IV. Some prudential issues

Serge Jeanneau[1]

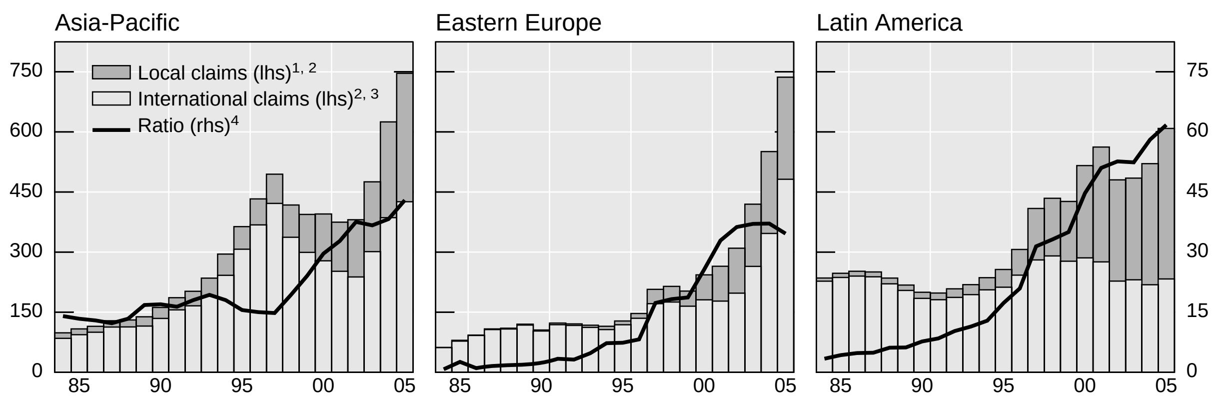
Overview

This chapter looks at two sets of prudential issues of relevance to Latin America and the Caribbean (LAC). The first set analyses the implications of foreign bank entry. Building on the work of Hawkins and Mihaljek (2001), it addresses four specific issues pertaining to such entry. First, it looks at the various forms of foreign bank entry and the implications that this has for banking supervision. Second, it considers whether market consolidation resulting from foreign bank entry poses new risks for systemic stability. Third, it analyses the impact of foreign bank entry on market transparency. Fourth, it discusses whether foreign banks should be incorporated into lender of last resort schemes and official safety nets. The second set is related to the planned implementation of Basel II. It discusses some of the concerns raised by supervisors in implementing the new framework in emerging market economies (EMEs). It also looks at the potential impact of Basel II on international bank lending to EMEs.

Graph 4.1

BIS reporting banks' foreign claims on emerging markets

By residence of immediate borrower



[1] Claims on local residents denominated in local currencies and booked by reporting banks' local affiliates. [2] In billions of US dollars. [3] Cross-border claims in all currencies plus claims on local residents denominated in foreign currencies and booked by reporting banks' local affiliates. [4] Local claims as a percentage of foreign claims.

Source: BIS International Banking Statistics.

---

[1] The author is grateful to Angus Butler, Juan Carlos Crisanto, Mar Gudmundsson, Steven Friedman, Gregor Heinrich, Jeffrey Miller, Dubravko Mihaljek, Ramon Moreno and Camilo Tovar for extensive comments. The views expressed are those of the author and do not necessarily represent those of the Basel Committee on Banking Supervision or the Bank for International Settlements.

Foreign banks and supervision

An important trend in EMEs has been the growing participation of foreign banks in domestic banking markets (Moreno and Villar (2005)). As shown on Graph 4.1, such an evolution has been particularly evident in Latin America, where heavy foreign investment in local entities has been followed by a rapid increase in local lending in local currency. This expansion of local lending has been a positive development for systemic stability to the extent that it has helped reduce currency mismatches. Greater foreign penetration has also contributed to improving the efficiency of financial intermediation. However, greater foreign participation in domestic markets has also raised questions concerning financial stability and supervision.

Licensing and supervision of foreign banks

The entry of foreign banks has brought to the fore the issue of whether such banks should be licensed as branches or subsidiaries. In this respect, country practices vary considerably across the region (see Table 4.1).

