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Joined position paper

The unintended consequences of Basel IV on developing countries

The proposed tightening of minimum capital requirements under Basel IV hampers the ability of regulated entities to provide the financing needs of already underserved markets. This effect comes in addition to other main impacts of the proposals in Europe and worldwide.

Roughly 4 billion people living in developing countries and emerging economies do not have access to financial services such as credit, savings and insurance. By increasing access to financial services for the poor segments of society, the financial sector can play an important role in alleviating poverty in developing countries and contribute to the United Nation (UN) Sustainable Development Goals (SDGs). A common practice for financing companies in developing countries is the joined participation of international commercial banks, development banks, export credit agencies, and local banks. International specialist banks often provide the most complex - and secured - structures (e.g. project finance, trade finance, commodity finance, (pre-) export finance), while development banks take higher risks and provide long-term financing, through subordinated loans or equity stakes. Export credit agencies mostly cover country risks. Local banks, for their part, often provide working capital facilities, less complex trade finance and more generally unsecured lending. The complementary expertise and due diligence of the several financing parties ensure all parties feel comfortable with their respective risks, and borrowers can tailor their financing needs to the sources of financing.

This common practice is hampered by different proposals under Basel IV. Basel IV, or the 'finalization of Basel III' called by others, three consultative documents are of particular relevance: Revisions to the Standardized Approach for credit risk (*bcbs 347*), Capital floors: the design of a framework based on standardised approaches (*bcbs 306*), and Reducing variation in credit-risk weighted assets - constraints on the use of internal model approaches (*bcbs 362*). Open for discussion is still the capital output floor. If this were to be introduced, it would make the capital framework less risk sensitive and it would cause a high capital increase. Therefore, we believe this is very undesirable.

Equity investments. Equity investments of development banks enhance the stability in financial markets by increasing the availability of capital in capital scarce markets. The Basel consultation paper *Revisions to the Standardized Approach for credit risk* proposes to increase the risk weight for equity exposures from 150% to 250%. We consider the proposed equity weightings to be too conservative, particularly for development banks that are managing a portfolio of equity (fund) investments. The benefit of a high level of diversification over countries, regions, sectors and vintage years that is key to the business model of development banks, is currently not incorporated. In addition, the Basel consultation paper proposes to introduce a 50% add-on for exposures to corporates with non-hedged currency mismatches. From a development finance point of view, contracting our customers in hard currencies (EUR and USD) is utmost importance because of the missing market in local currencies, and the add-on will further hamper this ability (EDFI, 2016).

Agriculture. To meet the resulting increased demand for food, global food production will have to increase by at least 60%, while at the same time arable land and natural resources are nearing their limits. Financing agriculture business in developing countries is of key importance, yet significantly impacted by the Basel proposals to revise the Standardised Approach (SA), to impose new constraints on Internal Rating Based (IRB) modelling and to introduce an output floor at aggregate level which may 'override' the capital outcomes of banks risk models. In doing so, Basel proposes to apply non-risk sensitive floors that are not tailored to the specificities of Agriculture business, nor to other types of highly collateralized lending. Agricultural lending is by and large secured lending with agricultural land, buildings and business assets as collateral and the underwriting criteria are far more conservative than generally applied for commercial lending. In case of default, the loss for the bank will be significantly limited. The bank can therefore provide more finance that would otherwise be possible and/or charge a more favourable rate than would be the case if only income were taken into account (unsecured lending). If this is not recognized in the capital regulation, agri businesses will be strongly disadvantaged (Rabobank, 2016).

Commodity finance and project finance. A specific other issue is the envisaged treatment of commodity finance and project finance. These exposures are not treated in accordance with the current practices of banks either, i.e. practices to mitigate and manage risk. All three aforementioned proposals will affect project finance. Most

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important reason is that finance lenders build structures into their deals to ensure they have early warning signals and options to prevent or minimize a loss. To this end, they create several layers of protection and use collateral. Risk assessments are based on analysis of each transaction (logistics risk, price risk, counterparty risk, risk of change of the value of collateral, liquidity of the commodity, global environment such as world production, level of stocks etc (see e.g. AFME commodity finance and project finance discussion papers, 2015 and 2016). We expect that negligence of such structures and risk mitigants in the Basel proposals will cause specific problems for our activities in developing countries and for our global trade finance business (Rabobank, 2016). Such effects may be reinforced because developing banks encounter problems with Basel IV at the same time and may be able to do less transactions too (see consultation response by the Dutch Banking Association, 2016).

