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# **Basel II implementation in developing countries and effects on SME development**

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## Summary

This Issue Paper examines the implementation of Basel II in low-income countries (LICs). The aims are to assess the low-income countries' views and concerns on Basel II, whether and how they intend to implement the new Basel Capital Accord, and the challenges they may face in doing so. The paper discusses in particular the possible implications of Basel II implementation for competitiveness of LIC banking sectors and financial inclusion. Drawing on a survey covering low-income countries especially from Africa, the paper finds that in addition to technical challenges that include the need to build long and reliable data base to run sophisticated risk assessment models, and to build supervisors' capacity to assess, validate and monitor the use of such models, LICs face broader issues related to Basel II implementation, such as competitiveness of national and foreign banks, access to credit by SMEs, potential increased pro-cyclicality of bank lending and their macroeconomic impacts. The paper concludes that LIC regulators may not need just technical assistance but also more 'political' support for their negotiations on regulations with international banks to ensure that their regulatory regimes are consistent with national aims for both financial stability and sufficient credit, especially to SMEs.

## **I. Introduction**

This Issue Paper examines the implementation of Basel II in low-income countries (LIC). The aims are to assess the low income countries' views and concerns on Basel II, whether and how they intend to implement the new Basel Capital Accord, and the challenges they may face in doing so. The paper in particular discusses the possible implications of Basel II implementation for competitiveness of LIC banking sectors and financial inclusion.

Specifically, the paper addresses the following questions:

- To what extent will Basel II be implemented by LIC regulators? What is the timetable? What approaches are being proposed for adoption? What are the main obstacles for implementing the different approaches? Are possible variations being considered?
- What are the main challenges facing regulators? Lack of human, financial resources? If a LIC is planning to implement the Internal Ratings Based (IRB) approach (which is more complex), is there sufficient capacity to validate models? Should the focus be on other regulatory issues, which need to be done previous to implementing Basel II?
- What about banks' preferences regarding the adoption of Basel II?
- Would banks that adopt the IRB approach (usually international banks) have competitive advantage over banks that adopt, or are asked to adopt, the standardised (simpler) approach? Is it a concern that this might cause a division of labour between banks, with small and riskier borrowers migrating to banks (usually national ones) that use the standardised approach?
- What can be done to mitigate possible negative impacts of implementation of Basel II on access to credit by the poor and SMEs?
- To what extent LIC regulators/others feel Basel II should be adapted to their own needs and circumstances?

Drawing on a survey conducted in late 2006 involving low-income countries, mainly from Sub-Saharan Africa, the paper finds that most LICs are adopting a very cautious approach towards Basel II. Their intentions are first to understand better how Basel II works and to have a better grasp of their possible implications, in order to be able to adopt an informed decision on the issue. It is a 'better wait' approach. Furthermore, several LIC countries feel that they have previous tasks to complete within Basel I or more generally within banking regulations before they tackle Basel II. The IMF and Basel Committee say they share this caution and do not push LICs to adopt Basel II. However, there seems to be pressure from international consulting firms, rating agencies and others for countries to adopt Basel II.

A few other LICs are already signalling a move towards Basel II. However, they intend to do so in a gradual fashion. For some countries, gradualism means starting with Pillars II and III, and later moving to Pillar I. For other countries, it means adopting first a simplified version of the standard approach under Pillar I, with no clear timetable for moving on to more sophisticated approaches later on.

The LICs' cautious attitude reflects their awareness about the complexities that Basel II involves, and their lack of human and financial resources to deal with these complexities. Major challenges comprise the need to build long and reliable data bases to run sophisticated risk assessment models, and to build supervisors' capacity to assess, validate and monitor the use of such models. But the challenges LICs face are not exactly the same. They can differ across countries according to the country's size (population, absolute GDP) and whether the country harbours foreign banks in its jurisdiction.

Regarding size, obviously large countries such as India do not face extremely serious human capacity constraint and thus are able to consider adopting Basel II soon (although through starting with the less complex approaches) – than for example Lesotho, which for being so small face acute human capacity limitation and therefore had not decided by the time of the survey whether to implement Basel II, even though its per capita income may be higher than India's.

