POLICY NOTE: GLOBAL FINANCIAL REGULATION

Global regulations risk distorting against emerging and frontier market investment opportunities

June 2023

SUMMARY

- **MOBILIST-funded research delivered by Risk Control Ltd[1] finds indicative evidence that developing country assets are penalised through *unduly* conservative capital market regulations.**
- **This can divert capital from otherwise attractive investments that contribute to sustainable development and to investors' returns.**
- **Research also finds that international standards and advanced economy (AE) regulation are often set without due consideration of consequences for emerging market and developing economies (EMDEs).**
- **Global and AE regulatory standards must therefore retain prudence and conservatism while considering consequences for EMDEs.**
- **Delivering this shift requires more than representation. It requires transparency and accountability over how standards are set and calibrated, and partnership between AEs and EMDEs on policy*making*, not only implementation of standards designed in the Global North.**

CONTEXT

Portfolio investment flows to EMDEs have been in decline over the past decade. Financial regulation within AEs is a key driver of these flows, affecting risk management practices and relative returns for AE and EMDE assets. A key consideration is the extent to which policy and regulation *are commensurate with actual risk* of EMDE assets or otherwise consistent with justified public policy objectives. Critically, MOBILIST-funded research finds indicative evidence of disproportionate conservatism relative to EMDE risk.

In this context, it is critical to understand the process through which international regulations are made, and the opportunities for EMDEs to represent their interests. MOBILIST-funded research finds that the *potential* for EMDEs to influence international financial regulation has increased over time, with greater participation in standard setting bodies among larger emerging markets in particular. However, international standards and AE regulations continue *in practice* to be set with limited reference to EMDEs' priorities and concerns.

For example, by 2030 G7 countries will account for less than 33% of global economic output, down from more than 50% in 2000. Yet 86% of responses to the consultation on the Basel III banking standards were posted by AE respondents. Moreover, in finalising the Basel III standards, Bengtsson (2023)[2] finds that all the areas in which major adjustments were made following the consultation were more important to AE respondents than to EMDEs.

Taken together, this implies that EMDEs remain predominantly *takers* and not *makers* of global capital market policy and regulation. This contributes to the risk of continued capital diversion from EMDEs as discussed above and documented further in MOBILIST-sponsored research.

1 https://www.mobilistglobal.com/research-data/financial-regulation-and-capital-flows-to-emdes/

2 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4431626

CASE STUDY 1: SOLVENCY II PENALISES INVESTMENT IN EMDE INFRASTRUCTURE

The Solvency II regulatory regime sets prudential standards for insurers in Europe. Solvency II defines 'capital charges' for each project, which inform the amount of money insurers should hold in addition to their liabilities to provide a cushion against unexpected events. Higher capital charges are applied to riskier assets and, all else equal, mean that insurers are required to hold more money in reserve for these assets.

Solvency II capital charges are lower for OECD and EEA infrastructure assets than for corporate debt securities in general, reflecting lower risk associated with infrastructure. All else equal, this allowance incentivises insurers into OECD and EEA infrastructure assets. Critically, no such allowance is made for infrastructure assets *outside* the OECD and EEA, meaning that no such incentive exists for most EMDE infrastructure projects.

Figure 1 shows that, however, much like infrastructure assets in high-income countries (HICs), infrastructure assets in low-income countries and middle-income countries (LICs/MICs) are less likely to default than corporate bonds in general. The figure shows the expected probability of default over time for three asset classes: HIC infrastructure debt (dark blue), LIC/MIC infrastructure debt (green), and rated corporate bonds (bright blue).

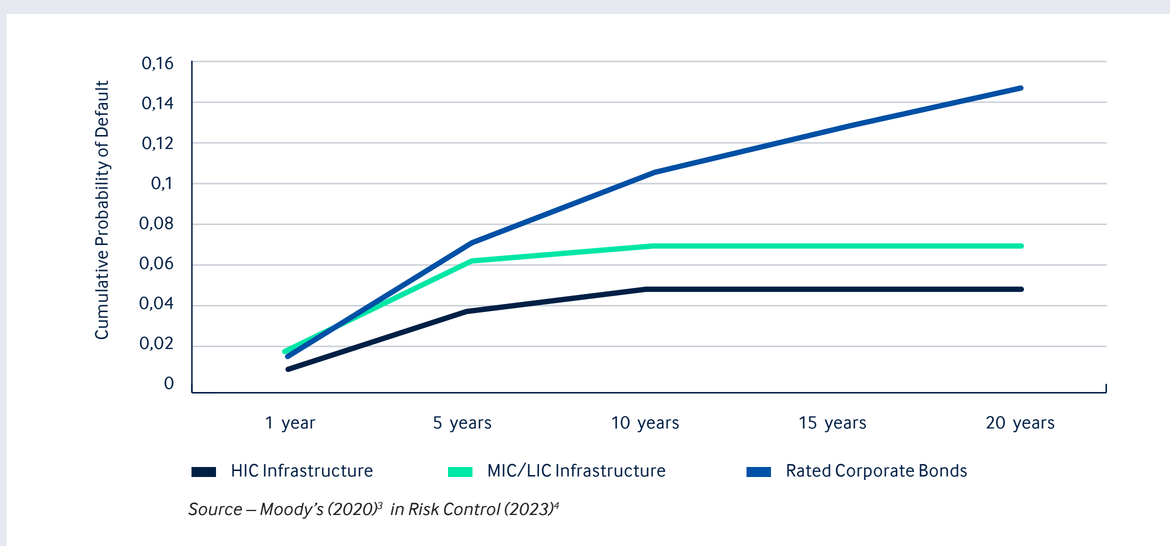
While LIC/MIC infrastructure debt is more likely to default than HIC infrastructure debt, rated corporate bonds are twice as likely as LIC/MIC infrastructure to default over a 20-year horizon.

