

Implications of Basle II for National Development Banks

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1. Introduction

The New Basel Capital Accord aims to increase risk sensitivity for capital adequacy requirements and to create incentives for the implementation and development of effective risk management systems. The effort of the Basel Committee was to establish a stronger relationship between economic risks perceived by banks and regulatory risks considered in the Basel Accord. There is general agreement that the resulting New Basel Accord is an improvement when compared to the risk profile of the 1988 Basel Accord.

A series of Quantitative Impact Studies were conducted by the Basel Committee in order to gather information concerning expected capital requirements in this new framework. The third study is the best one to evaluate the expected impact of Basel II and the results reported are as follows:

“The QIS3 results for the Standardised approach show some increases in capital requirements relative to current for all the country groupings. In the Foundation IRB approach, Group 1 banks on average report only small changes to current requirements, but the results show substantial reductions for G10 and EU Group 2 banks (which are more retail orientated on average). In the Advanced IRB approach, all the groups of banks report reductions in capital requirements compared with those under the current Accord.

The results are generally in line with the Committee’s objectives: minimum capital requirements would be broadly unchanged for large internationally

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active banks taking into account the fact that they are likely to use the IRB approaches. The proposals would offer an incentive for internationally active banks to adopt the more sophisticated IRB approaches. For smaller, more domestically orientated, G10 and EU banks capital requirements could be substantially lower than currently under the IRB approaches, largely reflecting the importance of retail for these banks. In other countries there will be significant variation depending on the conditions in different markets and the focus of activity of the banks.” (BCBS, 2003: 3)

The World Bank (2003: 1) commented on this result:

“The World Bank still views the current risk weights as largely defined on the basis of evidence from G10 countries which may offer very different levels of protection in emerging economies.”

Considering that the impacts of the Basel II Accord are an open question, this paper presents an initial effort to evaluate the implications of Basel II for National Development Banks, with emphasis on the situation of developing countries, where such institutions are most needed.

2. National Development Banks

According to the United Nations (UN-DESA, 2005), there are circa 750 National Development Banks (NDB) nowadays, most of them in developing countries. The first NDB, in Europe, date from the 19th century, but the creation of NDB gained momentum after the Second World War. The German Kreditanstalt für Wiederaufbau (KfW) and the Japan Development Bank are among the most significant examples. Moreover, the new developing countries, founded after the Second World War, needed appropriate institutions to finance development and growth, since their financial systems were small and underdeveloped. The successful experiences of NDB in Europe and Japan served as inspiration.

The United Nations (UN-DESA, 2005: 9-11) presented one of the best and more comprehensive definitions for NDB:

“A salient defining feature overall is the fundamental focus of NDBs [National Development Banks] on long-term financing to projects that foster development. This has been a permanent characteristic of these institutions after 1945 which continues to be of primary importance today. NDBs promote and finance enterprises in the private sector (Diamond, 1957), mainly for medium or long-term industrial projects (Boskey, 1959). Kane and Panizza both insist in their definitions on the long-term lending role of NDBs. According to Kane, it is ‘a financial intermediary supplying long-term funds to bankable economic development projects and providing related services’, while Panizza highlights considerations of externalities: NDBs are ‘financial institutions primarily concerned with offering long-term capital finance to projects generating positive externalities and hence underfinanced by private creditors’ (Panizza, 2004). (...) Therefore, although the definition given by Panizza is by no mean contradictory with those considerations, it may be refined: national development banks can be defined as ‘financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities’.”

This definition by the United Nations contains three aspects that are largely discussed in the literature when referring to NDB: long term credit, the presence of significant risks and economic and social benefits that increase economic return above the expected financial return.

The emphasis in long term operations is pervasive, even if authors do not agree considering the functions and scope of NDBs. The second aspect refers to the objective of promoting development and growth. Economic and social needs of the country are considered, besides of financial aspects. In the presence of positive externalities, when social benefits are greater than private gains, the market solution provides less resources than socially desirable and justifies the presence of NDB.

