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# How Basel III threatens small businesses:

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## Executive Summary

- Basel III requires an increase in the size of banks' equity relative to their loans and a more formal assessment of risk. It is built on the same foundations as Basel I and II. The reasons why those initiatives failed may well apply also to Basel III, not least because the adjustment of assets for risk cannot be conducted with any certainty.
- Sovereign debts once considered safe are not necessarily safe any longer.
- The rules agreed in September 2010 are to be phased in between 2013 and 2019 to give banks time to adjust. Most of the capital adjustment will come from banks lending less but better and with increased margins – that is, higher interest rates to customers.
- Big companies will be able to shop around within the competitive international markets. However, in a situation where five big banks dominate the UK market, Britain's small and medium-sized enterprises (SMEs) will be hit both by the reduced availability of loans and by higher interest rates.
- Since SMEs drive the UK economy, the consequence of Basel III is negative for the UK.

## Introduction

The 2008 financial crash was not caused by a lack of regulation; perhaps an excess of regulation was a larger factor, creating as it did the illusion of security. Regulators failed to do their job, as the British Financial Services Authority has admitted.

Nor was the crash a global problem driven by consumer spending. Yes, some consumers took advantage of cheap and plentiful loans, but catastrophic investments by banks, which did not understand what they were buying, were the prime cause. Much as it suited the Brown government to blame the outside world, the British crash was mainly caused by British banks, while the Bank of England, regulators and the government looked the other way.<sup>1</sup> Some other countries had wiser, or more conservative, banks.

Whatever its causes, the crisis prompted a review of banking regulation, and the new rules, known as Basel III, were signed off by the 27 leading banking countries in September 2010. The rules are to be phased in between 2013 and 2019.

This analysis of Basel III indicates that banks will not be adversely affected. However, small and medium sized businesses (SMEs) will be damaged. Unfortunately it is this SME sector that drives economic growth in most developed countries and especially the UK. With minimal impact on bottom lines elsewhere, the net effect of Basel III is likely to be negative for the British economy and perhaps even small businesses globally.

## Basel III in a nutshell

Bank equity is the buffer between loans and deposits (or, more precisely between risk adjusted assets and deposits: the application of presumed risk to assets is, as we will see, one of the reasons why the Basel approach to regulation fails). Equity – the shareholders' investments in the banks, and the earnings that the bank retains rather than distributes back to them – provides liquidity in straitened times and cushions swings in loan and deposit activity.

<sup>1</sup> Icelandic banks contributed too and under EU rules they fell under Icelandic, not FSA, supervision.

Basel III basically requires an increase in the size of equity relative to loans and a more formal assessment of risk.

Current regulations permit equity (common shares and retained earnings) to be as low as 2% of loans. The main Basel III change raises the minimum ratio to 4.5% and tightens the rules for those in the "conservation buffer zone" between 4.5% and 7%. Furthermore, it proposes an additional 0 - 2.5% countercyclical buffer to offset the economic cycle; its size has been left to national governments to decide.

"Tier 1 capital" extends equity to include "other qualifying financial instruments". The minimum will start at 4% in 2013 and increase to 6% in 2019.<sup>2</sup> Thus, the Tier 1 capital ratio requirement, including the 2.5% conservation buffer, rises to 8.5%, of which equity must provide 7% leaving 1.5% for other qualifying instruments which, as they have yet to be fully defined, leaves some wriggle room.

The above, together with a requirement for a month's liquidity to ensure survival under stress and various metrics to promote good behaviour, forms "Pillar I" of Basel III.

Pillars II and III essentially revise the existing Pillars in Basel II, namely:

- II: Enhanced Supervisory Review Process for Firm-wide Risk Management and Capital Planning.
- III: Enhanced Risk Disclosure & Market Discipline

The main issues arising from Basel III are:

1. Capital adequacy regulation.
2. The impact on the performance and profitability of banks.
3. The damage to SMEs and therefore to economies such as the UK's.
4. Variable national supervision.

## Capital adequacy regulation

Basel II failed in the run up to the crisis, and some commentators have argued that the underlying philosophy was to blame. Kevin Dowd, Emeritus Professor

Nottingham University Business School, for example concluded "To the extent that it had any impact at all, capital adequacy regulation would seem to have been seriously counterproductive – it appears to have saddled financial institutions with a large and useless compliance burden, hampered the development of best practice in risk management, undermined market competition and destabilised the world financial system."<sup>3</sup> Other authors in the same report reached similar conclusions. John Kay, Visiting Professor at the London School of Economics, concluded "The additional rules that will be introduced as a consequence will be irrelevant to the next bubble, as the Basel I and II capital requirements imposed on banks – the subject of so much debate over the last two decades – were irrelevant in the credit bubble."<sup>4</sup>

Since Basel III follows the same approach as Basel II, albeit with higher thresholds, we should not be too confident that it will assure financial stability.

