

SURVEY REPORT ON THE IMPLEMENTATION OF THE BASEL FRAMEWORK



CONTENTS

| | |
|---|----|
| INTRODUCTION | 3 |
| ABOUT THE SURVEY | 4 |
| KEY FINDINGS | 5 |
| <i>Broad Implementation of the Basel Framework</i> | 5 |
| <i>Measuring the Impact of the Adoption of the Basel Framework on Financial Inclusion</i> | 8 |
| <i>Mitigating the Impact of Global Standards on Financial Inclusion through Proportionality</i> | 8 |
| <i>Challenges of Implementing Proportionality in the Basel Framework</i> | 11 |
| ANNEX | |
| Detailed Survey Results | 12 |

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INTRODUCTION

Since the 2007-08 global financial crisis, international standard-setting bodies (SSBs) have introduced various global standards to guide national regulators and policymakers on the design and implementation of regulatory frameworks that minimize risk and promote a safe and sound financial system.

However, these global standards are widely considered to pose a challenge to developing countries as they can restrict the innovation and adoption of new products and services that would promote greater access to finance.

In 2010, the G20 Principles for Innovative Financial Inclusion were developed to create an enabling policy and regulatory environment for innovative financial inclusion. The eighth principle, which relates to proportionality, calls for building a policy and regulatory framework that is proportionate to the risks and benefits of innovative products and services, and which addresses the gaps and barriers in existing regulation. In July 2014, the members of the Alliance for Financial Inclusion (AFI) created the Global Standards Proportionality (GSP) Working Group,¹ a peer learning platform for policymakers and regulators aiming to strike a balance between financial inclusion, integrity and stability, and to examine the proportionate implementation of standards set by the global SSBs.

In May 2015, the global symposium, “Towards Proportionality in Practice: Financial Inclusion and Implementation of Global Standards”, was held in Kuala Lumpur (KL), co-hosted by Bank Negara Malaysia, the Toronto Centre and AFI. The adopted KL Resolution of Proportionality in Practice, calls for data and evidence on the impact of implementing global financial stability standards in developing countries, highlighting the costs of unintended consequences and the benefits of proportionate approaches. It also calls for continued peer learning on successful approaches to implementing proportionality globally.

Over the years, the SSBs have incorporated the goal of financial inclusion and a proportionate approach to regulation in their standards and guidance.² For the Basel Committee on Banking Supervision (BCBS), the concept of proportionality is embedded in the revised (2012) Basel Core Principles for Effective Banking Supervision (BCP). The BCP emphasizes that supervisory practices must be commensurate with the risk profile and systemic

importance of the banks being supervised. As a general approach, the BCP sets out the promotion of safety and soundness of banks and the banking system as the primary objective for banking supervision. It also recognises that jurisdictions may assign additional responsibilities to the banking supervisor, explicitly including financial inclusion and financial consumer protection, provided they do not conflict with this primary safety and soundness objective.

¹ Established as a successor to the Financial Integrity Working Group (FINTWG).

² <https://www.gpfi.org/publications/issues-paper-2-proportionality-practice-across-standard-setting-bodies-applying-standards-and>

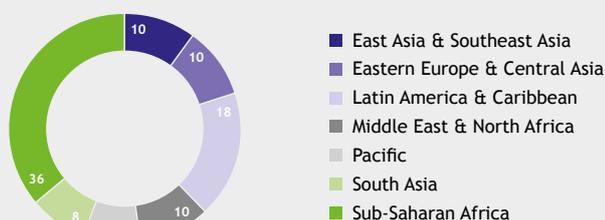
ABOUT THE SURVEY

The survey on the implementation of the Basel framework was distributed to members of the Global Standard Proportionality Working Group (GSPWG) in October 2017 and to the broader AFI network in May and June 2018. The purpose of the survey was to better understand the current approach and practices of AFI member institutions in implementing the Basel framework in their respective jurisdictions. The analysis in this survey report is intended to provide a snapshot of how AFI member institutions are implementing the Basel framework, including applying proportionality to the standards, and the challenges they face.

The survey asked 13 questions in four main areas: (i) broad implementation of the Basel framework; (ii) measuring the impact of the Basel framework on financial inclusion; (iii) mitigating the impact of implementing the Basel framework on financial inclusion through proportionality; and (iv) challenges of implementing proportionality in the Basel framework.

Responses were received from members in 39 jurisdictions, including 14 countries from Sub-Saharan Africa; seven from Latin America & Caribbean; four from East Asia and Southeast Asia; four from Europe & Central Asia; four from the Middle East & North Africa; three from the Pacific; and three from South Asia (Figure 1).

FIGURE 1: DISTRIBUTION OF SURVEY RESPONDENTS BY REGION (%)



KEY FINDINGS

BROAD IMPLEMENTATION OF THE BASEL FRAMEWORK

The Basel regulatory framework comprises a set of minimum global standards issued by the BCBS. Although the Basel standards are designed to apply to large and internationally active banks, many jurisdictions have decided to apply the Basel standards to a wider range of banks. The foundations of the framework were laid by the BCBS in 1988. The 1988 Capital Accord (Basel I) set a minimum risk-based capital requirement for banks as the main instrument for limiting risks and losses to protect financial beneficiaries, including depositors. Under the Basel I standards, banks were required to set aside capital for credit risk, and market risk was added in 1996. The Basel I standards required that internationally active banks maintained a capital ratio of no lower than eight percent based on the definition of regulatory capital and risk-weighted assets (RWAs). Over time, the Basel I standards were assessed to be too rudimentary amid the progress in risk management, the increasing complexity of banking businesses and the growing importance of cross-border activities in the banking sector.³

The Basel II framework published in 2004 aimed to improve the way regulatory capital requirements reflect underlying risks and better address recent financial innovations. The key objective of Basel II was to better match capital requirements to risks by improving risk-sensitivity and including operational risk.⁴ Basel II introduced a three-pillar approach by: (i) extending the minimum capital requirements (Pillar 1); (ii) emphasizing the importance of an adequate supervisory review process for every bank's capital planning (Pillar 2); and (iii) enhancing market discipline through mandatory disclosure (Pillar 3).

The Basel III framework was developed in response to the 2007-08 global financial crisis to strengthen the regulation, supervision and risk management of banks. The banking sector entered the financial crisis with too much leverage and inadequate liquidity buffers,⁵ and these weaknesses were accompanied by poor governance and risk management and inappropriate incentive structures. The Basel III framework introduced stricter requirements for the quality and quantity of regulatory capital, a leverage ratio, liquidity measures and additional requirements for systemically important banks.