By consequence, NDB are hybrid institutions (Bruck, 1998; UN-DESA, 2005): they must evaluate the projects financial return, but also consider economic and social impacts of the investments made. Bruck (1998) highlights that new dimensions were added to NDB since the 1980s. These new activities – regional, social and sustainable development, export financing, support to small and medium enterprises, among others – have significant positive externalities.

The presence of positive externalities also justifies that “[g]overnments have established development banks to take risks other financial intermediaries are unwilling to take.” (Long, 1994: 656). Long term credit, for instance, involves significant risks, that avoids the private financial system of doing such operations. The support to new sectors is also a risky activity. There is few information about the new industry and its development is very uncertain. For Aghion (1999), it is important to understand “development banking as an activity that can potentially foster the acquisition and dissemination of expertise in the financing of new industries and sectors”.

3. Basel II Accord

Basel II, differently from Basel I, is an accord that is mainly worried to the modernization of the prudential regulation. In contrast, Basel I was mainly worried to the equalization of the competitive advantage of internationally competitive banks. The main objective of the Basel Committee was to define requirements applicable to similar institutions in terms of size and market share.

Although the Committee was mainly focused on the equalization of the competitive advantage of internationally active banks, the proposed rules started to be used as an instrument of domestic prudential regulation.

Under such new aim, Basel I was awkward once it was mainly based on the capital requirements of the bank based only on the credit risk. Additionally, Basel I was designed under a central argument, which is, the capital requirement would incentive banks to be more prudent in terms of the credit risk they could take, thus avoiding unnecessary risks in the advance of credit.

Basel II, on the other hand, is explicitly worried with the prudential regulation. The new accord spreads the notion of risk, including not only the credit risk but also the operational and the market risk. Basel II also determines two other pillars in contrast to the pillar 1 of Basel I – the capital requirements – that is the supervisory review process (pillar 2) and the market discipline (pillar 3).

In this aspect, the new accord establishes the determination of capital requirements for each category of risk. In terms of the credit risk, the committee permits banks a choice between two broad methodologies for calculating their capital requirements: the standardized approach and the internal ratings-based approach (IRB).

In terms of the operational risk, on the other hand, the capital requirements are calculated according three methodologies: (i) the Basic Indicator Approach; (ii) the Standardized Approach; and (iii) Advanced Measurement Approaches (AMA).

In calculating eligible capital, it will be necessary first to calculate the bank's minimum capital requirement for credit and operational risks, and only afterwards its market risk requirement, to establish how much Tier 1 and Tier 2 capital is available to support market risk. In terms of the market risk, the capital requirements are also calculated in terms of two methods: the standardized method and the internal model approach.

Basel II also imposes great responsibilities on the supervisor's shoulders since they are responsible to evaluate the banks and judge their risk structures, the quality of the models utilized by the bank in the risk management as well as the quality of the database. As a consequence, the risk of failure is paramount. Moreover, the supervisors must be accountable.

The supervisory review should be conducted under four principles:

- a) Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels;
- b) Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process;

- c) Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum; and
- d) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Finally, the third pillar, the market discipline, is introduced in order to give rules of disclosure for the financial institutions that would allow the market participants to evaluate the perspectives of the institution. As explicitly mentioned by the new accord (BCBS, 2005: 240):

“The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The Committee believes that such disclosures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.”

4. National Development Banks and Basel II

Although the Basel Accord was originally meant for internationally-active banks, the regulation of financial markets based on its principles is increasingly being imposed on different countries and on different types of banks.

In this respect, national development banks (NDB) are not an exception. The main NDB are preparing to face the new regulation. The China Development Bank (CDB) reports on its webpage that “in 2005, we made enhancements to the internal risk rating process, methodology and calculation standard in accordance with the Basel II Accord” and that “we are currently building an internal risk rating system”.

Also the German bank Kreditanstalt für Wiederaufbau (KfW) is preparing itself to adopt the Basel II regulation (KfW, 2006). The main concern of the KfW (2001) is to

fulfill the capital requirements of the Basel Accord avoiding higher costs in its operations due to a mandatory increase in its own capital. Through better risk management techniques, the KfW wants to assure its contribution for development and growth at competitive costs.

