 2013b) P9

⁴⁰ (FSB 2011)

⁴¹ (Masters and Braithwaite 2011)

⁴² (Lall 2014)

⁴³ (Basel Committee on Banking Supervision 2013a)

buffer. As one media report noted, the results are good news for bank profits because institutions will be allowed to count more, higher-yielding assets in their liquidity buffers.⁴⁴

A New Focus on Global Compliance

The recent and pronounced shift in global policy circles towards ensuring *global compliance* with Basel standards means that financial regulation in LICs is even more likely to converge on them.

While Basel I was clearly intended to apply to large international banks and only be applied in the most advanced economies, in the wake of the financial crisis a strong expectation has emerged among those drafting the standards that they will be applied universally.⁴⁵ The role of global standards-setting bodies, including the Basel Committee on Banking Standards, is changing accordingly. No longer tasked only with forging agreement on new international standards, global standard-setting bodies are expected to monitor implementation among both member and non-member states.⁴⁶

A notable event in the shift towards compliance is the 2010 publication by the Financial Stability Board of minimum requirements for non-FSB member jurisdictions.⁴⁷ The framework explicitly establishes a global standard and includes provisions to enforce the standard in non-FSB member countries. The initial focus is on international cooperation and information exchange standards in financial regulation and supervision and includes elements of the BCBS Core Principles for Effective Banking Supervision, the IAIS Insurance Core Principles, and the IOSCO Objectives and Principles of Securities Regulation.

Crucially, the framework includes a ‘toolkit’ of measures that might be used to address non-compliance. This includes making non-compliance public, suspending the country from the FSB and other bodies, sending warning letters to international financial institutions warning them of the risks of conducting business with the jurisdiction, and home supervisors increasing the regulatory requirements of financial institutions operating in these jurisdictions.⁴⁸

The evaluation process will initially focus on consultations with countries that are deemed to be systemically important and will be expanded in the future. While it is rather unlikely that low-income countries will be blacklisted or excluded from international capital markets in case of noncompliance, the FSB Framework constitutes a pronounced shift in the governance of international financial markets to push more strongly for adherence to international standards beyond the members of the G20, the FSB, and the BCBS.⁴⁹

⁴⁴ (Masters 2013)

⁴⁵ Helleiner in (Helleiner, Griffith-Jones, and Woods 2010)

⁴⁶ (Byres 2013)

⁴⁷ The FSB Framework for Strengthening Adherence to International Standards

⁴⁸ (FSB 2010)

⁴⁹ (Fuchs, Losse-Mueller, and Witte 2013)

3. The Absence of LICs in Global Decision-Making Fora

Developing countries have largely been excluded from the negotiations and debates on global banking regulation. While steps have been taken since 2009 to improve the representation of developing countries, LICs remain particularly marginalised. LICs are not formally represented on the key bodies that decide global banking standards, namely the Financial Stability Board and Basel Committee on Banking Standards.

The Financial Stability Forum, which became the Financial Stability Board (FSB) in 2009, is tasked with coordinating the broad array of financial regulatory initiatives at the international level that are conducted by national authorities and international standard setting bodies. It was established in 1997 by G7 finance ministers and central bank governors. Developing countries were represented for the first time in 2009, when its membership was widened to include all G-20 countries as well as Hong Kong, the Netherlands, Singapore, Spain and Switzerland.

The Basel Committee on Banking Standards (BCBS) is a member of the FSB and its work is specifically on banking. It supports central banks and supervisory authorities by formulating supervisory standards and guidelines, recommending best practice, and encouraging convergence on common standards and approaches. The Committee was established in 1974 by central bank governors of the Group of 10 and subsequently expanded, first to include Spain and Luxembourg, and in 2009 to include all G-20 countries as well as a few other major banking locales, including Hong Kong and Singapore.

The participation of developing countries has led to some modification of the rules. For example, developing country representatives lobbied successfully to change the liquidity standards contained in Basel III due to concerns that there might be an insufficient variety and quantity of high-quality liquid assets in their economies.⁵⁰ However the vast majority of developing countries, including all LICs, remain without any formal representation. The membership of the Basel Committee for instance remains heavily biased towards high-income countries: of the 27 members, 20 are high-income countries, 5 are upper-middle income countries (Argentina, South Africa, Brazil, China, Turkey) and 2 are lower-middle income countries (India and Indonesia). LICs are not represented.⁵¹

In the past five years, greater efforts have been made to consult with non-member jurisdictions. In 2010, the Financial Stability Board created a series of Regional Consultative Groups (RCGs), which bring together member and non-member states to exchange views on financial vulnerabilities and promote financial stability.⁵² Countries represented in the RCGs are expected to pursue the maintenance of financial stability, openness and transparency; to implement international financial standards; and to undergo periodic international assessments, including the Financial Sector Assessment Program.⁵³ However, these groups do not have universal membership and LICs are poorly

⁵⁰ (Basel Committee on Banking Supervision 2010)

⁵¹ Own calculations, based on World Bank income classifications

⁵² The six groups cover the Americas, Asia, the Commonwealth of Independent States, Europe, Middle-East and North Africa, and Sub-Saharan Africa

⁵³ (Lombardi 2011)

represented. The membership of the Africa RCG, for instance, comprises nine country representatives and a representative of the West Africa Central Bank, and only two of the nine countries are LICs (Tanzania and Kenya).⁵⁴ Thus while the RCGs could provide some useful opportunities for LICs to exchange views on financial vulnerabilities, including with Basel Committee members, membership is far from universal and falls well short of formal representation and influence over the standard-setting process.

In 2010, a taskforce was established to identify financial stability issues of particular relevance to emerging and developing economies. The taskforce includes officials from emerging and developing countries, as well as representatives from the Financial Stability Board, World Bank, and International Monetary Fund. The taskforce has highlighted particular issues that are important for developing countries but have received little attention in international debates, including the management of capital flows and foreign exchange risks, domestic capital market development, prudential oversight of foreign financial institutions, and the application of international standards and policies.⁵⁵ However here again LICs have minimal representation in this taskforce, as only one LIC (Uganda) is a member.⁵⁶

Several studies make the case for more inclusive decision-making over global financial standards. From the perspective of LICs, there is a clear rationale for more formal representation, as this would enable LICs to bring greater attention to the particular challenges they face and an opportunity to shape global standards in their interests.⁵⁷

There are also wider public good arguments. While standard-setting bodies like the FSB and BCBS are placing increasing emphasis on worldwide compliance, without a universal membership, they will face severe legitimacy challenges.⁵⁸ The FSB's ability to foster information exchange, capacity building, and principles-based regulatory coordination across the world would be severely hindered, and there would be enormous resentment if it assumed a role of supporting multilateral sanctions against countries that were not meeting minimum standards.⁵⁹

4. To What Extent do LICs Adopt Global Banking Standards?

A series of studies over the past ten years show that LICs are usually keen to adopt the latest Basel standards and the data we have on implementation suggests that, remarkably, LICs appear to be as likely as other groups of countries to implement them.

When Basel II was agreed in 2004, a FSI survey was conducted among non-members of the Basel Committee. It found that 88 of 107 responding countries intended to implement Basel

⁵⁴ (Financial Stability Board 2013)

⁵⁵ (FSB 2011) P10

⁵⁶ (FSB, IMF, and WB 2011), see Annex 1 for list

⁵⁷ (Gottschalk and Griffith-Jones 2006, Segoviano and Lowe 2002, Kasekende, Bagyenda, and Brownbridge 2011, IMF 2012a).

⁵⁸ Helleiner in (Helleiner, Griffith-Jones, and Woods 2010); (Domenico Lombardi et al. 2011)

⁵⁹ (The Warwick Commission 2011)

II, including 16 of 22 African countries.⁶⁰ More recently, the World Bank's Bank Regulation and Supervision Survey (conducted in 2011 with responses from 174 countries) showed that while most developing countries were still using Basel I, 75 per cent of respondents, including many developing countries, said they intended moving to Basel II soon.⁶¹ In 2010, 15 out of 20 African respondents to an FSI survey stated their intention to implement Basel II, including four countries that indicated their objective was to go beyond the standardized approach.⁶²

Turning to implementation, a 2013 FSI survey shows that, as might be expected, the 27 Basel Committee members have implemented global banking standards to the greatest extent: 24 members have fully implemented Basel II, and all 27 are in the process of implementing Basel III.

The survey also provides implementation data for 74 non-member countries, including one-third of low-income countries (12 of 36) and just over one-third of lower middle-income countries (17 of 46).⁶³ Remarkably, among non-member countries that responded to the FSI survey, the data suggests that there is effectively no difference in the rate of adoption between countries at varying levels of development (see Table 2). 68 per cent of low-income and lower middle-income countries reported that they had either partially or fully adopted Basel II, compared to 71 per cent of high income and upper middle income countries. Similarly, 32 per cent of low income and lower middle-income countries reported that they had taken steps to implement Basel III, compared to 36 per cent of high income and upper middle-income countries.