BASEL I IMPLEMENTATION

- > According to the GSPWG survey, all respondents have implemented the Basel I framework (Figure 2), 74 percent of whom have adopted the framework in full while 26 percent have adopted part of the framework.
- > A few respondents explained that implementation is not complete as they have not implemented the requirements relating to market risks. However, these regulations are currently being developed or implemented in a pilot conducted under the Basel II framework (Superintendencia de Bancos de Guatemala and Banco Central de São Tomé e Príncipe).

FIGURE 2: IMPLEMENTATION OF THE BASEL I FRAMEWORK

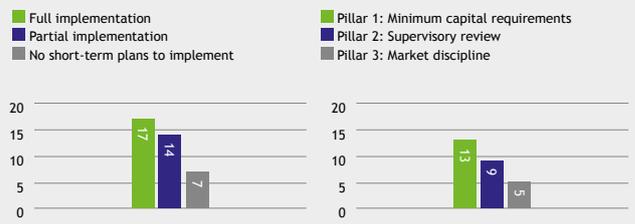
What is the status of adoption for Basel I Framework in your country?



FIGURE 3: IMPLEMENTATION OF THE BASEL II FRAMEWORK

What is the status of adoption for Basel II Framework in your country?

If "partial implementation" for Basel II, please indicate which component is implemented



Source: AFI Survey on Basel Implementation

BASEL II IMPLEMENTATION

- > More than 80 percent of respondents have implemented the Basel II framework (Figure 3), 45 percent of whom have fully adopted the framework while 37 have adopted the framework in part.
- > Of the respondents that have partially implemented the Basel II framework, almost all (93 percent) implemented the Pillar 1 minimum capital requirements, while 64 percent have implemented the Pillar 2 supervisory review requirement. Only about 36 percent have adopted the Pillar 3 market discipline requirements.
- > Some respondents that have partially implemented the Basel II framework explained that the Basel II requirements could not be fully implemented due to market structure challenge (Bank of Papua New Guinea). For some institutions, all three pillars are currently running as a pilot as regulations have not been finalized (Bank of Zambia).
- > The 18 percent of respondents with no short-term plan to implement the Basel II requirements provided the following explanations:
 - The financial system in their jurisdiction is relatively simple and would not require the complex requirements under the Basel II framework (Banque de la République d'Haiti).
 - The Basel I framework is currently considered to be most applicable to the existing financial system (National Reserve Bank of Tonga, Reserve Bank of Fiji).
 - A lack of capacity and resources to implement the Basel II framework (Bank of Sierra Leone).

³ <https://www.bis.org/bcbs/publ/d383.pdf>

⁴ <https://www.bis.org/fsi/publ/insights1.pdf>

⁵ <https://www.bis.org/bcbs/history.htm>

INFORMATION BOX 1: IMPLEMENTATION OF THE BASEL II FRAMEWORK BY BANK OF RUSSIA

The credit risk calculation requirement is based on a simplified standardised approach (SSA). In September 2015, Bank of Russia issued the Internal Rating Based (IRB) regulation, which gives banks an opportunity to seek approval from the Bank of Russia to use the IRB approach for regulatory capital calculations.

Market risk capital charge calculation is based on the standardised approach in line with the Basel standards. General interest rate risk is calculated using the maturity method, while the simplified approach is used for commodities risk. The delta-plus method is used for options. For equity position risk, the specific approach for arbitrage strategies has not been implemented as it is not applicable. The Basel 2.5 securitisation framework regulation was implemented and does not provide for an exemption of correlation trading portfolios from the standard risk weights of exposures in the trading book.

Bank of Russia issued the regulations on Internal Capital Adequacy Assessment Process (ICAAP) requirements for banks and the Supervisory Review and Evaluation Process (SREP) methodology in April 2015 and December 2015, respectively. The first assessment of ICAAP of the largest banks was undertaken by Bank of Russia in 2017. A draft regulation, which implements the revised requirements on the disclosure according to the BCBS's Revised Pillar 3 Disclosure Requirements (January 2015) was published in December 2016. Bank of Russia issued the final rule in 2017 and banks were required to publish their first Pillar 3 report under the revised framework concurrently with their Q1 2018 intermediate financial report.

INFORMATION BOX 2: IMPLEMENTATION OF THE BASEL II FRAMEWORK BY THE CENTRAL BANK OF EGYPT

Implementation of the Basel II standards commenced in Q1 2008 following an experimental implementation period in 2007. As a first step, the simple methods permissible under the Basel II capital adequacy standards were applied. These included the standardized approach for credit and market risks and the application of the basic indicator approach for measuring operational risk. The implementation of more advanced methods was postponed for five years.

Upon the actual implementation of Basel II in Q1 2008, banking institutions were required to submit to the Central Bank of Egypt their capital adequacy forms based on the Basel II requirements. In parallel, banks were also required to continue submitting their capital adequacy form in accordance with the Basel I standards until 31 March 2009. The central bank verified the accuracy of the calculations in accordance with the new instructions by sending a specialized team that conducted field checks on the data of 15 banks until September 2009.

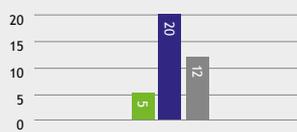
BASEL III IMPLEMENTATION

- > About 68 percent of respondents have implemented the Basel III framework (Figure 4). Of these, 14 percent have fully adopted the framework while 54 percent have adopted the framework in part. The remaining third of respondents have no short-term plans to adopt the requirements.
- > For countries that have partially implemented the Basel III framework, implementation has focused mainly on capital requirements (80 percent) and liquidity coverage ratio (LCR) (65 percent). Only 35 percent of those that partially implemented the Basel III framework adopted the net stable funding ratio.
- > A few member institutions have implemented requirements relating to capital conservation buffer (Central Bank of Egypt, Bank of Tanzania).
- > Some respondents that have partially implemented the Basel III framework explained that the Basel III requirements cannot be fully implemented despite the goodwill and encouragement of supervisors due to challenges the financial institutions face in implementing the requirements (Reserve Bank of Zimbabwe).
- > The 32 percent of respondents with no short-term plan to implement the Basel III requirements provided the following explanations:
 - The central bank lacks the capacity and resources to implement Basel III (Bank of Sierra Leone).
 - The Basel I framework is currently considered the most applicable to the existing financial system (National Reserve Bank of Tonga).
 - There are plans to adopt only some aspects of the Basel III framework, such as the leverage ratio and capital conservation buffer (Central de São Tomé e Príncipe).

