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The Politics of Regulatory Convergence and Divergence

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Introduction

Why do regulators in peripheral developing countries, particularly low- and lower-middle-income countries, respond differently to international banking standards? Why do some regulators implement substantial parts of the most recent and complex international standards, while others eschew them? This chapter sets out an analytical framework that explains why regulators in peripheral developing countries respond in different ways to international banking standards. It builds from the existing literature and the case studies in this volume to identify the conditions under which we can expect countries to converge on or diverge from international standards.

We explain how the interplay of international and domestic politics shapes the decisions that regulators make. We identify four factors that generate incentives for regulators to converge on international standards: politicians pursuing a development strategy that prioritizes integration into global finance and expansion of financial services sectors; domestic banks looking to enhance their reputation as they expand into international markets; regulators with strong connections to peer regulators in other countries who are implementing the standards; and sustained engagement with the IMF and World Bank through lending programmes and technical assistance.

Working in opposition to these incentives to converge are four factors that generate incentives for regulators to diverge from international standards: politicians pursuing interventionist financial policies, where the state plays an important role in allocating credit; politicians and business oligarchs using banks to direct credit to political allies; regulators who are sceptical about the applicability of Basel standards for their local context; and banks with business models focused on the domestic market for whom there are high costs and few benefits from implementing the standards, particularly if they are relatively small and weak.

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As the political, economic, and institutional context differs across peripheral developing countries, regulators experience these incentives through different channels and with varying levels of intensity, prompting them to respond in different ways to international standards. We distinguish between different pathways to convergence and divergence according to whether they are policy-driven, politically driven, regulator-driven, bank-driven, or IFI-driven, and we identify the salient features of these pathways. We also explain why, when faced with strong and competing incentives to converge and diverge, regulators are likely to respond with 'mock compliance'.

Our analytical framework focuses on three main actors: the regulator (usually situated within the central bank), large banks, and incumbent politicians. Regulatory outcomes are the product of the relative power position of these three actors within society, and are shaped by the wider domestic and international context in which they are embedded. Central to our argument is the observation that banks are rarely the most dominant actor in regulatory politics in peripheral developing countries, particularly the low- and lower-middle-income countries we focus on. While there are some exceptions, the underdeveloped nature of the formal economy and relatively small size of the banking sector leave individual banks, and the banking sector as a whole, with much less power to shape regulatory outcomes than in many advanced economies. Yet this does not mean that financial market players have little purchase on regulators' decisions. Far from it. Operating in a context of capital scarcity, regulators, politicians, and banks in peripheral developing countries are particularly attuned to the ways in which regulators, banks, and investors in other countries will react to their decisions, and, as we explain below, this has an out-sized impact on regulatory outcomes (see also Mosley (2003)).

It is this dynamic that sets regulatory harmonization between the core and periphery apart from regularity harmonization among core countries. In explanations of regulatory harmonization among core countries, the interests of large domestic banks loom large. For instance, in his seminal work, Singer (2007) argues that regulators face a dilemma of increasing regulatory requirements in order to mitigate the risk of financial crisis, or easing those requirements and enhancing the international competitiveness of the domestic financial sector (Singer, 2007, p. 19). It is these trade-offs that shape the nature of regulatory harmonization among core countries. In this chapter we show how the decisions of regulators on the periphery are shaped by power relations between regulators, politicians, and banks, and the extent and nature of the connections of these actors to global finance and networks of global financial governance.

Three key actors: regulators, banks, and politicians

In this section we examine the role and relative power position of regulators, banks, and politicians in regulatory decisions in peripheral developing countries. In the next section we explain how specific factors create incentives for these actors to converge on or diverge from international banking standards.

Regulators

Just as in many advanced and emerging economies, the task of regulating and supervising banks in many peripheral developing countries has been delegated to an independent government body that operates at arm's length from the executive and legislative branches. This is part of a wider trend that accompanied waves of privatization and liberalization in the 1980s and 1990s, often under the guidance of the World Bank. Responsibility for bank regulation and supervision was typically moved to the central bank or a specialized regulatory institution, with substantial operational independence.

The scope of the regulator's powers and the *de jure* and *de facto* independence that it has from the executive branch varies across peripheral developing countries. In general, regulatory authorities have the formal authority to impose and enforce a wide range of regulations on banks, although their actions are circumscribed by the scope of their legal powers, their resources and expertise, and, as we discuss below, political considerations. When it comes to international banking standards, independent regulatory authorities usually have the powers to implement the standards without consulting the legislative or executive branch, by issuing regulatory directives and guidelines which banks are then legally obliged to follow. However, as Basel standards have become more complex, regulatory authorities have needed additional powers to be delegated, and this has required new primary legislation.[1]

In deciding how the banking sector should be regulated, and whether international standards should be implemented, we expect regulators to draw on a

[1] For example, the implementation of Pillar 2 of Basel II requires national supervisors to have the powers to ensure prompt corrective action, the legal mandate to impose higher capital requirements, and the ability to conduct supervision at a consolidated level, while Pillar 3 requires the oversight of confidentiality rules (Stephanou and Mendoza, 2005). Under Basel III regulators may require additional legal authority to intervene on the basis of macro-prudential factors rather than institution-specific factors. They may also need quick specific additional powers. Implementation of the new 'definitions of capital' requires that supervisors have sufficient powers to make judgement calls about the point at which a bank is deemed to be unable to continue on its own. Where foreign banks have a systemically important local presence, supervisors may require increased supervisory powers over branches and the ability to require conversion of branches into subsidiaries to implement the requirements on D-SIBs, and prevent banks in host jurisdictions from circumventing the higher loss absorbency requirements (Fuchs et al., 2013).

combination of expert technical knowledge and normative beliefs. Designing banking regulation is intrinsically difficult as regulators face challenges of imperfect information and profound uncertainty (Haldane, 2012). Technical officials navigate uncertainty by drawing on a combination of technical knowledge and normative beliefs to diagnose problems and identify solutions (Chwieroth, 2007). Over time, particular normative frameworks and sets of policy ideas come to dominate an institution, shaping the manner in which external demands and events are interpreted and the responses that the staff will entertain and, potentially, implement (Chwieroth, 2010, p. 10). In the area of financial regulation, scholars have shown how economic ideology, particularly faith in self-correcting market mechanisms, has deeply influenced regulators' approaches to banking regulation, contributing to the global financial crisis (see, for instance, Cassidy, 2010; Gorton, 2012).

Regulators in peripheral developing countries operate in a context that is different in important ways to that of their counterparts in more advanced economies. As discussed in Chapter 2, many are tasked not only with ensuring financial stability, but also supporting the development of the financial sector and wider economy. While all regulators face an asymmetry of resources and information vis-à-vis the banks that they regulate, in low- and lower-middle-income countries, regulators operate in environments of institutional weakness and, in many cases, acute human and financial resource constraints. This makes it challenging to design and effectively enforce anything but the simplest forms of bank regulation (Abdel-Baki, 2012; Fuchs et al., 2013; Gottschalk, 2016, 2010; Gottschalk and Griffith-Jones, 2006). While this might lead us to expect regulators in low- and lower-middle-income countries to generally oppose the introduction of international standards, particularly the most onerous and complex elements, powerful ideational and reputational incentives may lead regulators to champion adoption, as we explain below.