Table 4.1

Approaches for foreign bank entry, selected countries in Latin America

Subsidiary or branch	Subsidiary	Branch
Argentina	Costa Rica	Guatemala
Aruba	Mexico	Paraguay
Bahamas		
Bolivia		
Brazil		
Chile		
Colombia		
Ecuador		
El Salvador		
Peru		
Venezuela		

Source: IADB (2004).

Some countries tend to favour branches because of a number of perceived advantages. Branches do not have to be separately capitalised; they are less likely to engage in connected lending; they are subject to consolidated oversight by home country supervisors;

and they are more likely to obtain support from parents.[2] However, branches also face some drawbacks. A significant weakness is that they are often restricted in their operations. Such restrictions usually take the following forms: constraints on domestic deposit taking, limits on expansion and requirements for some capital to be held in the domestic market in the form of so-called "endowment" capital. An additional drawback is that branches are more difficult to sell to third parties when problems of solvency arise.

By contrast, other countries favour subsidiaries because they are perceived to be easier to supervise and manage in periods of distress. In general, subsidiaries are regulated by host country authorities as legally separate entities and, hence, require their own capital within the host country.[3] This structure in principle makes the foreign bank more accountable to host country supervisors. To ensure that parent institutions stand behind their subsidiaries, host country supervisors often ask parent banks (and sometimes parent country supervisors) to provide "comfort letters". Even without such measures, parent banks monitor the activities of their subsidiaries closely in order to ensure the solidity of their operations and forestall any difficulties that could damage their good name. The incentive to monitor the activities of subsidiaries is strengthened by the fact that the courts can at times hold the parents liable in the event of difficulties.

Some argue that, given the more open nature of financial systems, the issue of branches versus subsidiaries may be less relevant. What matters most in practice is that, regardless of the legal form of their presence, foreign banks be initially licensed to carry out those activities that host country supervisors are familiar with and able to monitor properly. At the same time, licensing rules should be reasonably flexible and supervisors should continuously upgrade their capacity to monitor banks' activities.

Supervisory authorities in banking systems dominated by foreign-owned banks have sought to cooperate more closely with home country authorities. In many cases, formal channels of communication have been established with the framework for cooperation set out in bilateral memoranda of understanding.[4] Yet some central banks have expressed scepticism about overly legalistic modes of communication among supervisors. Moreover, some host country authorities have not always been fully informed about the domestic implications of operations at the global level (eg how global risk management could affect a domestic operation) or the situation of parent banks in home countries. One issue that arises is what would happen if a systemically important foreign-owned subsidiary ran into problems. There have been cases where a parent company has helped its subsidiary immediately without asking host country authorities for assistance. But there have also been some cases of parents abandoning their subsidiaries. This was the case in Argentina in 2002, where a few foreign banks explicitly abandoned their Argentine branches or subsidiaries (Del Negro and Kay (2002) and Lacoste (2005)).

An important consideration in LAC is the extent to which the existence of poorly regulated or unregulated offshore financial institutions (OFIs) presents a potential risk to the financial systems in which they operate (Singh et al (2005)). In some countries, particularly in Central

---

[2] Under Basel II, branches of banks incorporated in highly rated countries will be able to obtain cheaper funding because they will be subject to lower capital weights than subsidiaries incorporated in host countries that are lower-rated.

[3] Although they are also regulated by home country authorities that practice consolidated supervision.

[4] Areas of cooperation typically cover: exchange of information on operations of foreign-owned banks in host and home countries; exchange of information on management of foreign-owned banks; joint consultations; and visits to foreign-owned banks. In spite of the development of these forms of cooperation, the establishment of a closer working relationship has been complicated by the different legal treatment of confidential data and information in various jurisdictions.

America, non-regulated OFIs operate effectively as parallel banking structures that are part of larger financial entities. These entities may increase systemic vulnerability by exploiting regulatory arbitrage opportunities, such as the dumping of impaired assets from regulated to non-regulated entities. Focusing only on the regulated bank could lead to erroneous conclusions about the risk exposure of the banking system. The problem may be exacerbated if a regulator is not aware of the links between a regulated and an unregulated financial entity or does not have the legal capacity to supervise one of them. In Ecuador, for instance, the banking crisis of 1998-99 was exacerbated by the fact that apparently sound onshore banks turned out to be much weaker than expected when supervisors audited their closely linked but poorly regulated OFIs.