Impact on developing countries

FMO Development Bank and Rabobank thus have concerns about the current Basel proposals to restrict the use of internal models for credit risk as well as the treatment of trade finance and of equity holdings. We fear that the proposed amendments to the existing regulatory capital framework, if unaltered, will have a negative impact on developing countries and emerging market economies. It could limit the development banks contribution to the SDG's and the international banks role in the provision of credit in, and trading with, developing countries:

Sustainable Development Goals. On 1 January 2016, the seventeen United Nations (UN) Sustainable Development Goals (SDGs) officially came into force. The Goals call for action by all countries and parties – government, civil society and the private sector – to end extreme poverty, reduce inequality and tackle climate change by 2030. FMO and Rabobank fully support this shared plan of action for people, planet and prosperity. The financing products currently available to developing countries are important instruments to achieve these goals.

Credit availability. We believe there could be a direct and indirect impact on the availability for borrowers in these countries to obtain finance, at least in the short run. This risk is also recognized by the Institute of International Finance (IFF) (2016 and 2017) and the International Chamber of Commerce (2017). Prevailing market characteristics of developing and emerging countries play a role, as set out by IIF in one of their reports: they rely more on bank intermediation than other countries, trade is very important to them, they have less externally rated entities and they have a greater need for new infrastructure investment. This would discourage finance to developing and emerging markets and activities of both banks in these countries. We believe more attention for such effects is warranted. Furthermore, it illustrates that the proposals as a whole are not balanced well for commodity -, object-, and project finance (the "specialized lending" category) and Agriculture finance.

Knowledge and expertise. Development and commercial banks active in developing countries have the knowledge and expertise to judge and mitigate the risks associated in developing countries. Banks' long-term client relationships and their knowledge about their customers conduct form also an integral part of the credit risk assessment. The regulatory requirements under Basel IV may result in less availability of this knowledge to existing and potential clients in developing countries.

Going forward

The Basel proposals are in final drafting stage and given all discussions it seems likely that technical adjustments will be incorporated. As illustrated in this paper, we consider such improvements necessary. Thereafter there may also be calibrations in the translation of the Basel proposals into regulation, in order to be able to take account of differences between the financing structures of economies. We believe the potential impacts on developing countries and on trade have not yet received enough attention and that the new measures should be better targeted and more balanced.

We acknowledge that trade finance flows and decisions to invest or start activities in developing markets depend on many things, and certainly not only on Basel IV, but it will play a role. We believe that the effects should be made more moderate by making the requirements more granular and by a better recognition of collateral and risk mitigation techniques.

In our view, variance in calculation of 'risk weighted assets' can be reduced in a more effective and targeted way by benchmarking of models, harmonization of definitions, better monitoring, and more dialogue/knowledge exchange between banks and supervisors how models are designed. In addition, the minimum criteria for the use of data can possibly be harmonized further. Furthermore, we would like to point out that the European Central Bank (ECB) is already carrying out stringent tests of models for the large EU banks and that European Banking Authority (EBA) is investigating differences in Risk Weighted Asset (RWA) variance. EBA develops Regulatory Technical Standards, imposing restrictions on banks how to develop their models, without

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going as far as prescribing the 'best model' or to use 'one size fits all approaches' for all business models. We believe that objectively proved differences between markets and sectors should be factored in. See e.g. the AFME/GCD discussion papers about project finance and commodity finance and the widely shared preference of financial institutions and risk experts for keeping risk sensitivity.

We welcome more debate about the kind of measures that should benefit both the stability of banking and the ability to finance the economy. We are of course more than willing to explain our position.

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About FMO and Rabobank

FMO Development Bank is a non-commercial undertaking with the primary objective to contribute to the development of the business sector in developing countries. Due to the strong relationship with the Dutch government, FMO is able to take risks which commercial financiers are not, or not yet, prepared to take. FMO pursues its objective by keeping in line with the goals of the governments of the relevant countries and the Dutch government's policy with regard to development assistance. As an equity provider, FMO can have a beneficial influence on companies (hands-on management, enhanced corporate governance and institution building) that can help to achieve the desired effect of economic welfare for developing countries. Equity and mezzanine are constitutive factors of our core business.

Rabobank is an international financial services provider operating on the basis of cooperative principles. It offers retail banking, wholesale banking, private banking, leasing and real estate services. As a cooperative bank, Rabobank puts customers' interests first in its services. Rabobank is committed to being a leading customer-focused cooperative bank in the Netherlands and a leading food and agri bank worldwide. Rabobank employs approximately 50,000 people. Rabobank Group is active in 40 countries. Rabobank also works with partner banks in a number of – African and Latin American - developing countries, patterned on the Rabobank model. In 2016, Rabobank decided to merge the African activities into 'Arise', a cooperation between FMO, Norfund and Rabobank. For more information about the Rabobank Group go to www.rabobank.com.

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