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Economic crisis and banking regulation

It is now very probable that the economic crisis will last longer and have a much more substantial impact than predicted several months ago. What started as a sub-prime lending crisis in the United States has now become sovereign debt crisis. Under such circumstances, attempts to stabilize the banking sector may come at a cost not only to banks, but to the economy as a whole.

Lack of confidence

As the crisis developed, banks had to cope not only with higher write-off rates for corporate and retail clients, but also with liquidity problems since the confidence in the banking sector itself decreased. This has been further emphasized by the sovereign debt crisis.

Not long ago, sovereign debt was considered risk free for banks. Some banks were buying bonds issued by Greece with an expectations of high yields and perceived zero risk which was also implied by zero risk weighting under existing regulation. It was difficult to imagine that one day the Greek government would tell its bond investors that they would not be paid back in full.

Measures taken in response to the economic crisis

Capital and liquidity have been the primary areas of focus of the Basel Committee on Banking Supervision and reforms proposed were also supported by G20 governments. The measures are intended to stabilize the system. However, they will also lead to significant costs for the banks, which will have an impact on their clients and in turn on the economy as a whole.

The Cost of reform

After all the initiatives and proposed measures, the legitimate question is where the break even point is. Will the benefits of the new regulations outweigh the costs of reform? The Financial Stability Board and Basel Committee on Banking Supervision published their estimate of the impact on the real economy. Based on that, for a 1% increase in banks' capital ratios, lending spreads increase by 16 basis points and real gross domestic product falls over eight years to 0.17%, below its baseline level before rising back to baseline. The impact would be greater if the implementation were quicker.

As an example, at the end of 2009 banks' average core tier one ratios were 5.7%, compared with the Basel 3 minimum of 7%. Therefore, the cost of moving up to 7% over the Basel 3 transition period would be a 0.23% fall in real gross domestic product (1.3 times 0.17%). In addition, systemically important global banks represent around one-third of bank lending and additional capital requirements for those banks would mean an additional fall in GDP.

An additional fall in real GDP would also be caused by higher liquidity ratios. A 25% increase in liquid assets is estimated to reduce real GDP by 0.13%.

While these estimates were made under the assumptions of the planned implementation schedule, the attempts by banks to improve their liquidity and capital situation have occurred more rapidly. This is due not only to additional regulatory pressures such as the proposed increase in capital adequacy to 9% in June 2012, but also to market pressures. This increase in capital adequacy means an additional capital requirement of approximately 115 billion euros for 31 banks as requested by the European Banking Authority.

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Some claim that raising new capital should become cheaper as banks become safer. However, the amount of capital required to meet the new regulation will most likely increase costs, at least from the short term point of view. Banks have, therefore, already taken steps to improve the ratios, including capital increases (for example, UniCredit planned to raise its capital by 7.5 billion euros, which led to a decrease of its existing shares prices), higher retention of profits through lower dividend payments, cost reductions and even reducing on- and off-balance sheet exposures.

We will most probably see more changes in operating structures and business models in addition to mergers and acquisitions in coming years.

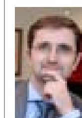
Lending reduction

If banks are not able to meet the capital requirements by raising capital, they need to pursue lending reduction. This would have a direct impact on the real economy as the credits for corporate clients and even retail customers become less available and more expensive. Banks will apply more strict rules when extending credits. As their own financing becomes more expensive, they will try to pass that cost on to their clients. In addition, companies that are dependent on bank financing may get into trouble due to tougher credit conditions.

Major critical implications of the regulations

In order to acclimate to the new market conditions and regulatory requirements, banks will have to cope with two main challenges: new business models and the cost of reform.

Banks will need to find strategies that will maximize their value under the current economic situation. Investors will probably not experience the returns seen in the past any time soon. Because these issues pose a threat not only for banks, but for the real economy as well, it is time to consider whether the cost of reform outweighs its benefits.



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