As for the presence of foreign banks, a continuum among LICs can be found as regards the presence of foreign banks in their jurisdictions. At the one end we can find countries with no foreign banks while at the other end there are countries where all banks are foreign. Ethiopia for example has no foreign banks, which implies it does not face the pressing issue of how to deal with foreign banks keen to adopt the most sophisticated approaches, and therefore can take the time to build capacity for Basel II implementation. At the other end one can find Botswana and Lesotho, where all commercial banks are foreign. These countries have therefore to deal with Basel II issues even if they decide not to adopt the new capital accord in the foreseeable future, as foreign banks will be wishing to adopt this approach globally. Though formally LIC regulators have the freedom to require all banks in their jurisdiction to follow a certain regulatory approach, foreign banks have great deal of leverage given their option of pulling out, if national regulations are not convenient for them. This could become a serious problem for LIC economies.

Given the pressing need for building up capacity to deal with Basel II, at present LICs' efforts are concentrated on building such capacity through participation in various activities and events such as local and foreign seminars, and training programmes. This leaves little space for discussion on possible broader negative implications of Basel II for their banking systems. This is the case even when LIC regulators are aware of these implications as a result of their own reflections and learning process.

Further important findings reported in this paper are that, first, in countries with foreign banks there is scant evidence of collaboration between home and host regulators. This despite the fact that host regulators know collaboration is crucial and that Basel II documents emphasise the need for such collaboration; and second, that very little technical assistance (TA) is being provided at present.

The remainder of this paper is organised as follows. Section 2 discusses what options are being considered by LICs regarding Basel II implementation. The section starts with providing a global picture on what countries intend to do, which is then contrasted by Asia’s picture and country-specific information, the latter based on interviews with banking regulators from African countries and the Caribbean. Section 3 presents what the main issues facing LICs are. Section 4 concludes.

## II. What do Countries intend to do in terms of Basel II implementation?

### II.1. Global versus Regional Pictures

The Financial Stability Institute (FSI) conducted a survey in 2004 and a follow-up survey in 2006 on implementation of Basel II in non-Basel Committee member countries (see Financial Stability Institute, 2006). The survey shows that 84 percent of all respondents worldwide intend to adopt Basel II between 2007 and 2015 – see Table 1. These intentions seem somewhat overoptimistic as countries often postpone Basel II implementation beyond their initial timetable due to technical obstacles and other considerations.

**Table 1: Number of Countries intending to adopt Basel II**

Regions	Number of Respondents	Respondents intending to adopt Basel II	Percent % in total
<i>Africa</i>	<i>17</i>	<i>12</i>	<i>71</i>
Asia <sup>1</sup>	16	16	100
Caribbean	7	4	57
Latin America	14	12	86
Middle East	8	8	100
Non-BCBS Europe	36	30	83
<b>Total</b>	<b>98</b>	<b>82</b>	<b>84</b>

<sup>1</sup> Excludes Japan as BCBS member-countries were not included in the survey.

As can be seen from Table 1, the results are aggregated on a regional basis and do not distinguish among countries with different levels of development.

Under Pillar 1, the standardised approach is expected to be the most widely used option of the three credit risk methodologies available for calculating capital ratios – 85 per cent of respondents planning to adopt Basel II intend to use this approach, while 67 and 55 per cent of all respondents intend to adopt the FIRB and AIRB approaches respectively. As regards operational risk, the basic indicator method is expected to be the generally adopted framework. Moreover, many countries are expected to implement Pillar 2 and 3 before the end of 2015 (Financial Stability Institute, 2006).

### Basel II by regions

In Asia, 100 per cent of respondents intend to implement Basel II at some point over 2007-2015. This is quite striking given that a fairly large numbers of low-income countries are located in Asia. But more detailed information from the FSI survey shows that intention of adopting Basel II does not necessarily mean doing it now. According to

the survey, only 7 out of a total of 16 respondents intend to adopt the standardised approach by 2007, while 3 intend to adopt the FIRB approach and 1 the AIRB approach in that year. This means that 11 countries at the maximum (but probably less than that) out of 16 intend to implement Basel II in 2007 through adopting one of the three options offered under pillar 1. However, a big jump in numbers can be observed for the year 2008, when 14 respondents expressed intention of adopting the standardised approach, 7 the FIRB approach, and 5 the AIRB approach.