Banks

Even when regulators have a high level of operational independence on paper, they are rarely fully independent in practice. Studies of financial regulation in advanced industrialized countries, particularly the US, have drawn attention to the ways in which private banks can 'capture' regulators (Johnson and Kwak, 2011; Lall, 2012; Mattli and Woods, 2009; Pagliari and Young, 2014; Stigler, 1971). In the US, for instance, the financial industry exercises a powerful role in regulatory decisions, including through lobbying, campaign contributions, and revolving doors between the industry and regulators (e.g. FCIC, 2011). Fragmentation among regulatory institutions helps the industry exercise this power (Lavelle, 2013).

While much of the literature has conceived of the relationship between the financial industry and state as a one-way street, with banks exercising power over regulators, others have argued that the relationship is one of mutual dependence. The sheer size of the financial sector relative to the rest of the economy in many industrialized economies means that regulatory decisions often reflect the interests of the sector, yet in large and lucrative markets, banks ultimately rely on the goodwill of the regulator to operate (Culpepper, 2015). In many European countries, a series of formal and informal ties between the political system and the banking system[2] enable banks to exercise a significant influence over the regulatory process through their political connections but also make banks receptive to political guidance (Monnet et al., 2014).

The ability of big banks to capture regulators is not limited to industrialized countries. Maxfield (1991) studies Mexico and Brazil and shows how the relative strength of bankers' alliances decisively shapes regulatory policies. In Mexico, a strong alliance between bankers, industry, and the central bank resulted in a set of policies that prioritized bank interests, promoting macroeconomic stability and the free flow of capital. In Brazil, in contrast, a weak alliance of bankers coupled with a strong state-planning authority led to a set of growth-oriented policies, including extensive intervention in financial markets. Pepinsky (2013) makes a similar argument, and shows how powerful financial sectors in Mexico and Indonesia successfully influenced regulatory policies and maintained restrictions on foreign ownership in the banking sector. Boone (2005) shows how strong and relatively autonomous financial sectors in South Africa and Mauritius made regulators more vulnerable to the demands of private finance.

A striking and important difference in low- and lower-middle-income countries is that the size of the banking sector is much smaller relative to the wider economy than in upper-middle- and high-income countries (see Chapter 2). As a result, while individual banks may be influential because they are linked to powerful politicians (discussed below), the financial sector doesn't have the structural power that we see in many advanced economies. Moreover, in a context where the wider economy is underdeveloped and dominated by small informal enterprises and smallholder agriculture, lending to government and state-owned enterprises is central to the business strategy of banks.

In this book we distinguish between *domestically oriented* and *internationally oriented* banks, arguing that they have very different incentives when it comes to banking regulation and the adoption of international standards. The salient feature of domestically oriented banks is that, irrespective of whether they are owned by domestic or foreign shareholders, their business model focuses on the

[2] For instance, German public saving banks (Sparkassen and Landesbanken) that held some 33 per cent of the assets of the German Banking sector in 2009 remain owned and controlled by regional governments.

domestic market. As we explain in more detail below, for banks reliant on the domestic market, the adoption of complex international standards has high costs and few benefits. Although domestically oriented banks stand to lose from the implementation of international standards, they rarely had sufficient power to decisively influence regulatory outcomes.

In contrast, internationally oriented banks focus their business strategy on international markets. For reasons we explain below, internationally oriented banks gain reputational advantages from the implementation of international standards and, unlike domestically oriented banks, they are more likely to have the power to decisively shape regulatory outcomes. Where they are present, large, internationally oriented banks shape regulatory outcomes. Yet relatively few low- and lower-middle-income countries have such banks, as they tend to be associated with more developed financial markets. This variation helps explain different responses to international standards.

A striking finding of our empirical chapters is that the presence of foreign banks, particularly those headquartered in Basel Committee countries, does not create pressures to converge on international standards. We might expect international banks to champion convergence as when they have to comply with different regulatory requirements across the jurisdictions in which they operate this can generate uncertainty and complexity, particularly for globally systemically important banks (Bauer and Drevon, 2015). It is also plausible that foreign banks will champion the implementation of international standards to put them at a competitive advantage vis-à-vis smaller domestic banks, as the latter struggle to comply with complex regulatory requirements. Yet, in our case studies, we find no evidence of foreign banks championing convergence on international standards. Where regulators have decided to implement Basel standards, there are examples of foreign banks providing technical assistance to domestic banks, and even to the regulatory authorities, but they haven't been strong advocates for implementation. Indeed, some international banks have cautioned regulators against implementing some of the more complex elements of Basel III, arguing that they are ill suited to their context.[3]

Politicians

Politicians exert influence over regulatory decisions directly, through their policies and oversight of the regulatory authority, and indirectly, through their political connections to banks. As several of our empirical cases powerfully illustrate, the existence of an independent regulatory authority does not preclude the influence of policy or politics. In a vital government institution like the central

[3] Interview with senior official from a large pan-African bank, via telephone, June 2015.

bank, senior officials are selected for their expertise, but they are also likely to be appointed on the basis of their broad alignment with the policy objectives of incumbent politicians. The more prevalent the appointment of such 'technopols' (people with a hybrid status as technocrats and politicians—see Domínguez, 1997) in the regulatory agency, the greater the influence that government policy is likely to have over regulatory outcomes. In several countries, the appointment of senior officials in the regulatory authority, including the appointment of central bank governors, is a decision for the executive branch.

While politicians may not take an interest in the complex technical details of international banking standards, they do set the overall policy stance towards the financial sector. Financial sector policies vary substantially across peripheral developing countries. Politicians may adopt an interventionist approach, using a variety of policy instruments to direct the allocation of credit in the economy in line with specific policy objectives. Alternatively, they may pursue policies that allocate credit purely on the basis of market prices, focusing on policy measures to improve market efficiency.

The policy-orientation of governments has important path-dependent effects on the institutional set-up for banking regulation. Where the government has a history of interventionism, often as part of a wider developmental state model, the executive branch is likely to have retained a high level of oversight and control over bank regulation and supervision, and regulatory authorities are likely to have a lower level of independence. In contrast, where the country has pursued a more market-oriented approach, it is more likely to have an autonomous regulator.

In general, it is reasonable to expect that the degree of alignment between international standards and pre-existing regulatory institutions will shape national responses to international standards, as has been shown for the adoption of international standards in advanced countries (Quillin, 2008). Specifically, for peripheral developing countries, we might reasonably expect countries that have historically pursued market-oriented policies and have an independent regulatory authority to be more receptive to the market-oriented Basel standards than countries where governments have historically pursued interventionist approaches.

Over and above this general trend, we explain below why politicians seeking to attract international capital to their country and the creation of an international financial centre may perceive the implementation of banking and other international standards to be a vital part of their country's economic development strategy, leading to a particularly powerful dynamic of convergence on international standards. As Reddy (2010) notes, eagerness to develop a thriving international financial centre is likely to result in an approach to regulation that puts self-regulation by market participants at its heart.

