

# Bank Rigging, Neoliberal Euphoria and Basel II

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*The Basel II accords were drafted at a time of neoliberal euphoria when capitalist bankers had obtained the cancellation of the few prudential rules that still remained from the 1930 Great Depression.*

*Basel II coincided with Alan Greenspan, chairman of the Federal Reserve, the US central bank, [\[1\]](#) speechifying about the ability of financial markets to regulate themselves and recommending the suppression of any constraint that still shackled the said bankers' 'creativity'.*

The Basel II accords were implemented in 2004-2005, just before the outbreak of the financial crisis in 2007, and are still valid in 2013-2014. The Basel III accords that were drafted in 2010 as the crisis was deepening, and revised in 2011, [\[2\]](#) are still only at the stage of interpretation and negotiation. They are not to be fully implemented until 2018-2019. This is why it is really worth beginning by taking the time to understand the Basel II accords, whereas most commentators focus on the Basel III measures as though they were already effective. Supervising authorities, governments in cahoots with major private banks, and most of the media attempt to convince citizens that constraints have been imposed on the finance industry.

This is a lie. As we shall see even the Basel III measures will not really change the slack regulations that allow banks to act as they please. Indeed banks will still be able to cook their books and fiddle their health reports thanks to the system whereby their assets are weighted relative to the degree of risk. They will also be allowed to legally trade off the balance sheet, and thus be prompted to take more risks. These two facts alone are enough to undermine the array of small measures that have been widely and loudly advertised. To show how harsh the Basel III standards are, banks grumble and try to get the authorities to soften the measures or delay their implementation. This is just taking the public for a ride. Leaders and supervisory authorities show how complicit they are with large private banks.

Before we turn to Basel III, let us examine the Basel II accords that are currently effective.

## **Basel II: licence to kill**

Basel II increased the deregulation that had been condoned by Basel I (see previous article [\[3\]](#)). Two major points are to be highlighted in Basel 2: 1. capital requirements were lowered; 2. banks were allowed to devise their own method for calculating their assets to achieve the required equity/assets ratio.

## **Basel II and lower capital requirement**

Capital requirements were lowered at the banks' request: they only amount to 2% of

weighted assets, now! Yes, that's right, only 2% of assets, weighted according to the level of risk, is required. Beyond the 2% of hard capital (i.e. capital brought by shareholders or retained surpluses) in order to reach the 8% target, Basel II allows banks to include as equity a number of elements, such as subordinated debt securities, which are only remotely related to capital. It is up to national authorities to define what banks can take into account beyond the 2% of hard capital in order to reach 8%. In other words: the 8% requirement stipulated by Basel I has been retained, but the method of calculation has been radically changed:

✘ on the numerator side (equity), the categories of debt that banks can include have been extended way beyond hard capital;

✘ on the denominator side they have been allowed to define the way they weight assets according to risks.

In [part 8](#) we saw how Banxia could fiddle its assets. Now Basel II also makes it possible to fiddle with the equity side and what the bank can add to reach an 8% ratio.

In the lingo of the Basel accords we speak of Tier 1 and Tier 2. [\[4\]](#) Basel II considers that Tier 1 (i.e. 4% of risk-weighted assets) consists of two parts: 2% of hard capital and 2% in which the banks can take various elements that are not part of the company's equity strict sensu into account. French or Belgian banks (with the blessing of their national regulators) have included for instance hybrid securities (half-capital, half-bond). Tier 2 embraces even more remote elements. Japanese banks in the 1990s for instance had been allowed by their national authorities to include their latent stockmarket capital gains in Tier 2. A few years later when the Japanese housing bubble broke out, they found themselves below the regulation ratios overnight. Yet this did not lead the Basel committee to draft a stricter definition of what could be included in Tier 2 or even in Tier 1. Not before 2010 did it announce more demanding standards to be implemented in 2018 or 2019, if ever!

To get an idea of what a bank is allowed to use to reach the 8% target, here is an extract from Dexia 2008 annual report:

'BIS eligible capital consists of two parts:

Tier 1 capital which comprises share capital, share premium, retained earnings including current year profit, hybrid capital, foreign currency translation and minority interests, less intangible assets, accrued dividends, net long positions in own shares and goodwill;

Tier 2 capital which includes eligible part of subordinated long-term debt, less subordinated debt from and equities in financial institutions.

Tier 1 capital is required to be at least 4% and Total eligible capital at least 8% of RWAs.' [\[5\]](#)  
We find similar statements in Dexia 2012 annual report. [\[6\]](#)

## **Basel II: Banks decide on the asset value to be considered**

Basel II is based on total trust in bankers: each bank can decide on its own model to assess risk. This is what practically all major banks do.