Both the 4.5% equity ratio and the 2.5% (equity based) conservation buffer are required under Basel III, but it is unclear why these are not merged into a single ratio. Reading between the lines it seems that the 4.5% really is the minimum and the extra 2.5% is merely desirable. However, stricter limitations should apply to banks in that buffer zone.

The discontinuity created by arbitrary thresholds creates a problem. Fall just 0.1% short of the minimum and regulators, in theory, take over. Report capital at just 0.1% above the minimum and the regulators can be kept at bay – even though that may be exactly when they should be getting involved. We can expect some creative accounting when capital ratios approach the minima. That is a key reason for the failure of Basel II. Assessments are adjusted, in terms of both of the volume of the equity assets, and of their risk. As Ismael Erturk, a Senior Lecturer at Manchester Business School, puts it "banks securitized loans and kept trading assets on the balance sheet because under Basel II such assets had lower risk weights and therefore required less capital."<sup>5</sup>

However formalised the process of risk assessment, it will remain an uncertain process open to manipulation. Assets

2 Basel Committee on Banking Supervision "Group of Governors and Heads of Supervision announces higher global minimum capital standards," 12th September 2010.

3 "The Failure of Capital Adequacy Regulation" Ch. 6 in *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, The Institute of Economic Affairs, 2009.

4 "The Future of Financial Services Regulation," Ch. 16 in *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, The Institute of Economic Affairs, 2009.

5 Personal email, 26th May 2011.

that turned toxic were deemed to be safe when they were purchased and, when thresholds are close, one must expect management to take a rosy view of them. Banks were pushed into "safe" holdings of sovereign debts, only for us to discover, in the cases of Ireland, Greece and Portugal, that they might not be as safe as expected. The only certain measurement of risk is after the event.

The countercyclical buffer has even less to commend it, since it conflicts with the long battle against banks distorting their reported performance by means of secret reserves. In the UK through the 19<sup>th</sup> century until about 1970, banks held secret reserves to smooth out the reported year to year profitability. The language was different, but the purpose was the same, namely to provide a countercyclical buffer. By the 1960s, the justification – building customer and shareholder confidence – was seen to be outweighed by banks' ability to misrepresent annual performance. Basel III does not seem to have learnt from this history.

In any case, a fixed buffer does not achieve the objective of ensuring that the savings in the good years can be used up in the bad years. And who is to decide which years should be deemed good and bad and by how much?

The countercyclical buffer does not appear in the table of phase-in arrangements. The Basel Committee may have little or no expectations of it. It was probably only included as a sop to some members, very probably Britain's Financial Services Authority (FSA), which was keen on the idea.<sup>6</sup>

### Impact on the performance and profitability of banks

Big banks will have to re-capitalise more than their smaller rivals to comply with the new requirements. The Committee's press release says "preliminary results of the Committee's comprehensive quantitative impact study show that as of the end of 2009, large banks will need, in the aggregate, a significant amount of additional capital to meet these new requirements. Smaller banks, which are particularly important for lending to the SME sector, for the most part already meet these higher standards."

In the 18 months since that study, the UK banks have already improved ratios by reducing lending and recovering profitability.<sup>7</sup> Of course the UK government has been

demanding increased lending, especially to SMEs, in an attempt to lift the economy. The banks claim to be lending more, yet SMEs claim they cannot successfully borrow. In any case, banks do not want to go to the market for more equity capital until the stockmarket rises and until the hangover of public ownership in RBS, Lloyds and Northern Rock is cleared. The explanation for the divergence in views between banks and SMEs is probably that the banks have been widening their margins. Charging enough interest ensures that the loan book shrinks of its own accord, while profits and retained earnings increase. Risky loans to SMEs can be reduced by charging interest rates high enough to frighten them off.

The Basel Committee's link of SMEs with smaller banks may be true for the world in general, but it is not true for the UK, where the former building societies never did much commercial business and the rest of the market is dominated by just four banks (Barclays, RBS, Lloyds and HSBC). Santander is new to the UK market but keen to build its commercial business: with the acquisition of Alliance & Leicester it achieved 3.9% of the market and with further acquisitions from RBS and Lloyds that should reach 9%.<sup>8</sup> These five banks may account for over 80%<sup>9</sup> of the UK banking market.