Politicians may also exert influence over regulation to further the interests of specific banks to whom they are politically connected. In countries where economic and political power is highly centralized, banks may be owned by powerful elites and used to further business and political interests. Hutchcroft (1998) shows how, in the Philippines, powerful families with sources of economic income outside of the state were able to dominate politics and the business sector, through family-owned conglomerates. As part of their wider business strategy they set up or acquired ownership stakes in domestic banks, using them to provide credit to their own businesses, and to shore up their connections to politicians. The regulator had very little power to enforce bank regulations vis-à-vis these powerful, politically connected banks (Hutchcroft, 1998).

Powerful politicians may also have direct ownership stakes in banks, or otherwise exercise influence over the business operations of banks in order to shore up their political power. In countries where state-owned banks dominate the banking sector, these banks provide incumbent politicians with a high level of discretionary control over credit allocation in the economy. While this control may be used to pursue policy objectives, as in the developmental state model, it may also be used for political patronage. Arriola (2013) shows how incumbent politicians in several different African countries have used discretionary powers over finance to make credit allocation contingent on political allegiance. While Arriola argues that this is particularly likely to happen when banks are state owned, politicians may also use ownership stakes in private banks to further their political goals. During processes of privatization in the 1980s and 1990s in African countries, bank licenses were often granted in ways that shored up political patronage systems, ensuring enduring links between politicians and banks (Boone, 2005).

Thus, to explain responses of regulators to international banking standards, we need to understand the interests and preferences of regulators, banks, and politicians, as well as the relations between them, a relationship that is often more complex than it may at first appear. While we conceive of bank regulation as a three-way game between regulators, large banks, and incumbent politicians, it is the politicians and regulators that exert the greatest influence over regulatory outcomes. This in turn implies an important role in our explanatory framework for policy ideas about how banks should be regulated; for party politics and political systems; and for the material interests of political elites. This distinguishes our analytical framework from the frameworks that scholars use to explain regulatory outcomes in industrialized economies, in which the business interests of large banks loom large (Culpepper, 2015; Helleiner and Porter, 2010; Lall, 2012; Mattli and Woods, 2009; Oatley and Nabors, 1998; Pagliari and Young, 2014; Singer, 2007; Underhill and Zhang, 2008).

International context

The connections between national politicains, regulators, and banks to international financial players and networks of global financial governance also play an important role in our anlaytical framework. As the interconnectedness of peripheral developing countries with global finance has increased, so too has the responsiveness of national regulations to an array of international interests and actors. There is a long history of engagement between peripheral developing countries, particularly low- and lower-middle-income countries and the World Bank and IMF. Widespread reforms in the 1980s and 1990s under structural adjustment loans, as well as in the wake of the Asian financial crisis, aimed to create regulatory institutions and practices explicitly aligned with the work of the Basel Committee (Hamilton-Hart, 2003; Mathieu, 1998). These reforms were very contentious and often only partially implemented (Killick et al., 1998; Mosley, 2010). Even where they were implemented, they often failed to strengthen the financial sector (Mathieu, 1998). Yet for many developing countries they ushered in a step-change in how the financial sector was structured and regulated,[4] reducing the level of state intervention and creating independent, arm's-length regulatory institutions. This created conditions that were more conducive to, although not sufficient for, the implementation of Basel II and III standards in later years.

More recently, engagement with international private finance has increased. Peripheral developing countries have increasingly opened up to foreign banks and cross-border flows of portfolio finance, and, more recently, governments have tapped into international capital markets to finance their own activities. Increased exposure to international finance renders peripheral developing countries particularly vulnerable to changes in the international environment, whether that is shifts in international credit cycles, or in the regulations that prevail in the financial core (Bauerle Danzman et al., 2017; Rey, 2015). With integration, regulators, banks, and politicians become acutely aware of, and responsive to, the preferences of international investors and credit rating agencies, as well as regulators in other jurisdictions. As we explain below, this engagement generates specific incentives for regulators, banks, and politicians in peripheral developing countries to converge on international banking standards.

Although the exposure of peripheral developing countries to international finance has increased, we should not expect external pressures and incentives to generate uniform responses across peripheral developing countries (Boone, 2005). Peripheral developing countries are embedded in international finance in different ways and to different extents and, as we argue below, domestic political economy dynamics condition countries' responses to these external pressures and incentives.

[4] See also Lavelle (2004) who argues that programmes of the International Financial Corporation, World Bank, and IMF were also key in fostering the development of equity markets in developing countries.

Convergence: drivers and political underpinnings

We now turn to the specific factors that drive convergence and divergence. In this section we explain the causal mechanisms that underpin the four factors we identify as providing strong incentives for regulators in peripheral developing countries to converge on international banking standards, and then do the same for the four factors we identify as driving divergence. These drivers of convergence and divergence are summarized in Figure 3.1.

Politicians seeking international capital

Politicians seeking to attract international capital into the financial services sector can be a strong driver of convergence on international banking standards. Following the rapid growth of East Asian countries in the 1970s and 1980s, many other developing countries looked to manufacturing as the pathway 'out of the periphery' (Haggard, 1990). In the past decade the viability of late developers cultivating an export-oriented manufacturing sector has been heavily questioned (e.g. Hallward-Driemeier and Nayyar, 2017). Perhaps in response, politicians are increasingly looking to drive development through the expansion of financial services. In some of our case studies politicians are working hard to position their country as an international hub for financial services, looking to emulate Singapore or Mauritius. In other cases, politicians are championing the adoption of international standards in order to attract international investment into banking, with the aim of increasing competition and reducing the cost of credit

Drivers of convergence →	**Drivers of divergence** ←
1. Politicians seeking international capital	1. Politicians pursuing interventionist financial policies
2. Regulators engaging with peers	2. Politicians and business oligarchs using banks to direct credit to allies
3. Domestic banks expanding into international markets	3. Sceptical regulators
4. Sustained engagement with the World Bank and IMF	4. Fragile domestic banks

Figure 3.1 Drivers of convergence and divergence in peripheral developing countries.

to the private sector. This may be part of a drive to liberalize the banking sector and break ties between the banking sector and related patronage structures (Walter, 2008).

The implementation of international banking standards is perceived by politicians as an important mechanism for signalling to potential investors that their banking sector is soundly regulated. Scholars have shown how reputational signalling has become important for developing countries, and moves to give central banks independence were often driven by politicians' desire to signal creditworthiness to international investors, in a context of growing financial interdependence (Ghosh, 2007; Maxfield, 1997). Similar reputational dynamics underpin the implementation of international banking standards. It is hard for international investors, and actors like credit rating agencies that intermediate the relationship between investors and peripheral developing countries, to reliably assess how well a financial sector is regulated. International investors and other market participants appreciate simple metrics such as compliance with international standards for providing a straightforward assessment of national performance that can be easily integrated into risk-return calculations (Mosley, 2003). We find that, for politicians seeking to improve their country's reputation in the eyes of international investors, implementing Basel and other international financial standards is an obvious way to signal commitment to transparency and more stringent regulation.

The incentive to implement Basel standards is particularly strong for countries seeking to establish themselves as financial centres, as they deliberately cultivate their image as secure and stable investment destinations as this enables them to attract a greater volume of lucrative business (Sharman, 2009). The reputational payoffs for compliance with international standards are comparatively high and governments may thus be willing to bear the costs of compliance (Brummer, 2012, p. 147; Ercanbrack, 2015, p. 214).[5] Enhancing its reputation as a sophisticated international financial centre is a major driver for Mauritius' high implementation of Basel II and III, as well as other international financial standards.[6]

In general, the greater the emphasis that politicians place on attracting and retaining international investment in the financial services sector, the stronger the incentives that regulators face to converge on international banking standards.