Even if NDB were not obligated to follow Basel II's regulation, there is a risk that market pressure would lead to the adoption of similar standards. As Francis (2006: 8) states: "market pressure has also played a role in the rapid acceptance and diffusion of the Basel capital adequacy standards, because private rating agencies consider meeting Basel adequacy standards as an important element in rating financial institutions".

NDB must take such market pressure into account because they are continuously moving more towards the concept of a bank and are expected to obtain its resources in the (capital) market (Bruck, 1998). This change followed the financial crisis of the 1980s and contributes to the behavior described by Bruck (1998):

"From a policy perspective, financial reform and financial development programs have increased the autonomy and independence of national development banks, while at the same time increasing their responsibility for maintaining adequate levels of capitalization, reducing their levels of arrears and bad loans, and requiring them to be fully self-reliant in searching for new resources and maintaining a financial position enabling them to raise funds at market cost under the new circumstances of increased risk. While liberalization may have initiated this change in the role of national development banks, when privatization and globalization is added to this force, the new requirements become increasingly more obligatory and more essential for maintaining the financial viability of national development banks."

Since financial health as measured by the market is increasingly important for NDB and disclosure involves detailed information about risk management and capital adequacy of financial institutions, similar information and Basel like standards may be demanded by investors and rating agencies, so that the NDB could be able to obtain resources at low cost in the market.

The World Bank is in a similar situation. As a multilateral development bank, it does not follow the Basel regulation, but its liquidity and risk management is very conservative and reflects the core principles of the Basel Accord (Bergamini Junior and Giambiagi, 2005: 33).

There is scarcely any literature dealing with questions addressed by national development banks. Considering the impacts of the Basel II Accord on such banks, existing work, either academic papers or applied research, is even more difficult to find.

This paper and particularly the main issues identified if national development banks are to be submitted to the Basel II Accord or to follow similar standards, results from a careful analysis of comments received by the Basel Committee on Banking Supervision during the three consultative processes conducted to finalize the New Basel Capital Accord. Special emphasis was given to the contributions of experts and banks with development activities, such as the German Kreditanstalt für Wiederaufbau (KfW) and some multilateral development banks.

5. Main Issues

i) Risk-intense operations

Risk is an inherent part of the national development banks' activities. Consequently, the main concern in the implementation of Basel II is the impact of a more risk sensitive regulation on banks that have as mission dealing with risk-intense operations.

Considering claims on corporates under the Standardised Approach, firms rated below BB-, ie, below investment grade, and unrated firms will receive a higher risk weight than in Basel I. By contrast, firms with rating above A- will demand less capital requirements than under Basel I. At national discretion, supervisory authorities may allow banks to risk weight all corporate claims at 100% without regard to external ratings. For Resti and Sironi (2003), the Standard Approach does not reflect differences in risk. An accurate risk-weight curve is steeper, as the one of the IRB Approach.

This leads to a significant concern for national development banks. The Advanced IRB Approach usually reduces capital requirements and banks are stimulated to adopt this approach, as stated by the Basel Committee (see above). In the case of banks that concentrate its portfolio in lower rated or unrated borrowers, this conclusion is not straightforward. An increase in unsecured capital requirements must be compensated by other measures and instruments within the IRB Approach, so that the choice between the IRB approach and the Standard approach requires careful consideration. Complexity and higher costs involved in the sophisticated model must also be taken into account. An external advisor helped the German KfW in the choice of the Advanced IRB Approach, probably influenced by the amendments made in the original 2001 Basel Accord (see below).

There was an intense debate during the consultative processes which expressed the important concern of the impact of Basel II on the cost and level of borrowing to smaller and lower rated borrowers. More generally, capital requirements influence price and availability of specific credits.

Risk management according to Basel II may also severely impact NDB in another aspect. Besides influencing interest rates and capital allocation, as in other banks, capital regulation could in practice hinder the operation of national development banks.

