2020/2

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REGIONAL NOTES
MAY 2020

Basel Framework Implementation in METAC Countries: Practices, Priorities, and Challenges Ahead

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Basel Framework Implementation in METAC Countries

***This note summarizes the results of a workshop on the implementation of the Basel framework in METAC countries.**[1] Using the results of a survey distributed prior to the workshop,[2] participants discussed achievements and implementation challenges, and identified a set of lessons learned from country experiences on how to implement international prudential standards. Discussions focused on (i) how key regulatory aspects could be implemented in order to enhance risk-based supervision, create strong capital and liquidity bases, improve the efficiency of prudential supervision, and strengthen the stability of the financial system; and (ii) how Implementation challenges could be overcome through country-specific step-by-step approach that depends on the sophistication and size of financial institutions, breadth of financial operations, granularity of available prudential information, and supervisory capacities.*

What is the Basel III Framework?

The new international Basel III framework was developed as a regulatory answer to the 2008 financial crisis in advanced economies, by the Basel Committee on Banking Supervision (BCBS).[3] It provides a "handbook" of relevant supervisory techniques for supervisors and regulators, which includes risk management and corporate governance frameworks. High quality capital buffers, and new liquidity risk measures for financial institutions are the center piece of the Basel III accord.

What are the Implementation Practices and Priorities in METAC?

METAC countries are at different stages of implementation of the Basel II and III standards, depending on the structure of their financial markets and regulations, their financial and human resources, and their institutional capabilities. Box 1 illustrates an "implementation path" followed by Egypt. Figure 1 shows a similar approach suggested in an IMF working paper[4] in three phases covering the three Basel pillars.

The survey results suggest that the implementation priorities in METAC countries do not differ significantly from those in advanced BCBS countries. Differences appear in areas where METAC countries have limited exposure to market risk and limited use of advanced approaches.

The highest priorities in METAC countries are: (i) the large exposure framework, (ii) the enhancements made to the definition of capital, including the minimum ratios for Core Equity Tier 1 (CET1), Tier 1, and total capital and buffers.

Other priorities include: (i) the leverage ratio, (ii) pillar 2 and 3, and (iii) the global standards on liquidity risk, especially the Liquidity Coverage Ratio (LCR) (Figure 2). The internal ratings-based approaches, more advanced approaches, market and

[1] The authors would like to thank the representatives of the METAC countries who answered the survey and those who participated in the regional workshop, which took place in Amman, Jordan, during November 3-7, 2019.

[2] All participating countries answered the survey: Afghanistan, Algeria, Djibouti, Egypt, Jordan, Libya, Morocco, Sudan, Tunisia, West Bank and Gaza, and Yemen.

[3] The BCBS is the primary global standard setter for the prudential regulation of banks. Its 45 members comprise central banks and bank supervisors from 28 jurisdictions.

[4] Caio Ferreira, Nigel Jenkinson, and Christopher Wilson. 2019. *From Basel I to Basel III: Sequencing Implementation in Developing Countries.* Working Paper 19/127, Washington: IMF.

operational risk are of a lower priority for METAC countries relative to BCBS countries.

The survey results and workshop discussions support the finding of the IMF working paper. This paper suggests that countries progressing from Basel I to III often follow an "intuitive implementation path": (i) they implement the new definition of capital to strengthen the quality of regulatory capital, and the enhanced capital structure and its buffers; (ii) they focus on systemically important banks, which should have a capital charge adequate to the risks and externalities that they pose to the financial system and the economy; (iii) they improve the monitoring of systemic risk, collect the necessary bank data and implement the liquidity framework (LCR, Net Stable Funding Ratio (NSFR) and liquidity monitoring tools and capabilities).

Box 1. Basel framework implementation practice by the Central Bank of Egypt

Egypt restructured its banking sector and regulations between 2004 and 2012. The main objective was to upgrade the banking sector to a proactive and forward-looking sector, in line with international best practices, and pave the road for the implementation Basel II and III standards. The restructuring plan approved by the Central Bank's (CBE) board had pillars, including: (i) privatization and consolidation of the banking sector, (ii) addressing non-performing loans, (iii) restructuring of state-owned banks, (iv) upgrading the CBE banking supervision function, (v) facilitating small and medium sized enterprises financing, and (vi) implementing Basel II in the Egyptian banking sector.