**Table 2. Number of Asian countries (out of 16 respondents) adopting the different credit risk approaches over 2007-2015**

	2007	2008	2009	2010-2015
<b>Standardised</b>	7	14	14	14
<b>FIRB</b>	3	7	8	14
<b>AIRB</b>	1	5	6	10

Source: Financial Stability Institute (2006).

## **II.2. Findings from our country interviews**

Our findings are based on interviews conducted with 8 countries in total, all from Sub-Saharan Africa. These were: Botswana, Ethiopia, Ghana, Kenya, Lesotho, Tanzania, Uganda and Zambia. In addition, detailed information has been obtained on India by drawing on previous studies and press reports, and an interview was conducted with an ex-banking regulator from the Caribbean, who reported the current thinking in the region and challenges for implementing Basel II. We believe these findings probably resonate with what countries from other developing sub-regions are experiencing at present. This may be particularly the case in South Asia, where most countries are low-income, and Central Asia, where most countries are either low-income or lower-middle income, with still fairly low levels of financial development.

### ***What have we found?***

On the basis of our sample of countries, it is possible to affirm that one of the biggest challenge facing LICs is lack of human skills and resources to deal with Basel II issues. In light of that, most bank regulators have not decided yet when or how they are going to implement Basel II in their countries. At present, they are still trying to understand how Basel II works and to have a better grasp of their possible implications, in order to be able to adopt an informed decision on the issue. It is a ‘better wait’ approach.

But some countries have already undertaken the decision on how to move forward. Basically, they are intending to adopt a gradual approach. This approach reflects a cautious position, due to the difficulties and challenges that implementation of Basel II will involve.

A couple of country regulators, for example, have informed us that they will start with pillars II and III, and in a second phase move to pillar 1 with the adoption of the simplified standardised approach. Moving to the IRB approach will only happen once

they have built a data base and capacity within the Central Bank. A timetable for adoption of the various phases has not been set yet.

Other countries have set a date for implementing the simplified standardised approach – Ghana regulators for example, have informed that they intend to adopt the simplified approach in 2008. Table 3 below reports the timetable for implementation of Basel II for selected low-income countries.

**Table 3: Timetable for implementation of Basel II in low-income countries**

Country	Credit Risk			Operational Risk		
	STA	FIRB	AIRB	BIA	SA	AMA <sup>1</sup>
<b>Vietnam</b>	End-08	Q4-08	End-08	Q4-8	Q4-08	Q4-08
<b>Bangladesh</b>	Jan-09	Not decided	Not decided	Jan-09	Not decided	Not decided
<b>Botswana<sup>2</sup></b>	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
<b>India</b>	Apr-09	Not decided	Not decided	Apr-09	Not decided	Not decided
<b>Nepal</b>	Jan-07	Not decided	Not decided	Jan-07	Not decided	Not decided
<b>Pakistan<sup>2</sup></b>	Jan-08	Jan-10	Jan-10	Jan-08	Jan-08	Not allowed
<b>Ethiopia</b>	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
<b>Ghana</b>	2008	Not decided	Not decided	End-06	End-09	Not decided
<b>Kenya</b>	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
<b>Lesotho<sup>2</sup></b>	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
<b>Sierra Leone</b>	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
<b>Tanzania</b>	Not decided	Not decided	Not decided	Not decided	Not decided	Not decided
<b>Uganda</b>	End-10	Not decided	Not decided	End-10	Not decided	Not decided
<b>Zambia</b>	End-08	Not decided	Not decided	End-08	Not decided	Not decided

Sources: Standard Chartered Bank; Central Banks' websites; interviews and email communication.

<sup>1</sup> Standardised Approach (STA); Foundation Internal Ratings Based (F-IRB) Approach; Advanced Internal Ratings Based (A-IRB) Approach; Basic Indicator Approach (BIA); Standardised Approach (SA); and Advanced Measurement Approach (AMA). <sup>2</sup> Middle-income country.

### III. What Are The Issues?

The vast majority of countries are adopting the 'better wait' and the gradual approaches, in face of the huge challenges posed by Basel II.