Frequently, these banks are owned by national governments. The capitalization of such banks involves a governmental decision in countries which are subject to international pressure to reduce governmental spending and to maintain fiscal discipline. Governments of developing countries may find it not easy to capitalize its national development banks in order to support risk-intense operations that promote development.

What should be avoided is the consequence that was most criticized under the 1988 Basel Accord (Basel I): that the increased capital requirements greatly diminish lending by banks, as in the late 1980s and early 1990s. Especially for NDB, efficiency and performance may be important but should not be driven to the first place in detriment to productive sectors' needs of financing and the countries' needs for development and growth.

Among the contributions and debates during the Consultative Processes, two specific fields, in which national development banks are particularly active, received most attention: credit to small and medium enterprises and long term credit. Among the risk-intense operations, these segments were especially disadvantaged in the initial versions of the Accord.

ii) Small and Medium Enterprises (SME)

In 2001, the German KfW simulated the application of the Basel II regulation to its SME's portfolio, in which 37% were operations with firms rated above investment grade and 60% were secured operations. In the Standard Approach, capital requirements were established at 100%, because it was expected that national authorities could treat such firms as unrated. Risk-weight declined to 90% when guarantees and financial insurances were included. In the IRB Approach, credits to firms above investment grade requires less capital, but the opposite occurs to the rest of the portfolio. Without guarantees and insurance, required capital increased 18%. In the Advanced IRB Approach, guarantees and insurances reduces capital requirements until 85%, nearly the same amount of the same portfolio in the Standard Approach.

This simulation showed the expected negative impact of the New Basel Accord on borrowing to SME and consequently on growth and employment. The negative consequences were especially feared in Europe, particularly in Germany. The issue mobilized a group of authorities and resulted in a special treatment for such firms in the Basel Accord. This special treatment for SME reduced average capital requirements by around 10%. In the Standard Approach, portfolio exposures may be risk-weighted at 75%.

The issue of SME highlights important aspects for NDB. More generally, the debate concerning SME shows that diversification and portfolio effects are not adequately considered under the Basel II framework, so that risks, and consequently capital requirements, are overestimated. The use of diversification as a risk management technique is discussed in further detail below.

Another important aspect derived from the issue of SME is the importance of mobilization to obtain special treatment under the Basel Accord. Powerful groups that are negatively impacted by the implementation of the Accord may organize themselves in order to include an exception in the regulation. In the same manner, developed countries are more prepared to defend national interest, as opposed to developing countries which face several difficulties in mobilizing themselves to achieve favorable conditions to national development and growth.

Instead of national discretion and special treatments, problems should be analyzed and solved. Ad-hoc solutions may deal with a specific aspect, but others may remain unsolved and still others may appear in the future. An international accord of financial regulation should avoid such imprecision and inconsistency.

iii) Long term credit

The 2001 Basel II Accord required more capital for long term credits. The adjustment for maturity increased capital requirements for long term credits and reduced it for short term operations.

In consequence, long term credit became less attractive, because more capital was needed. According to the KfW (2001), capital requirements increased disproportionately to risk and long term credit was severely affected. The immediate answer by banks would be to replace long term credit by a sequence of short term operations or to try securitization (that also has lower capital requirements).

In the opinion of the KfW (2001), higher capital requirements for long term credit would not increase the financial system stability, one of Basel II objective. Using Minsky's classification of financial units in hedge, speculative and Ponzi, the KfW argument may be easily understood. Higher capital requirements for long term credit would reduce the participation of hedge financing, when the borrower has enough cash flow to pay its commitments in the course of the loan contract. On the other hand, the incentive to shorten credit maturity would increase speculative credits or even Ponzi operations. If the firm's cash flow isn't enough to honor its commitments, it would be

obligated to roll over its debt. Potential instability would clearly increase, as firms might have to agree with worse conditions that may lead to default and bankruptcy.

This explains why the KfW was worried about this amendment and worked to convince the Basel Committee that this differentiation by maturity harmed systemic stability and should be attenuated. The KfW and other German institutions were especially dedicated to this issue because the German financial system is based on long term credit.