Domestic banks expanding into international markets

Regulators may also adopt international banking standards to facilitate the expansion of internationally oriented domestic banks into new markets. Relatively few

[5] However, for international financial activity that thrives on secrecy and regulatory forbearance, regulators may deliberately opt against adoption of international standards to signal commitment to continuing this approach. See (Goodhart, 2011).

[6] Discussions with senior government officials, Oxford, June 2016.

banks headquartered in low- and lower-middle-income countries have international operations, but this is changing, particularly with the expansion of regional banks across Africa, Asia, and Latin America. While many regional banks are headquartered in upper-middle- and high-income countries, a growing number are located in low- and lower-middle-income countries. In the Africa region, for instance, Togo (a low-income country) is the home supervisor of Ecobank, a major pan-African bank that operates in thirty-six countries, often with a systemically important presence. Similarly, Nigeria and Morocco (both lower-middle-income countries) are the home regulators of major pan-African banks, while Kenya (also lower-middle-income) is the home regulator for several banks that are active across the East African region (Enoch et al., 2015).

For home regulators of these internationally oriented domestic banks, implementation of international standards is an important mechanism for reassuring host regulators that their banks are soundly regulated at the parent level. Because of the risk of cross-border financial contagion, host regulators will seek assurance that a bank is soundly regulated at home before they issue a license allowing a foreign bank to operate in their jurisdiction. International standards can provide an 'epistemic signpost' that reassures host regulators that there is a high quality of regulation and supervision at the parent level (Brummer, 2010, p. 264). In the EU, member states are allowed to restrict access to third-country banks whose home country regimes do not meet EU standards. Similarly, in the US, the Federal Reserve has the authority to issue banking licenses to foreign banks only if they are 'subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country' and if they are 'well-capitalized and well-managed' on a global basis (Alexander et al., 2006, p. 146). In the 2000s, compliance with Basel Core Principles and implementation of the latest Basel standards were the common reference point for EU and US regulators in making these assessments.[7] Thus, while not an explicit condition for market entry, implementation of the international benchmark has been, as a matter of practical regulatory policy, an important mechanism for entering these markets.

There is evidence that, during the 1990s and early 2000s, regulators in emerging economies in Asia adopted Basel standards to help their banks gain entry into European and US markets (Chey, 2007; Ho, 2002). In the Middle East, regulators perceive compliance with the latest Basel standards to be vital for enabling Gulf banks to obtain regulatory legitimacy and approval, particularly in North American and European markets (Ercanbrack, 2015, p. 214).

Even where adoption of Basel standards is not a pre-requisite for market entry, regulators may adopt Basel standards to boost the reputation of their internationally active banks. Knaack (2017) argues that improving the reputation of China's

[7] Reliance on Basel as a signal of high-quality domestic banking regulation has waned since the global financial crisis, as both the EU and the US have come to distrust each other's modifications of Basel III.

internationally active banks is an important explanation for China's recent over-compliance with Basel standards, particularly Basel III. The Executive Director of the Reserve Bank of India gave a similar explanation for Basel adoption in India: 'Any deviation [from global standards] will hurt us both by way of reputation and also in actual practice. The "perception" of a lower standard regulatory regime will put Indian banks at a disadvantage in global competition' (Vishwanathan, 2015). As Goodhart (2011, p. 186) notes, soon after the Basel standards were first developed, the Basel Committee found that 'the recommendations and standards developed and intended only for large G10 international banks *became regarded by all other countries, and their banks, as reputationally binding*' [emphasis added].

The implementation of Basel standards may also be supported by locally incorporated banks that are tapping into international credit markets (Alexander et al., 2006; Chey, 2014; Gottschalk and Griffith-Jones, 2006). For banks issuing bonds to finance their operations, their cost of borrowing on international markets is largely determined by their credit ratings. In turn, there is anecdotal evidence that the major international ratings companies consider compliance with the latest Basel standards as being 'positive for bank creditworthiness' (Moody's Investors Service, 2015). For instance, in its assessment of Colombia, Fitch Ratings argued that the country's failure to fully align with Basel III standards meant that 'they trail international peers that use more conservative and globally accepted capital standards' (Wade, 2018).

In general, the higher the number of domestic banks with international operations, the stronger the incentives that regulators face to converge on international banking standards.

Regulators engaging with peers implementing standards

Regulators may also face strong incentives to implement international standards as a result of their engagement with peers in other countries who are already implementing them. Given that regulators in peripheral developing countries face particularly acute constraints in designing financial regulations, we expect them to learn from and emulate the practices of regulators in other countries. In general, the higher the level of engagement that senior officials have with peers who are implementing international standards, the stronger their incentives to follow suit.

Research on the diffusion of global norms provides insights into the specific ways in which transnational networks drive policy transfer, distinguishing between process of learning and emulation. We expect regulators to look to and draw lessons from the experiences of regulators in countries similar to theirs, and to apply these lessons in designing their own policies (Dobbin et al., 2007).

Learning is based on an evidence-based evaluation of practices in other countries and a progressive move from less effective to more effective policies. While this may take place, hard evidence of the efficacy of a policy in another jurisdiction may not always be available. Sociologists have drawn attention to the ways in which policies may still diffuse across borders, driven by a quest for normative acceptance and legitimacy rather than technical efficiency, as policymakers emulate the policies of those they perceive to be leaders in their field.[8] While processes of policy transfer are usually used to describe a move towards more effective policies, this is not inevitable. As Sharman (2010) shows, policy transfer can also be dysfunctional, leading to worse policy outcomes.

Transnational professional networks are a powerful vector for the transmission of regulatory practices around the world. They provide a forum for regulators to discuss the common challenges they face and to learn from each other's experiences, and they can play an important role in shaping regulators' decisions. As Ban (2016) powerfully shows, in Spain and Romania the extent to which bureaucrats engaged with international professional networks promulgating neoliberal ideas greatly shaped the policies these countries pursued. The highly technical and practical nature of the discussions within international financial networks fosters common knowledge and 'shared understandings' among the officials involved, which shape regulatory decisions at the national level (Porter, 2005). Crucially, international standards or norms—like Basel standards—become focal points around which discussions converge and, through this process, become widely accepted as 'best practices' (Simmons et al., 2006). Transnational networks can also be sources of coercive pressure, as Bach and Newman (2010) show in their study of insider-trading legislation: lead regulators backed by significant market power, such as the United States' SEC in securities, may use asymmetries within transnational networks to promote the global export of their domestic policies.

Financial sector regulators are particularly likely to follow decisions made by their peers, as their professional incentives dissuade them from following an experimental approach to regulation and encourage herd behaviour (Romano, 2014). Following 'international best practices' and the practices of successful peers helps insulate regulators from attribution and attendant costs, in the event of a financial crisis at home (Gadinis, 2015, p. 52). In some instances, there may be powerful socialization effects at work within peer networks. Where networks promulgate specific financial standards, non-implementation may result in social reproach from peers for failing to deliver on the group's regulatory programme or shared norms (Brummer, 2012; Martinez-Diaz and Woods, 2009). Engagement in

[8] See discussion of this literature in Sharman (2010).

transnational networks is a major driver of the diffusion of Basel II standards across the globe Jones and Zeitz (2019).

