Thicker cushions, when you're ready

BANK regulators make poor story-time princesses. Before the crisis, banks under their watch progressively thinned out the cushions of capital they were resting on while regulators slumbered on, oblivious to the huge lumpy risks beneath. Now they are trying to make amends. On September 12th the Basel Committee, a club of supervisors and bank regulators, finally reached agreement on how much extra stuffing needs to go into the cushions to absorb losses and buffer the financial system against the next crisis.

The committee's package of recommendations, known as Basel III, more than doubles the amount of equity capital (the best kind of capital) that banks must hold to 4.5% from a measly 2% under the old regime. In addition they will also have to pad this with another thinner cushion of equity equal to 2.5% of their assets. This extra "conservation buffer" can be flattened in an emergency. If it is, however, then the bank involved will be forced to conserve capital by, for instance, halting dividends. This raises the minimum equity that banks will hold to 7%. In practise few will want to be close to the limit, so most large banks will likely hold somewhere between 8% and 10%, according to analysts at Credit Suisse, an investment bank.

If two cushions of capital weren't enough, the Basel committee has added an optional third one too. This is a countercyclical buffer of up to 2.5% of risk-weighted assets that regulators can impose when they think credit is flowing freely. The logic is sound. The biggest flaw of risk-based capital regimes such as the current Basel II, is that they are pro-cyclical. When the economy is booming and asset prices are rising, loans seem less risky so banks are allowed to hold less capital at exactly the moment when they should be showing restraint. Many central banks that are concerned by emerging bubbles have only a very blunt instrument, short-term interest rates, to try to restrain this exuberance. During a financial crisis or economic slowdown, at just the moment that the economy needs credit, many banks are forced to cut back on lending to preserve capital. Once again central bankers can do little if falling official interest rates do not filter through to borrowers. The new capital buffer is intended to give bank supervisors a second tool: they can take away the punch bowl while the party is still in full swing or can top it up when the economy is slowing. Very big firms will likely have to stuff their cushions a bit more than the rest because of the harm they can cause to the entire financial system if they collapse.

And in addition to all of this equity, banks will also have to hold another 1.5% of capital that may be of slightly lesser quality than equity. This will help to provide an additional margin of protection against the complete collapse of banks that burn through all of their equity. And just to be sure that banks do not figure out how to fiddle their risk weightings too egregiously, the committee has also imposed a total leverage ratio that ensures that equity does not fall below 3% of total assets.

The new capital regime seems prudent without being so onerous as to hobble the mainstream of banking or to harm economic growth. Yet the real show of generosity from the committee was in the timing of the new regime. Banks will have until January 2019 before they have to meet the new targets in full. Phasing in the targets over time makes sense if regulators wish to avoid a credit crunch—weaker banks may simply have stopped lending rather than raised capital to meet the new guidelines. The worry, however, is that the deadline is so generous mainly because large parts of the German banking sector have little hope of meeting any stricter deadlines. The German banking association recently estimated that German banks had a shortfall of more than €100 billion ($129 billion). Instead of being a catalyst for urgent change, the Basel committee is allowing weaker banks to muddle along.

In this light the cash call that Deutsche Bank, Germany's biggest bank, embarked on just before the new Basel guidelines were released seems unlikely to set a trend.

Deutsche plans to sell shares to raise almost €10 billion in Europe's biggest rights offer this year. Most of the money will be used to bolster capital that will be consumed in its takeover of Deutsche Postbank, which has Germany's biggest network of retail bank branches but is also rather light on capital. Absorbing Postbank would trim almost €8 billion from Deutsche Bank's newly enlarged balance sheet and would leave it with just 8% of core equity, compared with 7.5% before the rights issue and takeover. More important is the fact that it bolsters Deutsche Bank's retail-banking arm, making it slightly less reliant on volatile earnings from its investment bank. It also progresses a long overdue consolidation among Germany's chronically unprofitable retail banks. Deutsche Bank reckons it can trim more than €700m a year in costs after the takeover while increasing revenue by another €250m. If it achieves these savings it may spur Germany's legion of savings banks and Landesbanken to look harder at their own options for avoiding duplication and trimming costs. With little chance of their raising outside capital over the next few years, only a sharp improvement in the profitability of their retail banking businesses can help them to retain the earnings they need to build up their own capital cushions.

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