Table 2: Implementation of Basel II and III by non-member jurisdictions

Income Group		Basel II	Basel 2.5	Basel III
Low Income Economies	None	4	9	9
	Partial	7	3	3
	Full	0	0	0
Lower-Middle-Income Economies	None	5	14	10
	Partial	12	2	6
	Full	0	0	0
Upper-Middle-Income Economies	None	7	22	13
	Partial	13	1	10
	Full	3	0	0
High-Income Economies	None	5	12	14
	Partial	11	6	5
	Full	3	2	0

Source: Compiled by the author using World Bank country classifications. Note: not all countries reported for each set of standards.

Among the 12 LICs that reported, 7 countries have partially implemented Basel II (Bangladesh, DR Congo, Madagascar, Malawi, Mozambique, Nepal, Uganda) and 3 have partially implemented Basel 2.5 (Malawi, Nepal, Uganda). Three low-income countries (Nepal, Uganda, and Zimbabwe) have taken steps to start implementing Basel III.

⁶⁰ (Financial Stability Institute 2004)

⁶¹ (World Bank 2012) P63

⁶² (Fuchs, Losse-Mueller, and Witte 2013)

⁶³ (Financial Stability Institute 2013)

Another study which examined Basel II adoption and implementation in 150 countries, similarly found that that LICs were keen to adopt Basel II, although it suggests that they were slower at implementing than other groups of countries.⁶⁴ Interestingly, unlike the FSI survey, the study identified some LICs that had *fully* implemented Basel II, including Bangladesh, Chad, and the Central African Republic.⁶⁵ This study found that slow implementation was due primarily to severe capacity constraints. For instance, Malawi embarked on an ambitious plan to implement Basel II by 2005 but abandoned this in light of implementation challenges, deciding instead to focus on implementing the Basel Core Principles. Similarly, in 2003, the Central African Banking Commission set out an intention to implement Basel II, but was persuaded by the IMF to delay implementation until 2015.⁶⁶

Given the data gaps and possible bias (it is reasonable to expect that countries implementing Basel standards are more likely to respond to the survey) this evidence has to be treated with due caution. However, studies suggest that, over the past ten years, LIC regulators have been eager to adopt the latest sets of Basel standards and the speed at which these standards are implemented does not appear to be radically different to those of other groups of countries.

The Implementation Puzzle

The relatively high level of implementation by LICs is surprising for two reasons. First, as we have seen, LICs had little influence over the process of developing the Basel standards. Second, and arguably more importantly, there are widespread concerns about the appropriateness of Basel standards for LICs. Major international bodies, including the IMF and World Bank advise LICs to focus on implementing the Basel Core Principles and take a cautious and gradual approach to Basel II and III, ensuring they tailor the standards to their domestic context.⁶⁷ Even the FSB, with its new focus on global compliance, notes that ‘while certain elements of the Basel II/III framework... are very relevant and may be useful to implement quickly, the full-scale adoption of the framework may distract many EMDEs – particularly low-income countries – from more basic and urgent reform priorities’.⁶⁸

Given this, we might reasonably expect LICs and lower-middle income countries (LMICs) to adopt a cautious approach to adopting Basel II and III standards. Yet this is not what we see: widespread concerns in international policy circles do not appear to have acted as a restraint on implementation. International organisations have expressed concerns at the approach of LICs to Basel standards. A recent World Bank report noted with concern that while more advanced countries often adopted a phased approach small and low-income countries were particularly likely to adopt overly complex regulations than was warranted given their level of development and the complexity of their financial systems.⁶⁹ This said, another report notes that some African supervisors take a very pragmatic, building block–like

⁶⁴ (Cho 2013)

⁶⁵ (Cho 2013)

⁶⁶ (Cho 2013)

⁶⁷ e.g. (Calice 2010, Griffith-Jones, Spiegel, and Thiemann 2011)

⁶⁸ (FSB, IMF, and WB 2011) P13

⁶⁹ (World Bank 2012) P63, see also (Cho 2013)

approach implementing only those aspects of Basel II and III that are particularly useful.⁷⁰

Why, given the concerns about appropriateness (detailed further in the following section) and the advice of major international organisations, do LICs appear to be so keen to adopt the latest Basel standards?

Few studies have attempted to answer this question directly, but the existing studies provide some clues. A fairly frequent observation in the literature is that the level of implementation of Basel standards is closely related to the *presence of foreign-controlled and foreign-incorporated banks*. A 2004 FSI report observed a high correlation between foreign ownership and the proportion of bank assets that were moving to Basel II. In the Caribbean for instance, nearly all of the banking assets moving to Basel II were related to foreign banking institutions, in Asia the proportion was nearly one-half, while in Latin America and the Middle East it was one-third.⁷¹ This finding is echoed in the analysis of Basel II adoption in 150 countries, which finds that the presence of foreign subsidiaries whose parent bank was already implementing Basel II was the most powerful explanation for the adoption and implementation of Basel II in the host jurisdiction. This effect was particularly powerful in developing countries.⁷²

This correlation is attributed primarily to the subsidiaries of foreign banks exerting pressure on developing country governments to implement the most recent Basel standards.⁷³ Notably, global financial institutions operating in developing countries prefer to be subject to a single standard for their worldwide operations and, as they are usually regulated under Basel II in their home jurisdictions, they seek the same set of rules abroad.⁷⁴ One study notes that after the new Basel II standard was agreed, many developing country regulators were concerned that if they adopted its complex regulatory approaches they risked losing supervisory power over foreign banks, but if they pursued a more simplified approach – one more appropriate to their local contexts – foreign banks might leave the market.⁷⁵ This said, as another study notes, given that Basel II is widely being adopted, threats by foreign banks to relocate are increasingly non-credible. Large banks seek to persuade rather than pressure host governments to adopt the latest standards by appealing to the benefits of a more ‘competitive’ financial sector.⁷⁶ In addition to foreign banks, there are suggestions that international consulting firms and rating agencies exert pressure on developing country governments to adopt Basel standards.

A second, less prominent explanation in the literature is that developing countries implement the latest Basel standards as a *signalling device*. Basel standards are widely perceived to represent ‘best practice’ and developing country governments do not want to be perceived by foreign investors as applying weaker regulatory standards than the global norms.⁷⁷ In other words, adherence to the latest standards is seen as a mechanism for attracting

⁷⁰ (Fuchs, Losse-Mueller, and Witte 2013)

⁷¹ (Financial Stability Institute 2004)

⁷² (Cho 2013)

⁷³ (World Bank 2012)

⁷⁴ (FSB, IMF, and WB 2011) P13

⁷⁵ (Gottschalk and Griffith-Jones 2006)

⁷⁶ (Lall 2014)

⁷⁷ (Kasekende, Bagyenda, and Brownbridge 2011) (FSB 2013b) (World Bank 2012) Tran 2005 cited in (Fuchs, Losse-Mueller, and Witte 2013)

investment. A third, related explanation, is that regulators perceive the adoption of standards as necessary for increasing a country's credit rating and hence for securing access to international financial markets.⁷⁸

A final possibility is that standards are *diffused through international professional networks*. One study finds that where national bank supervisors were members of international networks where there was a high incidence of Basel II implementation, they were more likely to adopt and implement Basel II at home. Conversely, when they belonged to professional networks where few countries had implemented Basel II, this had a dampening effect on Basel II adoption and implementation. Interestingly, as professional networks are often regional in nature, the author suggests that countries in the same region tended to adopt standards at a similar pace and a similar way.⁷⁹

5. How Appropriate are New Global Standards for LICs?

We turn now to the evidence we have on the appropriateness of Basel standards for LICs. Global standards affect LICs in two ways. The most obvious is the *direct* effect of LIC governments deciding to implement Basel standards in their jurisdictions. However global standards also affect LICs *indirectly*, when other countries adopt standards and they affect LICs through 'spill-overs'. For instance, an international bank with a subsidiary in an LIC may be governed under home-regulation based on Basel III with substantial implications for how it operates in the LIC. Direct and indirect effects are analysed below.

In evaluating appropriateness, the first pertinent question to ask is 'will Basel standards improve the stability and resilience of LIC financial systems and reduce their vulnerability to crises in other countries?' The evidence, scrutinized below, is mixed. LIC regulators welcome the new focus on macro-prudential regulation in Basel III because macroeconomic risks are often more significant for financial stability in LICs than the risks posed by individual institutions. However, there are concerns that some elements of Basel standards do not go far enough, other elements are poorly designed for an LIC context, and there are gaps, as the current standards do not address important sources of systemic instability in LICs. Moreover, it is not clear that the new standards will protect LICs from adverse 'spill-over' effects from regulatory initiatives pursued in other countries.