Transnational networks are not the only forum through which regulators in peripheral developing countries engage with their peers. Where national authorities supervise internationally active banks, this requires them to be in regular contact with supervisors in other jurisdictions. The existence of home-host communication and cooperation is much easier when there are common regulatory standards and supervisory practices, and this creates a powerful incentive for regulators to converge on and implement international standards (see for instance Cassidy, 2010; Chwieroth, 2010; Gorton, 2012).

In general, the higher the level of engagement in transnational regulatory networks, particularly in networks where Basel standards are actively promulgated, the stronger the incentives that regulators face to converge on international banking standards.

Sustained engagement with the World Bank and IMF

Regular interactions with international financial institutions like the IMF and World Bank, either through lending programmes or technical assistance, can provide strong incentives for regulators to implement international standards. While deep institutional reforms occurred under World Bank and IMF loans in the 1980s and 1990s, the World Bank and IMF have remained closely involved in the design of financial sector reforms in many peripheral developing countries.

In the wake of the Asian financial crisis in the late 1990s, the World Bank and IMF placed greater emphasis on strengthening supervisory capacity in developing countries, making the strengthening of regulation and supervision a condition in loans, and embedding long-term technical advisers in the banking supervision departments of central banks. Since the early 2000s, the IMF, World Bank, and Financial Stability Board have also conducted regular joint reviews of countries' supervisory practices under Financial Sector Assessment Programs (FSAPs), and this includes a review of the compliance with Basel Core Principles. The IMF and World Bank have funded regulators to attend training courses that promote Basel standards. In Africa, two 'AFRITAC' training centres funded by the IMF provide trainings and country-level technical assistance in East and West Africa with the explicit aim of supporting national regulatory authorities to comply with the Basel Core Principles, and to move from Basel I to Basel II and III.

There are more subtle forms of engagement too. As some of our case studies illustrate, there is often a revolving door between the IMF and World Bank and key institutions in peripheral developing countries, including central banks and ministries of finance. It is common for senior officials to spend part of their career in the IMF or World Bank, before returning to more senior posts in their home institutions. In addition to equipping officials with the technical skills to implement international standards, it is reasonable to expect that intense and regular engagement with IMF and World Bank staff leads to the diffusion of norms and ideas, helping to create regulatory institutions where the ideas and beliefs of senior staff are aligned with those prevailing in the IMF, World Bank, and closely related institutions.

Yet the IMF and World Bank have not universally championed the implementation of Basel standards. While the IMF and World Bank have enthusiastically supported compliance with the Basel Core Principles, their advice on the implementation of Basel II and III has been more circumspect. For instance, in its response to a Financial Stability Institute survey, Belize states that it is not implementing Basel II on the direct advice of the IMF (FSI, 2015, p. 4). A close read of FSAP reports reveals other instances in which the FSAP team has actively discouraged the implementation of Basel II, including in Rwanda, Barbados, and Cameroon. As our case studies show, in some instances peripheral countries have proceeded with Basel implementation *against* the advice of the IMF.

In general, we expect regular and extensive engagement with the IMF and World Bank to result in higher levels of implementation of the Basel Framework, although this may fall short of support for implementing the full suite of international standards.

Divergence: drivers and political underpinnings

While the international economic and political context in which peripheral countries are embedded can generate strong incentives for regulators in peripheral countries to implement Basel standards, they often face strong incentives to diverge from them. Four are particularly important: politicians pursuing interventionist financial sector policies, politicians and business oligarchs using banks to direct credit to allies, skeptical regulators, and fragile domestic banks.

Politicians pursuing interventionist financial sector policies

Where governments use interventionist measures to direct credit to specific sections of the economy or particular societal groups, this is likely to create incentives to diverge from the implementation of Basel standards. In many countries around the world, governments intervene in the allocation of credit through price or quantity rules in order to achieve specific policy objectives by providing competitive advantage to certain economic sectors. While often associated with the state-led industrialization strategies of fast-growing East Asian countries, policy-directed lending has been central to industrialization in many advanced countries.

In countries including Japan, South Korea, France, and Germany, a credit-based financial system allowed the state to exert influence over the economy's investment pattern and guide the development of productive sectors (Zysman, 1983; Haggard and Lee, 1995; Woo-Cumings, 1999; Naqvi et al., 2018). In the wake of the global financial crisis there has been a resurgence in interventionist financial policies, including renewed interest in national development banks, as governments have sought to channel credit into productive, longer-term projects.

Interventionist approaches were the norm in peripheral developing countries in the post-independence period, but many governments abandoned them in the 1980s and 1990s, often under the pressure of structural adjustment programmes (Mathieu, 1998). However, governments in some peripheral developing countries are pursuing interventionist financial sector policies, including Ethiopia and Bolivia, countries we examine in this book. In general, interventionist financial sector policies sit at odds with core aspects of the Basel framework.

The Basel Core Principles and Standards are premised on market-based allocation of credit, with the government only stepping in to address market failures. The Basel framework requires a formally independent regulator that operates at arm's length from the institutions it regulates (banks), as well as from the executive and legislative branches of government. Under this framework, the regulator's core role is to ensure the market works effectively by refereeing the allocation of credit by private institutions, and to limit excessive risk-taking. While such an approach is presented as apolitical, as Ghosh (2007) argues, the creation of independent regulatory institutions with narrow mandates is a political decision to prioritize a specific and narrow policy agenda, such as financial stability. In contrast, interventionist financial policies seek to channel credit on the basis of policy priorities rather than market prices, and deliberately seek to disrupt the market allocation of credit. Under such systems the government's core function is not that of referee, but that of a player, selectively allocating credit to specific industries (Zysman, 1983).

The market-orientation of the Basel framework is reflected in the Basel Core Principles, which emphasize the need for supervisors to have operational independence, free from political interference, and the relevant legal powers to ensure compliance. Policy-directed lending and the general use of financial intermediaries as instruments of government policy are identified as distorting market signals and impeding effective supervision (Basel Committee on Banking Supervision, 2012). Basel II standards place even greater emphasis on market actors and price signals than Basel I, with credit ratings agencies and banks accorded central roles in evaluating risks, and the third pillar of Basel II dedicated to improving market discipline, including through new public disclosure requirements. In countries where the government relies extensively on policy-directed lending, the Basel framework is unlikely to be an attractive basis for regulation.

Reformist politicians may promote the implementation of Basel standards as part of a wider agenda to move away from an interventionist to a market-oriented approach to the financial sector. Such moves are likely to provoke opposition from local elites who have been privileged within the existing system (Mosley, 2010). The implementation of Basel I in the developmental states of East Asia, as part of a wider market-based reform agenda, generated substantial resistance (Chey, 2014; Walter, 2008).

In general, the greater the level of interventionist financial policies in a country, the stronger the incentives that regulators face to diverge from international banking standards.

Politicians and business oligarchs using banks to direct credit to allies

Where politicians and business oligarchs use banks to direct credit to their allies, they are likely to oppose the introduction of international standards. Politicians may use their control over banks to allocate credit to political allies, while powerful economic elites may use banks to allocate credit to their own businesses and curry favour with politicians. Where such politically based lending is pervasive, regulation is typically lax, with regulators exercising a high level of forbearance. This may include the non-enforcement of regulations on non-performing loans extended to politically connected individuals, overlooking breaches to single obligor limits and related-party lending, and failing to follow due process when issuing bank licenses.