The higher capital requirements on long term credit and the stability concerns led to another exception, as in the case of the special treatment for SME. In the 2006 Basel II Accord, the national authorities were given discretion to decide whether credits should be adjusted by maturity or should have a uniform treatment regardless of its extension.

The waiver for the explicit maturity consideration of credits under the Internal Rating Approach was considered an important improvement in the Basel Accord by the German banks of the Zentraler Kreditausschuss (2003). The German financial system and particularly German banks are traditionally based on long term credit, so that this country gave up the regulation with maturity consideration and chose to consider an implicit equal maturity for all credits.

The question is if that would be the decision of regulators in developing countries. As discussed above, this decision will be of fundamental importance for NDB since great part of its lending is in the form of long term operations.

The special treatment for SME and the waiver for long term lending draw attention to the introduction of a multiplicity of regulatory options. This gives bank supervisors and accordingly national governments discretion, along with the responsibility to recognize certain internal procedures and methodologies. This contrasts with the original objective of the Basel Accord, i.e., the aim of leveling the playing field for internationally-active banks. Besides, there is no guarantee for developing countries that such ad-hoc solutions will be adopted. In particular, important measures to assure adequate financing and the possibility of NDB to promote development and growth may depend on the good will of the national regulator.

iv) Equity exposures

A very useful instrument to promote development and support firms and entire industries is by the use of equity, instead of conventional lending operations. Third party capital may not be the appropriate support to risky activities or to new industries or firms, when the future involves a high degree of uncertainty. On the other hand, to believe in new initiatives and support those firms and industries is an essential part of NDB's mission. Especially these actions are decisive to promote structural change and contribute to national development.

Concerning the Basel II Accord, the capital requirements for equity in the IRB-Approach may not incentive development banks to be active shareholders in important industries, including decisive ones for national development. The treatment received by equity exposures in the 2003 Basel Accord could be more restrictive in terms of capital requirements than debt (German Industry Federation, 2003; Zentraler Kreditausschuss, 2003).

Since then, some improvements were made, but the result is considered unsatisfactory. The minimum risk weight for equity exposures, in general, overstates risk in credit operations to firms with good credit ratings. To be coherent, capital requirements should be equal to debt or other instruments of comparable risk.

The strict regulation and the claims for more flexibility resulted in another ad-hoc solution, among other mentioned above. The Basel Committee decided that equity exposures under government development programs would require a lower risk-weighted capital.

For developing countries, this means that development strategies must be formalized, in order to receive special treatment under the Basel Accord and that NDB will not be able to informally promote certain development actions, which is usual in these countries. Bureaucracy will increase and may delay important support to some industries.

v) Risk management

As stated above, the effort of the Basel Committee was to establish a stronger relationship between economic risks perceived by banks and regulatory risks considered in the Basel Accord. For the German KfW (2001) this aim was not entirely achieved and the Basel II may require own capital above the level considered adequate by banks' risk management.

One explanation for the different perception of banks and the Basel Committee relies on the recognition of risk management mechanisms, such as guarantees, insurances, credit derivatives and asset-backed securities. The question is that risk management techniques evolved recently and risk reducing instruments should have a positive impact on capital requirements under the Basel Accord.

A striking example is asset-backed securities. According to the German Industry Federation, they are attached unjustified high risks. Securitization tranches that are rated between BB+ and BB- will be risk weighted at 350% as set out in paragraph 567 of the Basel Accord, comparing to a risk weight of 150% for corporate claims rated below BB-. A group of German banks (Zentraler Kreditausschuss, 2003: 2) also emphasizes that the Basel Committee should assure that "after securitization, the sum total of capital requirements of all banks involved in an ABS transaction must not be higher than before securitization".

Considering traditional measures, like insurances, Basel II shows significant advantages over Basel I, although the KfW (2001) and the German Industry Federation (2003) demanded further recognition of such instruments. Improvements were made during the consulting process, with the extension of the range of eligible collaterals among other, although some usual instruments and insurances are not entirely taken into account. An example is the special risk management measures present in specialized lending (Zentraler Kreditausschuss, 2003). Although these techniques limit risk exposure, they are not considered in the Basel II Accord. A widespread fear is that this might affect the development of the new markets and new instruments for risk management.

