# Basel III: How it affects our credit

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**"It's not too late to recapitalize." That seems to be the new mantra of the financial sector as it braces itself for the new capital and solvency requirements imposed by Basel III.**

The passing of the new banking regulations known as Basel III signals a concerted move toward the creation of a new global financial architecture.

One of the reforms' first casualties is Spain's La Caixa, Europe's largest savings bank. The company is scrambling to shift its banking operations to the newly created CaixaBank, which will become the eurozone's 10th largest bank by market capitalization.

The process of turning Spain's cajas, or savings banks, into full-blown commercial banks is one of the first consequences of the new regulation. Inevitably, other entities will follow suit.

Basel III benefits businesses and consumers to the extent that it gives the banking system greater stability and solvency.

However, as IESE's Jorge Soley, Ahmad Rahnema and Sergi Cutillas warn in a technical note on the potential implications of Basel III, the new rules will probably also reduce the supply of credit and make loans more expensive.

In order to maintain their operating margin, banks will have to opt for handing out smaller dividends, thereby bringing down their share price and hurting shareholders. Either that, or increase the price of their products and services. So don't be surprised if banks also raise the commissions they charge.

**More Capital**
Basel III introduces a set of recommendations on financial entity capital and liquidity that toughens significantly the solvency requirements contained in its predecessors, Basel I (July 1988) and Basel II (June 2004).

The latest installment in financial regulation is the response of the Bank for International Settlements — the so-called bank of banks — to the global financial crisis that began in 2007 with the subprime mortgage delinquencies.

The reform centers mainly on capital requirements. Banks and savings banks must significantly raise both their equity and its quality. Furthermore, they must have supplementary reserves so as to better withstand periods of tension in credit markets.

Specifically, Basel III requires that a bank's Tier 1 core capital amounts to at least 4.5 percent of its risk-weighted assets. The new rules also establish buffers of top-quality capital, of which at least 2.5 percent must be risk-weighted assets.

In actual practice, the new regulatory framework more than triples the volume of assets that banks and savings banks must set aside for possible losses. Banks must raise their total capital from 2 percent of risk-weighted assets under Basel II to 7 percent (the 4.5 percent minimum plus the 2.5 percent buffer).

**More Quality**
But that's not all: the very definition of core capital is now much more restrictive, as the new rules introduce a new system of deductions that aims to improve the quality of equity and avoid the fictitious creation of capital in the financial system.

With Basel III, core capital is limited to what one would call traditional capital — i.e., capital (contributed by shareholders), plus reserves (non-distributed profits from previous years), plus premiums from capital increases.

Therefore, from the core capital one must deduct stakes in financial entities and insurance companies that exceed 10 percent of their unconsolidated capital. They also need to deduct deferred taxes, trade funds and stakes in the U.S. mortgage market.

**How Much Are We Talking About?**
The new regulatory framework, with its solvency and liquidity requirements, necessitates a large number of funds for the financial system.

And although these reforms will be implemented gradually — starting January 1, 2013, and fully in place by January 1, 2019 — banks and savings banks are racing to recapitalize and comply with the new requirements now.

It is calculated that in Spain alone, some 40 bill
ion euros in capital will be needed, and 185 billion euros in liquidity, to abide by Basel III.

Clearly, a bigger effort will be needed, especially given that the Spanish government has decided to raise the core capital requirement to 8 percent for banks, one point more than that required by Basel III.

For the most troubled savings banks, the figure could go as high as 10 percent. And if these banks still do not meet the solvency requirements, the State will buy stakes in them temporarily, which could mean partial nationalization of some savings banks.

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