



How Does Basel II Affect Corporate Treasury?

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Basel II established an environment that allowed failing banks to cling to life. This article argues that, for the benefit of corporates and the wider economy, these banks should have been left to fail.

The housing industry and the financial businesses have both experienced bad times simultaneously. Is that a coincidence or is there a reason? I certainly would argue that there is a reason and we need to go back to the days of the Herstatt debacle to understand why. That incident created a huge fear among bankers, central bankers and bank regulators about the possible domino effects of a bank failure. How would they protect the financial industry from defaults? The regulators were not short of an answer and they developed the Basel framework, which subsequently became Basel II. The basic concept of the framework is that banks must pay dearly for what the regulators regard as high risk (corporate lending) and much less for low risk (government and collateralised lending, mainly real estate).

There have been two major real estate bubbles since the Basel regulation was first implemented; the first was at the beginning of the 1990s, while the second, during the second half of 2008, has turned into the worst financial crisis of many generations. With banks and investment houses failing, surely this means that Basel II fallen short in its aim to prevent such crisis?

There have always been banks and financial institutions defaulting. The focus of regulation should not be to dictate the kinds of risk that banks may take on but rather to create measures to decrease the effects spreading when banks and financial institutions actually do default.

Indeed, the problem with the Basel II framework is that the regulators have put the interest of the banks and the financial industry before the corporate industry and society as a whole. During the past decade this has led to a dramatic decrease in direct corporate lending from banks, instead being taken over by hedge funds and other parties. The regulators need to understand that stripping the banks of their ability to lend to the corporates will decrease growth and job creation and will not decrease the risk at all. With Basel II, all financial institutions have run in the same direction, creating a systemic risk instead.

As a small to medium-sized enterprise (SME) entrepreneur, I no longer regard the banks as a possible source of sufficient loans. The present legislation has seen SME lending transferred to much more expensive factoring alternatives. Further, as an effect of Basel II, large corporations mostly use the public market for their capital needs and have a much higher financial discipline nowadays, leading to business models focusing on creating positive cash flow and pushing the borrowing requirements out into the supply chain to its weaker parties. These parties face high borrowing costs and many are forced to use their own cash and cash secured by private mortgages - hardly a good way to create a robust supply chain.

Thus, the banks' poor track record of lending to the corporate sector can, in my opinion, be blamed on Basel II - and yet it may become worse. I recently met with a treasury risk manager, originally from the banking sector, and had an interesting discussion on how much the corporate treasury sector really knows about the costs Basel II is imposing on banks in terms of their corporate business. Indeed, this is a question that I shall take to treasury peer group meetings to gauge the level of understanding of the damage that Basel II may create. In the present financial crisis, the risk is that banks will start to question the profitability of the derivative lines and other facilities outstanding to the large corporations because they seldom provide a satisfactory level of return of the banks' capital adequacy requirement.

One conclusion that can be drawn from Basel II is that, if they really want, the regulators, central banks and politicians can create concerted regulation and implement it globally. One might therefore ask why this does not appear to have been a consideration when it comes to the payment system?

Consider this: Western Union can send money anywhere in the world in 15 minutes, yet it takes up to one week for a bank to do the same. Can it be because Western Union sends cleared money and that the clearing process for banks takes up to a week? Can that really be the reason? Let's cut to the chase. The reason why payments take so long is that the banks use the money to finance themselves with our cash - and they charge us for it. From a Basel II perspective, where saving the financial sector from default is more important than anything else, this system makes sense. But when looked at from a technological perspective, if one can download the whole Godfather trilogy in a matter of hours, why should a 5 KB payment take a full week?

European leaders are currently pushing for euro payments to take no more than two days within the single euro payments area (SEPA). They will probably succeed in the end, but why should it take as long as two days? And if a payment does take longer, what do you do?

One thing that confuses me is that when you ask a bank, when a payment is in transition, where the money

actually is, they do not know. It is worrying that they cannot tell you this. Face it, the global payment system is dysfunctional and those that really can make a change - the Bank for International Settlements, the central banks and the politicians - do not really seem to care. We entered the cyber age more than a decade ago, but payments are still managed using old principles. When wiring a payment takes longer than it would to withdraw the cash from your bank, get on a plane and deposit the cash at the receiving bank, there is undoubtedly a huge opportunity for reengineering. Certainly the payments business would be something for DHL and UPS to consider.

Maybe the problem is that the lobbying groups from the banks are much stronger than those of the corporate sector and the banks want to keep the free funding. But that means that the corporate, public and private sectors need to have more loans than necessary. A key question then is what are we as corporates going to do about the situation?

Now in this financial turmoil we start to hear voices demanding even further regulation and social engineering of the banking sector, I would argue that we need less. In fact, harsher regulation will probably create more and larger bubbles in the future. No, rather let the banks survive according to Darwin's theory of survival of the fittest. Basel II created an atmosphere of survival of those who conform and look where that took us.

Posted by:	Post
21 Feb 2009 - 19:56 Corporation, United States	The comparison to Western Union is somewhat unfair but worthy of further discussion.