In the case of NDB, whose aim involves dealing with risk-intense operations, it is imperative that the regulation recognizes risk mitigating techniques and instruments. The very reason for the existence of such banks would be questioned if risky credits

were to be avoided due to regulation. To maintain competitive charges, NDBs cannot be prevented from using all the different possibilities of reducing risk exposure.

In this regard, two NDB's activities are especially affected: export credit and project financing. The use of risk mitigating instruments in these activities are of fundamental importance and their recognition under the Basel Accord is indispensable in case of NDB following this regulation.

In the consulting process, different institutions suggested that the most common risk mitigating instruments – including mortgage – should be considered not only in the Advanced IRB Approach, but also in the Standard approach. For NDB in developing countries, this is an important measure. Since developing countries are the one most needing to improve and which face the greater probability of having NDB with a smaller structure and less resources to be able to adopt the IRB Approach, the distinction between Standard and Advanced Approach is more relevant.

As discussed above, also the benefits of diversification are only partially considered under the New Basel Accord. Francis (2006: 2) affirms that there is a “lack of recognition of portfolio diversification effects”. The question is that diversification is a powerful measure to reduce risk exposure. For instance, the China Development Bank (CDB, 2006) informs that they analyze industry correlations on default risks in order to develop an effective portfolio management as part of its financial strategy. Many institutions, including the German KfW (2001), worried about the limited effect of diversification in the Basel Accord regulation.

Portfolio effects are generally not considered under the Standard Approach. Even in the IRB Approach, there is a fixed correlation coefficient. In respect to corporate lending, the original proposal was a coefficient of 0.2. There was a suggestion to reduce the coefficient from 0.2 to 0.1 as the probability of default increases, due to the importance of non-systemic factors in such cases (Griffith-Jones, Segoviano and Spratt, 2002).

The limited impact of diversification was the motive for the SME Amendment, analyzed above. Another example is international diversification. Although its' benefits were stressed in several papers and contributions to the Basel Committee (cf. Griffith-

Jones, Segoviano & Spratt, 2002), the last version of the Accord has not incorporated this aspect, with negative consequences especially to developing and transition economies. As discussed above, these countries are insufficiently represented in the Committee and are not powerful enough to manage to include international diversification as an important issue in the debate.

As the regular framework does not consider diversification in the appropriate way, risk is overestimated. Two consequences may follow: (i) the increase of price and the reduction of credit availability, due to the wrong incentives of regulation and (ii) the use of different instruments and credit structures, such as the Standard approach combined with securitization.

A further aspect of risk management may be found in the Asian Development Bank's comments on the 2001 draft of the New Basel Accord. This document shows that regional and national experiences may differ considerably, so that an International Capital Accord will only partially be able to refer to such solutions. For instance, the KfW (2001) emphasizes long term relationships between banks and firms as a risk mitigating instrument. Under the Basel Accord, the recognition of such measures is not straightforward.

This leads to another question. Some measures of risk mitigation may be informal although very effective. To recognize such measures under the Basel Accord could be even more difficult, because it lacks the necessary flexibility in those cases. More generally, the Basel Accord has difficulty in dealing with single, nationally based, peculiar solutions. The point is that creative solutions will probably be used by all NDB, because this is in fact required by their activity of promoting development and offering financing to firms, industries and sectors not adequately supplied by the market. The use of creative solutions is especially the case in developing countries, where adversities are common.

vi) Market orientation and procyclicality

NDB have the important task of providing financing when most needed and possibly for segments and/or operations that due to the involved risks do not attract regular market-financing. To submit NDB to the usual regulation according to the Basel's principles would impose market-based measures/standards to banks whose objective is to be complimentary to the market and to incur in credit operations in which positive externalities increase social benefits above private gains. In sum, the mission of NDB is conceptually incompatible to a market-based regulation because the nature of NDB is different than that of market-based banks.