Moreover, MOBILIST-sponsored research by Risk Control Ltd finds that in the case of default, lenders are able to recover a *greater* share of capital from LIC/MIC infrastructure projects than is the case for HIC infrastructure projects.

Together, these findings suggest that the treatment of LIC/MIC infrastructure exposures within the Solvency II rules may be disproportionate to their true risk.

The MOBILIST-sponsored research concludes that: *"AE insurers currently make relatively small contributions to the financing of EMDE infrastructure which is dominated by bank and fund investment flows. But for insurers that have appetite for long-duration assets (mainly life assurance companies), this may reflect the prudential regulations that they face rather than an intrinsic preference for other assets. Adjusting the calibration to be consistent with actual risk is a sensible step to take."*

Figure 1 – Historical Credit Performance of Infrastructure Loans and Corporate Bonds



Source – Moody's (2020)[3] in Risk Control (2023)[4]

3 https://www.moodysanalytics.com/articles/2020/examining-infrastructure-as-an-asset-class
4 https://www.mobilistglobal.com/wp-content/uploads/2023/06/Financial-Regulation-and-Emerging-Markets_MOBILIST_Risk-Control_2023.pdf

CASE STUDY 2: BASEL BANKING STANDARDS FAIL TO REFLECT DIVERSIFICATION BENEFITS OF EMDE EQUITIES

Based on lessons of the Global Financial Crisis, the Basel Committee on Banking Supervision overhauled market risk capital requirements through its Fundamental Review of the Trading Book (FRTB) initiated in 2012. The FRTB is a comprehensive suite of capital rules intended to be applied to banks' wholesale trading activities, with implementation expected from 2024 or 2025 depending on the jurisdiction. Once fully implemented, these rules are likely to increase banks' costs of capital and so will likely affect the efficiency and liquidity of secondary markets.

Critically, the FRTB proposes a differentiation in capital charges between Advanced Economies and Emerging Market Economies, for example with higher capital charges for Emerging Market Economy (EME) equities relative to Advanced Economy (AE) equities. This can clearly be justified if EME equities are higher risk; however, MOBILIST-funded research finds no such evidence. Conversely, quantitative analysis of AE and EME equities finds that the additional risk a typical EME equity adds to a well-diversified portfolio is approximately the same as that associated with a typical AE equity. This is because EME equities are relatively uncorrelated with global markets, helping to mitigate volatility in the overall portfolio.

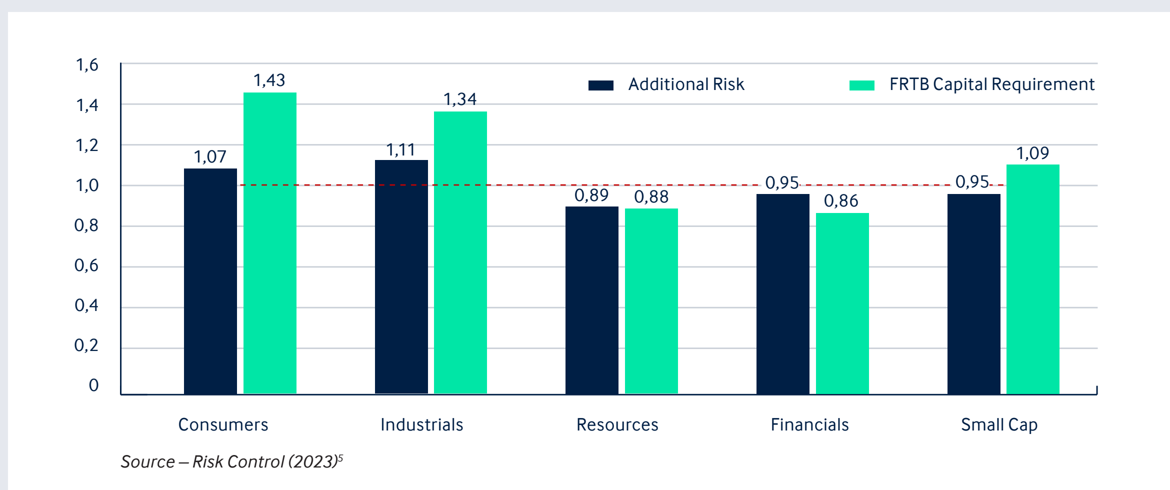
Figure 2 compares empirical estimates of the additional risk associated with a typical EME or AE equity, when added to a well-diversified portfolio, and FRTB capital charges associated with EME and AE equities. These estimates are presented as ratios of EME to AE risk and of EME to AE capital charges. For the dark blue bars in Figure 2, an estimate greater than 1 can be interpreted to mean that EME equities in the sector add more risk to a diversified portfolio than do AE equities in the same sector. For the green bars, an estimate greater than 1 can be interpreted to mean that EME equities in the sector carry a greater FRTB capital charge than do AE equities in the same sector, implying that the regulator assesses the EME equity to be higher risk than the AE equity.