FIGURE 4: IMPLEMENTATION OF THE BASEL III FRAMEWORK

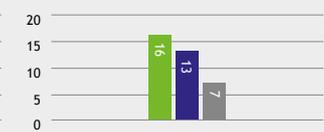
What is the status of adoption for Basel III Framework in your country?

■ Full implementation
■ Partial implementation
■ No short-term plans to implement



If "partial implementation" for Basel III, please indicate which component is implemented

■ Capital
■ Liquidity Coverage Ratio
■ Net Stable Funding Ratio



Source: AFI Survey on Basel Implementation

INFORMATION BOX 3: IMPLEMENTATION OF THE BASEL III FRAMEWORK BY THE CENTRAL BANK OF EGYPT

- > In 2015, the Central Bank of Egypt (CBE) issued a regulation on leverage ratio for compliance with standards issued by the BCBS in January 2014.
- > In April 2016, the requirements on conservation capital buffer were implemented, taking into consideration the transitional arrangements in line with Basel III.
- > In July 2016, the CBE issued a regulation on liquidity risk management that included the qualitative requirement for managing this risk and the implementation of liquidity coverage ratio (with the transitional arrangements in line with Basel III) and the net stable funding ratio.
- > In May 2017, the CBE issued a circular that sets out the methodology for identifying domestic systemically important banks (D-SIBs) and the additional capital charge calculations that will be effective in January 2019.

INFORMATION BOX 4: IMPLEMENTATION OF THE BASEL III FRAMEWORK BY THE CENTRAL BANK OF JORDAN

In October 2011, the Central Bank of Jordan (CBJ) issued a circular to licensed banks requiring them to review the impacts of implementing Basel III on: (i) capital adequacy ratio (CAR); (2) ratio of permanent net financing and liquidity coverage ratio (LCR); (3) leverage ratio; (4) return on equity (ROE) and dividends policy; (5) systems, data, reporting and information technology; and (6) strategic plan.

The circular also required banks to evaluate their ability according to Basel III requirements in the following areas: (i) determining the capital needed to meet the financial risks they may be exposed to and predicting the capital needed to meet any stress-testing scenarios; (ii) matching the current reserves with the required reserves according to Basel III; and (iii) updating the corporate governance of banks. The circular requested that the report be based on financial statements ending June 2011, and to report the results to the CBJ by the end of December 2011. The reporting timeline was subsequently postponed to the end of June 2012, based on financial statements ending December 2011. The Basel III regulatory capital framework was issued by the CBJ in 2016.

INFORMATION BOX 5: IMPLEMENTATION OF THE BASEL III FRAMEWORK BY BANGKO SENTRAL NG PILIPINAS

Bangko Sentral ng Pilipinas (BSP) continuously undertakes regulatory reforms aimed at aligning its policies, rules and procedures with the Basel III standards. Specifically, these reforms include the following:

1 Capital Requirement and Capital Conservation Buffer

- Circular No. 781 dated 15 January 2013 sets out the following requirements: (i) new minimum capital ratios of six percent Common Equity Tier 1 (CET1) ratio, 7.5 percent Tier 1 ratio and total CAR remains at 10 percent; and (ii) a capital conservation buffer of 2.5 percent. The requirements are applicable to all

universal and commercial banks (U/KBs) and their subsidiary banks and quasi-banks (QBs) and takes effect 1 January 2014.

2 Domestic Systemically Important Banks (D-SIBs)

- Circular No. 856 dated 29 October 2014 provides the framework for dealing with D-SIBs to maintain higher loss absorbency (HLA) capital in the form of CET1 capital. The HLA requirement is set at 1.5 to 3.5 percentage points depending on the bucket classification as applied on top of the minimum CET1 ratio of six percent and the CCB of 2.5 percent. Phased-in implementation commenced 1 January 2017 with full compliance on 1 January 2019.
- Circular No. 904 dated 10 March 2016 provides the guidelines requiring D-SIBs to submit a recovery plan, which is a detailed list of options or courses of action that will be taken by the D-SIB to address a range of severe stress scenarios to restore its financial strength and viability. The recovery plan forms part of the ICAAP of the bank.

3 Leverage Ratio Framework, including disclosure requirements

- Circular No. 881 dated 9 June 2015 provides the implementing guidelines of the BSP's Leverage Ratio of no lower than five percent, which serves as a back stop measure to the CAR. It is expressed as the ratio of capital measure to exposure measure. Capital measure is given by Tier 1 capital while exposure measure consists of on-balance sheet items, derivatives, securities financing transactions and off-balance sheet items. The monitoring period was from 31 December 2014 to 31 December 2016.
- Circular 990 dated 22 January 2018 provides the approval of the extension of the monitoring period to 30 June 2018. The regulation took effect 1 July 2018 as a Pillar 1 requirement.

4 Liquidity Coverage Ratio (LCR) Framework, including disclosure requirement

- Circular No. 905 dated 10 March 2016 provides the guidelines on LCR requiring banks to maintain an adequate level of unencumbered high-quality liquid assets (HQLAs) over a 30-day time horizon to promote short-term resilience of banks, particularly during significant liquidity stress events. The circular was first rolled out in March 2016 and initially applied to U/KBs.
- Circular No. 996 dated 8 February 2018 provides a revised LCR framework applicable to U/KBs and their subsidiary banks and quasi-banks to be consistent in the management of liquidity risk across a financial group. Phased-in implementation will be from 2016 to 2018, will full implementation on 1 January 2019.

5 Net Stable Funding Ratio (NSFR)

- Guidelines on NSFR were approved by the BSP Monetary Board on 24 May 2018; and a related circular was prepared for publication. They promote longer term resilience by requiring banks to fund their activities with more stable sources of funding over a one-year period. Beginning 1 January 2019, all U/KBs and their subsidiary banks and QBs shall maintain an NSFR of 100 percent on both solo and consolidated bases. The observation period is effective until 31 December 2018.