The CBE adopted a strategy based on two core principles for the implementation of Basel II: simplicity and communication. Simplicity is required for consistency with the levels of sophistication in banks' information and control systems, and to ensure a smooth transition with existing regulations; the application of the Basel framework's standardized approaches is its logical consequence.

Communication ensure that all stakeholders comprehend the content and implications of the new regulatory framework. Specific structures were set up to communicate with the banks, including forming working groups comprised of a representative sample of Egyptian banks and other stakeholders. This structure also provided a close monitoring of the impact on the banking system.

The CBE signed a Memorandum of Understanding with the European Central Bank and seven European national central banks, to benefit from technical assistance and training. Missions, seminars, workshops, and study visits were arranged where members of the newly created "Basel team" developed their knowledge and skills and benefitted from the European experience.

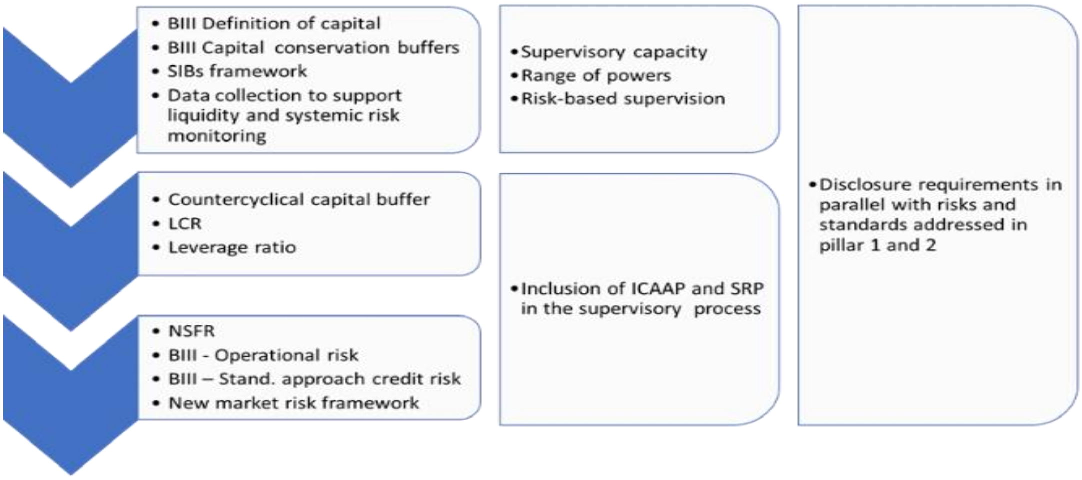
A dedicated task force was set up to manage all aspects of the implementation of Basel II. The full-time team included different skills and experiences to increase its ability to address all issues in a multidisciplinary way. A project Committee regularly met to assess progress.

The implementation project was organized around four phases:

- *Phase 1 (January–June 2009):* (i) Staff capacity building with the cooperation of different Egyptian parties, internal and external to the CBE; (ii) Development and issuance of the CBE Basel II implementation strategy.
- *Phase 2 (July 2009–June 2011):* (i) Coordination with the banking sector supported by discussion papers issued for the most significant topics; (ii) Organization of quantitative impact studies (QIS) to assess the consequences of Basel II regulations prior to their legal enforcement; (iii) Elaboration of "prudential filters" to neutralize the mechanical effect of the change in accounting standards on the calculation of capital adequacy ratio.
- *Phase 3 (July–December 2011):* (i) Fine tuning of future regulations based on feedback from the banking sector; (ii) Banks' internal preparation for implementation of Basel II standardized approach along with corrective action with varying duration for some banks, based on the QIS results.
- *Phase 4 (2012):* Parallel run of existing Basel I and II.