Figure 2 shows that the additional risk associated with EME equities in the Consumers sector is approximately 7% higher than the additional risk associated with AE equities in the same sector (that is, the dark blue bar shows a ratio of 1.07 for this sector). However, the additional risk implied by FRTB capital requirements is much higher – the green bar for this sector suggests that EME equities should be 43% riskier than AE equities.

Although indicative, these findings suggest that standards prepared by the Basel Committee could disincentivise banks from holding and making markets in EME equities in the Consumers sector. This is because they are required to hold in reserve more capital than would appear proportionate in the context of the actual risk associated with EME relative to AE assets in this sector. Similar though less severe penalties apply in the Industrials and Small Cap sectors, both which are critically important for sustainable economic growth in developing countries.

Overall, the MOBILIST-funded study argues that as a result of the FRTB's differentiation between EMEs and AEs, *"AE banks will find it harder to make markets in EM equities, leading to an acceleration in the tendency observed in many such markets of progressive exit by major global institutions".*

Figure 2 – Relative Risk of EME and AE Assets: Empirical and Implied Estimates



Source – Risk Control (2023)[5]

5 https://www.mobilistglobal.com/wp-content/uploads/2023/06/Financial-Regulation-and-Emerging-Markets_MOBILIST_Risk-Control_2023.pdf

CASE STUDY 3: BASEL BANKING STANDARDS STEM ENTRY OF EMDE CREDIT RATING AGENCIES

The Basel Committee on Banking Supervision's Standardised Approach for Credit Risk requires that *"Banks must use the chosen External Credit Assessment Institution (ECAI) and their ratings consistently for all types of exposure where they have been recognised by their supervisor as an eligible ECAI, for both risk-weighting and risk management purposes. Banks are not allowed to 'cherry-pick' the ratings provided by different ECAIs and to arbitrarily change the use of ECAIs".*

The fact that the same rating on a given security should be used for both risk-weighting and risk management purposes is uncontroversial. However, MOBILIST-funded research argues that this is the only part of the above regulatory standard that is not problematic. The Basel Committee's intention is indicated in their comments about cherry-picking. Market competition and more importantly, market development, is frowned upon and considered cherry-picking.

In practice, the effect of this rule is to freeze the corporate rating market in favour of the incumbents with the largest market shares (such as the two New-York based rating agencies Moody's and Standard & Poor's). Other ECAIs ratings can only be used if the incumbents are not present. To illustrate, there are only four ECAIs registered by the Financial Sector Conduct Authority (FSCA) for South Africa: a) Moody's Investors Service South Africa (Pty) Ltd., (b) Global Credit Rating Co. (Pty) Ltd., a regional rating agency which, since May 2022, has been an affiliate of Moody's Investor Services, (c) S&P Global Ratings Europe Ltd. with its South Africa Branch and (d) Sovereign Africa Ratings (Pty) Ltd., which specialises in rating sovereign and sub-sovereigns. In effect, South African rating methodologies are now dependent on governance processes that are based in New York.

POLICY IMPLICATIONS

Retaining the overall conservatism of global capital market regulation is critical to maintaining financial stability; any undue relaxation would be against the interests of EMDEs. Instead, MOBILIST encourages:

- *Proportionality* – Financial regulation should accurately reflect the absolute and relative risk associated with EMDE securities. Regulatory impact assessments should by default consider specific consequences for EMDE capital flows and international standards should be calibrated based on publicly available quantitative analysis of relative risk across markets/assets.

- *Representation* – EMDE perspectives should be considered more fully in the formulation of global capital market standards and regulation, through both greater representation in relevant forums and greater consideration of EMDE priorities in those forums. The Basel Consultative Group (BCG) is an important forum in this regard.

- *Accountability* – Evidence on the extent to which EMDE perspectives are considered should be monitored, made public, and used to hold the standard-setting bodies accountable. The G20 should consider an openly available Transparency Dashboard to monitor the inclusion of EMDE perspectives in standard-setting bodies' decisions.

- *Partnership* – Some EMDEs may need assistance from OECD and development finance partners in relation to the setting of policy and regulation, where most assistance at present focuses on the *implementation* of rules set by developed markets. This could include assistance relating to the preparation of regulatory impact assessments and communication of technical concepts for political (and non-English) audiences.