# The Finance Column

Alex Preston

# Basel III is not just window-dressing

Two years to the week after Lehman Brothers went down, international regulators approved a series of measures aimed at preventing a repeat of the 2008 financial crisis. On 12 September, central bankers from 27 nations met at the offices of the Bank for International Settlements in Basel, Switzerland, to forge new guidelines on the amount of capital (basically equity) that banks need to hold against the assets on their balance sheet. Many think that the Basel Capital Accord (or "Basel III", as it's known) is a whitewash, a sop to placate whining politicians.

Bank stocks rose to their highest level in four months as news emerged of the weaker-than-expected regulation. Lloyds TSB and Royal Bank of Scotland shares jumped 3 per cent in relief. The local Swiss regulator immediately stated that it would insist on more stringent rules for its own banks. The UK and US will likely follow suit. Paul Myners, the former City minister, gave the measures a grudging 3 out of 10. The Nobel Prize-winning economist Joseph Stiglitz lambasted the timetable of the accord as "unconscionable". At first glance, you can see their point. All of the major UK and US banks will pass the requirements with flying colours: of the 62 US banks with over $10bn in assets, 61 pass. The once-shaky Lloyds and RBS will make the grade with ease. Even the banks that are struggling (mainly German and Spanish) have until 2019 to meet the standards. As with the stress tests carried out earlier in the year, Basel III seems designed to help bolster confidence in the sector, rather than force the large-scale reforms many had hoped for.

## Too big to fail

Time for some painful details. Basel III states that banks should now hold 4.5 per cent of "core" Tier 1 capital (the best kind) against their "risk-weighted" assets. This more than doubles the previous 2 per cent limit. Furthermore, an extra 2.5 per cent of capital will be held as a buffer against the kind of shocks we experienced two years ago. A final capital charge will be applied to systemically important banks – the "too big to fail/too big to save" institutions such as Barclays and Citigroup.

The most important element of the regulation, however, is the liquidity coverage ratio, which requires banks to have sufficient easily liquidated assets on hand to cover a month's worth of outgoings. It is this final rule that might help prevent another Lehman Brothers, because it was liquidity that finally brought down the US giant.

New rules: the Bank for International Settlements

However, one important issue remains unaddressed by the accord: the definition of "risk-weighted assets". Much of the criticism of Basel III has been directed at the numerator in the capital adequacy calculation – what can be included as Tier 1 capital. But the danger lies with the denominator. Central to the Basel III regulation is allowing banks (with the help of the rating agencies) to decide the riskiness of their asset base.

Banks are judged – as is any corporation – by their return on equity. With more (and better-quality) equity having to be held against risk-weighted assets, the onus will fall on the bankers to find ways of reducing the perceived riskiness of their asset base. One way they have done this in the past? Taking sub-prime loans – highly risky securities – and packaging them into AAA-rated "collateralised debt obligations" that were supposedly close to risk-free. And we all know how that ended.

So is Basel III just window-dressing, as many have claimed? No. The Basel Committee on Banking Supervision has already stated that the current standards are merely the first wave. There will be further tweaks to address the "too big to fail" problem and, one hopes, some definitive guidance on the calculation of risk-weighted assets.

The requirements, though less than some hoped for, are nonetheless an improvement on what went before. Some estimate that German banks alone will have to raise €75bn of new capital to meet the tests – a cloud over the otherwise sunny landscape of the German economy.

## Shock absorbers

As for the timescale, while nine years may seem far too long to fast-living City types, it makes sense to give banks time to recover from the financial crisis. Imposing constraints upon their ability to make loans in the current market only risks exacerbating the downturn. Anyway, it is unlikely that there will be another crash in the near term. With the scars so fresh, the risk is rather that banks will continue to hoard capital and prolong the slump.

More important, we now have a regulatory framework in place. No matter that the laws don't come into effect for almost a decade: banks are being judged against the rules from today. This is why Deutsche Bank raised almost €13bn of new equity the day the rules were announced. The cash will partly be used to buy a stake in its rival, Postbank, but Deutsche Bank also wanted to send a message to the markets by upping its capital ratios. It is distancing itself from its weaker German peers and positioning itself alongside the likes of HSBC and JPMorgan. It is likely that banks will view membership of the "too big to fail" club as a boon, despite the tougher capital requirements.

What makes Basel III a dramatic development in financial history is that the Americans are on board. The US largely ignored the requirements of Basel II, preferring to allow the invisible hand of the market to regulate its banks. That the Americans have embraced Basel III gives it the credibility and momentum that previous standards lacked. This is the first time we have seen truly global banking regulation in action. It's a critical step towards building banks that can withstand the kind of shocks that were so devastating in 2008. ●

*Alex Preston's column appears fortnightly. His novel "This Bleeding City" is published by Faber*

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