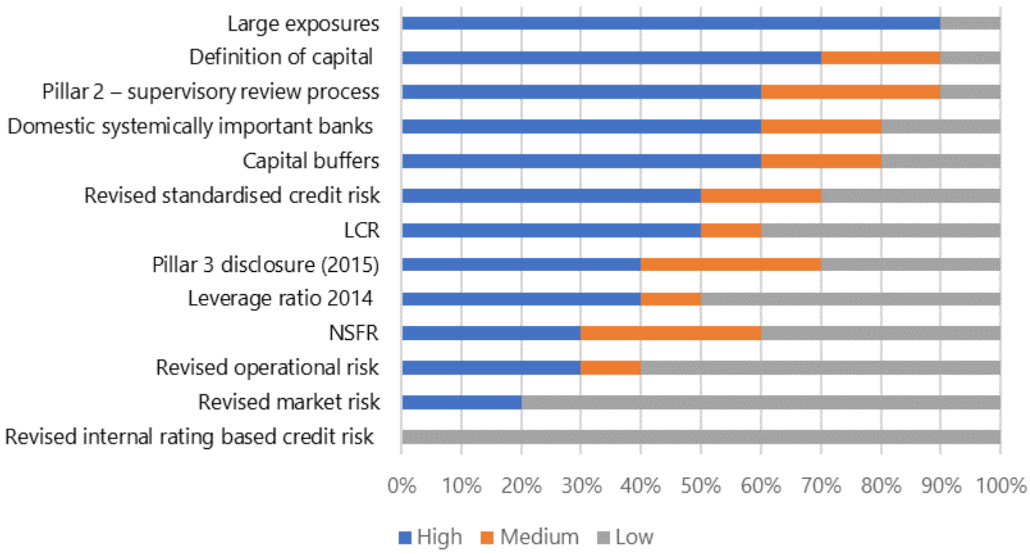
The CBE is currently implementing Basel III.

Figure 1. A Possible Sequence of Implementation of the Basel Framework



Source: IMF working paper 19/127.

Figure 2. Prioritization of Basel III Implementation in METAC Countries



Source: METAC survey and authors.

METAC Countries Plan New Capital Definition and Buffers

Developing economies often have higher level and quality of capital: (i) they do not have access to hybrid and complex capital structures, (ii) they do not use internal models for capital adequacy, and (iii) their economic environment is perceived as riskier.

Table 1 shows that METAC countries have higher capital requirements than Basel III. The capital levels will be further enhanced as countries intend to adopt the more prudent Basel III capital definition. Furthermore, countries intend to implement a conservative approach regarding the CET1 deductions—e.g. allow full deductibility of mortgage servicing rights, deferred tax assets, significant investments in unconsolidated financial institutions.

Most developing countries rely on CET1, which explains why the implementation of the new definition of capital is not perceived as challenging—there are not too many

regulatory adjustments and deductions as in advanced economies. However, as it was discussed during the workshop, investments in insurance companies, such as goodwill and intangibles should be treated in a conservative manner (through deductions from CET1).

Table 1. Capital Requirements in Selected METAC Countries

	CET1	Tier 1 Capital	Total Capital
Basel III	4.5	6	8
Afghanistan		6	12
Algeria	7	7	9.5
Djibouti	6	7.5	12.5
Egypt	7	10	12.5
Jordan	6	7.5	12
Morocco	8	9	12
West Bank and Gaza	6.5	8	13
Sudan		8	12
Tunisia		7	10
Yemen	7	10	10
Libya		8	12

Source: METAC survey and authors.

The revised Basel framework focuses on increasing the capacity of financial institutions to absorb losses in order to avoid the use of tax revenue to bail them out. The framework builds on a strong CET1 base with three capital buffers: (i) conservation buffer, (ii) countercyclical buffer, and (iii) buffer for domestic systemically important banks. Workshop participants commented that their countries are motivated to further stack up their CET1 to comply with all the given buffers as they are convinced that a strong capital base is the foundation of an effective prudential framework.