A second question is 'will Basel standards support inclusive growth in LICs?' As discussed in detail below, the literature highlights a series of ways in which Basel standards, including Basel III, may have unintended (mainly adverse) consequences on growth and development in LICs. For instance, Basel standards may reduce the availability of long-term finance.⁸⁰

Basel Core Principles, Basel I and II

A first striking observation that emerges from the literature is that while international organizations including the IMF, World Bank and now the FSB strongly advocate that all

⁷⁸(Taylor 2010)

⁷⁹(Cho 2013)

⁸⁰(Kasekende, Bagyenda, and Brownbridge 2011) P6

countries, including LICs, implement the Basel Core Principles, there is a surprising lack of evidence that adherence to these principles improves financial stability. Cross-country studies find no significant relationship between most Basel Core Principles and banking system stability, with the notable exception of one of the twenty-nine Core Principles, which measures the quality of supervisory reporting. Countries in which banks have to report their financial data regularly and accurately to regulators and market participants have banks showing greater financial strength.⁸¹ Thus, while many LICs are striving to comply with Basel Core Principles, strengthened capital regulations and empowered supervisory agencies, there is little evidence suggesting that this improves banking-system stability, enhances the efficiency of intermediation, or reduces corruption in lending.⁸² As another report notes, ‘one has to look beyond adherence to the principles to the actual implementation and functioning of bank supervision.’⁸³

Turning to Basel I and II, there are relatively few studies on the impact on LICs of adopting these standards, although there is a substantial literature on implementation challenges (discussed in section 6). The studies that have been conducted raise concerns that, as in more advanced countries, the implementation of Basel II can lead to an increase in bank concentration and favoured large internationally active banks over small domestic banks.⁸⁴ While the subsidiaries of large international banks were able to adopt A-IRB approaches, this proved to be too a steep hurdle for smaller domestic banks, putting them at a competitive disadvantage.⁸⁵ In addition, small domestic banks are placed at greater disadvantage under Basel II than their counterparts in more advanced countries because of the inappropriate design of the Basel II ‘standardized approach’ for an LIC context. (This is the main alternative approach to risk for banks not adopting the A-IRB approach). It relies on using external sources to assess risk, including credit ratings agencies, which have a low penetration rate in LICs.

Placing small domestic banks at a disadvantage has adverse consequences for inclusive growth in LICs as these banks are usually the primary providers of loans to SMEs and consumer credit. There is some evidence that Basel II capital requirements resulted in banks lending more to more profitable, but not necessarily more socially productive endeavours in developing countries. In particular, the standards appear to have contributed to a credit gap, with consumer credit being particularly adversely affected.⁸⁶

Some elements of Basel II are welcomed, particularly its emphasis on strengthening the regulatory infrastructure. Under pillar 3 (market discipline) supervisors are asked to develop disclosure requirements for banks that are sufficient to allow market participants to assess key pieces of information on the scope of application, capital, risk exposure, and risk assessment processes. This contributes to strong public oversight over the performance and stability of the banking sector.⁸⁷

⁸¹ (Fuchs, Losse-Mueller, and Witte 2013)

⁸² (Barth, Gerard Caprio, and Levine 2012)

⁸³ (Fuchs, Losse-Mueller, and Witte 2013)

⁸⁴ Gottschalk in (Gottschalk 2010)P3

⁸⁵ (Beck et al. 2011)

⁸⁶ (Gottschalk and Griffith-Jones 2006) P13; Sen and Ghosh in (Gottschalk 2010)

⁸⁷ (Fuchs, Losse-Mueller, and Witte 2013)

Basel 2.5 and III

Turning to the most recent standards, notably Basel 2.5 and Basel III, the studies conducted to date suggest that emerging and developing country governments broadly support the reform objectives of enhancing financial stability.⁸⁸ As Basel III standards are only now being implemented, it is hard to gauge the magnitude of likely effects on LICs.⁸⁹ However the existing studies highlight six concerns, discussed in turn below.

1. Capital Adequacy Ratios May Reduce Lending in Priority Areas

New capital adequacy standards are a major feature of Basel III and are intended to address risk at the level of individual banks and the financial system as a whole. A concern raised in the studies conducted to date is that these new standards may lead capital to be reallocated away from areas that are central for inclusive growth. This sub-section first sets out the analysis to date of the adjustment costs LIC banks are likely to face in complying with the new standards in order to gauge the magnitude of any effects. It then considers the various ways in which the new capital standards may adversely affect the allocation of capital.

Magnitude of Adjustment Costs: Mixed Evidence

A series of studies ask whether the quantity and quality of capital held by banks in developing countries is sufficient to meet the new standards. While few specifically analyse LICs, the findings of these studies enable us to draw inferences for LICs.

The main finding of the various studies is that, on average, banks in emerging and developing countries will be able to comply relatively easily with the new Basel III capital requirements. While regulators will have to amend legislation, the adjustment costs for banks are not expected to be substantial. For instance, one study of Bolivia, Colombia, Ecuador and Peru suggests that major banks already meet the Basel III capital adequacy ratios, both in terms of the quantity and quality of capital required.⁹⁰

The reason for this is twofold. First, developing countries are more volatile environments for banks and there is limited regulatory capacity, so LIC regulators frequently impose higher capital standards than required under global standards.⁹¹ In Africa, more than one third of national regulators impose higher capital standards than the minimum required under both Basel II and Basel III. In addition, banks in developing countries often hold more than required under national regulations because of the volatility of their operating environment.⁹² As a result, leverage as measured by capital to nominal assets is much lower in Africa than in most developed markets.

This said, some adjustment costs may arise if regulators in developing countries opt to increase the level of capital they require banks to hold in order to preserve the differential between their own requirements and global minimum standards.

⁸⁸ (FSB 2013b)

⁸⁹ Moreover, even where some argue that new regulations already appear to be having an affect, such as deleveraging by foreign banks, it is hard to establish whether this is the result of short-term responses to the financial crisis or longer-term changes resulting from regulatory reforms. (FSB 2013b)

⁹⁰ (Galindo, Rojas-Suarez, and del Valle 2011) P15

⁹¹ (World Bank 2012)

⁹² (Kasekende, Bagyenda, and Brownbridge 2011) P5, P11-12; (World Bank 2012)

Given that many LIC banks are relatively well capitalised, from an LIC perspective, Basel III is arguably over-reliant on capital adequacy ratios and overlooks problems arising from weaknesses in areas such as loan provisioning and consolidated supervision which are greater sources of risk.⁹³ Rather than placing emphasis on further increasing these capital requirements, as Basel III does, there is a strong argument for investing in upgrading supervisory capacity. In the words of one report 'capital cannot compensate for a lack of supervisory capacity in the long run'.⁹⁴

Turning to the *quality* of capital that LIC banks would be required to hold under Basel III, the evidence is mixed. Several studies suggest that, on average, banks in developing countries will be able to comply relatively easily with new quality standards. One study notes that many African countries impose a broader range of restrictions on the composition of banking assets and liabilities than required under Basel standards, including restrictions on large loan concentrations, foreign exchange exposures, and activities that fall outside traditional banking. Overall, this should result in African banks holding relatively high quality capital (although accounting weaknesses and a lack of transparency concerning the composition of capital may put the quality of capital into question in some cases).⁹⁵

Others studies are more circumspect. One shows that the quality of core capital in a broad range of developing countries varies greatly depending on the business characteristics of specific banks and variations in national tax regulations. Thus while the adjustment costs may be low on average, some regions or countries may face substantial costs. In particular, banks in Latin America and the Caribbean are expected to have to make substantial adjustments to their core Tier 1 capital (deductions of up to 30 per cent) in order to meet the new and more stringent Basel III definitions.⁹⁶ Notably, some aspects of the new capital standards, including moves to improve the risk coverage of the capital framework for counterparty credit risk, will have little immediate impact because LIC bank activity in derivatives, repurchase agreements, and securities financing is limited. However, they may become relevant as financial markets deepen.

There is clearly the need for a detailed study of the likely adjustment costs that LIC banks will face. However the studies conducted to date suggest that banks in LICs are likely to be well positioned to meet the new standards on the quantity core capital, although the evidence suggests they may face greater challenges in meeting stricter standards on the quality of capital.

Ways in Which Capital may be Re-allocated: Cause for Concern

A first concern is that large international banks will reallocate capital away from LICs as they seek to move assets from low-rated borrowers to high-rated ones in a move to improve the quality of their capital. This is an *indirect* effect of Basel III on LICs. LICs would be particularly adversely affected, as they are perceived to be especially risky.⁹⁷ Notably, global banks can be expected to reduce their holdings of LIC sovereign debt securities.⁹⁸ The

⁹³ (FSB 2013b)

⁹⁴ (Fuchs, Losse-Mueller, and Witte 2013)

⁹⁵ (Kasekende, Bagyenda, and Brownbridge 2011) P5

⁹⁶ (World Bank 2012)

⁹⁷ (Calice 2010) (FSB 2012)

⁹⁸ (FSB 2013b)

rationale is straightforward. For a local bank, its own country's sovereign debt is a 'risk-free' asset but for a global bank, a host government's sovereign debt is a foreign sovereign exposure, so it has a positive risk weighting. Thus global banks can be expected to reduce their holdings as capital standards are tightened.

