
New fault lines in financial regulation

Deleveraging could trigger another crippling credit crunch in Europe at a time when the recovery is still fragile. By Jacques de Larosière.



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Since the outbreak of the financial crisis, governments and regulators have made a major effort to strengthen the system to reduce the chances of a recurrence. Much of what has been decided seems to go in the right direction and, as such, should be welcomed. But some aspects of the present reforms could have unintended negative consequences. In some cases, it is not so much the quantum of reforms that raises questions, but the thrust of the strategic choices that have been decided.

I shall try to analyse these possible 'fault lines' under four headings:

- Capital;
- Liquidity;
- Sifis and shadow banking; and
- Supervision.

Capital requirements The rationale of the capital increase decided by the Basel Committee on Banking Supervision – five times more on average than the pre-crisis situation – is simple: if banks had significantly more own funds of unquestionable quality (common equity), their loss absorbency capacity would be higher and, by definition, the system would be more resilient when facing shocks. This is, of course, unarguable. Actually, banks are 'over-achieving' these requirements to a large extent. Indeed, many of them have anticipated the latest Basel constraints. While the agreement allows them to phase in the new rules gradually until the end of 2018, banks are, in fact, already applying them.

Taking a look at the largest 15 European banks, you may observe that they achieved – under Basel II – a core Tier I of 10.5% (Q2, 2011) compared with 11.1% for the largest six US banks¹. And a number of European banks, prodded by the markets, are announcing they will comply with the stricter rules of Basel III as early as January 1, 2013 – six years ahead of schedule – without taking advantage

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