MEASURING THE IMPACT OF THE ADOPTION OF THE BASEL FRAMEWORK ON FINANCIAL INCLUSION

Enhanced capital and liquidity regulations can help to create a more robust banking system less prone to crises, which tend to have major macroeconomic effects in terms of foregone output. Tighter regulatory standards may also lead to smaller output fluctuations and, therefore, higher welfare even in the absence of banking crises.⁶ On the other hand, money set aside as regulatory capital against credit, operational and market risks, and for liquidity risk can be costly to banking institutions and potentially reduce access to finance either through the cost of borrowing or lower loan volumes. While the contraction of credit can be harmful for any economy, the impact on emerging markets is far greater given their less developed capital markets and higher levels of financial exclusion.⁷

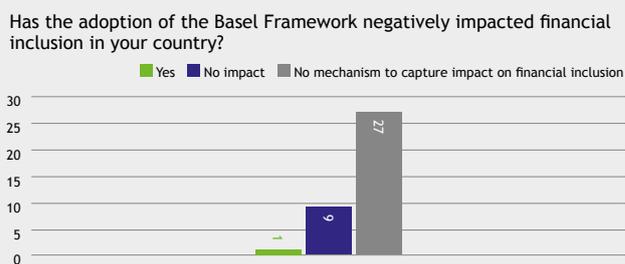
According to the GSPWG survey:

- > Most respondents (73 percent) indicated that they currently do not have any mechanism to measure the impact of the Basel standards on financial inclusion.
 - Some countries indicated that while there is no formal mechanism in place to measure the impact, the continued offering of products and services by banking institutions provided some evidence that the Basel reforms have not adversely affected financial inclusion (Bangko Sentral ng Pilipinas).
- > About 24 percent of respondents indicated that the Basel standards have not had an impact on financial inclusion (Figure 5).
 - Some respondents indicated that banks were already operating at levels above the minimum Basel capital and liquidity requirement. As such, compliance with the Basel standards has not altered the behaviors of banks or had a negative impact on financial inclusion (Bank of Thailand).
 - In fact, given that some banks were already sufficiently capitalised, they were well positioned to pursue financial inclusion activities through agent banking and digitization (Reserve Bank of Malawi).
- > Only one respondent (or three percent) thought the standards were having a negative impact on financial inclusion.
 - These negative impacts were identified as more expensive financial services; fewer financial services; and more expensive client onboarding (National Bank of Angola).

MITIGATING THE IMPACT OF GLOBAL STANDARDS ON FINANCIAL INCLUSION THROUGH PROPORTIONALITY

A major aspect of proportionality relates to differentiation: the extent to which regulation is applied to banks should reflect their specific circumstances.⁸ The principle of proportionality is acknowledged in the BCP. Principle 8 states: “Supervisory approach: An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address

FIGURE 5: THE IMPACT OF THE BASEL FRAMEWORK ON FINANCIAL INCLUSION



Source: AFI Survey on Basel Implementation

risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable”.

The application of proportionality is embedded in several aspects of the Basel standards. Pillar 2 is one example, as supervisors will, in exercising their judgement, consider the size, complexity, business model and risk profiles of individual banks. Basel II also offers a menu of approaches ranging from simpler approaches to more advanced ones for calculating risk-weighted assets (RWAs) for credit risk, market risk and operational risks. For credit risk management, large banks are incentivised to develop their own internal ratings (i.e. internal-ratings based (IRB) approach) while smaller institutions are provided with a simplified approach by relying on external credit assessments. More generally, capital charges are graduated according to each bank’s portfolio mix including, for example, equity holdings, project finance exposures and retail loans.⁹

According to the AFI survey:

- > More than half (52 percent) of respondents have adopted new credit categories and corresponding lower capital and liquidity requirements to mitigate the impact of global standards on financial inclusion (Figure 6).
 - For example, Bangko Sentral ng Pilipinas (BSP) allows lower risk weight for banks’ micro, small and medium-size enterprises (MSMEs) loan portfolios that meet prudential standards consistent with the treatment under Basel II. This is based on the premise that retail and SME credit are found to be less sensitive to systemic risk and have shorter maturity periods. Thus, qualified MSME and microfinance loan portfolios are assigned a 75 percent risk weight (please refer to Information Box 5 for more details).
 - Of those that have adopted new credit categories and

6 <https://www.bis.org/publ/bcbs173.pdf>

7 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3007433, <https://www.law.ox.ac.uk/business-law-blog/blog/2017/09/dark-side-implementation-basel-capital-requirements>

8 <https://www.eba.europa.eu/documents/10180/807776/European+Banking+Authority+Banking+Stakeholder+Group+Position+paper+on+proportionality.pdf>

9 Ibid.

corresponding lower prudential requirements, 24 percent of respondents indicated that the approach has been accepted by assessors, while 76 percent responded that the approach has not yet been evaluated by assessors.

- > Only about one-third of respondents have implemented a tiered approach in the Basel pillars proportionate to the characteristics of the sector (Figure 7).
 - For example, in Russia, Basel standards are applicable to all credit institutions regardless of their size and complexity, but domestic systemically important banks (D-SIBs) are subject to more sophisticated requirements. The proportionality principle is used, for example, with Pillar 2 implementation. In accordance with the ICAAP regulation, D-SIBs must use advanced risk assessment processes. They are also subject to a capital surcharge (“systemic importance capital buffer”). D-SIBs are subject to the requirements of the liquidity coverage ratio (LCR) and the additional capital adequacy requirements in accordance with Basel III. Effective 1 January 2018, D-SIBs are also subject to the net stable funding ratio (NSFR).
 - Of those that have implemented a tiered approach to the Basel pillars, only 27 percent indicated that the approach has been accepted by assessors.
- > Only 27 percent of respondents have adopted the internal-ratings based (IRB) approach to justify lower capital requirements proportionate to lower risk (Figure 8).
 - Of those that have adopted the IRB approach, 67 percent indicated that their approach has not been assessed by assessors. Two respondents (22 percent) reported that the approach had been accepted by the assessor and one (11 percent) indicated that the approach had not been accepted.
- > Apart from the above three measures, some respondents (14 percents) had adopted other proportionate approaches to mitigate the impact of the Basel framework on financial inclusion (Figure 9).
 - Bank of Russia has made amendments to the banking law to stipulate proportionate regulation (in force since June 2017). According to these amendments, banks are divided into those with universal and basic licenses, and they are subject to differentiated regulations. For example, the minimum capital amount for banks with a basic license (BBL) is 300 million rubles, and one billion rubles for universal banks. BBLs are subject to some restrictions in conducting operations with foreign counterparties, i.e. they have no right to open corresponding accounts with foreign banks. The Internal Capital Adequacy Assessment Process (ICAAP) results of BBLs should be assessed once every two years. BBLs are not required to disclose information on risks and capital management procedures.
 - Bangko Sentral ng Pilipinas (BSP) introduced differentiated minimum prudential liquidity requirements for stand-alone thrift banks, rural banks, cooperative banks and quasi-banks (see Information Box 6 for more details).
 - All respondents indicated that their approaches have not been evaluated by assessors yet.