The reliance on global credit ratings in the Basel framework, which many developing country governments perceive as over-stating the risks of operating in their jurisdictions, would exacerbate this trend.⁹⁹ In Africa for instance, only five countries are rated by global credit agencies to be investment-grade and they account for two-thirds of total cross-border investment.¹⁰⁰ To address this problem, one report recommends that parent banks recognize local credit ratings for sovereign exposures denominated in local currencies and booked in local subsidiaries. However this requires cooperation between home and host country regulators, which poses its own challenges (see discussion below).¹⁰¹

A second concern is that the implementation of Basel III will lead capital to be reallocated within LICs in ways that are detrimental to growth and development, either because LIC regulators decide to implement Basel III or because subsidiaries of international banks alter their asset base in order to comply with home country regulations.

Studies highlight several possible adverse effects. First, there is the risk that the new regulations will lead to a reduction of lending to the private sector as banks turn towards less risky government securities, thereby reducing growth.¹⁰² Reduction in lending to the SME sector is a particular concern as provision of credit to this sector is often heavily dependent on banks and it is considered to be a relatively risky liability, and the SME sector is a major source of employment.¹⁰³ This threat has been recognized in emerging Europe, where a recent report recommends an urgent evaluation of the appropriate risk assessment methodologies under Basel III for evaluating credit to SMEs.¹⁰⁴

Third, there are concerns that Basel III will reduce the availability of trade finance.¹⁰⁵ Trade finance plays an important role in LICs as many rely heavily on international trade. Large international banks dominate the trade finance market and initial Basel III proposals promoted vocal criticism from large banks and some developing countries for over-estimating the risks associated with trade finance, which, they argued, is a low risk, short-tenor, self-liquidating activity. A survey by the Asian Development Bank suggested that the Basel III proposals could lead to a global reduction in trade finance of 13 per cent.¹⁰⁶ In 2011, in response to these concerns, the Basel Committee made revisions to reduce the capitalization requirements on confirmed letters of credit and to enable counterparties in trade finance transactions to receive a rating, for risk-weighting purposes, higher than the sovereign country where they are based. (Prior to this, traders with good track records operating in LICs were given low ratings). Despite these changes, the international banking

⁹⁹ (FSB 2012) P15

¹⁰⁰ (Calice 2010), P2

¹⁰¹ (O'Dogherty 2013) See also (Medinacelli 2013b) (FSB 2013b)

¹⁰² (Taylor 2010) is ambivalent; (Kasekende, Bagyenda, and Brownbridge 2011) P11 argues strongly for increases.

¹⁰³ (Calice 2010) P3

¹⁰⁴ (European Bank Coordination 'Vienna' Initiative 2012) P7

¹⁰⁵ (St John, Gertz, and Watson 2014)

¹⁰⁶ (Steven Beck et al. 2013)

industry continues to lobby for further changes, arguing that Basel III standards will still increase the costs and reduce the demand for trade finance.¹⁰⁷ The challenge for LIC regulators is to assess how real these concerns are for their jurisdictions. So far there is insufficient evidence to reach a clear conclusion.

Finally, although it has received little attention in the policy discussions, it is worth noting that large internationally active banks successfully lobbied to retain their right to use the A-IRB approach to risk-weighting capital assets under Basel III. As a result, the unlevel playing field established under Basel II, which favours large international banks over small domestic banks in LICs is further entrenched under Basel III.

2. New Liquidity Standards May Reduce Lending in Priority Areas

Studies raise similar concerns about the possible adverse consequences of the new liquidity standards on the allocation of capital within LICs. Once again, the likely magnitude of adjustment costs that banks in LICs face are discussed and then the paper examines the ways that these effects may arise.

There have been few detailed studies of the likely adjustment costs arising from the new liquidity standards. Some reports suggest that many developing country financial markets, including in Africa, are awash with liquidity and will face no problems meeting the new global minimum liquidity standards.¹⁰⁸ However others suggest that banks may face challenges in ensuring that their liquid assets are sufficiently high quality. Banks may find it difficult to meet the Liquidity Coverage Ratio (LCR) (requiring them to hold sufficient high quality liquid assets (HQLA) to survive a 30 days of acute stress) due to a limited supply of government or highly-rated corporate bonds in developing countries. In South Africa for instance, the supply of government bonds domestically is expected to be insufficient to meet the expected demand from South African banks and the ratings of most corporate bonds is below the minimum required under Basel III.¹⁰⁹ In so far as banks in LICs do need to make substantial adjustments to their portfolios to meet the LCR, this may have the adverse effect of reducing the turnover and liquidity of bond markets, resulting in more volatile prices and higher liquidity premia, and driving up the cost of finance.¹¹⁰

A further concern is that international banks operating in LICs estimate liquidity at the consolidated level and operate under home supervision. This leads parent banks to withdraw liquidity from subsidiary banks at times when the parent bank is under stress. In addition, differences in the definition of HQLA by the home and host jurisdictions may result in shedding of assets considered liquid by the host authority but not by the home authority.¹¹¹ In so far as home-regulator definitions of HQLA rely on the assessments of credit rating agencies, LIC sovereign bonds are unlikely to meet the HQLA requirements. In sub-Saharan Africa, where most countries are LICs, as at March 2013, only twenty countries had been rated by at least one of the major international credit agencies and of these, not one obtained a rating that met the Basel III definition of HQLA (AA- or higher).¹¹² As

¹⁰⁷ (FSB 2012) P13

¹⁰⁸ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁰⁹ (FSB 2012)

¹¹⁰ (FSB 2012) (FSB 2013b)

¹¹¹ (FSB 2012)

¹¹² (International Monetary Fund 2013)

discussed below, overcoming this challenge requires stronger cooperation between home and host country regulators.

Concerns have also been raised about the second component of the Basel III liquidity framework, the Net Stable Funding Ratio (NSFR) (the longer-term structural ratio that addresses liquidity mismatches and provides incentives for banks to use stable sources to fund their activities).¹¹³ In particular, developing country regulators have raised concerns that the Basel III definitions of 'stable funding sources' do not necessarily reflect the reality of funding in their jurisdictions. For instance, in South Africa, deposits by public sector entities and wholesale funding are among the most stable sources of finance, but they are not considered to be very stable under the Basel III liquidity framework.¹¹⁴

Adjustments made to comply with the NSFR could reduce the availability of longer-term financing. If, prior to Basel III implementation, corporate loans are funded via short-term deposits or other liabilities that are regularly rolled over, then, to avoid liquidity mismatches and comply with the NSFR, banks would have to increase the term of funding sources or, in the likely event that long-term funding is scarce, reduce the maturity of the loan.¹¹⁵ Thus while there is a clear rationale for reducing the level of maturity mismatch on bank balance sheets in order to improve financial stability, this may well reduce the availability of long-term bank finance and harm growth in LICs.¹¹⁶ Institutional investors are often identified as alternative sources of long-term finance, but regulatory standards applied to such investors has arguably led to excessive focus on short-term returns, to the detriment of the provision of long-term finance.¹¹⁷ In addition, institutional investors play a very limited role in LIC financial markets. To mitigate adverse impacts, additional instruments may be required to provide sufficient and sufficiently long-term, credit, particularly to SMEs, such as public development banks.

Interestingly, one analyst suggests that there may be unintended *benefits* for financial inclusion from the new liquidity standards. Under the LCR and the NSFR, retail deposits (from natural persons and small businesses) are given more favourable treatment than wholesale deposits, providing banks with incentives to increase their holdings of retail deposits. This may strengthen the business case for initiatives designed to increase the outreach of the bank into new segments of retail savers.¹¹⁸

3. Systemic Risks Inadequately Addressed

Given the vulnerability of developing countries to banking crises the new emphasis on macroprudential policy measures in Basel III is welcomed by many developing country regulators. Appropriately designed, such measures could help regulators smooth out credit allocation domestically and there may be positive spill-overs to their adoption by advanced economies, as this may reduce the pro-cyclicality of cross-border credit supply.¹¹⁹ However several reports cast doubt on the ability of Basel III standards to meet either objective.