In order to minimise the risks associated with OFIs, supervisors in the region have sought to impose conditions or restrictions on them to facilitate more adequate supervision. A number of jurisdictions have legislation that allows supervisors to refuse authorisation to banks with corporate structures that cannot be supervised. For example, in Brazil and Panama banks will in general not be granted licences if they are chartered in jurisdictions where local supervisors are not able to perform consolidated supervision. In Guatemala, where OFIs account for 30% of private banking activity, new regulations introduced in 2002 prohibit the operations of OFIs not formally associated with locally licensed financial conglomerates. There has also been growing recourse to consolidated supervision. For example, the Brazilian and Salvadorean authorities are now conducting consolidated supervision of their banks. To further strengthen the supervision of parallel banking structures operating in several jurisdictions, it may be necessary to appoint a lead supervisor to deal with multinational entities on a consolidated basis.

Market transparency and discipline

The acquisition and subsequent delisting of subsidiaries on local stock exchanges can adversely affect the quality of financial information available to market participants and host country supervisors (CGFS (2004) and Domanski (2005)). For one, delisting dilutes the available pricing signals on the profitability of domestic banking business. Another effect is that local financial analysts usually abandon their coverage of banks that become foreign subsidiaries. As local analysts may have an informational advantage over their international counterparties, this may diminish the quality of available information.[5]

As an example, delisting has been a major issue in Mexico. During 2000-05, five of the largest institutions in that country, representing almost 80% of total bank assets, were acquired by foreign-owned banks. All of these five institutions were subsequently delisted from the Mexican stock exchange. As these banks represented 15% of total stock market capitalisation at the time of acquisition, their delisting led to a considerable loss of market information and scrutiny by independent analysts.[6] The disclosure of timely and meaningful information about developments in institutions accounting for much of Mexico's banking sector was impaired, making it necessary to significantly improve information flows from parent banks to markets and from home supervisors to host authorities.

---

5 Information requested by supervisors can to some degree substitute for information provided by markets.

6 Domanski (2005) also notes that after the foreign acquisition of Mexico's two largest banks, the correlation of the prices of the remaining domestic banks and newly acquired banks dropped significantly, which is consistent with the view that the share price of foreign-owned banks reflects less information about domestic financial conditions.

Market concentration

Consolidation resulting partly from foreign bank entry has been associated with a sharp increase in market concentration since the early 1990s (see Chapter I). Many countries follow policies that limit concentration but views differ as to what should be the maximum desirable market share for a single bank or a small group of banks. The issue of market power appears to have been less of a concern in small open economies, perhaps because collusion is more difficult to maintain in such economies. Moreover, there may be some intrinsic advantages in allowing the formation of larger banking groups. Larger banks can benefit from economies of scale, are better able to diversify their activities and can deploy superior risk management techniques.

Nevertheless, mergers between foreign parent institutions have led to a lively debate in some host countries because of concerns that the larger entities would result in greater systemic risk. In Chile, for example, the merger of the Spanish parent banks of two domestic banks led to the single ownership of nearly 30% of banking system assets. Although the two Chilean entities continued to be run and managed separately after the merger, many in the industry were concerned that the newly acquired institutions had become too big to fail and asked themselves whether their large presence in the banking system posed systemic risks. The Chilean authorities responded to those concerns by requiring banks exceeding a market share of 20% to meet higher capital adequacy and liquidity ratios and to reduce their exposure to the interbank market. To increase competition, new bank licenses were issued and banks were allowed to offer interest on deposit accounts. Chilean companies were also allowed to borrow on international capital markets.

Another concern is that changes in business strategy or risk appetite at the parent level could affect the resources allocated to specific countries. Global financial institutions increasingly manage their affiliates in emerging market countries as part of portfolios that respond to evolving risk-adjusted investment criteria. Changes in credit allocation across countries, which may even include a complete retrenchment of activities from a given country, could have a significant impact on the availability of credit in a host country, particularly if the foreign ownership of domestic claims is relatively important. Foreign ownership, therefore, exposes local banking systems more directly to changes in global market conditions.