Comparison of METAC Countries with International Practice

METAC countries have either implemented Basel I or II, and some are working on Basel III. Development in the latter follows the global trend—METAC countries seem to front run the implementation process (Table 2). Figure 3 provides a detailed breakdown of the areas of Basel III implementation—60 percent of the survey respondents have, or are in the process of, implementing the capital buffers.

Table 2. Implementation of the Basel Framework: International comparisons

Risk-based capital regime and adoption of key Pillar 1 requirements

Pillar 1 requirements	BIII RBC Regime	BII RBC Regime	BI RBC Regime	Total
Risk-based capital	60	10	30	100
Leverage ratio	14	1	1	16
Large exposures	11	2	1	14
LCR	51	0	3	54
NSFR	14	0	1	15

Implementation of the Basel risk-based capital framework

Region	BIII	BII	BI	Total Countries
Africa	6	4	5	15
Americas	6	1	16	23
Asia	8	3	7	18
Europe	31	1	1	33
Middle-East	9	1	1	11
Total countries	60	10	30	100

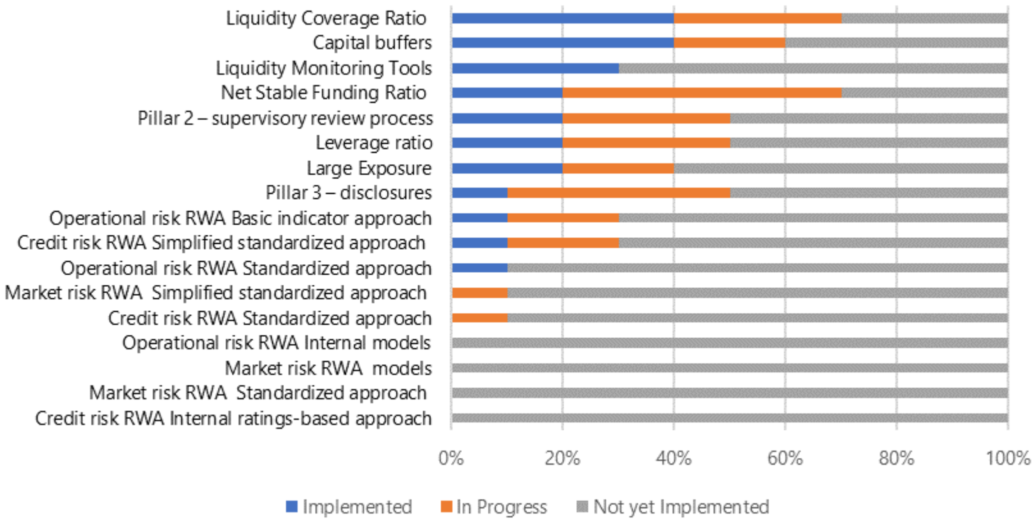
Source: FSI Insights on policy implementation No 11, The Basel framework in 100 jurisdictions: implementation status Column headings: "B"=Basel; "RBC"=risk-based capital. Large exposures are based on the 2014 standard.

Around 30 percent of METAC countries intend to implement the standardized approach for credit risk. The level seems rather low as most of countries still follow the Basel II regime for credit risk. Given its relative simplicity, the leverage ratio has been adopted by more than 50 percent of survey respondents.

The leverage ratio that provides an important backstop to the risk-based capital regime, is also useful for jurisdictions using the standardized approach for capital measurement. It can be a binding constraint on banks when the average credit risk weights under the standardized approach falls below a certain threshold. Pillar 2 and 3 show high implementation status as the leverage ratio.

Seventy percent of METAC countries have either implemented the Basel III liquidity standards or are in the process of implementing it. Of the two quantitative liquidity rules introduced under Basel III, the LCR has been prioritized before the NSFR. Due to the lack of developed capital markets it is often harder for financial institutions in METAC countries to provide the longer-term funding to comply with the NSFR requirements. The internal model-based approaches for credit, market and operational risks are not of current interest and are often not applicable due to limited data availability.