¹¹³ (World Bank 2012)

¹¹⁴ (FSB 2012)

¹¹⁵ (FSB 2013a). See also (Erbenova 2013)

¹¹⁶ (FSB 2013a) P5

¹¹⁷ (FSB 2013a) P10

¹¹⁸ (Porteous 2013)

¹¹⁹ (Calice 2010) P5

Within developing countries, given the relatively high levels of capital already held by banks, the introduction of a 2.5 percent countercyclical capital buffer under Basel III is unlikely to be high enough to be effective.¹²⁰ As a complement to the countercyclical buffer, Basel III also introduces a simple leverage ratio to address procyclicality and reduce systemic risk. This has the potential to be particularly useful in developing countries where weaknesses in bank regulation often allows banks to disguise the riskiness of their asset portfolio. However, here again, the high levels of capital held in the banking sector may lead this simple leverage ratio to have limited impact.¹²¹

Concerns also arise from the design of the countercyclical buffer, which is arguably inappropriate for an LIC context. As designed, the buffer is based on a 'mechanistic reliance' on trend deviations of private sector credit as a percentage of GDP (a credit-to-GDP ratio). Many argue that this is inappropriate for developing countries given their experience of large swings in credit and growth cycles.¹²² Developing countries often experience sudden economic booms (driven by resource windfalls, peace dividends in post-conflict situations, or donor bubbles) followed by busts induced by internal or external shocks. As a result, a simple credit to GDP ratio is unlikely to capture the build up of risk in the financial sector. To improve the effectiveness of the countercyclical buffer, one study recommends that measures of nominal private sector growth are integrated into its design.¹²³

A greater challenge is that the macro-prudential aspects of Basel III do not address the systemic risks that can arise from the banking system's reliance on foreign currency denominated liabilities, yet this is a major source of systemic risk for developing countries, including LICs. In particular, the build-up of currency mismatches on bank and borrower balance sheets, combined with sharp currency fluctuations can heighten credit and liquidity risks.¹²⁴ Although developing countries have used a variety of prudential and administrative measures to limit currency mismatches, such measures are not included in the Basel III framework.¹²⁵ As three African regulators assert 'this is a major lacuna in the new global regulatory framework'.¹²⁶ Capital controls are a policy tool that can be used to address systemic risks arising from the intermediation of short-term external capital through the banking system.¹²⁷ Yet the use of this policy instrument may be curtailed by commitments under international trade agreements.¹²⁸

Turning to the question of macroeconomic spill-overs from other jurisdictions, will the adoption of Basel III by advanced economies reduce the pro-cyclicality of cross-border credit supply to LICs? This question is of great importance to LICs. Developing countries, particularly those more integrated into world markets, are extremely vulnerable to pro-cyclical flows of external finance, with very negative effects on their growth and

¹²⁰ (Kasekende, Bagyenda, and Brownbridge 2011) P18; (Griffith-Jones, Spiegel, and Thiemann 2011)P17

¹²¹ (Griffith-Jones, Spiegel, and Thiemann 2011) P17

¹²² (FSB 2013b) See also (Frait 2013). For a helpful discussion of the rationale behind countercyclical buffers see (The Warwick Commission 2011)

¹²³ (Fuchs, Losse-Mueller, and Witte 2013)

¹²⁴ (Griffith-Jones, Spiegel, and Thiemann 2011) P18

¹²⁵ (FSB, IMF, and WB 2011) P26

¹²⁶ (Kasekende, Bagyenda, and Brownbridge 2011) P22

¹²⁷ (Griffith-Jones, Spiegel, and Thiemann 2011), P2

¹²⁸ (Gallagher 2011)

development. In particular, the ‘search for yield’ characteristic of low interest rate environments in developed economies generates incentives for credit creation, carry trade, and leverage that is often associated with the pumping up of asset bubbles in emerging economies and elsewhere. Regulatory action in home countries has tended to amplify procyclicality: during booms, national regulators in home countries tend to support the expansion of their banks abroad, while in the subsequent crash home country regulators tend to exert less forbearance on international lending than local lending.¹²⁹ To date there is little evidence on the extent to which Basel III can be expected to dampen the procyclicality of cross-border credit flows to developing countries and this is an area that requires further analysis.

In the absence of effective instruments in Basel III to address pro-cyclical cross-border flows at source, there are strong grounds for LICs strengthening regulations at the national level. As the Warwick Commission notes, there are few political incentives for home countries, particularly large advanced countries, to act to ameliorate cross-border impacts on LICs, so stronger host-country regulation is often best protection. For instance, LIC regulators could require all lending activity to be carried out by locally regulated subsidiaries. Where host country authorities identify risks to domestic financial stability, borrowing outside the locally regulated sector could be made illegal and any charge on local assets by unregulated external lenders unenforceable.¹³⁰

Host-regulation notwithstanding, actions to curb pro-cyclical cross-border flows are also required at the international level, as markets are subject to contagion. For this reason, all countries have a legitimate concern to avoid pro-cyclical excesses in other countries, and there is a strong case for international coordination and for strengthening of regional and global regulatory institutional arrangements.¹³¹ While the contagion risk from LICs are too small to be of concern to countries with much larger financial markets, they would benefit from cooperation at the global level.

4. Bank Resolution: A Missing Component

Given the comparatively small size of the financial sectors in LICs many banks are of systemic importance on a national scale and the too-big-to-fail problem is ubiquitous.¹³² The lack of effective resolution systems and crisis management tools is identified in the literature as one of the weakest points in the financial safety net in most countries, and this is particularly the case in LICs.¹³³ The efficient resolution of failing subsidiaries of foreign banks is a major and critical challenge, especially in those LICs where such banks often have a dominating position. Information asymmetries are acute and bank supervisors in host countries often lack the necessary information to prepare adequately for a failure event. Crucially, the liquidity and equity positions of banks can be changed within hours in favour of the parent and at the expense of the subsidiary.¹³⁴

¹²⁹ (The Warwick Commission 2011)

¹³⁰ (The Warwick Commission 2011)

¹³¹ Griffith-Jones in (Helleiner, Griffith-Jones, and Woods 2010)

¹³² (Fuchs, Losse-Mueller, and Witte 2013)

¹³³ Effective resolution systems rely on the capacity to intervene in a failing bank in time to prevent economic damage and contagion. Effective crisis management tools rely on the capacity to coordinate a response to a crisis when it occurs.

¹³⁴ (Beck et al. 2011)P208

While Basel III takes steps to create effective resolution regimes for the largest global banks, these initiatives are ill-suited to respond to the needs of LICs. Under the auspices of the Basel Committee, supervisory colleges and crisis management groups have been created for those banks deemed to be 'globally-systemically important banks' (G-SIBs). A first problem is that the representation of LIC supervisors in these supervisory colleges is extremely weak. In cases where these banks are of disproportionate systemic importance in their jurisdictions, LIC regulators have a strong interest in being included in these resolution mechanisms. However from the perspective of the home supervisors convening the supervisory college, the activities of international banking groups in LICs are such a part of the total balance sheet that LIC regulators are often overlooked. Even if they are included, active participation requires substantial money and time costs required for already over-stretched LIC regulators.¹³⁵

Perhaps more importantly, many of the international banks that are systemically important in LICs are not classified as G-SIBs. Thus the supervisory colleges set up under the auspices of the Basel Committee are not necessarily supervising the activities of the cross-border banks that are most important for LICs. In Africa for instance, the total assets of regional African banks by far exceed the engagements of large international banking groups in the region, such as Barclays, Citibank, and Standard Chartered. This underscores the need for effective institutional arrangements for cooperation on bank resolution at the regional level, and here Basel III provides little guidance.¹³⁶

Here again, LIC regulators could use national regulations to heighten their control over cross-border banking. One possibility is to require the creation of stand-alone subsidiaries. While this would provide LIC regulators with more control, others caution that such firewalling would also take away the advantages of multinational banks in terms of scale economies and the use of joint platforms. In Africa for example, the Bank of Africa, Ecobank, First Rand, and Standard Bank, four important regional banks throughout the continent, have centralized their group functions for treasury and liquidity management, group audit, large credit authorization, and electronic data processing.¹³⁷ There is also the risk that host country prudential rules could be used as a protectionist device to restrict foreign financial institutions in domestic markets (although this could be mitigated through international commitments to a 'national treatment' principle in the implementation of host country prudential regulation).¹³⁸ An alternative 'half-way' option would be to require subsidiaries of multinational banks to make their corporate structures more transparent and to draw up contingency plans (i.e. to resolve subsidiaries on a stand-alone basis if the need arises).¹³⁹ In all these areas, Basel III provides no guidance at present.

5. Regulation of Cross-Border Banking is Not Strong Enough

A more general concern, closely related to several of the issues raised above, is that Basel III fails to provide the incentives and institutional mechanism for greater home-host cooperation.

¹³⁵(Beck et al. 2011); (FSB, IMF, and WB 2011) P19; (Fuchs, Losse-Mueller, and Witte 2013)

¹³⁶(Fuchs, Losse-Mueller, and Witte 2013)

¹³⁷(Beck et al. 2011)P208

¹³⁸(The Warwick Commission 2011)

¹³⁹(Lukonga 2010) cited in (Beck et al. 2011)

As is clear from the preceding discussion, foreign banks play an increasingly important role in LICs and weaknesses in home-host cooperation pose major challenges for effective regulation at the national level. At the heart of the challenge for LIC host regulators is that international banks operating in their jurisdiction assess risks and estimate capital and liquidity at the consolidated level and in doing so, home regulation and home supervisor's guidance prevails. When host regulators seek to tighten regulation and supervision of foreign banks, they require cooperation from the home regulator, including for access to information.