FIGURE 6: ADOPTION OF NEW CREDIT CATEGORIES AND LOWER CAPITAL AND LIQUIDITY REQUIREMENTS

Is the definition of new credit categories such as small enterprise loans and microenterprise loans and corresponding lower capital/ liquidity requirements adopted in your country to mitigate the impact of global standards on financial inclusion? How have assessors assessed this approach?

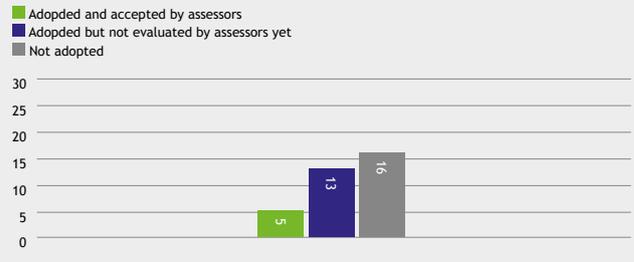


FIGURE 7: ADOPTION OF TIERED IMPLEMENTATION OF THE BASEL PILLARS PROPORTIONATE TO SECTOR CHARACTERISTICS

Is tiered implementation of Basel pillars proportionate to sector characteristics adopted in your country to mitigate the impact of global standards on financial inclusion? How have assessors assessed this approach?

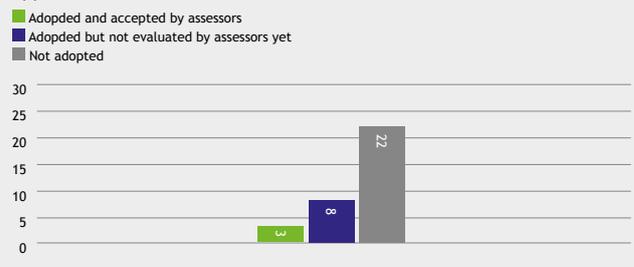


FIGURE 8: ADOPTION OF THE INTERNAL RATINGS-BASED (IRB) APPROACH TO JUSTIFY LOWER CAPITAL REQUIREMENTS

Is the use of Internal Ratings-Based (IRB) approach to justify lower capital requirements proportionate to lower credit risk adopted in your country to mitigate the impact of global standards on financial inclusion? How have assessors assessed this approach?

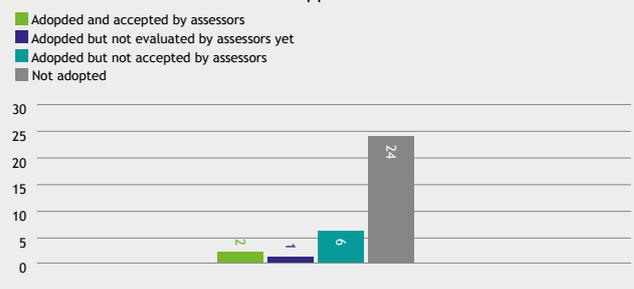


FIGURE 9: OTHER PROPORTIONATE APPROACHES TO MITIGATE THE IMPACT OF THE BASEL FRAMEWORK ON FINANCIAL INCLUSION

Besides the three measures mentioned above, are there other proportionate approaches adopted in your country to mitigate the impact of Basel framework on financial inclusion?



INFORMATION BOX 6: PROPORTIONATE APPROACHES TAKEN BY BANGKO SENTRAL NG PILIPINAS TO MITIGATE THE IMPACT OF BASEL IMPLEMENTATION ON FINANCIAL INCLUSION

Definition of New Credit Categories

Consistent with Basel II, Bangko Sentral Pilipinas (BSP) allows a lower risk weight for banks' micro, small and medium-sized enterprises (MSMEs) loan portfolios that meet prudential standards. This is based on the premise that retail and SME credit are less sensitive to systemic risk and have shorter maturity periods. Thus, qualified MSME and microfinance loan portfolios are assigned a 75 percent risk weight.

Under existing BSP regulations, MSMEs are business enterprises engaged in industry, agribusiness and/or services with total assets (exclusive of land) that do not exceed P3 million for microenterprises, P15 million for small enterprises and P100 million for medium-scale enterprises. For SMEs, exposures may take the form of direct loans or committed credit lines. To qualify for a lower risk weight, the MSME portfolio must be highly diversified, i.e. have at least 500 borrowers distributed over a number of industries.

All MSME exposures in the qualified portfolio must be current. All non-current MSME exposures are excluded from the count and are to be treated as ordinary non-performing loans. Current MSME exposures not qualifying under highly diversified MSME portfolios are risk weighted based on an external rating and are risk-weighted in the same manner as corporate exposures.

Tiered Implementation of the Basel Pillars

The BSP adheres to the principle of proportionality by taking domestic financial market conditions into account. Thus, the implementation of Basel III reforms is being calibrated in terms of content and sequencing to better suit the local landscape. Regulatory flexibility is exercised in certain cases as long as statutory requirements are not compromised and the interests of the depositing and investing public are protected.

Recognizing the importance of proportionality in its supervision approach, the BSP issued a separate risk-based capital adequacy framework, the Basel 1.5 framework for thrift banks (TBs), rural banks (RBs) and cooperative banks (CBs) that are not subsidiaries of universal and commercial banks (U/KBs). This simplified version of Basel II takes the simple operations/business models of these banks into account. The implementing guidelines of Basel 1.5 are contained in Circular No. 688, which took effect in January 2012.

The Basel 1.5 framework contains only a few key changes to the existing Basel I framework. These changes include, among others, an increase in risk weight for foreign currency-denominated exposures to the Philippine national government based on the country's sovereign rating (from 0 percent to 50 percent), and the Real and Other Properties Acquired (from 100 percent to 150 percent). The Basel 1.5 framework also includes a capital requirement for operational risk using the Basic Indicator Approach.