Official safety nets

An important supervisory issue is to determine whether depositors in foreign banks should receive the same degree of protection as depositors in domestic banks. Some have argued that because foreign banks have the backing of their parents, they may not require lender of last resort arrangements nor participate in deposit insurance schemes. Arrangements giving depositors priority in the event of the winding up of a foreign bank or empowering the central bank to take over an impaired foreign bank may be hard to apply in practice.

Moreover, a strong argument in favour of extending deposit insurance to all banks is that all depositors should receive the same degree of protection. If foreign banks did not have to pay deposit insurance premia, they would enjoy an unfair advantage over domestic banks and therefore have an incentive to finance riskier activities with deposits collected in the host country. In practice, virtually all EMEs require foreign banks to participate in deposit protection arrangements on the same basis as domestic banks (see Table A15).

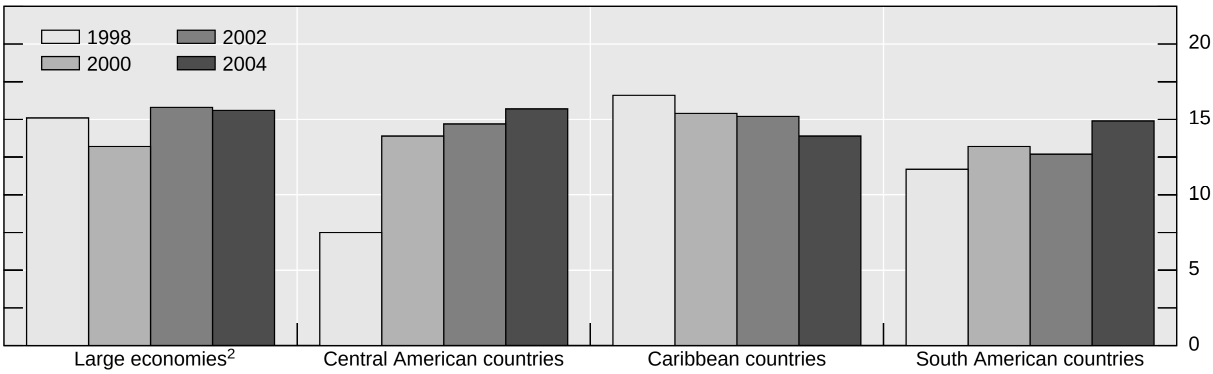
Prudential policies and Basel Core Principles

Many EMEs have taken steps in recent years to enhance banking regulation and supervision and a number have already developed sophisticated approaches to monitoring their banking systems. However, in some countries improvements in the regulatory environment have been limited. Recent assessments under the International Monetary Fund/World Bank Financial Sector Assessment Programs (FSAPs), which focus in part on progress in implementing the Basel Core Principles for Effective Banking Supervision (BCPs), suggest that significant weaknesses in banking supervision remain in a number of EMEs.[7] Three issues may be cited:

The first is the absence of effective consolidated supervision in some countries. This is thought to be of particular relevance in Central America, where reportedly few countries have implemented it yet (ASBA (2006)). This increases the risk that subsidiaries of banking institutions could experience financial difficulties which are not readily detectable, adversely affecting the financial sector and the economy.

Graph 4.2

Regulatory capital to risk-weighted assets[1]



[1] In per cent. [2] Argentina, Brazil and Mexico.

Sources: IMF; BIS calculations.

A second issue is the measurement of bank performance and capital adequacy. Most countries in LAC claim that their banks calculate capital requirements on the basis of the current Basel Accord methodology (IADB (2004)). The general focus on Basel I, as well as efforts to address the BCPs, apparently have had a positive impact on capital adequacy ratios across the region (see Graph 4.*2* and Table A16) and promoted the development of better risk management methodologies. However, such ratios can give a misleading picture of risks to the financial system. For example, capital adequacy ratios are sometimes not calculated on a consolidated basis and risk weightings are inadequate because of a lack of appropriate measurement.

A third concern has to do with deficiencies in risk management. Many countries have not succeeded in instilling a culture of risk management in banking institutions and, thus, compliance with banking regulations tends to be largely mechanical. By the same token,

[7] The BCPs, which were introduced in 1997, are mainly intended to help countries assess the quality of their prudential and supervisory systems, and to support supervisory reform. An updated document was released in October 2006 (BCBS (2006a)).

regulations on large credit exposures and on connected lending are not seen as being strict enough. This is an issue of particular concern in Central America. In some countries, such as Chile and Panama, there is also insufficient attention to market risk. In addition, banks in many countries have made great strides recently in implementing robust frameworks for managing operational risk but this is not universally the case due to resource constraints that have forced them to focus first on enhancing their management of credit risk.