Home-host cooperation and information sharing is undermined by conflicts of interest as home regulators have a strong incentive to strengthen the competitive position of their banks abroad.¹⁴⁰ If the host jurisdiction is large, this incentive may be tempered by a concern that the build up of financial instability in the host state could ricochet back to the home state, making the home state more likely to cooperate. However if, as in the case of LICs, the host jurisdiction is small, there is little incentive for the home regulator to consider adverse implications on financial instability in the host state.¹⁴¹ Strengthening mechanisms and creating incentives under Basel III for home regulators to cooperate with their LIC counterparts would be of decided benefit to LICs.

6. Weak Regulation of Non-Bank Financial Institutions

A final criticism of Basel III from the perspective of LICs is that it places a disproportionate emphasis on strengthening the regulation of the banking sector, to the relative neglect of the non-bank sector. This is an issue of growing international concern as, during the financial crisis, shadow banking provided the propagating mechanism for contagion effects, including through special investment vehicles, money market mutual funds, hedge funds, and securitisation.¹⁴² Crucially, Basel III's efforts to more stringently regulate banks may have the adverse effect of diverting risky financial activities into non-bank financial institutions.¹⁴³

In LICs, the growth of the 'shadow banking sector' through large international non-banking institutions such as special investment vehicles is often relatively small. A more pressing challenge for LIC regulators is the growing presence of small-scale non-bank institutions such as savings and credit cooperatives and micro-finance institutions. These institutions are increasingly important providers of financial services and have grown rapidly in recent years, particularly in Africa.¹⁴⁴ While the expansion of the industry is generally welcomed, non-bank institutions often suffer from major institutional weaknesses and they are often inadequately regulated.

Basel III and other international standards provide no guidance on the regulation and supervision of small-scale non-bank institutions. Given that these small-scale financial institutions are often domestic, there is a valid argument for *not* developing international standards in this area so that LIC regulators can design regulations specific to their needs. However, there are concerns that compliance with Basel standards by LICs (many aspects

¹⁴⁰ (FSB, IMF, and WB 2011) P9; (Kasekende, Bagyenda, and Brownbridge 2011) P24

¹⁴¹ (FSB, IMF, and WB 2011, Kasekende, Bagyenda, and Brownbridge 2011, Griffith-Jones, Spiegel, and Thiemann 2011) (FSB 2013b)

¹⁴² (Murinde and Mlambo 2010) P6

¹⁴³ (Ghosh, Gonzalez del Mazo, and Ötcher-Robe 2012)

¹⁴⁴ (Calice 2010) P7

of which are not particularly relevant to their jurisdictions) will divert scarce resources away from the regulation and supervision of the non-bank financial sector. In many developing countries regulations are already much more stringent in the banking than the non-banking sector and there is some evidence of banks establishing non-bank financial companies to circumvent banking regulations. With Basel III, there is the risk that this trend will be reinforced. The rapid growth of the small-scale non-bank sector in the context of weak regulation could lead to usurious lending practices and crippling debt levels among vulnerable segments of the population, as it has done among farmers in Southern India.¹⁴⁵

6. Implementation Challenges

Moving beyond the merits and demerits of Basel standards, LICs face major implementation challenges.¹⁴⁶ These arise from two sources: weaknesses in regulatory institutions, resulting from human and financial resource shortages and poorly designed oversight and governance; and gaps in the wider financial infrastructure which impede effective regulation and supervision.

Regulatory Weaknesses

LIC regulatory institutions face acute human and financial resource constraints. Developing country governments cite a shortage of high-quality human resources as the most important constraint to the implementation of Basel standards.¹⁴⁷ A study of supervisory capacity in African countries shows that qualified staff and the availability of analytical tools, are particularly limited.¹⁴⁸

In many cases, weaknesses in the governance arrangements of regulatory bodies undermine their efficacy. In many LICs central banks and regulatory authorities still do not have political and operational independence; they have limited supervisory skills and lack the required enforcement powers.¹⁴⁹ There is little legal protection for official actions and which greatly constrains the ability of official bodies to regulate the financial sector effectively.¹⁵⁰ In francophone West Africa for instance, the Banking Commission lacks sufficient power to enforce corrective measures in the case of non-compliance with regulations.¹⁵¹ As one report notes, weak supervisory capacity and a lack of regulatory independence are often at least as important as gaps in the regulatory framework in explaining financial fragility.¹⁵²

Turning to the implementation challenges associated with specific Basel standards, it is striking that many LICs still struggle to comply with the basic Basel Core Principles (which address the governance, resources and independence of bank supervision) and with the

¹⁴⁵ (FSB, IMF, and WB 2011) P9; (Griffith-Jones, Spiegel, and Thiemann 2011) P16

¹⁴⁶ (FSB, IMF, and WB 2011).

¹⁴⁷ (FSB 2013b)

¹⁴⁸ (Beck et al. 2011)

¹⁴⁹ (Beck, Fuchs, and Uy 2009)

¹⁵⁰ (FSB, IMF, and WB 2011).

¹⁵¹ (Beck et al. 2011)

¹⁵² (World Bank 2012)

implement of Basel I standards.¹⁵³ For instance, among 16 African countries where fulfilment of the Core Principles has been assessed, they were, on average largely or fully compliant with only 20 of the 29 principles.¹⁵⁴ Extremely weak supervisory capacity leads many African countries to rely even more heavily on capital requirements than implied by the full observance of the Basel Core Principles and implementation of Basel I.¹⁵⁵

Given this context, the shift from compliance-based supervision in Basel I to risk-based supervision in Basel II is a formidable challenge for LIC regulators.¹⁵⁶ In many LICs, supervisory processes focus on compliance with regulatory standards and are not set up to identify and manage the changing risks in the banking system. The ability to monitor risks on the institutional and systemic levels is hampered by insufficient data quality and poor reporting processes.¹⁵⁷ In addition, in many LICs, accounting practices are not harmonised across domestic and foreign banks, compounding monitoring challenges.¹⁵⁸ Making the transition to a risk-monitoring approach carries significant costs for banks and regulators alike. Building up supervisory capacity—including staff training, new processes, and substantial investments in information technology infrastructure—is beyond the budget scope of many LIC regulatory institutions.¹⁵⁹

In particular, the A-IRB approaches under Basel II (discussed in previous sections) are extremely difficult for LIC regulators to supervise. These risk management systems rely on highly skilled regulators using judgement and discretion, thereby placing even more onus on regulators being independent, immune from lawsuits, and willing to challenge the well connected.¹⁶⁰ Even if the human resources are available, regulators need a high level of information, including on each bank's internal risk management practices, its exposure to risks, its funding structure, and its overall risk profile.¹⁶¹ These challenges are compounded by the fact it is often extremely hard for host country regulators to access this information from multinational banks operating in their jurisdictions as they are governed first and foremost by home-country regulation. For this reason, studies recommend that LICs implement Basel II selectively, and avoid adopting the more complex approaches to risk assessment under Pillar 1 (minimum capital requirements).¹⁶² Indeed, moving beyond the simplified standardized approach could result in a de facto loss of supervisory power and would therefore be counterproductive.¹⁶³

Basel III adds a further layer of complexity, exacerbating implementation challenges (as an indication, Basel I was 30 pages long, Basel II was 347 pages, and Basel III is 616

¹⁵³ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁵⁴ (Beck et al. 2011)

¹⁵⁵ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁵⁶ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁵⁷ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁵⁸ (Murinde and Mlambo 2010) P6

¹⁵⁹ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁶⁰ (Taylor 2010, Murinde and Mlambo 2010, Calice 2010)

¹⁶¹ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁶² (Fuchs, Losse-Mueller, and Witte 2013)

¹⁶³ (Beck et al. 2011). Interestingly, given the inappropriateness of Basel II for smaller banks, many advanced economies adopted a partial approach to implementation. In the United States for instance, Basel II was adopted for the largest international banks, but other banks remained on Basel I. (Cho 2013)

pages).¹⁶⁴ In terms of microprudential regulation, Basel III continues to rely on A-IRB approaches, which remain particularly hard for LIC regulators to supervise and Basel III fails to provide effective incentives or mechanisms to improve home-host cooperation.¹⁶⁵

While the macroprudential approach of Basel III is welcomed, it poses particular challenges as the development of macroprudential supervisory capacity is in its infancy. In Africa for instance, most central banks do not have dedicated financial stability units. The additional resource demands of adopting a macro-prudential approach are considerable, particularly in skills, training, modelling, technology, and data. This approach requires new crosscutting skills combining macroeconomic analysis and regulation, new modelling techniques, data collection and analysis, and practical criteria for triggers and interventions. It requires a cultural shift from a relatively passive rules-based supervisory approach (particularly under Basel I) to active risk management. In addition, it may require changes to the legal framework, as regulators may lack the legal authority for intervening on the basis of macroprudential factors (rather than institution-specific factors).¹⁶⁶