True, there are also some largely retail banks owned by grocery multiples, namely Co-operative, Harrods, Sainsbury's and Tesco. Even so, the five biggest banks will continue to dominate the UK market for commercial lending, both to SMEs and large companies, for some time. If widening margins is the [covert] key banking strategy to cope with increased capital ratios and restoring the bottom line, then this lack of competition is crucial. As we saw in the long drawn out case of PPI (permanent protection insurance) where the British Bankers' Association (BBA) acted for all the leading UK banks, the big banks are strong believers in "hang together or hang separately". In August 2010, the FSA announced its conclusions on this mis-selling of insurance to customers who could never benefit. In October, BBA requested judicial review, partly to delay restitution. It was only the arrival of a non-British CEO that caused Lloyds to break ranks in May 2011, after which the others could no longer hold out.

Such episodes show that the dominant UK banks are likely to do whatever it takes to keep competitors out. There is

<sup>6</sup> FSA 09/2: narrative leading to question 12.

<sup>7</sup> "Relative to pre-crisis levels as of end-2006, banks in the United States, the euro area and Japan had by end-2009 increased their common equity ratio on average by 1.3 percentage points and their Tier 1 capital ratio on average by 1.5 percentage points." S'lovik and Cournède – see below.

little doubt that they will strongly resist any further efforts to break them up, or even to ring fence their retail and investment divisions.

Meanwhile, the new rules create a major increase in reporting and bureaucracy. Just on the issue of asset risk assessments, for example, Moody's note that "Regulatory liquidity risk reports will have to be produced at least monthly with the ability, when required by regulators, to be delivered weekly or even daily."<sup>10</sup> But such detailed reporting, whether it is useful or not, comes only at considerable cost – and the expense and complexity of banking regulations is already a significant barrier against new market entrants.

The conclusion therefore is that banks will re-capitalise enough to meet the thresholds by the due dates, partly by restraining lending to riskier – that is, smaller – businesses. Bureaucracy will increase. Both will drive up bank margins, which will damage SMEs in particular. Banking bottom lines will remain healthy unless there is a serious challenge by new competitors – but the new bureaucracy itself will discourage that.

### **The damage to SMEs and therefore to economies such as the UK's.**

The Basel Committee clearly anticipates that the new regulations will reduce the commercial loan business below where it would otherwise be. Increasing the buffers in difficult equity markets means, as mentioned above, fewer loans and/or higher interest rates. The plan to start phasing in the new arrangements only from 2013, and through to 2019, may be only partly intended to give the banks adequate notice. It may also be made in the hope that economic recovery will be underway by then, which would make the changes much easier for the banks to bear. However, one cannot be certain that things will look much rosier by 2013.

The Basel Committee claims that, by eliminating the busts, Basel III will be good for economic growth. On the other hand, a Bank of International Settlement paper concludes that it will *reduce* economic growth: "Each percentage point increase in the capital ratio causes a median 0.09 percent decline in the level of steady state output, relative to the baseline. The impact of the new liquidity regulation is of a similar order of magnitude, at 0.08 percent."<sup>11</sup> In other words, the 5% increase in capital ratio is likely to produce an 8.5% decrease in GDP.

OECD also estimates that Basel III will reduce annual GDP growth – albeit by a very small amount, namely between 0.05% and 0.15%.<sup>12</sup> They attribute this to widening the margins between deposit and lending rates of interest: "Economic output is mainly affected by an increase in bank lending spreads as banks pass a rise in bank funding costs, due to higher capital requirements, to their customers." They predict an increase in spreads of 50 basis points.

However, the OECD is being generous to Basel, because the impact on customers will be skewed against SMEs, for which they did not allow.

A Cass Business School paper argues that interest rates to low risk borrowers will be stable "but that there will a reduction in availability and higher cost at the riskier end of the credit spectrum."<sup>13</sup> In other words, the sluggish large customers will not be affected, but the SMEs and the more volatile businesses will bear the brunt of both a lower availability of loans and higher rates of interest. According to Footnote 35 of the Cass analysis<sup>14</sup> "the output impact of an immediate introduction of Basel III (without taking account of monetary easing), could result in a fall of global output below trend of as much as 7½%."

UK bankers concur: "the price of credit offered by banks to small businesses will rise owing to Basel III, according to the British Bankers' Association (BBA)."<sup>15</sup>

8 Conversation with Sarah Davies, Santander, 9th May 2011.

9 This figure is very difficult to ascertain. According to the British Banking Association (April 2011 figures), the five big banks plus Northern Rock accounted for two thirds of mortgages.

