

More on Basle III

In an earlier article (March 10, 2016), I had criticised the complexity of the Basle III models for capital charge, and whether higher capital would meet the objective of eliminating the cost of bank bail outs falling on the tax payer. A recent book, *"The End of Alchemy"* by Mervyn King, a former governor of the Bank of England, makes the same point. To quote from the book, *"Regulation has become extraordinarily complex, and in ways that do not go to the heart of the problem. ... The objective of detail in regulation is to bring clarity, not to leave regulators and regulated alike uncertain about the current state of the law. Much of the complexity reflects pressure from financial firms. By encouraging a culture in which compliance with detailed regulation is a defence against a charge of wrongdoing, bankers and regulators have colluded in a self-defeating spiral of complexity."* One example of complexity I recently came across pertains to the interest rate risk in the banking book. The Basle III norms prescribe that the economic value of equity should be calculated under *six* different interest rate scenarios!

Mr King also suggests a solution: the riskier assets of each bank should be vetted and valued by the central bank to determine in advance the "hair cut" it would apply for buying/refinancing them, and determine capital based thereon. To give a numerical example, if a bank had \$ 10 mn reserves with the central bank, \$ 40 mn of liquid securities on which the hair cut is 10%, i.e. \$ 4 mn, and \$ 50 mn of illiquid, riskier business loans (hair cut 50%, i.e. \$ 25 mn), the bank would need a capital of \$ 29 mn to finance/pay for the haircuts. One wonders how the capital would be serviced, the implications to interest margins and, therefore, to the cost of capital for borrowers.

Again, as for the valuation/haircut on riskier assets suggested by Mr King, as Mark Buchanan wrote recently in Bloomberg, *"this would require decades of price history on hundreds or thousands of different assets – something that simply doesn't exist for many of those assets."*

Bank capital apart, another major problem that is coming up is the question of capital adequacy norms for clearing companies which guarantee and settle trades. This leads me to speculate on one other issue: at what point of time will the question of capital adequacy for central banks come up? After all, Mr. King's model outlined above means trusting the ability of central banks to fund assets of the commercial banks, when needed, no doubt with a haircut.

The largest cost of a financial crisis is the loss in output occasioned by disruption of loans to the real economy. Despite zero to negative interest rates since the financial crisis in 2008, growth is not picking in the advanced industrial economies. Private investors are increasingly being tempted to go for riskier assets. The three central banks' balance sheets have been bloated to levels unimaginable even a decade back – and at least a part of the assets have credit risks, and all of them a price risk, when interest rates start going up.

And yet, all of us have great confidence in the solvency of the central banks. The reason of course is the ownership. It is idle to forget that the ultimate guarantee of solvency of any financial institution is the ownership by the government. One recent example in our own country is telling: several public sector banks recently announced record level of losses. I do not think even a single depositor has closed her account, and not because of the bank's capital ratios. Hardly any one of us looks at these numbers while opening or continuing an account – we have “faith” that the owner will bail us out.

The last word on the subject should deservedly be left to Keynes, who described banking as an illusion. Everything is fine so long as the illusion persists that the bank can liquidate its assets and get their value back when needed, and of the depositor that so will he. Once that confidence is shattered, the illusion bursts. Will Basle III or Mr King's proposals change human psychology? Is public sector banking, devoted primarily to intermediation between the saver and the borrower, the only realistic solution? It is worth emphasising that there are serious limits to the models of quantitative finance, based on the theories of financial economics, to predict future outcomes.

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