It is common for regulatory institutions in developing countries to face acute resource constraints, and in some cases this may be intentional. Hutchcroft (1998) explains why the central bank in the Philippines was one of the strongest government institutions and widely respected for maintaining a high level of macroeconomic stability, yet it housed a banking supervision department that was weak and where regulatory forbearance was the norm. He argues that this was due to the economic interests and political priorities of the powerful oligarchs. Underlying political economy dynamics also help explain why Singapore and Malaysia had strong regulatory institutions, while in Indonesia they were very weak (Hamilton-Hart, 2003).

Where political lending is pervasive, politicians and powerful economic elites are likely to resist moves to increase the quality of regulation and supervision and allocate more resources to regulators, moves that are required for the implementation and enforcement of international banking standards. In China, for instance, the introduction of Basel I was opposed by powerful groups within the party-state apparatus that benefited from politically directed credit allocation. Implementation only began in earnest after the Asian financial crisis alerted the leadership to the risks associated with an unreformed financial sector (Walter, 2010). In Malaysia and Thailand, powerful family-owned banks strongly resisted disclosure requirements that are an integral part of the Basel framework, as this would have revealed high levels of related-party lending (Walter, 2008).

Our case studies are a reminder that it is important to distinguish conceptually between interventionist financial sector policies, where credit is allocated on the basis of objective policies, and politically directed lending where credit is allocated on the basis of political favours to individuals. These two conceptually distinct phenomena are often conflated in the literature, reflecting an (often implicit) assumption that interventionist policies will be accompanied by high levels of politically directed lending, while systems of market-based credit allocation will be accompanied by low levels of politically directed lending (e.g. Arriola, 2013; Barth et al., 2006). Yet it is equally possible for politically directed lending to be pervasive under market-based systems of credit allocation, and for it to be negligible under interventionist systems, as several chapters in this book highlight.

In general, the more that banks are used by politicians and business oligarchs to allocate credit to allies, the stronger the incentives that regulators face to diverge from international banking standards.

Sceptical regulator

Given all the debate surrounding the appropriateness of Basel standards for low- and lower-middle-income countries, particularly Basel II and III, it is very plausible that the regulatory authority will be a source of resistance to the introduction of international standards, particularly the more complex elements of Basel II and III.

Supervisory capacity is a particularly acute constraint in many developing countries, and can be a major deterrent to moving from relatively simple compliance-based supervision under Basel I to risk-based supervision under Basel II (Beck, 2011; Fuchs et al., 2013; Gottschalk, 2010; Griffith-Jones and Gottschalk, 2016). Even national authorities in developed Basel member jurisdictions have found implementation of the new Basel standards challenging because of human resource constraints, above all the advanced, internal-ratings based approaches of Basel II and the macroprudential elements of Basel III (Bailey, 2014; BCBS, 2013).

The complex approaches of Basel II and III can also exacerbate information asymmetry between supervisors and banks, giving banks greater opportunity to game the regulations. These concerns are even more salient in developing countries, where human and financial resources are scarcer, and where remunerative differences and brain drain to the private sector pose significant challenges for regulatory authorities (Abdel-Baki, 2012; Fuchs et al., 2013; Gottschalk, 2016, 2010; Gottschalk and Griffith-Jones, 2006). Barth and Caprio (2018) argue that the Basel standards are too cumbersome and too costly for countries with small financial sectors, particularly countries with banking systems with total assets of less than US$10 billion.

In particular, we expect regulators to oppose the implementation of components that are irrelevant given the conditions in their financial markets (such as the requirements for counter-party credit risk in countries where banks do not have substantial trading books; and liquidity requirements where there is a shortage of assets that meet definitions of high quality) or overly complex given data availability and resource constraints (such as internal model-based approaches for assessing risk).

It is also plausible that regulators will block the implementation of international standards when this is likely to publicly expose weaknesses in the banking sector, and, in an extreme case, may even lead to banks being closed or trigger a financial crisis, for which they may be held accountable.

In general, the greater the resource constraints and technical challenges associated with implementing international standards, and the weaker the banking sector, the stronger the incentives that regulators face to diverge from implementing international standards.

Fragile domestic banks

Banks with business models focused exclusively on the domestic market in peripheral developing countries are likely to oppose the implementation of complex regulations because of the additional compliance costs this generates. An interesting finding from our empirical studies is that in low- and lower-middle-income countries, this often applies irrespective of whether these banks are foreign-owned or domestically owned. Opposition is likely to be strongest from small, weak banks, for whom the costs of implementation are highest.

In general, and unlike their counterparts in developed countries, banks in most developing countries are expected to be able to easily meet the levels of capital and liquidity required under Basel II and III, although adjustment costs vary greatly depending on the business characteristics of banks, variations in national tax regulations, and the availability of a sufficiently diversified portfolio of high-quality liquid assets.[9] The reason for this is that banks in developing countries typically hold capital well above the minimum international standards as a result of national regulatory requirements and the risky nature of the financial sector in which they operate. This does not mean that capital is necessarily of high quality as other factors, including accounting weaknesses, may put the quality of capital

[9] See for instance (Abdel-Baki, 2012; Frait and TomŠÍk, 2014; Gobat et al., 2014; Kasekende et al., 2011; World Bank, 2013). Another study of Bolivia, Colombia, Ecuador, and Peru suggests that major banks in these countries already meet the Basel III capital adequacy ratios (Galindo et al., 2011).

into question, but it does mean that nominal compliance with the Basel standards ought to be within reach. In Africa, for instance, more than one third of national regulators impose higher capital standards than required under both Basel II and Basel III (Kasekende et al., 2011).

However, the adjustment costs for banks of moving from Basel I to Basel II and III can be extremely high, particularly for smaller banks that have relied on relationship-based lending.[10] In particular, banks need to train staff and upgrade information technology systems to bring their risk management into line with Basel standards. As Rajan and Zingales (2003) explain, in the absence of disclosure requirements and proper enforcement, financing is typically relationship-based. Incumbent financiers use connections to obtain information to monitor loans, and various informal levers of power to cajole repayment. Disclosure and impartial enforcement tend to level the playing field and reduce barriers to an entrance into the financial sector. The incumbent financier's old skills become redundant, while new ones of credit evaluation and risk management become necessary. For banks focused on serving the domestic market, the implementation of international standards, particularly the more complex elements of Basel II and III, entails high costs and few gains.

Local subsidiaries of international banks may have more sophisticated risk-management systems, and greater technical expertise, reducing the costs of compliance relative to small domestically owned banks. We might reasonably expect this to lead foreign subsidiaries to champion the implementation of international standards, in order to gain a competitive edge over domestic banks. Yet our case studies don't bear this out. Instead, the local subsidiaries of international banks are ambivalent or even circumspect about the desirability of fully implementing Basel standards. Even if a bank has the internal systems to readily comply with Basel II and III, the situation in the wider economy, including a lack of readily available credit information and limited access to high-quality liquid assets, may impede compliance. Moreover, the structural features of the wider economy render banking sectors in many low- and lower-middle-income countries highly profitable and lacking in real competition, despite a high number of foreign and local banks (see Chapter 2). In such an environment, there is less incentive for the subsidiaries of international banks to try and use the introduction of complex regulations to gain a competitive edge.