As set out in the Basel II 2006 revision, 'the Committee permits banks a choice between two broad methodologies for calculating their capital requirements for credit risk. One alternative, the Standardised Approach, will be to measure credit risk in a standardised

manner, supported by external credit assessments. The other alternative, the Internal Ratings-based Approach, which is subject to the explicit approval of the bank's supervisor, would allow banks to use their internal rating systems for credit risk.' [7] Obtaining such approval is fairly easy for large banks.

The standardised approach calls upon standards devised by the Basel committee that supports the influence of rating agencies. In the theoretical example introduced in [part 8](#), we used the standardised approach. Bank claims on States or public sector entities that are rated between AAA et AA- are weighted as 0% risk (par. 53). As a consequence, the corresponding assets should not be counted at all. This in turn means that banks do not require equity to write off possible losses on these claims. Claims on banks or corporates [8] that are rated between AAA et AA- are weighted as 20% risk, so banks can deduce 80% of assets corresponding to such claims. Claims on banks and corporates rated between A+ and A- are weighted at 50%, claims on banks and corporates rated between BB+ and B- at 100%. If their rating is below B-claims are weighted at 150%. Claims on individual persons are weighted at 75%, and on small and medium size businesses at 100% since these are not rated by rating agencies.



### **Dexia: a telling illustration of a soft option adopted by the Basel Committee and national supervisory authorities**

The case of Dexia is a telling illustration of how dangerous the system of risk-weighted assets is, whether using the standardised approach or the internal rating approach.

In June 2011 Dexia passed the *stress test* imposed by the European supervisory authority on 90 major European banks with flying colours. [9] Four months later it had to be bailed out for the second time in three years. The report Dexia presented to pass this test is revealing.

While the total amount of (non weighted) assets reached 567 billion euros, risk-weighted assets only amounted to 141 billion euros. In the theoretical example of [part 8](#), risk weighting had made it possible for a fictitious bank, Banxia, to reduce its assets from 100 to 40. Dexia did much better than this in June 2011 when its assets shrank from 100 to 25. Hats off to the Dexia conjurers! 'Reality' surpasses fiction!

In its report to the European authority Dexia claimed that the equity / risk-weighted assets ratio reached 12.01%. Enough to dazzle regulators! If **non** weighted assets had been taken into account, the ratio would have been only 3%, which would have been closer to reality. If the supervisory authorities did not allow banks, including Dexia, to add financial products that are not capital to their hard capital, their ratio would have been even more disturbing. We ought to emphasize that if the Basel III regulations (to be fully implemented in 2018-2019) had been in force regarding the equity / NON weighted assets ratio and the equity / weighted assets ratio, Dexia would still have passed the test. Which shows that Basel III does not provide any solution.

### **Banks: the art of deception**

The case of Dexia is by no means isolated. In 2011, according to the Liikanen report, equities amounted to between 2 and 6% of **non** weighted assets of major banks. In the case of the Deutsche Bank, equities amounted to hardly more than 2% (which involves a degree of leverage of 50). For ING and Nordea (Sweden), equities came to just under 4%. For BNP

Paribas, Crédit Agricole, BPCE, Société Générale or Barclays, they represented about 4% (degree of leverage of 25). For the Spanish banks Santander and BBVA, Italian banks Intesa Sanpaolo and Unicredit, or the Belgian KBC, they reach about 6% (with a degree of leverage of about 16). [\[10\]](#)

Yet all these banks passed the *stress test* in June 2011 presenting an equity/weighted assets ratio of over 10%.

On the basis of their 2012 annual report, published in 2013, we calculated the equity /weighted assets ratio and that for equity /**non** weighted assets for two major European banks with a reputation for stability: BNP Paribas and the Deutsche Bank. As the following illustration shows, the results are liable to worry even the most trusting.



If the *Financial Times* is to be believed – and it is certainly not in its interests to create panic in the markets— the Deutsche Bank’s situation is even more worrying and scandalous than the above diagram suggests. The leverage ratio of Europe’s biggest bank that appears to be 2.7% (or 1/37) is really only 1.6% (1/62)! [\[11\]](#) This implies that if the Deutsche Bank were to register a « minor » loss of 10 billion € out of its 2000 billion € of assets, it would be on the verge of bankruptcy; if the loss was 32.2 billion, all its capital would be swallowed up! In the same article, the *Financial Times* claims that the UBS’s ratio (the major Swiss bank) would come to 2.5%, that of the Société Générale (France) 2.8%, and that of Barclays (the United Kingdom) 2.5%. [\[12\]](#)

### **Basel III will not bring about introduce true financial discipline**

The general principles of general principles, whose Basel III were adopted in 2010 and are to become effective worldwide as of 2018 or 2019, they only include only one significant change: instead of the 2% hard capital demanded by Basel II, banks will have to put up 4.5% of hard capital [\[13\]](#). To this will be added a further 3.5% of assets that will be loosely calculated to reach the 8% previously required by Basel I and 2II.

