Note:

The following is the English translation of an op-ed originally published by Economico Valor, a Brazilian business news outlet. The original text, in Portuguese, is available at http://www.valor.com.br/opiniao/3062218/basileia-e-relacao-com-bancos-de-desenvolvimento. Free registration is required.

The op-ed is co-authored by Rogério Sobreira, head of research for the Board of Public Policy Analysis (DAPP) at the Getulio Vargas Foundation (FGV) and a researcher at MINDS; and Russell Green, the Baker Institute's Will Clayton Fellow in International Economics.

Valor ECONÔMICO

27/03/2013

Basileia e a relação com bancos de desenvolvimento

"Basel and the relationship with development banks"

Por Rogério Sobreira e Russell Green

The crisis of 2007/2008 has brought about the realization that the existing model of prudential regulation based on incentives - essentially the two Basel Accords - proved ineffective to combat the type of bank behavior that led to the crisis. In such circumstances, regulators around the world have begun to discuss ways to avoid the excessive leverage of financial institutions, especially banks, and improve the quality of regulatory capital, these being the two faults in the building of effective prudential regulation pointed out by the Basel Committee on Banking Stability.

In the rush to implement preventive measures, however, regulators are likely to cause collateral damage to an important segment of financial services - development banks - which operate largely divorced from the systemic risk that these measures are intended to combat.

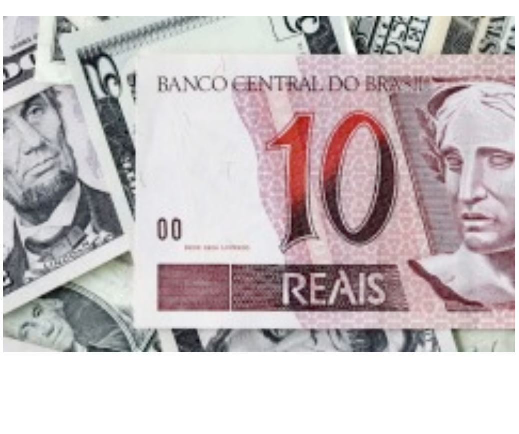
Basel 3, the implementation of which is underway in Brazil and the rest of the world, mainly aims at improving the quality of regulatory capital and raising capital requirements to discourage excessive leverage. By doing so, it is expected substantially reduce the likelihood of systemic problems.

High losses from holding risky assets can affect the banking system's ability to properly operate the payment system of the economy, i.e. the system whereby people purchase most goods and services in the economy, thereby leading to bank runs arising from loss of public confidence. The potential for crises like this justify the high prevention efforts contained in the prudential regulation.

> Enforcement of these rules creates difficulties for banks that fund economic development

Development banks are treated as banks in the Brazilian regulatory context, despite being distinct in many ways, and in our view they should not be classified as banks. The experience of several developed and developing countries (e.g., Japan, Germany and South Korea) shows the key role that these institutions play in economic development funding. They are distinct from commercial and investment banks because they have high government participation in their ownership and financing, depending little or nothing on deposits from the public to acquire assets and meet payments.

Because of this strong government involvement in its financing, development banks have little involvement in the operation of the payment system of the economy, they do not lend to other banks and do not heavily engage in derivative transactions. Thus, these institutions do not contribute to systemic risk in the financial sector, which makes the capital and liquidity requirements defined in the Basel Accords inappropriate for them.



In this context, it is interesting to note the case of India. Its largest and most dynamic development institutions, engaged in the financing of infrastructure, are classified as "non-banking financial companies" (NBFC), which are outside the regulatory framework applied to banks. Its capital requirements, liquidity and reserve are distinct and will not be impacted by Basel 3. It should be noted, however, that in India, NBFCs get a good portion of their funds in the money market. Hence in Brazil, since development banks do not borrow from the money market, there would be even less reason to submit them to Basel standards.

Additionally, the imposition of Basel hinders these banks' capacity to execute the mission for which they were created, namely financing economic development. For instance, Basel requires a higher capital requirement for borrowers who do not have an "investment grade" credit rating. Yet providing finance to sectors that do not have access to the private credit, or for whom access is too costly - like financing innovation - is central to the economic development process. These should be the prime customers of development banks.

This was the case, for example, for the Bank of Northeast Brazil (BNB). Once subject to Basel, BNB was forced to make a sharp balance sheet adjustment in the period from 1999 to 2003, which dramatically reduced the ability to extend credit to strategic sectors of the northeastern economy. BNDES, in turn, although it was not required to make an adjustment of the same magnitude in the period, ended up being required to favor borrowers with better risk classification precisely to avoid the need to collect a larger amount of regulatory capital.

In short, therefore, both institutions had their primary mission - to support development, offering credit to strategic and therefore riskier sectors - affected because of the requirements imposed by Basel. The goal of subjecting them to the Basel rules were directly related to the restructuring process experienced by the Brazilian banking sector from 1995 to 1999 - when deviations could be understood as a sign of weakness in the system. Today it does not make sense to subject them to the Basel 3 rules, which, according to our estimates, will once again produce a negative impact on their ability to perform their mission, with perverse effects on development and economic growth in Brazil.

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