A direct consequence of market-driven financing is described by Francis (2006: 9):

“A shift towards market-driven investment allocation decisions by banking and capital market segments leads to an overall concentration of financial flows into selective sectors. This happens because of the competition pressures (...) as well as because of a tendency for herd behaviour and speculation that drive investments into particular sectors at particular phases of a boom, which divert capital away from where it is much required”

Many institutions and academics identified pro-cyclical movements as a consequence of the Basel II regulation (Zentraller Kreditausschuss, 2003; Francis, 2006; among others). According to Griffith-Jones, Segoviano and Spratt (2002: 1), “[t]he use of market-sensitive measures of risk (...) is inherently pro-cyclical. (...) The natural tendency of market practitioners – including bankers – to underestimate risks in booms and overestimate risks in recessions will thus be formalized, and legitimized, in regulation.”.

Additionally, the German Industry Federation (2003) states that recessions may be intensified, because credit risk and default probability increase in the downturn, reducing credit availability. Regulation may intensify the credit cycle since it formalizes the pro-cyclical market movement. Basel II's procyclical effects were considered “far greater than had been assumed. In the event of realistic fluctuations of the probability of default by 100%, a 40% capital fluctuation is therefore to be expected.” (Zentraller Kreditausschuss, 2003: 2).

National development banks try to operate in a complementary manner in respect to the rest of the financial system. If these banks are to follow the Basel II regulation, the contra cyclical dimension will be limited by greater capital requirements in the downturn. Furthermore, the impact of market-driven financing to particular industries is even more difficult to evaluate. NDB should support firms and sectors that have the potential to lead the country to higher development level. This dimension of NDB will be lost if they are submitted to the Basel Accord.

vii) Funding

Capital requirements impact not only the asset side of the balance sheet, but also its liabilities. In the Basel I Accord, inter-bank claims were attributed a 20% weight on all short term loans, increasing until 100% weight in the case of longer term loans to non-OECD countries.

The New Basel Accord increased the risk weight of bank claims. The 20% weight is restricted to good rated banks (rating between AAA and AA-) and long term loans receive a minimum of 50% for banks rated below AA- and a maximum of 150% for banks rated below B-. This means that NDBs may have difficulty in obtaining resources in the market, due to their rating and/or the period chosen.

Considering their objective, multilateral development banks receive special treatment under the New Basel Accord: lending to such institutions is risk-weighted in 0% (paragraph 59 of the 2006 Basel II Accord). This measure makes it easier to obtain capital in the market, since the investor bank does not need additional own capital to maintain the new assets in its balance sheet.

There is no guarantee that NDB will have a similar special treatment and once again an ad-hoc solution was introduced to deal with a particular issue regardless of similar situations that would demand an equivalent measure.

viii) NDB's associated financial institutions

Even if NDB were not submitted to the Basel Accord – considering that they are not internationally-active banks and that they do not contribute to financial system instabilities – their operations and contributions to development and growth will be affected by the implementation of the Accord through its impact on associated (accredited) financial institutions.

NDB are usually large institutions that spread financial support throughout the economy partly in direct credit operations and partly with the help of commercial banks. These banks have capilarity and are responsible for credit analysis, approval and guarantees. Since commercial banks incur in credit risk, capital requirements should apply.

According to KfW (2001), greater capital requirements will impact such operations and increase costs when lending is not done directly by the NDB. To try to maintain the same volume of lending, the KfW was preparing itself to react in different manners: increase the number of associated banks, adopt new forms of operations, increase electronic processing, etc..

The potential impact on total credit of NDB is significant. In Brazil, for example, the NDB Banco Nacional de Desenvolvimento Econômico e Social (BNDES) performed 117.5 thousand operations in 2005 through institutions accredited as fund transferring institutions, which accounted for 53% of total annual disbursements (BNDES, 2006).