Remedial supervisory measures are also commonly deficient, reducing the incentives for diligent risk management. Such deficiencies include undue forbearance,[8] lack of supervisory capacity or authority for timely intervention, and lack of reasonable protection against legal action. While there have been improvements in bankruptcy legislation in some countries problems in enforcing creditor rights remain significant (see Arrieta and Luy (2002)).

Compliance with the main guidelines contained in the BCPs would do much to address most of these weaknesses. The BCBS has stated that one of the key conditions for a successful implementation of Basel II will be compliance with the BCPs (see BCBS (2006a,b)). In fact, some countries, would benefit from devoting scarce resources to ensuring their compliance with the BCPs first, in particular in the areas of consolidated supervision and capital adequacy calculations, before turning their attention to implementing Basel II.

A snapshot of Basel II

Basel II consists of three mutually reinforcing pillars: Pillar 1, regulatory capital requirements; Pillar 2, the supervisory review process; and Pillar 3, market discipline.

The new framework will allow for a more risk sensitive determination of capital requirements. For credit risk, the various alternatives include: the standardised approach, which relies on external credit assessments for determining credit risk weights, and the foundation internal ratings-based (IRB) and advanced IRB approaches, which rely to varying degrees on banks' own internal rating systems and estimates of underlying risk parameters. The framework also contains options regarding risk mitigation techniques and securitisation. In addition, there will be an explicit capital charge for operational risk which will be based on three alternative measurement methods. Countries will have to decide whether to stay with the current framework or move to Basel II, which will require banks to adopt one of the available options for credit and operational risks.

In order for required capital adequacy ratios to truly reflect the capacity of the banking system to absorb shocks, other elements of the prudential and supervisory framework will need to be strengthened. This is why a successful implementation of the first pillar of Basel II will require the parallel introduction of the other two pillars. The introduction of Pillar 2 aims at ensuring that banks have an adequate process for the assessment of their overall capital adequacy in relation to their risk profile and risk management strategy, and that supervisors have a robust framework for assessing banks' internal processes. Pillar 3 contains a set of disclosure requirements that will promote market discipline by allowing market participants to assess key pieces of information related to Pillars 1 and 2.

[8] The willingness of regulators to postpone action when certain thresholds are breached.

Planned implementation of Basel II in EMEs

In 2004 and 2006, the Financial Stability Institute (FSI) conducted surveys on implementation of Basel II in non-BCBS member countries (see FSI (2004 and 2006)). The objective of the surveys was to identify Basel II implementation plans and determine corresponding capacity building needs in the non-BCBS supervisory community. In the most recent survey, 82 non-BCBS jurisdictions responded that they would adopt Basel II between 2007 and 2009. Taking into account the 13 BCBS member countries, close to 100 countries worldwide could therefore be implementing Basel II over the next few years.

Table 4.2

Adoption of Basel II

Regions	Countries surveyed	Countries that responded	Countries intending to adopt Basel II	Percentage
Asia	18	16	16	100
Africa	25	17	12	71
Latin America	16	14	12	86
Caribbean	8	7	4	57
Middle East	9	8	8	100
No-BCBS Europe	39	36	30	83
Total	*115*	*98*	*82*	*84*

Source: FSI (2006).

According to the FSI surveys, one of the major drivers in moving to Basel II in non-BCBS jurisdictions is the intended local implementation of this framework by foreign controlled banks or local branches of foreign banks. This is particularly the case in non-BCBS Europe, the Middle East and Latin America, where in the latter case foreign institutions hold roughly a third of banking assets expected to be moving to Basel II. The role of foreign players is also important in the Caribbean, where foreign owned or controlled financial institutions account for a large share of banking assets in some countries.