However the fundamental fact to remember is that **assets will continue to be calculated according to the risk they present**. This completely invalidates all claims about Basel III providing solutions to the banking crisis. Clearly, the requirement of 4.5% hard capital in proportion to risk-weighted assets is a joke, opening up endless possibilities for cooking the books.

A study carried out by the Basel Committee in 2012-2013 concluded that the same type of assets may be risk-weighted within a range of 1 to 8 depending on the bank. Bank X may estimate that it needs only 1/ 8 the capital that Bank Y considers necessary to cushion the risk on interest rates in a given portfolio of derivatives. Out of 15 major banks in 9 different countries, the average variable of difference is from 1 to 3, all assets included [\[14\]](#). A Barclays bank study shows that risk-weighting is used by banks to reduce required equity to a minimum. Barclays reports that 20 years ago banks considered that weighted assets represented on average 53 % of their total assets, whereas in 2012, they represented only 32% [\[15\]](#). TAs for tAs for the European Banking Authority (EBA), it has published the results of the results of a study showing that half of the risk-weightings calculated by banks are not based on any objective factors. The study was carried out using the accounts presented by 89 banks from 16 EU states. It also shows differences of 70% in the evaluation

of the same type of risk from one bank to another [\[16\]](#).

Nevertheless, the Basel Committee ignores the evidence and maintains the present system of risk-weighting. Even though certain other official bodies, such as the OECD, have begun to produce documents in favour of abandoning the risk-weighting of assets. In a recently published OECD report, the authors propose counting assets without weighting them for risk, in order to obtain a reliable equity/assets ratio [\[17\]](#).

Furthermore, several regulators recognize this. Andrew Haldane, director of the Department of Financial Stability at the Bank of England, affirms that the increase in the ratio of equity to the banks' balance-sheets which is to be generalised as of 2018-2019 is totally inadequate and unlikely to diminish the risks and effects of bankruptcy. Thomas Hoenig, of the US Federal Deposit Insurance Corporation, an institution created during the Roosevelt presidency to regulate the banking system, also considers that the level of equity to be required from 2018-2019 needs to be multiplied by at least three [\[18\]](#). Like the author of the OECD report cited above, Andrew Haldane and Thomas Hoenig are in favour of abandoning risk-weighting in the calculation of assets and wish to see an absolute ratio (i.e. with no weighting) between equity and assets/capital and assets brought in. Dan Tarullo, one of the governors of the Federal Reserve, has declared that an equity/non risk-weighted assets ratio fixed at 3% (as decided by the Basel Committee) is insufficient. The US authorities intend to impose a ratio of 5% on their biggest banks, which goes to show that the Basel Committee's decision, within the framework of Basel 3/ Basel III, to fix a ratio of 3% [\[19\]](#) really is minimalist. Let us also bear in mind that the Vickers Commission, charged by the British Government in 2011 with making recommendations to answer the banking crisis, suggested a ratio of 4% in 2011. The British prime minister found this too restrictive. Last but not least, the *Financial Times* blazoned an editorial on the subject, proposing where the proposal was to move to a ratio of 6% ratio [\[20\]](#).

## Conclusions

From the beginning of the 1980s the private banking sector has unshackled itself from the restrictions imposed and maintained following the 1930 banking crisis. The regulatory authorities and the governments, henchmen to neoliberalism, have slackened the reins and the banks have made the most of it, taking their revenge on the social achievements won by popular struggles as they went. The current crisis, which began in 2007-2008, has not pressed the authorities and regulators into establishing real control over private capital. The measures taken to put a resemblance of order back into the financial sector are totally insufficient to avoid new crises and incapable of restraining unbridled profit-seeking.

There must be complete and radical rupture with these methods, which put the burden of saving the banks onto the shoulders of their victims. It is time to finish with the reasoning whereby this system offers impunity and golden parachutes to those who create chaos. The governments are at the beck and call of the big banks and put the administrations at their service; there is an ongoing relationship of complicity. The number of ministers of finance or prime ministers who come directly from the banking sector and return to it afterwards has continually increased since 2008.

The newly announced measures of Bank control are no more than cosmetic, they are purely and simply a cover-up. Strict and unavoidable rules and regulations must be imposed that reach well beyond those of Basel III, in particular. But frankly this crisis should motivate measures that touch the very structure of the financial and capitalist systems.

Banking is too serious a matter to be left in the hands of private bankers, it must be socialised (this implies expropriation) and put under the control of the population (bank employees, customers, associations and public services), it must be subjected to public service rules [21] and its returns be used for the common good.