Unfortunately, a special treatment for NDB would not solve this question, because it refers to risks incurred by commercial banks. To create another amendment would not be simple and justified. The risks incurred in fund transferring are the same as in other credit operations. Dealing with this issue brings the question of how to allocate risks between NDB and associated banks in a efficient manner under the Basel Accord regulation.

ix) Prudential regulation and NDB

In spite of the fact that the national development banks around the world will probably be submitted to Basel II rules, it is necessary to discuss the rationale for the submission of this kind of institution to this accord.

As mentioned above, the main objective of Basel II is to reinforce the prudential regulation of the financial system. However, prudential regulation is important to financial system where the risks associated to the loss of confidence in the normal operation of the institutions (banks) are real and the interrelation of the institutions are such that a failure in one big institution can lead to bank runs and to the collapse of the payment system, with a negative externality to the economy.

In other words, prudential regulation laws do make sense only to institutions that are in the center of the payment system such as commercial banks. Prudential regulation, thus, cannot be identified with risk administration. Prudential regulation consists of a set of measures to prevent systemic crises. Thus, institutions that are not in the center of the payment system – or, in other words, institutions that are not in the center of the causes of systemic crises – should not be subjected to prudential regulation and should manage their risk properly.

This is precisely the case of the national development banks. Those institutions are not central institutions in the operation of the payment system and, as a consequence, should not be subjected to prudential regulation or at least to the prudential regulation as suggested by Basel I and Basel II. This does not mean, however, that these institutions should not manage their risks in a proper way.

For those institutions, it is much more important to develop mechanisms to deal more properly with the risks involved in the process of long term credit advance. Moreover, it is important to consider the fact that the vast majority of these institutions are public. Thus, it is also important to develop rules and mechanisms to evaluate the effectiveness of these institutions when advancing long term credit. In other words, such institutions cannot be evaluated (i) as if they were central to the operation of the payment system and, as a consequence, directly affected by confidence crisis that could trigger bank

runs; and (ii) as if they were private institutions aimed to maximize their profits. Submit those institutions to prudential regulation, thus, would limit their objective and their economic function.

6. Concluding Remarks

NDB are mostly public banks, whose decisions are political, rather than technical. Risk management and financial viability were not determinant until recently (Bruck, 1998). The adoption of procedures or even robust internal rating system benchmarked to Basel II may have one positive impact of improving risk management, so that NDB may be better positioned and prepared to promote economic development and growth.

The disadvantages are clearly superior to this possible positive impact, which could rather be achieved through other regulations or incentives instead of the adoption of the Basel Accord. The main difficulty is that the Basel II regulation leads to the diffusion of market-based criteria in credit concession, while NDB are banks whose aim is supply financing to activities and industries that incur significant risks and whose economic and social benefits maintain economic return above the expected financial gain. Summing up, NDB are banks that operate complimentary to the market, based on a broader social and economic basis, rather than on strict market indicators. The adoption of the Basel Accord is conceptually incompatible with the function of NDB.

Additionally, the Basel standards lack the necessary flexibility to cope with the singularities and creative solutions that are always present when the task is to promote development and growth of developing countries. Even recent but usual risk management instruments, fundamental in risk intense operations done by NDB, are not adequately contemplated in the Basel II Accord.

Another pervasive question is the creation of special treatments and amendments based on the capacity of specific groups and/or countries to mobilize themselves and achieve an exception in the Basel II Accord. When dealing with specific issues, the Committee seems to avoid general solutions and chooses ad-hoc responses and waivers, as in the question of SME, long term financing, risk weighting of multilateral development banks, among others. Under this structure, imprecision and inconsistencies may occur

and there is no guarantee that NDB will have the preferential treatment it deserves and which its functions require.

Finally, it is important to mention the fact the NDBs are not the typical institutions that should be subject to this kind of prudential regulation. As mentioned, these institutions are not in the center of financial turmoil and do not play a central role in the operation of the payment system. Thus, these institutions should be subjected to a different set of regulation that would help them to deal with the proper risks involved in the process of advance long term credit. This is a very important aspect of this debate since the implementations of Basle II rules without a profound discussion of the role of NDBs could prevent them to perform their task properly.

7. References

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