Key findings

Financial regulation of NDBs

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THE VISIBLE HAND:
Development
Banks
in Transition

The Third Basel Capital Accord (Basel III), built in response to the 2007-9 financial crisis, made much progress in building a safer and less leveraged system. However, the Sustainable Development Goals (SDGs), the climate crisis and the COVID crisis require bold action. Any discussion of financial regulation should consider not only a resilient financial system, but also one that effectively promotes sustainable development goals. These are not necessarily contradictory objectives. Development banks have unique characteristics to manage risk and can contribute to a more sustained growth path, which helps reduce overall financial instability.

Objectives and research questions

This paper intends to help promote a dialogue among governments, development banks and regulators. It analyses specific aspects of Basel III framework applied to National Development Banks (NDBs). Do these banks deserve special treatment? What can regulators do to adapt Basel rules in order to reduce possible impacts? In particular, it discusses Basel III higher capital requirements, capital buffers, as well as the changes made to the treatment of market risk, concentration, liquidity risk and operational risks.

Methods

The paper starts with a brief history of banking regulation and a summary of the main theoretical approaches underlying it.

It provides an analytical discussion of Basel III new regulatory requirements, considering NDBs' characteristics. The paper compares the experiences of three large non-retail-deposit-taking NDBs under Basel III: BNDES of Brazil, CDB of China and KfW of Germany, drawing on both secondary information and interviews.

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Results

The paper recognizes that compliance with the Basel III framework has brought tangible benefits to the three cases and that some of its requirements had little impact on them. The biggest constraint seems to come less from the complexity of the framework, and more from tightening the levels and quality of capital requirements. Although in the three cases, capital has not been a binding constraint for them in regular times, it can become so in times of crises. Other concerns are: a) the disincentive to use the internal rating models (IRB), which, if well calibrated, could be more suitable to Development Banks' own risks; b) the new large exposure rule, which is problematic, given NDBs focus on large infrastructure projects; c) high-risk weights required for project finance and equity, which are extensively used to support, respectively, large and complex projects and innovation. Finally, Basel framework still needs to be enhanced in order to consider climate risks as a systemic risk and go further by creating clear incentives for long-term green finance.

Recommendations

- **Consider national regulator tailored rules for each Nnational Development Bank (NDB)**, in the light of NDBs particular forms of ownership, funding structure, business model and the strategic role they play on behalf of their national governments.
- **An alternative approach is to build a different regulatory framework at the global level for NDBs.** An international framework might help protect NDBs against the risk of undue political intervention.
- **Basel III still needs to appropriately factor in climate risks**, remove indirect disincentives to climate finance and go further by creating clear incentives instead, necessary both for bank stability and for building a more sustainable future of the world.

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Access the research paper
FINANCIAL REGULATION OF NDBs