10 Moody's Analytics, "Basel III New Capital and Liquidity Standards – FAQs," 10th January 2011.

11 "BASEL III: Long-term impact on economic performance and fluctuations," P. Angelini, L. Clerc, V. Cúrdia, L. Gambacorta, A. Gerali, A. Locarno, R. Motto, W. Roeger, S. Van den Heuvel, and J. Vilek, Bank of International Settlement, Working Paper 338, February 2011.

12 "Macroeconomic Impact of Basel III," Authors: Patrick Slovik and Boris Cournède, Author Affiliations OECD, France, 14 Feb 2011.

13 "Is the cure worse than the disease?" Bill Allen, Ka Kei Chan, Alistair Milne and Steve Thomas, Cass Business School, City University, London, September 30th, 2010.

14 Based on Macroeconomic Assessment Group (MAG), 2010, Interim Report, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements," available at <http://www.bis.org/publ/othp10.htm>

15 "Basel III to raise credit cost," Steve Tolley, 28th October 2010, Fundweb, <http://www.fundweb.co.uk/markets/britain/basel-iii-to-raise-credit-cost/1020993> article, accessed 14th May 2011.

This is bad news for the UK, where SMEs account for half the total of GDP, much the fastest growing part of it and most of the potential for the future. The financial services sector is integrated with banking and will not be hit by Basel III; and therefore the outlook for other sectors, notably SME manufacturing, is bleaker still.

On the plus side, banks can improve profitability by lending better rather than more. A closer understanding of their SME clients' business models and involvement in growing their business could be good for both sides, assuming bank executives are well enough trained to do that and SME owners are well enough trained to listen. But to pin our hopes on this could be over-optimistic.

If we accept that SMEs will bear the brunt of Basel III, what should be done? Perhaps we should just agree to pay that price, however damaging it may be for the British economy, as part of the ups and downs of economic cycles. We should certainly not distort financial markets simply to favour SMEs – though equally, the distortions created by Basel III and the UK banking oligarchy should be countered.

One measure would be greater competition: any financial institution that lends to private citizens should be empowered to lend to SMEs and encouraged to do so.

Greater transparency might help. For example, banks should report the shares of their lending to SMEs, private citizens and larger companies, together with the average interest rates charged to those three sectors.

### **Variable national supervision**

Basel III increases the risk to the UK financial services sector and also the UK economy because its more stringent rules will be applied more vigorously in some countries than others. When the rules are light, as with Basel I and II, the vigour of their enforcement mattered little. But the calls for more regulation and more regulator involvement will increase the variation in national supervision. Furthermore, the interval before full enforcement will allow banks to chip away at the rules, at least in some countries, and regulators to develop different supervisory approaches. And the counter-cyclical buffer is a matter for national discretion.

In all of this we should remember that it is not so much the banks, or even their creditors, that we should be protecting, as the banks' customers and especially SMEs.

### **Conclusion**

Regulations usually give rise to unintended consequences. In the case of Basel III, one unintended consequence is that SMEs will be particularly damaged, both by constrained lending and higher rates of interest. As a consequence, economic development will be damaged, perhaps by as much as 8% – especially in a country like the UK where SMEs contribute half the GDP and most of the growth.

Also, the basic formula of less lending needing more equity will reduce shareholder returns and therefore put a downward pressure on share prices. So we can certainly expect some creative accounting.

And since the 2008 crisis, banks have been cleaning out the stables – providing for or writing off "toxic" debts. Indeed the best time for over-providing for bad debts is when even worse news is already being reported. Once Basel III comes into play after 2013, any over-provision plus leverage will encourage lower new provisions for bad debts. This increases both asset values and retained earnings and thus has a very positive effect on the equity/capital ratio, a very useful facility if the threshold is close.

The UK banks may also be at a disadvantage relative to overseas competitors if the UK (in line with Whitehall's usual approach on regulations) decides to introduce a relatively strong countercyclical buffer and more vigorously supervises banking practice. In particular, labyrinthine processes to reduce risk will add to costs and complexity without necessarily achieving anything in real terms; risk arises not from the expected but from the unexpected.

However, it is not the banks that we should worry about. They will find ways to minimise the harm to themselves; and their strength, their close alliance and their defences against competition will protect them. The losers will be SMEs, the businesses that grow GDP. That really is something to worry about.