The International Monetary Fund (IMF) and The World

Bank conducted a joint Financial Sector Assessment Program (FSAP) review for the Philippines in November 2009. The FSAP assesses the strengths and weaknesses of the financial sector. The results of the review are in the Technical Notes of "Focused Update of the Basel Core Principles for Effective Banking Supervision (BCP)" and "Access to Finance", both on The World Bank website.

Other proportionate approaches adopted by BSP to mitigate the impact of the Basel framework on financial inclusion are:

- i Risk-weighting of bank loans to the extent guaranteed by Credit Surety Fund (CSF) Cooperatives
 - To further support the growth of micro, small and medium enterprises (MSMEs), BSP Circular No. 979 dated 25 October 2017 was issued to amend the risk-based capital adequacy framework for banks by assigning a lower risk weight of 20 percent on performing loans to MSMEs to the extent guaranteed by a qualified CSF Cooperative. The existing regulations provide that a 75 percent risk weight shall be applied to qualified MSME portfolios.
 - A qualified CSF Cooperative refers to a cooperative that is organized consistent with the provisions of the Republic Act (R.A.) No. 10744 (Credit Surety Fund Cooperative Act of 2015) and its implementing rules and regulations. The CSF Cooperative must have an initial leverage ratio of three, which means it can guarantee MSME loans up to three times its capital. The leverage ratio can be subsequently increased subject to review of its performance. This policy intends to facilitate an increased flow of funds to MSMEs to promote the growth of the sector and the domestic economy. The CSF program was first launched by the BSP in 2008 with the aim to enhance the creditworthiness of MSMEs. The program was institutionalized with the enactment of R.A. No. 10744 on 6 February 2016.
- ii Minimum prudential liquidity requirements for stand-alone TBs, RBs, CBs and QBs
 - The BSP requires only U/KBs and their subsidiary banks and QBs to comply with the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).
 - Smaller institutions – stand-alone TBs, RBs, CBs and QBs – are subject to the Minimum Liquidity Ratio (MLR), which is better suited to their simpler liquidity risk profile. The calculation of the liquidity ratio is simple and straightforward. It is expressed as a percentage of a covered institution's eligible stock of liquid assets to its total qualifying liabilities. The stock of liquid assets are required to be unencumbered and readily liquefiable, while the qualifying liabilities include both on-balance sheet and off-balance sheet commitments. TBs, RBs, CBs and QBs, will be required to monitor the level of their respective ratios throughout 2018. The MLR takes effect 1 January 2019. The BSP considers the adoption of the LCR, NSFR and MLR a significant step in aligning its supervisory framework with international standards. It also illustrates the BSP's commitment to the application of proportionality in its approach to supervision.

CHALLENGES OF IMPLEMENTING PROPORTIONALITY IN THE BASEL FRAMEWORK

The application of proportionality in a regulatory and supervisory approach is not a straightforward task. One of the key challenges of implementing a proportionate approach is that risks and benefits are often perceived and measured differently by different stakeholders. Moreover, as highlighted earlier in this survey report, some risk implications (and benefits) cannot be easily or definitively quantified, although qualitative analysis is possible. The challenges of risk and benefit assessment multiply in complexity when the various regulatory and supervisory standards of the SSBs are applied across different products, services and institutions. The difficulty of implementing the different standards and guidance will challenge even those policymakers, regulators and supervisors in countries with relatively higher levels of regulatory and supervisory capacity and financial inclusion. For countries with less capacity and financial inclusion, the challenge will be even greater.¹⁰

According to the AFI survey:

- > Inadequate national infrastructure and systems to capture data and develop the standards was identified as the biggest challenge to implementing the Basel framework in a proportionate manner. About half (52 percent) of respondents highlighted this as a challenge (Figure 10).
- > Other key challenges relate to the conservative application of standards by national regulators due to the uncertainty of assessors' stances (28 percent of respondents). Lack of expertise and knowledge among national regulators to develop proportionate standards was also perceived as a major challenge (28 percent of respondents).
- > Respondents identified other challenges as well:
 - The Basel standards are complex given the relatively small financial system (Banco Central de São Tomé e Príncipe).
 - Inadequate information technology (IT) systems in financial institutions to capture relevant information for regulatory reporting (Bangko Sentral ng Pilipinas).

- Broader legal reforms may be needed to fully implement the Basel framework (Central Reserve Bank of El Salvador). In some instances, the banking law, which requires regulations to be applied in the same way for all financial institutions, may affect the ability of regulators to apply proportionality (Guatemala).
- Challenging economic conditions can pose additional challenges and a lack of expertise in the banking sector makes it challenging for banks to fully implement the Basel II requirement (Da Afghanistan Bank).
- For jurisdictions with different types of financial institutions, it is more complex to implement regulations that are proportionate to the business and risk profiles of the financial institutions. For example, Bank of Russia has four sets of regulative requirements for D-SIBS, universal banks, banks with the basic license and non-banking credit institutions.

INFORMATION BOX 7: CHALLENGES FACED BY BANGKO SENTRAL NG PILIPINAS IN IMPLEMENTING THE BASEL FRAMEWORK IN A PROPORTIONATE MANNER

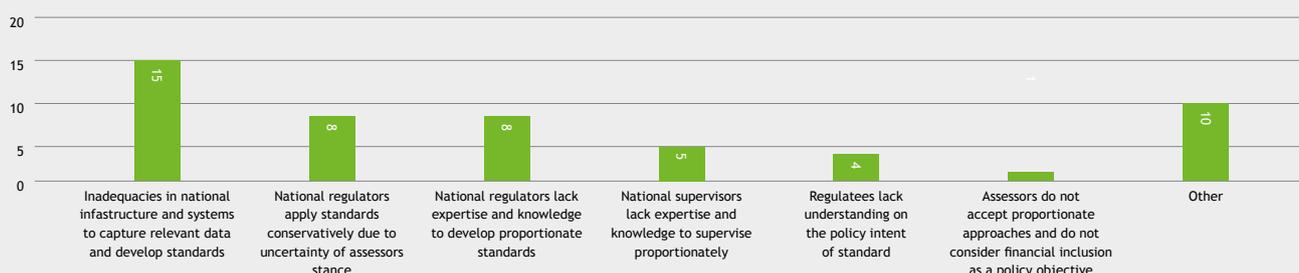
A key challenge is the readiness of BSP-supervised financial institutions' information technology (IT) systems to capture relevant information required for reporting to the BSP. Some of the data needed to determine with higher precision whether certain reforms are suitable is not readily available to the BSP, as this data has not yet been captured by existing IT systems.

