Basel 3: Implications for the Australian Financial System

CEDA Presentation

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In the time available to me I want to make four points about international regulatory trends, their implications for the Australian financial system, and the process of financial regulatory change in Australia. And in that regard, I am tempted to suggest that the subtitle of my talk should be, in the words of the 1970s rock group Bachman Turner Overdrive, "Baby, you ain't seen nothin' yet". Not because of Basel 3, but because of a range of other developments which tend to make Basel 3 yesterdays news. Nevertheless, given my allotted topic, I'll focus primarily on Basel 3, and allude to those as I proceed.

One consequence may be that the size of the financial sector will shrink with, ideally (in my view) less emphasis being given to trading and dealing relative to the core economic functions of the financial sector. In that regard, it is perhaps worth giving a quote from a 1984 article by the Nobel Laureate James Tobin which I had forgotten about and stumbled across upon recently "...we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity". I wonder what he would have thought about how the financial sector has changed since his death in 2002, and what his attitude towards High Frequency Trading etc would be?

The points I wish to make are as follows – and I'll expand upon them subsequently.

- The international regulatory response to the GFC is a piecemeal approach of specific responses to individual problems, not well grounded in a holistic view of the workings of the financial system.
- Basel 3 higher capital requirements are warranted, they should have relatively minimal implications for Australian banks, but the risk weighting approach is "too clever by half" and simpler approaches should be the objective.
- Basel 3 liquidity requirements may be of more significance, but (a) the Liquidity Coverage Ratio is founded on false premises and will have minimal effects on loan interest rates, while (b) the calibration of the Net Stable Funding Ratio requirement is critical in terms of balancing system stability objectives with facilitating one of the core functions of banking – that of liquidity production, and has already started to influence bank funding patterns and relative interest rates.

- A new Inquiry would be useful in terms of better understanding the structure of the financial system – and how best to influence its evolution.

The Grand Vision

Is there a "grand vision" for redesign of the financial system underpinning the current regulatory agenda, or is it primarily just "tinkering with the plumbing"? Do we need significant institutional changes to create a better, more efficient, and more robust financial system?
To date, there has been a tendency for reforms to be directed to rectifying specific issues identified in the GFC.

- Excessive leverage, solution – increase capital requirements;
- liquidity and counterparty spillovers, solution – use of Central Clearing Counterparties, higher risk weights for financial sector counterparties, minimum liquidity requirements;
- Inappropriate incentive structures, solution – ad hoc interference in remuneration structures, codes of practice for credit rating agencies, etc.
- Problems in resolving troubled financial institutions and achieving a "graceful" exit or recovery, solution – expanded intervention powers for regulators, requirements for contingent capital and "bail-inable" debt, living will (recovery and resolution plan) requirements
- Bank runs, solution – expand or introduce explicit deposit insurance
- Banks arbitraging regulatory requirements such as risk weighted capital requirements, solution – introduce more complexity into the risk-weighting system

There is much concern about the aggregate effect of such a plethora of piecemeal changes. A couple of simple examples may illustrate. First, increased demands for high quality collateral for derivative and other transactions accompanied by the impact of the Basel Liquidity Coverage Ratio requirements in increasing the demand for government securities can be expected to create a "liquidity premium" in government security rates. Government bond rates may no longer be a good indicator of the risk free rate of time preference, but pushed below that because of that liquidity demand. Second, the high ($250,000) cap for coverage of deposits at any ADI under the financial claims scheme, must – particularly when banks are competing strongly for deposits in response to Basel 3 liquidity requirements – reduce retail investor demand for corporate or government bonds, which other regulatory changes are trying to promote.

My thesis is that it is largely a "tinkering" approach that holds sway. This appears particularly so in Australia where the "if it ain't broke, don't fix it" maxim (prompted by our successful navigation of the GFC) has currency. I think that the appropriate approach should be to ask the questions: "it may not be broke, but can it work better?" and "how can we best ensure that it doesn't break in the future".

And we should recognize that while we survived the GFC relatively unscathed, there was massive government intervention involved in achieving that outcome. Importantly for thinking about the regulatory future, those interventions have entrenched a number of financial system features (too big to fail, implied government guarantees) that undermine the basis of the deregulatory approach practiced since the early 1980s

In some countries, radical reforms are being contemplated, or introduced. The most obvious example of this is the British banking reforms proposed in the June 2012 White Paper introducing "ring fencing" of retail banking, and the Liikanen Report for the European Union released a few days ago suggests somewhat similar changes. The USA is also implementing some potentially far reaching changes as a result of the Dodd-Frank Act, but that case probably serves more to emphasize how regulatory change is ultimately driven by political considerations and vested interests rather than by economic logic.

The British proposals have an economic logic to them, although not necessarily one which all would agree with. Whether they survive the lobbying process to emerge largely unscathed as legislation remains to be seen, but recent financial sector scandals can only serve to weaken the opposition forces. (Think of JP Morgan – the "Whale" trading losses, Barclays – Libor, HSBC and Standard Chartered – US government allegations regarding money laundering)

Basel 3 Capital Requirements
The changes to capital requirements take two main forms. One is increasing the level of capital required. The second is "tinkering" with the already complex risk-weighting system.