Opposition to the implementation of international standards is likely to be particularly high among banks that are financially weak, poorly governed, or have lent extensively to politically connected clients. Basel implementation

[10] Tarullo (2008, p. 167) suggests that the costs to an individual bank of compliance with some of the more complex elements of Basel II (internal model approaches to credit risk) are US$42 million per institution.

is likely to engender particularly strong opposition from banks during an economic downturn.

In general, the higher the prevalence of weak domestic banks, the stronger the incentives that regulators face to diverge from international banking standards.

Pathways to convergence, divergence, and mock compliance

In the sections above, we set out the key actors and the factors that generate incentives for regulators in peripheral developing countries to converge on, or diverge from, international banking standards. A logical implication of the preceding discussion is that in countries where regulators face incentives to converge that are stronger than incentives to diverge, we expect greater levels of convergence on international standards than when incentives to diverge outweigh incentives to converge.

In line with the preceding discussion, we expect *convergence* to be high where a country has traditionally pursued a market-based approach to credit allocation and where the political and business elite pursue a development strategy that prioritizes integration into international finance and the expansion of the financial service sector; where regulators have substantial autonomy and are embedded in an international policy environment that encourages adoption of international standards; and where large domestic banks have a substantial international footprint.

Conversely, we expect *divergence* to be high in cases where a country has a history of interventionist policies towards the financial sector, or where politicians and business oligarchs extensively use banks for political ends; where the regulator is sceptical about the applicability of Basel standards for their local context and does not prioritize engagement in international policy networks that encourage the adoption of Basel standards; and where there are a substantial number of weak and poorly governed domestic banks.

Of course, country contexts are not static. In this section, we explore pathways of convergence and divergence, and explain why trajectories are likely to differ depending on which actor is driving the process. We also discuss the ways in which regulators are likely to respond when they face strong incentives to both converge and diverge, arguing that the outcome is likely to be mock compliance or stalled implementation.

A summary of the argument is reflected in Table 3.1.

Pathways to convergence

Countries can embark on a process of convergence with international standards for different reasons. *Policy-driven convergence* is led by incumbent politicians

Table 3.1 Pathways to convergence, divergence, and mock compliance

Drivers of convergence				Drivers of divergence					Pathway	Outcome
Politicians seeking international capital	**Regulators engaging with peers**	**Domestic banks expanding into international markets**	**Sustained engagement with the World Bank and IMF**	**Politicians pursuing interventionist financial policies**	**Politicians and business oligarchs using banks to direct credit to allies**	**Sceptical regulator**	**Fragile domestic banks**	→		
✓	–	–	–	–	–		–		Policy-driven	Convergence
–	✓	–	–	–	–		–		Regulator-driven	
–	–	✓	–	–	–		–		Bank-driven	
–	–	–	✓	–	–		–		IFI-driven	
–	–	–	–	✓	–		–		Policy-driven	Divergence
					✓				Politically driven	
–	–	–	–	–		✓	–		Regulator-driven	
–	–	–	–	–	–		✓		Bank-driven	
✓	–	–	–	✓	–		–		Politically driven	Mock compliance
–	✓	–	–	–	✓		–		Regulator-driven	

Note: ✓ denotes the factor driving the process of convergence or divergence with a strong vision of integrating their countries into global finance and expanding the financial services sector, perhaps with the support of local business elites. Politicians may face resistance from the regulator, particularly if the regulator has limited expertise and resources, and from small domestic banks, particularly if they are used to a lax regulatory environment. For these groups, the costs of adjustment to a new regulatory regime can be very high.

In this scenario, we expect politicians to make bold and ambitious public statements about the implementation of international standards to signal their reformist intentions to international and domestic audiences. However, implementation may be slow and targets frequently missed, as the regulatory authorities and domestic banks resist implementation. This scenario is unlikely to be stable, as politicians can take policy decisions that shift the preferences of the regulatory authority and banks over time. For instance, politicians may decide to reform and strengthen regulatory institutions, including by appointing governors to the central bank that are aligned with their strategy, providing them with additional resources and greater powers. Politicians may also take policy decisions that lead to the internationalization of the banking sector, shifting bank preferences in favour of implementing international standards. Over time we expect the consistent pursuit of convergence by politicians to result in high levels of Basel implementation.

Regulator-driven convergence is led by regulators, and is particularly likely when the regulatory authority has a high level of independence, and when senior officials engage extensively in international policy discussions and aspire to senior positions in international financial institutions organizations. In this situation, the regulatory authority is likely to adopt a normative identity focused on the championing of 'international best practices'.

Where regulators initiate convergence, they are may meet resistance from domestically oriented banks and ambivalence or opposition from politicians. Whether the reform initiative is successful depends on the level of independence the regulator has from the executive branch and whether it has sufficient resources and power to compel banks to comply. If for historical reasons the regulator has substantial independence that is widely respected by politicians, then the regulator may succeed in issuing regulations in line with international standards, and enforcing them.

In situations where banks and politicians form an alliance against regulatory reforms, the regulator may champion an ambitious level of convergence, but is unlikely to be able to follow through. This scenario can persist as a relatively stable equilibrium unless politicians change their policy stance and start to favour the internationalization of the financial sector, or domestic banks expand overseas and press for convergence. Regulators on their own are rarely powerful enough to shape the preferences of the other key actors (politicians and banks).

Bank-driven convergence occurs when large domestic banks champion the implementation of international standards as part of a drive to expand into new international markets. These proposals are likely to be met with opposition from smaller banks, and inertia or opposition from the regulator and politicians. In this situation, individual banks may voluntarily comply with the standards, while they continue to advocate and lobby for formal implementation by regulator. Where these banks have a high level of political influence, they may well succeed in gradually shifting the preferences of politicians and/or the regulator in favour of implementation. In particular, once banks have expanded overseas, home regulators have an incentive to implement international standards in order to facilitate cross-border supervision with host supervisors.

Finally, *IFI-driven convergence* occurs when implementation is championed by the IMF or World Bank. Where these are opposed by regulators, politicians, and banks, little meaningful implementation is likely to occur, unless it is made a condition for accessing financial support, in which case implementation may happen on paper, but is unlikely to fully occur in practice. However, if the regulatory authorities are supportive of implementation, then an alliance between international financial institutions and senior technocrats may be sufficiently powerful to convince politicians to push reforms through.

Pathways to divergence

Unlike processes of convergence, where regulators have to take the active step of aligning with international standards, divergence is the default option. Divergence occurs when a new set of international banking standards is agreed by the Basel Committee, but the regulator takes no steps to align domestic regulations with the new standards. Over time, as the Basel Committee issues more standards, the gap between national regulations and those prevailing at the international level widens, and divergence becomes more pronounced.

It is unlikely a regulator will actively change national regulations so that they are less aligned with international standards. As discussed above, the reputational gains from implementing international banking standards in the eyes of international investors and regulators in other jurisdictions can be substantial. Deliberate decisions to undo regulations based on international standards is likely to be interpreted as a signal of weak prudent regulation, with the attendant risk of capital flight. This is a similar logic to that outlined by Boylan (2001) who explains that newly elected governments will be reluctant to reverse central bank independence lest they pay the high costs associated with transgressing this sort of reputational mechanism: the massive outflow of foreign capital from their economies (Boylan, 2001, p. 57).