To address this challenge, the BSP invests resources in engaging stakeholders early in the policy formulation process and in regular consultations. Financial institutions are also given ample time to transition to the new prudential standards and to assess the impact of these standards on their operations. After the prescribed observation period, the BSP reassesses whether further calibration is necessary to ensure regulatory requirements are proportionate to the nature, size and complexity of the financial institution's operations.

¹⁰ <http://www.gpfi.org/publications/issues-paper-2-proportionality-practice-across-standard-setting-bodies-applying-standards-and>

FIGURE 10: CHALLENGES OF IMPLEMENTING THE BASEL FRAMEWORK IN A PROPORTIONATE MANNER

What are the key challenges faced in implementing the Basel Framework in a proportionate manner for your country?



Note: Respondents can select more than one

Source: AFI Survey on Basel Implementation

ANNEX: DETAILED SURVEY RESULTS

1. WHAT IS THE STATUS OF ADOPTION FOR BASEL I FRAMEWORK IN YOUR COUNTRY?

| FULL IMPLEMENTATION | PARTIAL IMPLEMENTATION | NO SHORT-TERM PLANS TO IMPLEMENT |
|--|--|----------------------------------|
| 28 | 10 | - |
| Afghanistan, Angola, Argentina, Armenia, Bangladesh, Egypt, Fiji, Georgia, Haiti, Jordan, Malawi, Mexico, Mongolia, Namibia, Nigeria, Palestine, Papua New Guinea, Philippines, Russia, Seychelles, Sierra Leone, South Africa, Tajikistan, Tanzania, Thailand, Tonga, Vanuatu, Zimbabwe | Bhutan, Cambodia, Costa Rica, El Salvador, Guatemala, Honduras, São Tomé and Príncipe, Senegal, Uganda, Zambia | - |

2. WHAT IS THE STATUS OF ADOPTION FOR BASEL II FRAMEWORK IN YOUR COUNTRY?

| FULL IMPLEMENTATION | PARTIAL IMPLEMENTATION | NO SHORT-TERM PLANS TO IMPLEMENT |
|---|--|--|
| 17 | 14 | 7 |
| Argentina, Bangladesh, Egypt, Georgia, Jordan, Malawi, Mexico, Morocco, Namibia, Nigeria, Palestine, Philippines, Russia, South Africa, Thailand, Vanuatu, Zimbabwe | Afghanistan, Angola, Armenia, Bhutan, Cambodia, Costa Rica, Honduras, Mongolia, Papua New Guinea, São Tomé and Príncipe, Senegal, Seychelles, Tanzania, Zambia | El Salvador, Fiji, Guatemala, Haiti, Sierra Leone, Tonga, Uganda |

3. IN REFERENCE TO YOUR RESPONSE INDICATING “PARTIAL IMPLEMENTATION” OF BASEL II FRAMEWORK, PLEASE INDICATE WHICH COMPONENT IS IMPLEMENTED. PLEASE CHECK ALL THAT APPLY.

| PILLAR 1: CAPITAL | PILLAR 2: SUPERVISORY REVIEW | PILLAR 3: MARKET DISCIPLINE |
|--|---|--|
| 13 | 9 | 5 |
| Afghanistan, Angola, Armenia, Bhutan, Cambodia, Costa Rica, Honduras, Mongolia, São Tomé and Príncipe, Senegal, Seychelles, Tanzania, Zambia | Afghanistan, Angola, Armenia, Bhutan, Costa Rica, Honduras, Papua New Guinea, Senegal, Zambia | Angola, Armenia, Bhutan, Senegal, Zambia |

4. WHAT IS THE STATUS OF ADOPTION FOR BASEL III FRAMEWORK IN YOUR COUNTRY?

| FULL IMPLEMENTATION | PARTIAL IMPLEMENTATION | NO SHORT-TERM PLANS TO IMPLEMENT |
|--|--|---|
| 5 | 20 | 12 |
| Argentina, Egypt, Malawi, Mexico, South Africa | Angola, Armenia, Bangladesh, Bhutan, Cambodia, Costa Rica, Georgia, Honduras, Jordan, Morocco, Palestine, Papua New Guinea, Philippines, Russia, Seychelles, Tanzania, Thailand, Uganda, Vanuatu, Zimbabwe | Afghanistan, El Salvador, Fiji, Guatemala, Haiti, Mongolia, Nigeria, São Tomé and Príncipe, Sierra Leone, Tajikistan, Tonga, Zambia |

5. IN REFERENCE TO YOUR RESPONSE INDICATING “PARTIAL IMPLEMENTATION” OF BASEL III FRAMEWORK, PLEASE INDICATE WHICH COMPONENT IS IMPLEMENTED. PLEASE CHECK ALL THAT APPLY.

| CAPITAL | LIQUIDITY COVERAGE RATIO | NET STABLE FUNDING RATIO |
|--|---|--|
| 16 | 13 | 7 |
| Angola, Armenia, Bangladesh, Bhutan, Georgia, Jordan, Morocco, Papua New Guinea, Philippines, Senegal, Seychelles, Tanzania, Thailand, Uganda, Vanuatu, Zimbabwe | Angola, Bangladesh, Cambodia, Costa Rica, Georgia, Morocco, Palestine, Philippines, Russia, Senegal, Tanzania, Thailand, Uganda | Angola, Bangladesh, Palestine, Philippines, Russia, Thailand, Uganda |

6. HAS THE ADOPTION OF THE BASEL FRAMEWORK NEGATIVELY IMPACTED FINANCIAL INCLUSION IN YOUR COUNTRY?

| NO IMPACT | NO MECHANISM TO CAPTURE THE IMPACT | YES |
|---|--|--------|
| 9 | 27 | 1 |
| Bangladesh, Bhutan, Malawi, Namibia, Palestine, Papua New Guinea, Thailand, Tonga, Zambia | Afghanistan, Argentina, Armenia, Cambodia, Costa Rica, Egypt, El Salvador, Fiji, Georgia, Guatemala, Haiti, Honduras, Jordan, Mexico, Mongolia, Morocco, Nigeria, Philippines, Russia, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, South Africa, Tajikistan, Tanzania, Vanuatu | Angola |