The surveys revealed that Basel II was set to apply to approximately 95% of banking assets in Latin America but to a lesser 25% of such assets in the Caribbean.[9] However, the implementation of Pillar 1 in the region shows some variation. In the case of Latin American countries, banks controlling close to 50% of banking assets intend to apply the foundation IRB approach between 2007 and 2009. During the same period, banks controlling a third of bank assets plan on implementing the simplified standardised approach. In the Caribbean, banks controlling a majority of banking assets intend to apply the simplified standardised approach between 2007 and 2009, although a few responding countries indicated that some of their banks would also implement the advanced IRB approach. It should be noted,

9 However, the FSI noted that if the country with the largest banking system in the region was removed, the amount of assets covered by the new framework would increase to close to 100%.

however, that anecdotal reports gathered by the BCBS indicate that progress in implementing Basel II may be slower than suggested by the responses to the FSI surveys.

With respect to Pillar 2, the FSI surveys highlight that Basel II will necessitate the existence of a solid supervisory infrastructure, including operational autonomy of the supervisory authority, an adequate supply of resources for supervision, clearly defined normative and disciplinary competences and an adequate legal framework. At the same time, solid accounting standards will be required to ensure that capital ratios accurately reflect a bank's capacity to absorb risk. One of the particular challenges highlighted in the FSI surveys in the implementation of Pillar 2 relates to acquiring and upgrading the human and technical resources necessary for the review of banks' responsibilities under Pillar 1.[10] An additional challenge is coordination by home and host supervisors in the cross-border implementation of Basel II. The freedom of national supervisors to conduct a tailoring of rules to the specific circumstances of each country will prevent the implementation of fully consistent rules across countries. Efforts will therefore be required to reduce such inconsistencies.[11] Concerning Pillar 3, the development of financial indicators that would ensure a proper functioning of market discipline also depends on compliance with the BCPs. A significant challenge identified by the FSI surveys will be to align supervisory disclosures with international accounting standards.

Appropriateness of Basel II for EMEs

Beyond the practical issues related to the implementation of Basel II, the broader question of the extent to which the new framework is appropriate for EMEs remains. One of the key issues is whether risk weights taken from a framework designed by industrialised countries can be successfully adapted to economies that differ in their economic structure and are generally more vulnerable to financial shocks (Goldstein (1997)). Prima facie, there would be a case for banks in emerging economies to hold greater capital if there is greater risk of loss, associated for example with greater macroeconomic volatility and a greater incidence of macroeconomic or financial disruptions (Villar (2006)). Several countries have already adjusted the Basel I framework to account for their specific needs. A number of countries have imposed higher capital adequacy ratios on their banks than the mandated minimum or have adapted their risk-weights for different categories of assets.

Basel II and lending to EMEs

The introduction of the new capital framework constitutes an important topic of discussion concerning the evolution of international bank lending to EMEs over the next few years. As noted above, an important objective of Basel II is to ensure that the regulatory capital held by international banks becomes a more accurate reflection of the credit quality of their loan portfolios. Some commentators (Griffith-Jones and Spratt (2001) among others) have argued that this increased risk sensitivity will lead to a curtailment in the supply of capital to EMEs.

---

[10] In response, the FSI introduced a new online training facility ("FSI Connect").

[11] Supervisors of the BCBS member countries have worked closely through the Accord Implementation Group (AIG) to achieve a high degree of consistency. Members of the AIG have also worked with supervisors of the non-BCBS countries through the Core Principles Liaison Group (CPLG) to share information and points of view concerning implementation in non-BCBS countries.

However, there are reasons to think that Basel II will not have the dramatic impact that these commentators have suggested. The main one is that banks do not price their loans on the basis of regulatory capital charges but rather on the basis of economic capital, which is the capital set aside as a buffer against unexpected losses (Hayes and Saporta (2002)). This economic capital is linked to the credit quality of bank assets. In turn, the level and cost of economic capital determine the pricing of bank loans and other assets. In practice, the level of economic capital should not be directly affected by a change in regulatory capital requirements. In fact, Basel II intends to align the determination of regulatory capital more closely with the methods used to determine economic capital. This should mean that the introduction of Basel II will not change the way banks evaluate the risk of lending to EMEs (Caruana (2005)).