Divergence, then, occurs when politicians, regulators and banks are ambivalent towards international standards so there is no champion for implementation, or when one or more of these actors successfully thwarts their implementation. *Policy-driven divergence* occurs when the pursuit of interventionist financial sector policies creates a mismatch between the need for the regulator to ensure that government and state-owned banks make informed, impartial policy-based decisions in the direct allocation of credit, and the role envisaged for the regulator under the Basel framework. When interventionist policies are the main mechanism for allocating credit in the economy, we expect a high level of divergence to occur, and for this to be a relatively stable equilibrium, as regulators, politicians, and banks are all vested in this arrangement. In countries where there is a hybrid approach and only some institutions allocate credit in this way (such as national development banks), the regulator may exempt these institutions from complying with Basel standards, even if other banks are regulated under them. Indeed, governments in advanced and emerging economies have exempted their development banks from full compliance with Basel standards (Castro Carvalho et al., 2017; Hohl et al., 2018).

Politically driven divergence occurs when political and business elites have a vested interest in maintaining an opaque and highly personalized system of credit allocation. This is also likely to be a fairly stable equilibrium as an alliance of political and business elites is likely to have sufficient power to block any initiatives to implement international standards.

Regulator-driven divergence occurs when the regulator seeks to block the implementation of international standards out of concern that they are ill suited to the domestic context. Sceptical regulators are likely to advocate cautious and selective implementation of the standards and tailoring to suit the local context. Even when regulators have relatively little power, and convergence is being driven by politicians and internationally oriented banks, this strategy of selective adoption is likely to be successful. Politicians and banks are looking to use the implementation of the latest international standards as a signal to international investors, credit rating agencies, and regulators in other countries that regulation is sophisticated and effective. Precisely because they are relying on the implementation of standards as a heuristic shortcut for assessing the quality of regulation and supervision, these third parties are unlikely to differentiate between full and selective adoption of the latest international standards.

Bank-driven divergence is likely to occur when a critical mass of domestic banks are weak and poorly governed, and implementation of international standards is likely to publicly expose their fragility. Domestic banks are likely to advocate for a delay in implementation and, where they are particularly fragile, we expect regulators and politicians to support them, fearing reputational, economic, and political fall-out if they proceed with implementation. In situations where regulators want to regulate internationally oriented domestic banks according to international standards, they may opt to create a segmented regulatory regime, where international standards only apply to specific parts of the financial sector. For instance, many members of the Basel Committee exempt smaller banks from the purview of Basel II and III, only applying the full suite of Basel standards to large, internationally active banks (Castro Carvalho et al., 2017).

Mock compliance

Specific sets of dynamics occur when regulators simultaneously face strong and conflicting incentives to converge on and diverge from international standards. In this situation, regulators may issue regulations that are aligned with international standards, but *intentionally* fail to enforce them. Scholars have labelled such situations forms of 'cosmetic' or 'mock compliance' (Chey, 2014, 2006; Walter, 2008).

Politically driven mock compliance occurs when politicians want to implement international standards in order to signal creditworthiness to international investors, yet are concerned that implementation will limit their ability to direct credit for policy or political reasons. *Regulator-driven mock compliance* occurs when the regulator wants to implement international standards in order to support the international expansion of domestic banks and enhance their professional standing in the eyes of their peers, yet is concerned that implementation will expose hitherto undisclosed weaknesses in capital provisioning by domestically oriented banks.

Whether mock compliance is a sustainable strategy depends on the incentives and information available to the third parties to whom implementation is intended to signal sophisticated and robust regulation. Forms of mock or cosmetic compliance can be quite sophisticated and hard to detect without detailed scrutiny of national regulations. Japan, for instance, managed to circumvent the implementation of Basel I standards by maintaining national accounting standards that enabled banks to hold much less regulatory capital than intended by Basel I standards (Chey, 2014). Conversely, in situations where a country has a reputation for lax regulation and widespread regulatory forbearance, claims to be faithfully implementing and enforcing more complex regulations based on international standards are unlikely to persuade third parties unless there is an overhaul of the regulatory institution and a demonstrable change in the incentives of politicians and business elites. Paradoxically, even where mock compliance is suspected, credit rating agencies and even international creditors may not have an incentive to investigate or punish mock compliance: the global financial crisis has exposed the perverse incentives that persist in financial markets, particularly among intermediaries.

Conclusion

This chapter has set out a framework for explaining why regulators in peripheral developing countries respond very differently to international banking standards. It has identified the key actors, drivers of convergence and divergence, and explained how this leads to specific trajectories of convergence on and divergence from international standards, as well as instances of mock compliance.

Table 3.2 Matching case study countries against the explanatory framework

Country	Pathway	Outcome (number of BII and BIII components implemented)
Pakistan	Policy-driven convergence	Ambitious implementation (14)
Rwanda	Policy-driven convergence	Ambitious implementation (10)
Ghana	Policy-driven convergence	Ambitious implementation (8)
WAEMU	IFI-driven convergence	Ambitious implementation (10)
Tanzania	Regulator-driven convergence	Selective implementation (8)
Kenya	Regulator-driven convergence	Selective implementation (7)
Bolivia	Regulator-driven convergence	Selective implementation (5)
Nigeria	Regulator-driven mock compliance	Mock compliance (6)
Angola	Politically driven mock compliance	Mock compliance (5)
Vietnam	Politically driven mock compliance	Mock compliance (3)
Ethiopia	Policy-driven divergence	No implementation (0)

Notes: Ambitious implementation = includes at least one of the more complex components (internal models under Basel II and/or liquidity or macroprudential/liquidity standards under Basel III); Selective implementation = standardized approaches under Basel II and only microprudential capital requirements under Basel III; Mock compliance = on paper, not enforced

In the case study chapters that follow, we use this framework to explore the political economy of Basel implementation in eleven low- and lower-middle-income countries across Africa, Asia, and Latin America. While the real world never maps perfectly onto an abstracted explanatory framework, our case study countries can be classified according to the extent to which they align with the dynamics described above (Table 3.2).

In four cases (Pakistan, Rwanda, Ghana, and West African Economic and Monetary Union (WAEMU) implementation of Basel standards has been ambitious, and included some of the more complex elements of Basel II and/or III. In the first three cases, convergence was the result of politicians perusing policies to attract international capital into the financial services sector. In WAEMU it was the result of sustained engagement with the IMF, and a regulator that was very supportive of Basel implementation. In a further three cases (Tanzania, Kenya, and Bolivia) convergence was championed by regulators and resulted in selective adoption of the standards, with regulators implementing the more straightforward elements of the Basel framework. In three cases (Nigeria, Vietnam, and Angola) we see mock compliance, where international standards are implemented on paper but not enforced. In Nigeria mock compliance is driven by conflicted incentives within the regulatory authority, while in Angola and Vietnam it is driven by conflicted incentives on the part of politicians. Finally, we have one case of divergence (Ethiopia), which is driven by interventionist policies towards the financial sector.

In Chapters 4 to 15 we examine each case in turn.

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