#### 1) Capacity to validate models and monitor their use

A major challenge facing LIC regulators is their insufficient technical capacity to validate the more complex models (F-IRB and A-IRB models) that Basel II proposes for use, and to monitor their use. Related to this is the lack of sufficiently long and reliable data base available to banks, including international ones, to be able to run the models adequately. This is the main reason why LIC regulators, if and when they implement Basel II, do not intend to adopt the more complex approaches.

In addition to the more complex models, the Basel Committee also proposes the use of the standardised approach. This approach differs from the more complex ones in that it relies on credit rating agencies to determine the risk level for



different categories of borrowers. But because LICs do not have domestic rating agencies (and if they have them their penetration is very low) and the process of establishing credit bureau systems is only at the initial stages, they are not even considering adopting the standardised approach. Instead, their intention is to adopt a simplified version of such an approach – the so-called simplified standardised approach – in which the risk weights for different categories of assets are fixed and pre-determined by the regulatory authorities. This latter approach, which can be found in Annex 11 of Basel II documents – see Basel (2006), is very similar to Basel I, but differs from it for having more risk buckets.

It should be emphasised that the issues facing LICs are not simply – or even mainly – technical. There are also broader issues, such as competitiveness of national and foreign banks, access to credit to SMEs, potential increased pro-cyclicality of bank lending resulting from Basel II and their macro-economic impact, discussed below.

## 2) Presence of Foreign Banks

Although most countries intend to postpone implementation of Basel II or opt for the simpler approaches for determining credit risk, these are not easy options either. The main reason is that most LICs have foreign banks (see Table 4 for Africa), and these banks intend to adopt the most complex approaches (F-IRB and A-IRB) in the countries where they operate through their subsidiaries and branches.

**Table 4: Variation in ownership structure across low-income countries, where available**

Mainly Govt	Mainly Foreign	Foreign+Govt	Equally Shared	Mainly Local
Eritrea	Botswana	Burkina Faso	Burundi	Benin
Ethiopia	Central Afr Republic	Congo, Dem. Rep.	Ghana	Mali
Togo	Chad	Sierra Leone	Kenya	Mauritania
	Côte d'Ivoire		Rwanda	Somalia
	Gambia, The		Senegal	Sudan
	Guinea-Bissau			Zimbabwe
	Liberia			
	Madagascar			
	Malawi			
	Mozambique			
	Niger			
	Tanzania			
	Uganda			
	Zambia			

Source: World Bank (2006)

Note: Mainly government (foreign; private) means more than 60% of total assets are held by banks which are majority-owned by government (foreign; local private) shareholders.

Foreign+Government means these two together concentrate more than 70%. Equally shared is a residual category (in Senegal, foreign plus private local add to more than 70%).

*The question then is: how should LIC regulators deal with these banks?*

Botswana and Lesotho (not strictly LICs) can be cited as extreme cases in that these countries have only foreign commercial banks in their jurisdictions. By the end of 2006, neither country had decided whether or how to implement Basel II. They still had a number of pre-requisites to meet before moving to Basel II in a major way. Botswana for example still had to fully comply with the Basel Core Principles, put in place a risk-based supervision – Pillar 2 of Basel II – and build an adequate legal and regulatory framework.

Moreover, neither Botswana nor Lesotho has domestic rating agencies. Therefore, it is most likely that, if and when they adopt Basel II, it would seem to justify adopting the simplified approach (Annex 11). Allowing foreign banks to adopt the F-IRB or A-IRB would imply loss of supervisory power in their jurisdictions, as they still do not have the technical capacity to validate these models or monitor their use.

Of course, countries where foreign banks co-exist with local ones would face similar problems. If they adopted the simplified approach for local banks, while letting foreign banks adopt the more complex approaches, this too would imply loss of supervisory power over the foreign banks. In light of this, the most appropriate response might instead be to enforce the simplified approach to all banks, local and foreign. But would this be feasible?

Compliance with the simplified approach to meet the regulatory requirements in the host country implies that foreign banks would have to have a double reporting system – one for the home regulators, the other for the host regulators. European banks are already unhappy with the lack of regulatory homogeneity between the US and Europe, as it implies higher challenges, and will certainly oppose to it happening again between their home countries and LICs where they have subsidiaries. Undoubtedly, this is an area of potential conflict between foreign banks and host regulators. Moreover, the simplified approach is expected to require higher capital levels, thereby creating further tensions between foreign banks and host regulators as well as the competitiveness issues with national banks, discussed below.