7. IS TIERED IMPLEMENTATION OF BASEL PILLARS PROPORTIONATE TO SECTOR CHARACTERISTICS ADOPTED IN YOUR COUNTRY TO MITIGATE THE IMPACT OF GLOBAL STANDARDS ON FINANCIAL INCLUSION? HOW HAVE ASSESSORS ASSESSED THIS APPROACH?

| ADOPTED AND ACCEPTED BY ASSESSORS | ADOPTED BUT NOT EVALUATED BY ASSESSORS YET | NOT ADOPTED |
|-----------------------------------|---|--|
| 3 | 8 | 22 |
| Russia, South Africa, Vanuatu | Afghanistan, Angola, Honduras, Mongolia, Palestine, Philippines, Seychelles, Zambia | Argentina, Armenia, Bangladesh, Bhutan, Cambodia, Costa Rica, Egypt, El Salvador, Fiji, Georgia, Guatemala, Haiti, Jordan, Malawi, Mexico, Nigeria, São Tomé and Príncipe, Sierra Leone, Tajikistan, Tanzania, Thailand, Tonga |

8. IS THE DEFINITION OF NEW CREDIT CATEGORIES SUCH AS SMALL ENTERPRISE LOANS AND MICROENTERPRISE LOANS AND CORRESPONDING LOWER CAPITAL/LIQUIDITY REQUIREMENTS ADOPTED IN YOUR COUNTRY TO MITIGATE THE IMPACT OF GLOBAL STANDARDS ON FINANCIAL INCLUSION? HOW HAVE ASSESSORS ASSESSED THIS APPROACH?

| ADOPTED AND ACCEPTED BY ASSESSORS | ADOPTED BUT NOT EVALUATED BY ASSESSORS YET | NOT ADOPTED |
|--|--|--|
| 4 | 13 | 16 |
| Nigeria, Russia, South Africa, Vanuatu | Afghanistan, Angola, Argentina, Egypt, Georgia, Honduras, Mexico, Mongolia, Palestine, Philippines, Seychelles, Tajikistan, Zambia | Armenia, Bangladesh, Bhutan, Cambodia, Costa Rica, El Salvador, Fiji, Guatemala, Haiti, Jordan, Malawi, São Tomé and Príncipe, Sierra Leone, Tanzania, Thailand, Tonga |

9. IS THE USE OF INTERNAL RATINGS-BASED (IRB) APPROACH TO JUSTIFY LOWER CAPITAL REQUIREMENTS PROPORTIONATE TO LOWER CREDIT RISK ADOPTED IN YOUR COUNTRY TO MITIGATE THE IMPACT OF GLOBAL STANDARDS ON FINANCIAL INCLUSION? HOW HAVE ASSESSORS ASSESSED THIS APPROACH?

| ADOPTED AND ACCEPTED BY ASSESSORS | ADOPTED BUT NOT ACCEPTED BY ASSESSORS | ADOPTED BUT NOT EVALUATED BY ASSESSORS YET | NOT ADOPTED |
|-----------------------------------|---------------------------------------|---|--|
| 2 | 1 | 6 | 24 |
| South Africa, Vanuatu | Russia | Angola, Malawi, Mexico, Mongolia, Palestine, Zambia | Afghanistan, Argentina, Armenia, Bangladesh, Bhutan, Cambodia, Costa Rica, Egypt, El Salvador, Fiji, Georgia, Guatemala, Haiti, Honduras, Jordan, Nigeria, Philippines, São Tomé and Príncipe, Seychelles, Sierra Leone, Tajikistan, Tanzania, Thailand, Tonga |

10. BESIDES THE THREE MEASURES MENTIONED ABOVE, ARE THERE OTHER PROPORTIONATE APPROACHES ADOPTED IN YOUR COUNTRY TO MITIGATE THE IMPACT OF BASEL FRAMEWORK ON FINANCIAL INCLUSION?

| NO | YES |
|---|---|
| 30 | 5 |
| Afghanistan, Angola, Armenia, Bangladesh, Bhutan, Cambodia, Costa Rica, El Salvador, Fiji, Georgia, Guatemala, Haiti, Honduras, Jordan, Malawi, Mexico, Mongolia, Morocco, Namibia, Nigeria, Palestine, São Tomé and Príncipe, Seychelles, Sierra Leone, Tajikistan, Tanzania, Thailand, Tonga, Vanuatu | Argentina, Egypt, Philippines, Russia, South Africa |

11. HOW HAVE ASSESSORS ASSESSED THESE APPROACHES?

| ADOPTED BUT NOT EVALUATED BY ASSESSORS YET | NOT ACCEPTED BY ASSESSORS |
|---|---------------------------|
| 3 | - |
| Argentina, Egypt, Philippines, Russia, South Africa | - |

12. WHAT ARE THE KEY CHALLENGES FACED IN IMPLEMENTING THE BASEL FRAMEWORK IN A PROPORTIONATE MANNER FOR YOUR COUNTRY? PLEASE CHECK ALL THAT APPLY.

| NATIONAL REGULATORS APPLY STANDARDS CONSERVATIVELY DUE TO UNCERTAINTY OF ASSESSORS STANCE | ASSESSORS DO NOT ACCEPT PROPORTIONATE APPROACHES AND DO NOT CONSIDER FINANCIAL INCLUSION AS A POLICY OBJECTIVE | INADEQUACIES IN NATIONAL INFRASTRUCTURE AND SYSTEMS TO CAPTURE RELEVANT DATA AND DEVELOP STANDARDS | NATIONAL REGULATORS LACK EXPERTISE AND KNOWLEDGE TO DEVELOP PROPORTIONATE STANDARDS | NATIONAL SUPERVISORS LACK EXPERTISE AND KNOWLEDGE TO SUPERVISE PROPORTIONATELY | REGULATEES LACK UNDERSTANDING ON THE POLICY INTENT OF STANDARDS |
|---|--|---|--|--|---|
| 8 | 1 | 15 | 8 | 5 | 4 |
| Angola, Cambodia, Costa Rica, Honduras, Jordan, Nigeria, South Africa | Mongolia | Afghanistan, Angola, Cambodia, Costa Rica, Egypt, Fiji, Haiti, Honduras, Namibia, Nigeria, Palestine, São Tomé and Príncipe, Seychelles, Tajikistan, Zambia | Afghanistan, Cambodia, Costa Rica, Fiji, Honduras, São Tomé and Príncipe, Seychelles, Tajikistan | Costa Rica, Fiji, Seychelles, Sierra Leone, Tajikistan | Cambodia, Egypt, El Salvador, Palestine |

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