The countercyclical capital buffer is expected to be particularly difficult to implement as regulators lack the necessary accurate information. As discussed above, a mechanical application of credit-GDP is unlikely to be an effective basis for a countercyclical buffer in LICs. While it is possible to design more effective buffers, LIC regulators lack the macroeconomic tools and methodologies to do so.¹⁶⁷ There are similar concerns about the feasibility of implementing the new liquidity standards given data quality and systems constraints. More basic approaches such as the simple customer loans-to-deposit ratio seen in some LICs are often more appropriate and easier to implement than the standards specified under Basel III.¹⁶⁸ Given these constraints, one report suggests focusing first on establishing dedicated macro-prudential surveillance units before moving to full-fledged macro-prudential supervision (including intervention powers).¹⁶⁹

Basel III and the wider trends in financial supervision also make greater demands on cross-government coordination at the national and regional level. Following the financial crisis, emphasis is being placed on disaster-preparedness and this requires effective cross-government coordination including between central banks, ministries of finance, deposit insurers, court judges, and tax authorities. In many LICs, lender-of-last-resort, liquidity management, and payment systems routines and infrastructure are often ill-prepared, cumbersome in operation, and highly discretionary.¹⁷⁰

At the regional level, greater cooperation is required among regulators and supervisors as financial markets become more integrated. Indeed, there are large economies of scale to be reaped by regional cooperation in technical areas such as harmonizing approaches to bank regulation or payment systems.¹⁷¹ In many regions, countries have heterogeneous financial

¹⁶⁴ (World Bank 2012)

¹⁶⁵ (Murinde and Mlambo 2010) P6; (Calice 2010) P3

¹⁶⁶ (Beck et al. 2011)

¹⁶⁷ (FSB 2012)

¹⁶⁸ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁶⁹ (Fuchs, Losse-Mueller, and Witte 2013)

¹⁷⁰ (Beck, Fuchs, and Uy 2009)

¹⁷¹ (Beck, Fuchs, and Uy 2009)

markets and implementation of Basel standards is uneven, impeding consolidated cross-border monitoring.¹⁷² Developing effective mechanisms for cross-border cooperation between regulators is a priority issue for LIC regulators.¹⁷³

Gaps in Financial Infrastructure

Aside from stronger supervisory institutions, the new emphasis on macroprudential regulation in Basel III requires sound financial infrastructure (particularly credit reporting institutions, payment and settlement systems, and the legal framework governing financial transactions). Yet in many LICs such infrastructure is very weak.

Credit reporting institutions are particularly important for macroprudential supervision. Although regulators can obtain information from individual financial institutions, credit registries enable regulators to obtain a more comprehensive picture of interconnected risks in the financial sector because they typically contain information on all loans above a particular threshold. In particular, information from credit registries can provide the basis for evaluating the systemic importance of financial institutions, enabling regulators to assess and monitor their interrelated exposures. It can also inform countercyclical buffer decisions, by increasing the accuracy of risk-weighting in banks' loan portfolios.¹⁷⁴ Yet credit-reporting institutions are particularly weak in LICs. In sub-Saharan Africa for instance the coverage of credit reporting institutions is much lower than any other region in the world, with credit registries only covering 16 per cent of GDP and credit bureaus only covering 8 per cent of GDP.¹⁷⁵

Well-designed payment and settlement systems similarly contribute to systemic stability by reducing counterparty risk in interbank markets and in complex securities and derivatives transactions. In emerging markets, the development of robust securities settlement systems has often lagged the rapid expansion of equity and derivatives markets, and strengthening these systems is key for ensuring systemic stability. In LICs equity and derivatives markets are nascent, but as they develop, strengthening securities settlement systems will be key to effective macro-prudential regulation.¹⁷⁶

7. Conclusion: How Should LIC Regulators Respond?

Global banking standards are of growing importance to LICs and many LIC governments are proceeding to implement the latest global standards. Strikingly, the available data suggests low-income and lower-middle income countries are just as likely to implement Basel standards as high-income and upper-middle income countries. Yet, as we have seen, LICs play little role in the global standards-setting process and there are widespread concerns in the academic and policy literature that these standards are inappropriate for developing countries. Concerns include the failure of standards to address major sources of financial

¹⁷² (Medinacelli 2013a)

¹⁷³ (Beck, Demirgüç-Kunt, and Levine 2007, Claessens and Horen 2014)

¹⁷⁴ (World Bank 2012)

¹⁷⁵ (World Bank 2012)

¹⁷⁶ (World Bank 2012)

instability; possible unintended consequences for productive investment; and, as they are complex to implement, the risk of diverting precious institutional resources away from more pressing issues.

LIC regulators face important and pressing questions about how to respond to new global financial regulations and their decisions are impeded by the relative weakness of the evidence base. There is a paucity of credible evidence on the precise impact that global banking standards are likely to have on LIC economies, we do not have a complete picture of the rates of implementation across LICs, and we have little understanding of the conditions under which LIC regulators decide to adopt global standards.

More precisely, three research gaps and corresponding questions stand out:

- What drives the adoption and implementation of global standards in LICs and given politics and institutional constraints, how much *de facto* flexibility do LICs have in respect of the new regulatory standards? How much do they need?
- What national and regional institutional arrangements do LICs need in order to harness global banking standards, properly to manage the risks stemming from cross-border banking, and, ultimately, to promote inclusive growth? How can LICs adapt global standards to their specific national and regional regulatory contexts to support a stable financial system that fosters inclusive growth?
- What are the priority issue areas where LICs should advocate for reforms to international financial standards and regulatory initiatives? What strategies for influencing global standard-setting processes and institutions are likely to yield the best outcomes for LICs?

Addressing these gaps will provide scholars with a better understanding of the economics and political economy of international financial regulation in LICs, and provide policymakers with a much-needed evidence base.

Appendix 1: List of Low Income Countries

Table 3: Low-income economies (\$1,035 or less)

Afghanistan	Gambia, The	Myanmar
Bangladesh	Guinea	Nepal
Benin	Guinea-Bissau	Niger
Burkina Faso	Haiti	Rwanda
Burundi	Kenya	Sierra Leone
Cambodia	Korea, Dem Rep.	Somalia
Central African Republic	Kyrgyz Republic	South Sudan
Chad	Liberia	Tajikistan
Comoros	Madagascar	Tanzania
Congo, Dem. Rep	Malawi	Togo
Eritrea	Mali	Uganda
Ethiopia	Mozambique	Zimbabwe

Note: 25 of 36 LICs are in Africa; 25 of 48 countries in sub-Saharan Africa are LICs

Appendix 2: Financial Markets in LICs

Finance is a key part of LIC strategies for inclusive growth. Well-functioning financial systems mobilise savings and channel them to productive investment and improve the efficiency of resource allocation by screening projects and monitoring use of funds, thereby spurring growth. When financial regulations are effectively structured, encouraging the challenging of credit towards small and medium enterprises and preventing abusive lending practices for instance, they can promote inclusive growth and reduce structural inequalities.¹⁷⁷ Many LICs have undertaken broader financial sector reforms since the 1990s and this has led to lower incidences of banking crises in the 2000s, although pockets of fragility persist.¹⁷⁸

Relative to other countries, the financial systems in LICs are small and under developed. Many African financial systems for example, are smaller than a mid-sized bank in continental Europe, with total assets often less than US\$1 billion.¹⁷⁹ Although the nonbank financial intermediary and microfinance sectors are growing, the banking system continues to account for over 80 percent of financial system assets in the median LIC, and stock market capitalization in LICs represents a fraction of private credit extended by the banking system.¹⁸⁰

In many LICs, ownership patterns have shifted dramatically over the past two decades towards privately-owned systems, often controlled by foreign banks. Foreign bank penetration has more than doubled for the median LIC since 1995, and is particularly high in Sub Saharan Africa.¹⁸¹ While in the mid-1990s less than a quarter of banking systems were dominated by foreign-owned banks and many countries still had predominantly government-owned banking systems, by 2005, more than half of the region's countries had a banking market with either a dominant or a significant share of foreign-owned financial institutions. There is also a rise in South-South banking, particularly on a regional level: South African and Nigerian banks are playing a greater role in sub-Saharan Africa, while Malaysian and Singaporean banks are playing a greater role in in Vietnam and Cambodia.

Foreign bank entry has several advantages for LICs. It can help foster governance, bring in much-needed technology and experience, and can help exploit scale economies in their small host economies. Yet there are also risks, particularly when a foreign subsidiary dominates the local financial system and the parent company is in trouble—a scenario that has become again more likely in the current global financial turmoil.¹⁸²

The World Bank has developed a series of indicators for assessing and benchmarking the development of financial sectors across countries. These indicators look at four attributes: the depth of the financial sector, access to financial services, the efficiency of financial services, and the stability of financial institutions and the wider financial system. Analysing

¹⁷⁷ (Griffith-Jones, Ocampo, and Gallagher 2012)

¹⁷⁸ (Era Dabla-Norris et al. 2012)

¹⁷⁹ (Beck, Fuchs, and Uy 2009)

¹⁸⁰ (Era Dabla-Norris et al. 2012)

¹⁸¹ (Era Dabla-Norris et al. 2012)

¹⁸² (Beck et al. 2011)

these indicators for LICs provides a helpful overview of the challenges facing LIC regulators as they seek to pursue inclusive growth, and underscores the differences between LICs and other developing countries (Table 4).¹⁸³ The discussion below draws on World Bank and IMF analysis of LICs, as well as other studies on the banking sector in African countries. In interpreting the statistics, caution is needed as data coverage and quality for LICs is often poor.

