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OPINION: The Basel III Effect

Andrew Papageorgiou, managing partner at Realm Investments, considers the implications of Basel III on the Australian financial sector.

In the current Basel III implementation environment the trade for everyone and sundry is clear. How do we position ourselves to benefit, or protect ourselves from suffering the ill effects of Basel III?

Here in Australia the idiosyncrasies of a heavily banked market coupled with a lack of broad investor participation has led to a very different market environment to the US or Europe. Our banks have enjoyed returns on equity that have been the envy of the developed world, what is more the absence of competition has allowed them to achieve these numbers at levels of risk well below developed world peers.

BIS working paper 383, released in July of this year makes some interesting observations around some of the metrics of bailed out versus non-bailed out banks in the period preceding the global financial crisis. What is interesting is that the metrics that these bailed out banks achieved through excessive asset creation and risk chasing has been eclipsed by our own banks through doing little more than providing reasonably vanilla services with the occasional brain explosion at an institutional level thrown in.

In truth it is getting tougher for the Australian banks to maintain their profitability. The current result season has seen banks looking to protect their margin through reducing their cost to income ratios, to off-set the impact of low system growth and rising funding pressure (with the exception of NAB which is playing catch up in technology).

However this is no co-incidence, the commentary out of the architects of the Basel framework is clear, they want smaller, less complicated and safer banks. The reason why the framework is difficult to comply with is because it is supposed to be.

For large banks, counter cyclical buffers, domestically important capital penalties, higher capital charges for cross border presence, capital charges against certain RMBS securities, penalties for OTC instruments are cases in point. All of the elements are designed at making it tougher to be big, important or complicated.

This means the banks have a decision to make, look for capital accretion through retaining earnings (reducing dividends) and selling assets (shrink), or alternatively raise more capital in an attempt to maintain market position (stay big). Ultimately the key driver here is the cost of capital.

Retail challenges

Our last note titled "The retail buffer", explained the role of the retail investor in buffering banks and from higher capital charges by soaking up bank tier 1 and tier 2 as well as hybrid equity that protects credit ratings, however surely there are limits to the amount of issuance investors can absorb.

CBA's Ian Narev clearly stated that they are banking about as much as they can bank under the current

framework; he also welcomed a review of the system to provide the market with clarity around the way forward.

If Basel III is implemented as is currently indicated by APRA, the behaviour will be predictable, with assets that suffer under the liquidity and capital frameworks shunned while pristine, repo eligible risk will be more valuable to banks than ever. In a heavily banked oligopoly where the vast majority of domestic fixed income assets are held by very few hands, the behaviour of the big four will be self-fulfilling.

The structure of the oligopoly does offcourse allow the divestment of assets to be measured and controlled, however some will find it harder than others. Specifically the regional and smaller banks will find it difficult to hold off, with some early signs of divestment already evident on broker axe lists.

The larger banks will seek creative outcomes, however ultimately framework adherence will require some form of divestment or a reduction in margin. This will potentially provide investors an opportunity to soak up risk on reasonable if not attractive terms.

This phenomenon is global and it is a consequence of unprecedented systemic solvency issues intersecting with the application of a significant new regulatory framework. The big four will need to adjust to what will unquestionably be a new reality. All of that said the question then becomes who steps in to compensate for a less important and influential banking sector.

Fixed income investment in this country remains under-developed, which is to be expected given the strength of equity and property market returns over the last couple of decades. However now we have a problem.

If Ian Narev is correct (and on the face of it, it seems he is), the big banks cannot plausibly continue to soak up market risk at the historical rate, which means someone else needs to step in.

Fixed income remains a relatively inaccessible asset class which makes it difficult to engage money outside of the normal banking and asset management channels, however if the banks cannot lend and mum and dad's don't invest in credit, it will be left to the government to think of a more creative direct way to support the borrowers who do not fit neatly in the Basel III bank cookie cutter.

This conundrum at once illustrates the negative aspect of too big to fail (or actively regulate) while also clarifying why the status quo is perhaps undesirable. Systemic transitions are never seamless and this one will be no different. A root and branch review may seek to soften the blow, however if a global standard is set, Australia may have little choice but to adhere to a global set of rules which is driven towards delivering a uniformity and consistency in credit standards globally.

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