Australian banks are well placed to deal with the higher capital requirements of Basel III (even with APRA's higher standards) for the following reasons: Strong capital positions; strong profitability with high earnings retention due to dividend reinvestment plans; currently slow credit growth

Moreover, the funding cost implications are minor. One reason is the Australian dividend imputation tax system, which means that any tax-induced cost of higher equity capital requirements relative to debt/deposit funding is lower than for banks overseas. Another is that, even if equity is more expensive than debt, and shareholders do not reduce their required returns as leverage declines, requiring a relatively marginal change in capital and leverage adds only a few basis points to overall funding costs. My calculations put it well below 10 basis points. If we are concerned about the macroeconomic effects via lending costs, this can be offset by RBA interest rate policy.

But every basis point counts in competitive markets! Maybe this impost is unfair to banks relative to other forms of less regulated financing? Or maybe it is just working to rectify an existing imbalance arising from the ability of banks to exploit implicit government guarantees via high leverage. The new capital requirements are still very low compared to the longer term historical average. The ratio of equity to total assets fell from 15.4 percent in 1901 to 6.7 percent in 1945 and to much lower levels by the 2000's.

Turning to the structure of capital requirements, many commentators are questioning the merits of the complex risk weighting approach and reliance on bank internal models. Recently Andy Haldane from the Bank of England titled a talk addressing this issue as "The dog and the Frisbee", noting that dogs are good at catching Frisbees but not, as best as we can tell, really on top of the complex calculations needed to sort out the aerodynamics involved. While Basel 3 incorporates an additional "straight" leverage requirement, that is seen, and calibrated, as a backstop to the risk-weighted requirement. Bringing it front and centre is worth considering – as long as supervisors have powers to adjust the requirement when excessive risk taking is seen to be occurring.

Liquidity Requirements

The Basel LCR requirement is based on flawed logic. In a general liquidity crisis the central bank must step in and provide system liquidity through repurchase agreements or other mechanisms. Provided banks have sufficient repo-eligible securities, it does not matter whether they are government or private sector issued. Credit risk associated with the collateral provided by banks in such repo transactions can be managed by applying appropriate "haircuts" and margining requirements. If an individual bank faces an idiosyncratic liquidity problem, it should be able to sell private sector securities into the market to resolve the problem. So, the logic of only government debt being eligible is questionable.

In Australia, the shortage of government debt has led to the introduction of the RBA's Committed Liquidity Facility as an alternative to bank holding of eligible securities. The pricing of that is indicative of the relatively benign effects of the LCR on bank funding costs. A fee of 15 basis points is charged. If a bank's required liquidity holdings to meet the LCR are, let's say, 20 per cent of assets, this involves an additional cost of 3 cents for each 100 dollars of assets or 3 basis points. Not something that will "break the bank"!

The Basel III Net Stable Funding Ratio requirement requires banks to better align their use of longer term (one year plus) funding with their longer term loan commitments. It has the potential to significantly affect bank funding arrangements and loan arrangements for the following reasons:

- It reduces the ability of banks to "ride the yield curve" (borrow short and lend long) and profit from its traditional upward slope.
- It reduces the extent of liquidity creation by banks, by forcing a reduction in the average maturity gap between loans and deposits.

Such liquidity production is a key economic function of bank intermediation, and the merits of introducing and the calibration of such an impediment as the NSF ratio can be debated. Underpinning the NSF ratio introduction is the view that banks had become engaged in socially excessively risky liquidity production – the consequences of which were seen during the Global Financial Crisis and the need for various forms of government support for ongoing funding.

A Child of Wallis

There are good arguments for a new Inquiry to consider how things fit together. The structure of the Australian financial sector has changed markedly since the Wallis report (growth of superannuation being the most obvious). But thinking about how the financial sector operates is also changing. In that regard it is worth noting that while there was much that was good in, and arising from, the Wallis Report, it was founded on a number of assumptions which are, at least questionable, and which recent experience has brought to prominence. I'd note the following:

- An economics 101 faith in the general benefits and stability properties of markets. Not only can individual financial markets suffer from severe market failures, the interactions between financial markets is extremely complex – and reflected in increased attention being paid to such things as network analysis
- Belief that structural separation of APRA, without its own balance sheet, from the RBA would reduce the risk of depositor bail-outs and investor perceptions there-of. We now live in a world where, currently, large systemically important financial institutions which are TBTF or TBTS dominate – with adverse consequences for competition, governance, and market discipline
- Belief that depositor preference was sufficient to prevent bank runs without need for a deposit insurance scheme. We now have the FCS, which needs some redesigning – although many current suggestions for redesign involve a misunderstanding of how the Scheme works. But analysis of the financial system and its regulation needs to take that into account.
- A perception that capital markets would evolve more rapidly and reduce the dominant competitive position of the major banks. There is still relatively little direct debt financing (as opposed to intermediated) financing of business, despite the massive growth of superannuation (the effect of which on the way financial markets work also needs to be reviewed). Technology is continually changing the way in which financing can occur, and the potential for a relatively greater role for capital markets in the provision of finance and wealth management is one result. Unfortunately, it is also increasing the scope for greater misallocation of society's intellectual resources into primarily redistributive trading activities which, in my view, add no social value. I think James Tobin would turn in his grave!