Financial Size and Depth

The depth of the financial sector, approximated by private sector credit to GDP, is closely associated with long-term economic growth and poverty reduction,¹⁸⁴ and the evidence shows that LICs have particularly shallow financial sectors. On average private credit is only 17 percent of GDP in LICs, compared with 31 percent in lower-middle income countries, and 48 percent in upper-middle income countries (Table 4). There is substantial variation within LICs with Chad, for example, having a private credit to GDP ratio of less than 3 percent.¹⁸⁵ The gap between LICs and groups of countries is even starker in other parts of the financial system. For instance, only a third of African countries have stock markets, which are mostly small and illiquid.¹⁸⁶

However the financial sector in LICs is evolving. Standard indicators of financial intermediary development, such as liquid liabilities to GDP, bank deposits to GDP, and private credit to GDP have demonstrated financial deepening in many LICs over the past decade.¹⁸⁷

Table 4: Key Attributes of LIC Financial Sectors

	Depth of Financial Institutions Domestic private credit to the real sector by deposit money banks as a percentage of local currency GDP <i>Simple average</i>	Access to Financial Institutions Number of adults reported having an account with a formal financial institution per 1,000 adults <i>Simple average</i>	Efficiency of Financial Institutions Spread (difference) between lending rate (rate charged to loans to private sector) and deposit rate (interest rate on deposits) <i>Simple average</i>	Stability of Financial Institutions Average weighted z-score for commercial banks <i>Simple average</i>
High-Income	107.4	87.1	4.2	21.6
Upper-Middle-Income	48.1	46.3	6.5	18.2
Lower-Middle-Income	31.2	24.0	8.9	21.5
Low-Income	17.1	16.5	14.3	12.8

Note: Data from World Bank Global Finance Development Report 2014 (Appendix). Country coverage is not comprehensive and varies across indicators. Number of LICs covered for each indicator: depth of financial institutions (27); access to financial institutions (16); efficiency of financial institutions (19); stability of financial institutions (30).

¹⁸³ The World Bank database considers these 4 attributes from the perspective of financial institutions and financial markets, so there are 8 indicators in total. However while there is data on LICs at the institutional level, market level data is extremely limited, so this analysis focuses on the institutional indicators. (World Bank 2013b)

¹⁸⁴ (Čihák et al. 2012)

¹⁸⁵ (Beck et al. 2011)

¹⁸⁶ (Beck et al. 2011)

¹⁸⁷ (Beck, Fuchs, and Uy 2009)

Access to Finance (Inclusion)

Financial development is also about the ability of individuals and firms in an economy to access financial services. Without inclusive financial systems, poor individuals and small enterprises need to rely on their personal wealth or internal resources to invest in their education, become entrepreneurs, or take advantage of promising growth opportunities. Besides the direct benefits of enhanced access to financial services, it also reduces inequality, particularly through indirect labour market mechanisms.¹⁸⁸

The main proxy variable for assessing financial access is the number of bank accounts per 1,000 adults. Financial systems in LICs are characterized by very limited access, with only 17 in 1,000 adults reporting that they have an account with a formal financial institution, compared with 24 in lower-middle income countries, and 46 in upper-middle income countries (Table 1). Other studies reveal an acute shortage of long-term finance. Analysis of banking in sub-Saharan Africa shows that finance is mostly short term, as evidenced by the maturity structure on the asset and liability sides of bank balance sheets: more than 80 percent of deposits are sight deposits or are deposits with a maturity of less than one year, and less than 2 percent of deposits have a maturity of more than 10 years.¹⁸⁹

Efficiency

Inefficiency in the financial sector is reflected in high intermediation costs and this makes banking costly for households, firms, and governments.¹⁹⁰ Banking in many LICs is particularly expensive, as reflected by high interest spreads and margins. High spreads between deposit and lending interest rates provide disincentives for both savings and lending, as they depress the returns for savers and push lending interest rates up. On average the interest spread in LICs is 14 percent, compared with 9 percent in lower-middle income countries, and 7 percent in upper-middle income countries (Table 1). Using simple back-of-the-envelope calculations, Beck et al. estimate that high costs impede access of households in many African countries to finance. For instance, they estimate that as many as 94 percent of households in Malawi, 89 percent in Sierra Leone, and 93 percent in Uganda are unable to afford checking accounts given their annual income and the assumption that they cannot spend more than 2 percent of household income on financial transaction account charges.¹⁹¹

Stability

Much of the debate in the wake of the global financial crisis has focused on ensuring stability of financial systems and this is also important in LICs.¹⁹² LICs are vulnerable to banking crises. Studies show that African countries (more than half of which are LICs) are as vulnerable to systemic crises as countries in other parts of the world: of 124 systemic banking crises that took place between 1970 and 2007, 44 were in Africa.¹⁹³ Systemic crises have enormous costs in terms of lost output, employment and fiscal costs.¹⁹⁴ One assessment of 10 banking crises in Africa estimated losses at between 3 per cent and 25

¹⁸⁸ (World Bank 2012)

¹⁸⁹ (Beck et al. 2011)

¹⁹⁰ (World Bank 2012)

¹⁹¹ (Beck, Demirgüç-Kunt, and Soledad Martínez Peria 2007)

¹⁹² (Griffith-Jones, Spiegel, and Thiemann 2011)

¹⁹³ (Laeven and Valencia 2008)

¹⁹⁴ (Reinhart and Rogoff 2009, Laeven and Valencia 2008)

per cent of GDP.¹⁹⁵ While LICs proved to be relatively resilient during the recent global financial crisis, many remain vulnerable to global shocks as the result of sizeable sovereign debt overhang, volatility in commodity export prices, and substantial short-term capital inflows and outflows.¹⁹⁶

To measure the stability of financial institutions, the World Bank uses the z-score of commercial banks (lower scores suggest greater instability).¹⁹⁷ On average, commercial banks in LICs have average z scores of 13 compared with 22 in lower-middle income, and 18 in upper-middle income countries (Table 1), suggesting they are less financially stable. The higher risk profile of LIC financial institutions can be attributed to the narrow range of formal actors and economic activity in LICs, coupled with low scope for diversification in shallow markets, which leads to a concentration of banks' exposures to a limited number of counterparties.¹⁹⁸

The LIC Regulatory Challenge: Stability vs. Development

In the wake of the financial crisis, the international policy debate has focused on financial stability, yet LIC regulators need to ensure that the financial system also supports growth and development, and there may be trade-offs between the two goals.¹⁹⁹ If LIC regulators focus too much on stability, asset creation may suffer, inter-sectoral flows of funds stagnate, savings and investments slow down, the government sector may crowd out the private sector, damaging economic development and growth.²⁰⁰ This is a major challenge in Francophone West Africa for instance, where a number of prudential rules are criticized for being overly restrictive, hindering access to credit, and slowing down economic development.²⁰¹

Yet if the financial sector expands too fast, without due regard for stability, the economy can be left vulnerable to financial crises. In Vietnam for instance, high growth has been accompanied by rapid financial sector development and deepening international financial integration. Despite financial regulatory reforms, supervisory capacity lags banking sector expansion, resulting in high levels of non-performing loans and a vulnerable financial sector.²⁰² Countries with shallow financial markets and an economy dominated by the export of minerals face a particular challenge. Angola for instance has experienced rapid double-digit growth fuelled by commodity exports during the past decade. The banking sector grew rapidly and is now among the largest in Africa, yet it is extremely vulnerable due to heavily reliance on extractives and exposure to the volatile foreign exchange flows they generate. Moreover, regulation and supervision is very weak.²⁰³

¹⁹⁵ (Daumont, Le Gall, and Leroux 2004)

¹⁹⁶ (FSB, IMF, and WB 2011) P8

¹⁹⁷ Defined as the sum of capital to assets and return on assets, divided by the standard deviation of return on assets. This variable explicitly compares buffers (capitalization and returns) with the potential for risk (volatility of returns). The z-score has a direct link with the probability of default, and for this reason the variable has been used extensively in the empirical literature. (Note that this indicator provides an assessment of the riskiness of individual financial institutions, but does not assess systemic risk within the financial sector).

¹⁹⁸ (Era Dabla-Norris et al. 2012)

¹⁹⁹ (Murinde and Mlambo 2010) P3

²⁰⁰ (Murinde and Mlambo 2010) P5

²⁰¹ (IMF 2012b) (IMF 2013)

²⁰² (Anh et al. 2013)

²⁰³ (IMF 2009, World Bank 2013a)

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