The tension could be mitigated by the home regulators, depending on how they set the rules for global versus country allocation of capital. For example, it might be the case that if capital requirements are higher in a specific LIC due to the imposition of the simplified approach, the bank might be able to accommodate this higher requirement without an impact on the bank's global capital allocation. But this will depend on how the global allocation rules are set by the home regulator, and also on the banks' portfolios. Presumably, banks with their credit portfolios concentrated in developed countries will have more room to absorb higher capital requirements in LICs without an impact on its global capital requirement levels than banks with stronger presence in the developing world.

Although formally LIC regulators have the right to tell foreign banks which approach (e.g. standardised) they should follow, foreign banks then have the option of pulling out of the country. This may be particularly relevant for large foreign banks, mainly active in

developed economies, for whom the scale of operations in an individual LIC country is very small in relation to their total operations. Reportedly, this would be less the case for international banks more concentrated in operations in LIC countries.

Furthermore, the threat of possible withdrawal, especially if the foreign bank holds an important part of the banking system's assets and liabilities, may be highly problematic and put pressure on host regulators to comply with banks' regulatory preferences (e.g. bias towards IRB). Therefore, LIC regulators may not need just technical assistance but also more "political" support for their negotiations on regulations with international banks to ensure that their regulatory regime is consistent with national aims for both financial stability and sufficient credit, especially to SMEs.

It is still not clear, however, what the various home regulators – which are mainly G-10 regulators but that also can be from outside the G-10 including emerging market country regulators – will decide and even less whether they will find a common position.

### **3) Collaboration between home and host supervisors**

It would probably help if home and LIC host regulators could try to address the issue of divergent regulatory regimes together.

However, a worrying finding is that, among those LIC regulators interviewed, no communication or any sort of collaboration is taking place between them and their counterparts in the home countries to discuss this and other Basel II related issues. As the above implies, collaboration is crucial even if the country decides not to adopt Basel II at all. LIC regulators know it is important to collaborate with home regulators, and have reported that although collaboration is not the case at present, they expect it will take place in the future. But it is not clear why it is not happening yet.

### **4) Competitiveness issue**

It has been mentioned above that one main potential problem facing LIC regulators is loss of supervisory power over foreign banks in their own jurisdictions if they propose the simplified approach to local banks while permitting foreign banks to adopt the more complex ones. However, a further possible negative implication of such dual regulatory regime is that allowing foreign banks to adopt the F-IRB or A-IRB approaches may grant these banks competitive advantage over local banks, which would have to adopt the simplified approach and which would be far away from being able to adopt the internal risk based approaches at some point in the future.

This would happen because, as said before, the F-IRB and A-IRB approaches are likely to result in less capital requirements. The Fifth Quantitative Impact Study (QIS 5) conducted by the BIS shows that for different groups of banks within and outside the G-10, the AIRB approach would bring the largest falls in capital requirements – by 29 per cent for one group of banks and over 26 per cent for two other groups, followed by the F-IRB approach. At the same time, the standardised approach would either imply similar levels of capital or, for at least one group of banks, a substantial increase, of nearly 40 per cent (Basel 2006b, p. 2, Table 1). A competitive advantage obtained through the adoption

of the F-IRB and A-IRB approaches could, in turn, lead to banking concentration favouring foreign banks in detriment to local ones.

### **5) Credit portfolio concentration and access to SMEs**

The use of risk based IRB models by foreign banks to determine the amount of capital to be allocated for different types of borrowers is, moreover, likely to result in both more expensive and rationed credit to borrowers perceived as of higher risk, and more and cheaper credit to borrowers perceived as of lower risk. For reasons such as information asymmetry, small borrowers and SMEs are likely to be judged as of higher risk than the larger ones, such as large companies. This can cause a concentration in banks' credit portfolio away from small borrowers and towards the larger companies. Furthermore, portfolio concentration implies that risk is being concentrated thereby making financial institutions more vulnerable to shocks and unexpected changing circumstances. This goes against the intended objective of regulatory measures, which is to reduce risks and vulnerabilities to which banks are normally exposed (Gottschalk and Sodre, 2006).

