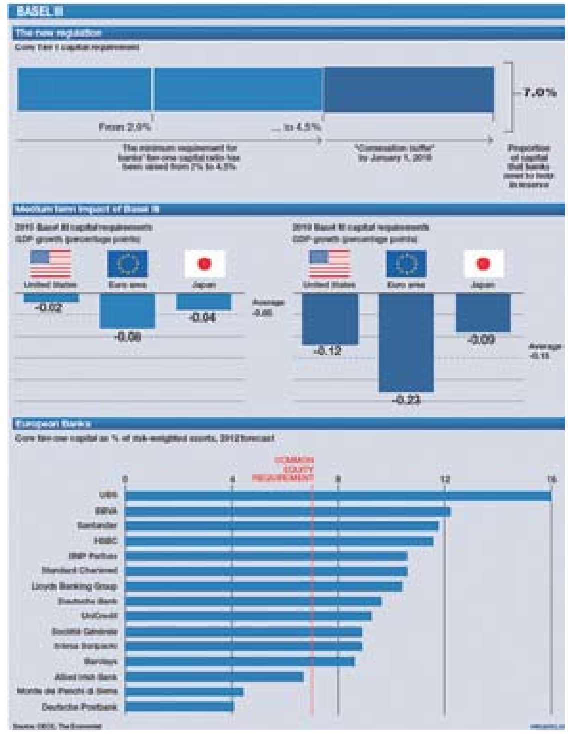
BANK FOR INTERNATIONAL SETTLEMENTS

Implementation of the Basel III requirements - an international regulatory framework - will start from 2015 in an effort to improve regulation, supervision and risk management, in the banking sector

New banking regulations, effective from 2015, have been the centre of much debate recently, as banks struggle to meet the requirements proposed by the Basel Committee on Banking Supervision (BCBS). In December 2009, the BCBS set out its concrete proposals, named Basel III, in response to the financial crisis of the preceding few years. The objective of the Basel Committee's reform package is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy,.

As part of the Basel III rules, the minimum requirement for banks' tier-one capital ratio (ratio of equity capital to risk-weighted assets [RWA]) has been raised from 2% to 4.5%. Effective as of 2019, lenders will also need to add a "conservation buffer" of 2.5%, meaning banks must hold a total core capital equal to 7% of their RWA. BCBS Secretary General Stefan Walter recently spoke at a conference about the motivation behind the reforms, highlighting that in the most recent phase of the crisis there has been a significant spillover of risk between the banking sector and sovereigns, as governments increased their debt in an effort to stabilize their banking systems and economies.

As a result, debt-to-gross domestic product (GDP) ratios in a number of economies increased by as much as 10-25 percentage points. It, therefore, is clear that the economic benefits



of raising the resilience of the banking sector to shocks are immense.

While some believe that these new rules will be too harsh, others – such as Lord Turner, the chief of the UK Financial Services Authority – have said that they do not go far enough to protect the system. In a speech he said that raising tier-one capital ratios to between 15% and 20% would be more appropriate. "Have we got it right? Are we being radical enough? And do we understand the root of this financial crisis?", Turner said.

Today's regulators are the inheritors of a half-century long policy error, in which regulators have allowed private sector banks to pursue their private interest in maximizing leverage levels, at times influenced by a deep intellectual confusion between private costs and social optimality.

An unfortunate result of the implementation of Basel III is the requirement of banks to reach the new ratios of Basel III. There are only three solutions:

1- Increase profits and retain them therefore not distributing dividends and making shareholders unhappy. If retained over the years, the capital of banks will slowly reach the Basel III rules.

2- Raising equity, but in the present market conditions very few investors want to buy new equity from banks. Therefore this solution is not realistic.

3- Decrease the balance sheet of banks. This is what is happening all over the Western World. Banks do not renew credits lines and do not grant new loans.

The third approach which is presently being applied by many banks decreases the economic growth of most European countries by stopping the expansion of mostly SMEs which are the backbone of Western economies.

Given the catastrophic situation of banks in Europe, it is distressing that a welcome and constructive change in banks capital ratio is at the same time hindering the growth of economies in Europe by reducing company's access to credit.