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Financial Regulation and Capital Flows to EMDEs

Executive Summary

Financial regulation within Advanced Economies (AEs) is a key driver of capital flows to Emerging Market and Developing Economies (EMDEs). Bank capital rules affect the ability of developed country banks to lend and invest in EMDE financial instruments. Trading book capital rules influence whether banks can deal in Emerging Market (EM) cash and derivative instruments, and they crucially affect the liquidity of markets in these securities. Insurer and bank capital rules affect incentives to invest in important exposures closely associated with EM trade and investment, most notably infrastructure projects.

The regulatory environment for AEs has evolved greatly in the 15 years since the Global Financial Crisis (GFC) of 2007-9. That crisis and its after-shock, the European sovereign debt crisis of 2013, persuaded the global regulatory community, led by AE representatives, to engage in a major review of banking rules, boosting capital requirements for banks, and tightening the liquidity regulations they face. The pre-GFC regulatory environment for banks, provided by the Basel II package, has been superseded by a set of rules published in 2018 as the 'Basel III Final' package. As of 2023, these rules have begun to enter the national regulations and laws of many countries around the world. In parallel, regulatory rules for insurers have progressed as Solvency II rules in Europe have come into force, and the International Association of Insurance Supervisors (IAIS) has developed a comparable package of rules at an international level.

The three major elements of the changes in banking regulations set by the Basel Committee on Banking Supervision (BCBS) are (i) increases in capital ratios, (ii) the Fundamental Review of the Trading Book (FRTB), and (iii) the revised Credit Risk Standardised Approach (SA) and floors regime. The Basel capital rules work by multiplying a bank's individual exposures by Risk Weights (RWs) to obtain a total amount of Risk Weighted Assets (RWAs). The bank then multiplies its RWAs by capital ratios to calculate the amount of capital it must hold. Of the above changes, (i) involved adjusting the overall ratios upwards while (ii) and (iii) consist of changing the ways in which RWAs are computed in case (ii) for exposures in the trading book and in case (iii) for credit exposures in the banking book.

The GFC also led governments and regulators to update the mechanisms for determining financial regulations. The previous architecture for regulatory decision-making was revised with the G20 taking over from the G10 as the preeminent body for identifying high-level priorities in regulation. The Financial Stability Forum was revamped with an increased membership and increased numbers of members were admitted to the Standard Setting Bodies (SSBs) for banking, insurance, and securities markets with the International Organization of Securities Commissions (IOSCO). These developments introduced at least the potential for EMDE influence on regulatory policymaking.

This study considers these developments. First, to provide context, we examine data on capital flows to EMDEs, showing how they have evolved through the last two decades, and their sensitivity to the disruptions caused by financial crises. Leaving out capital flows to China, one may observe that most categories of public and private market capital flows have trended down in recent years. The exception is Foreign Direct Investment, which is probably the least sensitive to the regulatory policy environment. Also, despite the negative trend of capital flows through bank lending in recent years, the COVID-19 crisis appears to have brought an unexpected and sharp rise in bank lending. We suspect this phenomenon is temporary and reflects the peculiar conditions prevailing in the last two years for which we have data, 2021 and 2022.

The core of the paper is a set of vignettes of regulatory policy issues that we label "regulatory frictions". Each vignette describes a specific set of developed country or global regulations that may adversely affect economic and financial developments in EMDEs. Clearly, capital charges or other rules that accurately reflect the relative risk or liquidity of EMDE exposures or markets are uninteresting, in this regard, as any prudential regulator is justified in adopting such rules. Our presumption in examining the set of issues included is, therefore, that the regulations in question are not commensurate with actual risk. We provide calibration evidence that this is the case.

The issues we examine are as follows:

1. Treatment of EM securities in FRTB
2. Impact on EM infrastructure loans of insurer prudential capital rules
3. Effect of MiFID II research rules on Emerging Market (EM) investment research

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4. Regulatory constraints on EM production of Voluntary Carbon Credits (VCCs)
5. Restrictions on the use of local Credit Ratings Agencies (CRAs)
6. Effects on bank activity in EM securities markets from capital consolidation rules
7. Impacts on Correspondent Banking in EMDEs of Anti Money Laundering (AML) and Know Your Customer (KYC) rules.

These are complex and major issues, all of which merit thorough analysis. This report should, therefore, be viewed as establishing a set of topics which are deserving of further study. It is introductory in nature, rather than conclusive. In each case, we provide preliminary thoughts on what could be done to mitigate the problem identified.

The last part of the report describes the architecture of regulatory policy decision-making outlined above, to identify how EMDE voices could be more influential in the design and implementation of financial regulation. It appears that EMDEs do have the requisite representation on SSBs and the scope through their periodic occupancy of the G20 presidency to place some issues on the table for discussion. In practice, however, almost all the regulators and policymakers we interviewed as part of this study confirmed that regulatory design and decision-making are the domain of a small number of AE countries.

Why is this? Part of the explanation is the tendency of EMDEs to act as 'price takers' in the process without trying to establish common cause and take initiatives jointly. Another issue is the relative lack of resources that many EMDEs face in the regulatory policy area. Since the approach to devising regulation within the current system relies on 'soft law' developed in a consensual way, agreement is reached through the preparation of technical analysis and evidence. But generating such evidence is costly and challenging for EMDE governments.

How might EMDE influence be enhanced? EMDEs should seek to find common cause either in the SSBs or when one of their number occupies the G20 presidency. The SSBs could also consider some changes in the ways they work, conducting regular analyses of the impact of regulations on EMDEs, checking calibrations where these may be incommensurate with risk and seeking to widen responses to consultations. Where there are committees within SSBs that focus on EMDEs, the evaluation of new rules and their impact should receive just as much emphasis as adoption and implementation (which tend to receive the most attention currently).

On the potential role of multilaterals, the Bretton Woods institutions are already involved with EMDEs on issues of financial regulation, but greater attention is paid to the adoption of AE rules than to the capacity building necessary for EMDEs to enter more actively into regulatory design and decision making at an international level. Regional MDBs which already assist regional country groupings on issues of common interest could potentially play a larger role in capacity building in financial regulation and the analysis of regulatory impact.

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