Foreign banks using the IRB approach would have the incentive to concentrate their portfolio in the upper end of the market as this would save them capital, and thereby would have a competitive advantage to lend to "good" companies over local banks using the standardised approach. The latter group of banks would, in turn, be pushed towards lending to the riskier segments of the markets, making them potentially riskier. This would create a division of labour between foreign and local banks that would not bode well for the stability of the entire financial system. It is true that such division of labour may already exist where foreign banks co-exist with local banks, but in introducing a dual regime Basel II would reinforce this pattern.

Although LIC regulators are aware of some of these possible implications, there is hardly any discussion of these within their jurisdictions, as their efforts are concentrated on trying first to improve their understanding of the technical issues on Basel II.

### **6) Pro-cyclicality**

The use of risk-sensitive models under the IRB approach is bound to result in these models detecting an increase in the measured probability of default during economic downturns. As a consequence, the assets of a portfolio will be downgraded – what is called migration – which in turn will lead to higher capital charges. Recent empirical evidence supports the claim that the use of the IRB approach to measure risk may have the effect of a higher variation in the capital charge over the business cycle, as compared to the use of Basel I type of rules for measuring risk (see Goodhart and Segoviano, 2005). This in itself may lead to both increased cost and reduced quantity of credit during economic slowdowns. Furthermore, the fact that it is harder to raise capital during economic downturns may reinforce the tendency in credit reduction, ultimately leading to a credit crunch and a deepening of the economic downturn, with further impacts on banks' portfolios.

A reason why the measured risk by these models tends to be so much time-variant is that even when they are forward-looking, their time horizons often are limited to one year

(see Borio et al, 2003 and Fitch Ratings, 2005). These models therefore result in assigning borrowers ratings in light of their current (or over a limited time-horizon) status. That is what is called the ‘point-in-time’ approach.

The potential problems of inequity (i.e. banking concentration) and access to credit by SMEs show that regulatory measures are not neutral, that they can have an important impact on competitive and equity issues. Moreover, bank regulation can exacerbate pro-cyclicality of bank credit and thereby contribute to larger swings in the business cycle. The latter problem in particular should be a concern for regulators, as it also has a bearing on the stability of the financial system. Indeed, accentuated macro-economic volatility is a major factor underlying banking crises, due to sharp variations in key prices, such as exchange and interest rates, and therefore in banks’ balance sheets.

In LICs pro-cyclicality may be somewhat mitigated with the adoption of the simplified approach, but for that the host regulators would have to be able to enforce its adoption among foreign banks. There is, however, uncertainty about whether and how they will be able to do it (see discussion above).

## **7) Technical assistance**

Although LIC regulators are keen to learn about Basel II, little technical assistance is being provided on it – at least to those we have interviewed. However, the IMF is beginning to provide advice on Basel II to some, mainly middle-income countries. There is no common view on what sort of technical assistance might be useful. But one idea floated by a LIC regulator is that they may greatly benefit from spending some time (say a month) in a home country central bank to see how things work.

In the absence of TA, LIC regulators are trying to learn as much as they can through attending local and international seminars, and through organising awareness forums with their banks and counterparts in neighbouring countries. But even attending such events is not always straightforward. Informed that Crown Agents was organising a one-week workshop on Basel II in Zambia, I asked a regulator from a neighbouring country if she would attend the seminar, and the response was: ‘I am aware of the seminar and would like to attend, but still don’t know whether I will be able to go due to budgetary constraints’.

#### **IV. Conclusions**

It is advisable that LIC regulators proceed cautiously in implementing Basel II. Political support may be needed for that, so that LICs do not rush to implement the more complex approaches, which are favoured by the international banks.

LIC regulators also need to carefully assess the broader implications of Basel II, not just for banking stability, but also for credit policy (which have implications for macro stability and growth), and for access to credit for SMEs (which have implications for employment, poverty reduction and equity). Furthermore, issues of impact of bank regulation on competitiveness of national versus international banks and their effects on SME financing, as well as financial stability need to be carefully assessed.

Higher levels of technical assistance to LICs are required. In addition, regional collaboration, in the mode of the Caribbean Group of Regulators (not discussed here) is desirable, which may give them the option to search for a uniform approach, and to forge a common position on specific issues.

