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Basel III is priming big banks to work the system

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The slow implementation period for the new Basel III capital regime, which will not be fully phased in until 2019, means that the world cannot afford to have another large-scale banking crisis for nine years. Can we rely on the bankers to do the decent thing and refrain from jumping the gun?

Merely to formulate the question invites a cynical response, in the light of recent history. Yet a longer historical perspective provides modest reassurance, in that the gap between big banking crises since the 1970s has usually been quite long.

The first serious post-war banking crisis came after the collapse of the Bretton Woods semi-fixed exchange rate system and an acceleration in the deregulation of banking. That precipitated a liquidity explosion and property market boom, which culminated in a banking crisis in the UK in 1973, along with a rather less severe one in the US. These difficulties were compounded by currency losses, which sank the Herstatt Bank in Germany and Franklin National Bank in the US.

The Latin American debt crisis followed in 1982 when Mexico announced it was unable to service its debt. Then there was trouble in 1990 when banks in the US, Europe and Japan were hit by another property plunge. After that came the Asian crisis in 1997, followed 10 years later by the biggest episode of collective memory loss in banking since the 1930s. On that basis, with a little rounding up, we could say that bankers have on average a nine-year itch.

This lag makes intuitive sense since bankers' risk appetites are inevitably dulled by the searing experience of the crisis and the regulatory backlash that it spawns. It also takes time to rebuild balance sheets that are weighed down by bad debts, especially when regulators accept that the capital base is too slender to permit timely recognition of losses. That said, the interesting question is what changes have taken place in finance that might shorten the itch. One that stands out is the extraordinary speed with which banking psychology has returned to business as normal this time, despite the overwhelming nature of the crisis.

That tells us, among other things, that the extreme scale of the bail-outs bred extreme moral hazard, which is a big warning signal for the future.

Compared with the periods after 1982 and 1990, it also seems possible that the big banks will recapitalise themselves more quickly and write off dud loans in more timely fashion. The message in Deutsche Bank's imminent €10.2bn ($13.3bn) rights issue is that a polarisation is about to take place across the banking industry between the giants and the also-rans. The game is to rebuild the balance sheet fast for competitive advantage.

Yet this strengthening of capital is not uniformly positive from a systemic perspective. A consequence of the crisis is that there is now a more heavily concentrated group of giants that are too big to fail.

With gung-ho investment bankers increasingly taking the helm of large integrated financial institutions and pocketing funds from shareholders who have exercised minimal restraint over past banking excesses, the prospect for taxpayers who foot the bill for last resort lending is unnerving.

Meantime, there is a “more-of-the-same-only-more-so” kind of problem, which relates to the Basel regime itself. Much of what went wrong in the crisis was prompted by Basel I. By its nature, a capital adequacy regime raises banks’ capital costs and reduces their profits. The bankers’ response was to push business off the balance sheet and create a shadow banking system that escaped all capital constraints.

Basel III is much tougher on capital than Basel I or the recently implemented Basel II. It is the central plank of the regulatory response to the crisis. Yet that implies that the bankers’ incentive to game the system is even greater than before. The temptation to engage in regulatory arbitrage and find ways of taking increased risk to generate profits to compensate for the capital hit can only be that much greater.

All of this will be compounded by problematic accountancy, since no agreement has been reached on the issue of fair value and considerable uncertainty prevails over the treatment of shadow banking, which looks all too likely to remain shadowy.

Of course, the watchdogs will be on their guard. But they should recall the plot of G.K.Chesterton’s *The Man Who Was Thursday,* in which six of the seven members of the European anarchists’ council, each code-named by days of the week, turned out to be undercover detectives trying to defeat anarchism.

It would be too bad if zealous regulators and supervisors fell over themselves in pursuit of un-shadowy banks while the real action was elsewhere.