Figure 3: Implementation of Basel III in METAC Countries



Source: METAC survey and authors.

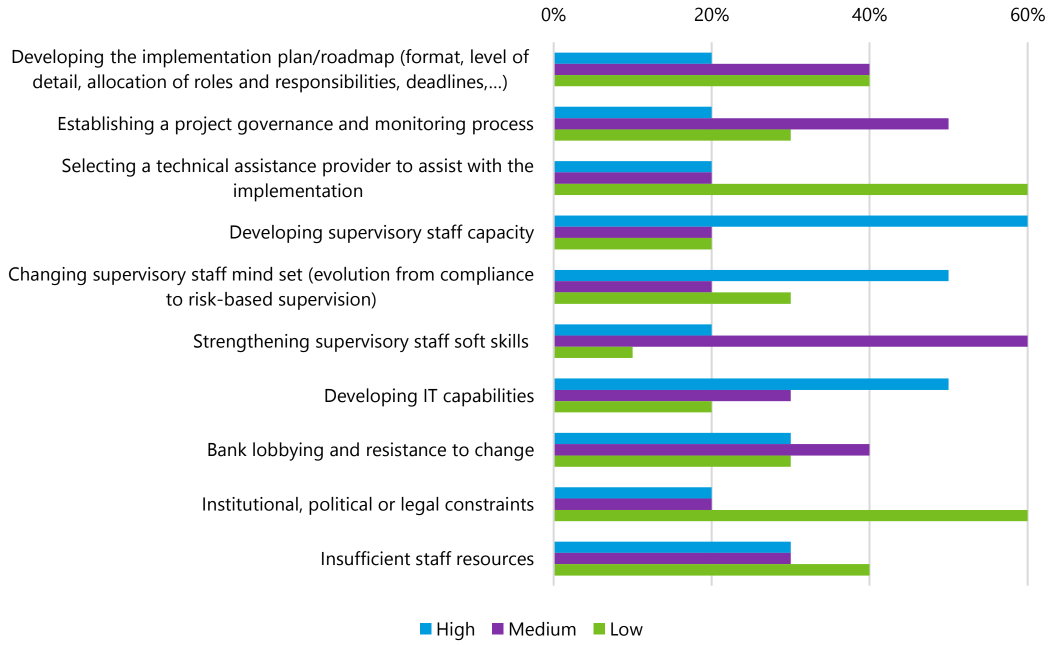
What Are the Key Implementation Challenges?

METAC countries face important obstacles in implementing the Basel framework (Figure 4). The top four implementation challenges mentioned in the survey are: (1) developing supervisory staff capacity; (2) developing IT capabilities; (3) changing supervisory staff mindset to move toward a risk-based supervisory approach; and (4) insufficient staff resources.

Countries also noted that IT capabilities and data availability and collection are key for the implementation of enhanced approaches, and that further steps should include:

- Development of prudential reporting templates.
- Communication to the industry—e.g. through workshops.
- Organization and analysis of quantitative impact studies for each of the main Basel framework elements to be implemented
- Application of the requirements of the Basel working paper on risk data aggregation and risk reporting.

Figure 4. Key Implementation Challenges of the Basel Framework in METAC Countries



Source: METAC survey and authors.

Lessons Learned and Next Steps

Further enhancements of risk-based supervision and the implementation of the key components of the Basel framework remain the main focus of METAC countries. Despite the advantages of a full implementation of the Basel framework, partial and country-specific approaches are the best way forward to further develop countries' efforts to promote financial stability.

The Basel framework offers a variety of supervisory approaches, from simple to very complex. Learning from other METAC countries and the international experience is important, but such learning should be translated and adapted to the context of each country.

METAC should continue to play its role in assisting countries in strengthening the implementation of the Basel framework:

- Capacity building should target different groups and should be issue-specific, not general.
- Training should focus on building technical and analytical skills, and should be practical (hands-on).
- Targeted capacity development should be aligned with country implementation plans and timelines, and should provide flexibility where necessary.

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