All the above could help LIC economic authorities decide on pace and modality of implementing Basel II in ways most appropriate for their development objectives.

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Ricardo Gottschalk, IDS

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Specifically, the paper addresses the following questions:

- To what extent will Basel II be implemented by LIC regulators? What is the timetable? What approaches are being proposed for adoption? What are the main obstacles for implementing the different approaches? Are possible variations being considered?
- What are the main challenges facing regulators? Lack of human, financial resources? If a LIC is planning to implement the Internal Ratings Based (IRB) approach (which is more complex), is there sufficient capacity to validate models? Should the focus be on other regulatory issues, which need to be done previous to implementing Basel II?
- What about banks' preferences regarding the adoption of Basel II?
- Would banks that adopt the IRB approach (usually international banks) have competitive advantage over banks that adopt, or are asked to adopt, the standardised (simpler) approach? Is it a concern that this might cause a division of labour between banks, with small and riskier borrowers migrating to banks (usually national ones) that use the standardised approach?
- What can be done to mitigate possible negative impacts of implementation of Basel II on access to credit by the poor and SMEs?

Drawing on a survey conducted in late 2006 involving low-income countries, mainly from Sub-Saharan Africa, the paper finds that most LICs are adopting a very cautious approach towards Basel II. Their intentions are first to understand better how Basel II works and to have a better grasp of their possible implications, in order to be able to adopt an informed decision on the issue. It is a 'better wait' approach. Furthermore, several LIC countries feel that they have previous tasks to complete within Basel I or more generally within banking regulations before they tackle Basel II. The IMF and Basel Committee say they share this caution and do not push LICs to adopt Basel II. However, there seems to be pressure from international consulting firms, rating agencies and others for countries to adopt Basel II.

A few other LICs are already signalling a move towards Basel II. However, they intend to do so in a gradual fashion. For some countries, gradualism means starting with Pillars



II and III, and later moving to Pillar I. For other countries, it means adopting first a simplified version of the standard approach under Pillar I, with no clear timetable for moving on to more sophisticated approaches later on.

The LICs' cautious attitude reflects their awareness about the complexities that Basel II involves, and their lack of human and financial resources to deal with these complexities. Major challenges comprise the need to build long and reliable data bases to run sophisticated risk assessment models, and to build supervisors' capacity to assess, validate and monitor the use of such models. But the challenges LICs face are not exactly the same. They can differ across countries according to the country's size (population, absolute GDP) and whether the country harbours foreign banks in its jurisdiction.

Regarding size, obviously large countries such as India do not face extremely serious human capacity constraint and thus are able to consider adopting Basel II soon (although through starting with the less complex approaches) – than for example Lesotho, which for being so small face acute human capacity limitation and therefore had not decided by the time of the survey whether to implement Basel II, even though its per capita income may be higher than India's.

As for the presence of foreign banks, a continuum among LICs can be found as regards the presence of foreign banks in their jurisdictions. At the one end we can find countries with no foreign banks while at the other end there are countries where all banks are foreign. Ethiopia for example has no foreign banks, which implies it does not face the pressing issue of how to deal with foreign banks keen to adopt the most sophisticated approaches, and therefore can take the time to build capacity for Basel II implementation. At the other end one can find Botswana and Lesotho, where all commercial banks are foreign. These countries have therefore to deal with Basel II issues even if they decide not to adopt the new capital accord in the foreseeable future, as foreign banks will be wishing to adopt this approach globally. Though formally LIC regulators have the freedom to require all banks in their jurisdiction to follow a certain regulatory approach, foreign banks have great deal of leverage given their option of pulling out, if national regulations are not convenient for them. This could become a serious problem for LIC economies.

Given the pressing need for building up capacity to deal with Basel II, at present LICs' efforts are concentrated on building such capacity through participation in various activities and events such as local and foreign seminars, and training programmes. This leaves little space for discussion on possible broader negative implications of Basel II for their banking systems. This is the case even when LIC regulators are aware of these implications as a result of their own reflections and learning process.

Further important findings reported in this paper are that, first, in countries with foreign banks there is scant evidence of collaboration between home and host regulators. This despite the fact that host regulators know collaboration is crucial and that Basel II documents emphasise the need for such collaboration; and second, that very little technical assistance (TA) is being provided at present.