Public debt taken on to bail out the banks is definitely illegitimate and must be repudiated. A citizens' audit must determine which other debts are illegitimate or illegal and allow an anti-capitalist alternative to take shape and mobilise.

These two measures must be included in a larger programme [22].

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## notes

[1] Alan Greenspan chaired the Fed from 11 August 1987 to 31 January 2006.

[2] BIS, 'Basel III: A global regulatory framework for more resilient banks and banking systems', December 2010 (revised June 2011) [http://www.bis.org/publ/bcbs189\\_dec...](http://www.bis.org/publ/bcbs189_dec...)

[3] Eric Toussaint, 'Banks bluff in a completely legal way', <http://cadtm.org/Banks-bluff-in-a-c...>, 4 July 2013.

[4] See the 2006 revision of Basel II: Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework <http://www.bis.org/publ/bcbs118.htm> p. 12 to 19.

[5] See <http://www.dexia.com/EN/shareholder...>, pp. 128-29.

[6] See <http://www.dexia.com/EN/shareholder...>, p. 78.

[7] See Basel II 2006 revision: <http://www.bis.org/publ/bcbs128fre.pdf>, page 33 (paragraphs 50-51).

[8] These can be loans to banks or corporates, or securities (for instance bonds issued by banks or firms).

[9] These 90 banks represented 65% of European bank assets. See (in French): <http://www.lesechos.fr/entreprises-...> By the way, the two Cyprus banks at the heart of the crisis in March 2013 had also passed the test without any problem. Of those 90 banks, 59 (namely the biggest ones) had used their internal risk-rating approach.

[10] This paragraph is about equity compared with assets. For Barclays and Deutsche Bank, see the Liikanen report, figures 3.4.18 et 3.4.19.

[11] See *Financial Times*, "Banks feeling bruised by new capital ratios", 5 July 2013, p. 15. The FT's calculation refers to the 4th quarter of 2012. This is the "ratio of adjusted tangible equity to adjusted tangible assets."

[12] In « Solvabilité réelle des banques systémiques mondiales », Olivier Berruyer compares the leverage effect of the 28 banks considered as systemic by the G20, See (in French only) <http://www.les-crises.fr/solvabilit...>

[13] For a more favourable presentation of Basel III, see Finance Watch : « Basel III in 5 questions »,

May 2012 [http://www.Finance-Watch.org/.../\\_B...](http://www.Finance-Watch.org/.../_B...) For the EU, certain elements of Basel III are to be implemented in 2014. The accord still has to be finalised, despite the fact that the European Parliament adopted **the reform of banking prudential rules CRD IV-CRR** on 16 April 2013. See <http://www.europarl.europa.eu/news/...>

Note that the bank Natixis has synthesized Basel III and **the reform of banking prudential rules CRD IV-CRR**: <http://cib.natixis.com/flushdoc.asp...> Finance Watch has also produced a position paper on the subject : <http://www.finance-watch.org/press/...>

[14] See Brooke Masters and Patrick Jenkins, « Risk models fuel fears for bank safety », *Financial Times*, 1 February 2013. See also a paper published by Finance Watch in the context of an audition at the Bundestag : see graph p. 5 <http://www.financewatch.org/iframe/P...>

[15] See the *Financial Times*, 1 February 2013.

[16] Brooke Masters, « Bank risk weightings in spotlight after EBA uncovers discrepancies », *Financial Times*, 27 February 2013.

[17] OECD, “Business models of banks, leverage and the distance-to-default”, January 2013, <http://www.oecd.org/finance/BanksBu...>

[18] The summary of remarks by Andrew Haldane and Thomas Hoenig is based on : *Financial Times*, “Warnings over steps to reform biggest banks”, 28-29 October 2012, p. 3.

[19] According to the *Financial Times*, in early July the Basel Committee decided to give the banks until 2015 to reach the ratio of 3%. See the *Financial Times*, “Basel fuels bank safety metric fears », 5-6 July 2013.

[20] FT, « In praise of bank leverage ratios », 11 July 2013, p. 8. “ ... there is a strong case for complementing the risk weighted metric with a blunter tool/ a leverage ratio, limiting how many assets can accumulate on given equity, regardless of the perceived risk. (...) the leverage ratio should be tough enough to bite. A threshold that is twice as high as the one agreed in Basel would not be a scandal”.

[21] Banking should be entirely public sector, eventually integrating a small cooperative element with which it would coexist and collaborate.

[22] See Damien Millet and Eric Toussaint, “Europe: what emergency programme for the crisis?” <http://cadtm.org/Europe-What-emerge...>, published on 1 July 2012.

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