Moreover, the existence of better capitalised banks that manage and price risks more efficiently over an appropriate time horizon should lead to the emergence of a more stable and resilient financial system, therefore reducing the probability of abrupt changes in lending conditions. The more formal risk evaluation methodologies contained in Basel II should facilitate an earlier detection of inappropriate lending strategies, which should help in introducing corrective actions at an earlier stage, again reducing the probability of sharp adjustments in lending decisions (Caruana (2005)). Overall, Basel II may therefore not have a pronounced impact on lending flows to EMEs and may even contribute to reducing their volatility and procyclicality.

Nevertheless, three features of Basel II are likely to have some bearing on the pricing or volume of loans to EMEs.

First, Basel II relates the capital charges for credit risk to explicit indicators of credit quality, measured either externally or internally. This stands in contrast to the current framework, under which capital charges against sovereign and interbank loans are based on whether the borrower belongs to the OECD or not. The experiences of Korea, Mexico and Turkey show that OECD members can also be vulnerable to financial crises and the removal of this arbitrary distinction should lead to a more rational determination of regulatory capital. Quite clearly, some borrowers will gain from this transition, while others will lose. Capital charges on lending to countries that enjoy a relatively high credit standing will generally be reduced, while charges on lending to countries that are of a low credit standing will tend to rise (see Table 4.3). In the case of countries for which capital charges may increase, the key issue is whether the new minimum requirement will substantially exceed the economic capital that banks would otherwise hold, in which case a rise in loan pricing would likely ensue.[12]

Second, Basel II may also have an impact on the maturity of loans to EMEs. Under the current framework, lending to non-OECD borrowers carries a full capital charge of 8% for loans with maturities longer than one year, compared with a charge of 1.6% for shorter-term claims. This preferential treatment of short-term loans is considered by some to have encouraged short-term lending to EMEs in the early 1990s (see the discussion in BCBS (1999)). Although there are some reasons for imposing a lower capital charge for short-term loans, the more gradual increase in the charge along the maturity spectrum contained in Basel II should help in reducing maturity biases in lending.

---

[12] Assessing the extent to which this will be the case is not straightforward since it depends on the method used to calculate economic capital, the precise composition of a bank's portfolio and a host of other competitive factors that determine loan pricing.

Table 4.3

Current versus new risk weights for selected sovereigns

	Rating	OECD	Risk weight (%)[1]	
			Current	New
Argentina	B–	No	100	100
Brazil	BB–	No	100	100
Chile	A	No	100	20
China	A–	No	100	20
Colombia	BB	No	100	100
Czech Republic	A–	Yes	0	20
Greece	A	Yes	0	20
Hungary	A–	Yes	0	20
Indonesia	B+	No	100	100
Israel	A–	No	100	20
Korea	A	Yes	0	20
Malaysia	A–	No	100	20
Mexico	BBB	Yes	0	50
Peru	BB	No	100	100
Poland	BB	Yes	0	100
Russia	BBB	No	100	50
Singapore	AAA	No	100	0
South Africa	BBB+	No	100	50
Thailand	BBB+	No	100	50
Turkey	BB–	Yes	0	100
Venezuela	B+	No	100	100

[1] The 100% risk weighting implies a capital charge of 8%.

Sources: Standard & Poor's; BIS.

Third, Basel II could affect the flows of credit within EMEs. The impact of the new framework will depend on the treatment of domestic and foreign banks located in EMEs. Many domestically owned banks are likely to adopt the standardised approach, under which minimum capital charges are unlikely to change much. Indeed, the majority of corporate exposures in EMEs are likely to fall into the "unrated" category, which will attract an 8% charge. The impact of Basel II on the local operations of foreign banks is the subject of a more intense debate. Foreign bank participation in certain EMEs is concentrated in a few internationally active banking groups, which are generally sufficiently sophisticated to adopt the IRB approach. One concern is that foreign banks operating on the IRB approach will enjoy a competitive advantage over domestic banks operating under the standardised approach. However, according to some analysts this outcome is unlikely because foreign banks on the IRB approach will be facing higher capital charges for low credit quality business than domestic banks operating on the standardised approach (Hayes and Saporta (2002)).[13]

[13] Moreover, the adoption of the most advanced approaches will not automatically reduce capital requirements. In fact, the move to a closer approximation of capital requirements to actual risks could lead to an increase in capital requirements for banks having a higher level of credit risk than that prevailing under the Basel I framework. In addition, regulators will have the freedom to impose more stringent capital requirements than those of Basel I or Basel II.