

Basel III

Unexpected consequences of a pharaonic project

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Like the construction of the Aswan dam in its time, the implementation of Basel III is leading to significant and sometimes unexpected changes in the financial landscape.

For thousands of years, the Nile was a source of prosperity for the lands that it crossed. Its periodic cycles irrigated the neighbouring lands providing the resources needed for their development. However, once every ten years, extreme fluctuations led to famine and devastation. When too high, the flooding devastated entire crops. When too low, drought conditions prevailed.

Regulating these fluctuations was always a necessity. The culmination of these efforts was the construction of the High Dam at Aswan in the 1970s. This dam was designed to prevent major flooding while at the same time improving the irrigation of the Nile valley. Despite the dam's undisputed benefits, the equilibrium of the entire region was nevertheless modified, sometimes in an unexpected manner.

For example, it is estimated that evaporation from Lake Nasser, an artificial lake which was created after the construction of the Aswan dam, represents 14% of the flow of the Nile. In an even more visible manner, numerous ancient Nubian temples, including those at Abu Simbel and Philae, had to be moved stone by stone in order to avoid being submerged.

Like the Nile, the financial markets are necessary for the irrigation of the economy. However and like the Nile, their crises are destructive. Markets additionally obey the same statistical laws, whose principal parametre, the Hurst exponent¹, bears the name of a hydrologist who specialised in the Nile flooding. The dilemma concerning the regulation of the financial markets can also be described in a similar manner: how can we assure financial stability while continuing to finance the economy?

¹ See for example Benoît Mandelbrot, *Fractales, Hasard et Finance, Champs sciences, 2009*



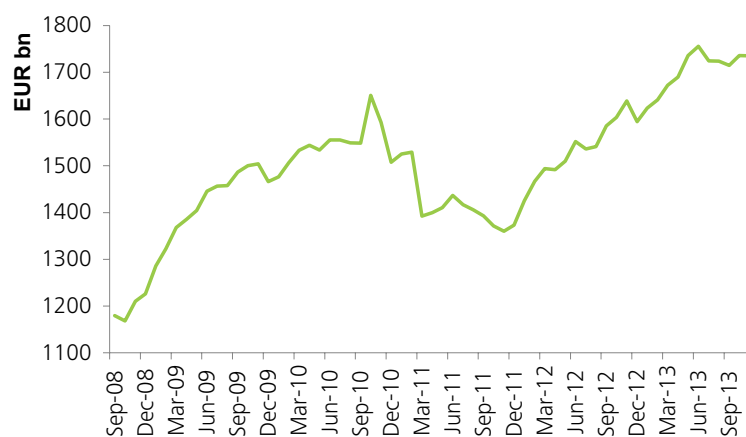
At a time when new regulations are in the process of redefining the banking and financial landscapes, it is worth paying attention to the unexpected secondary effects of these new pharaonic projects. We currently see two such effects that are profoundly affecting the structure of financial markets and that all investors should be aware of.

Public debt is now being held by banks at parity with insurance companies

Banking regulation has traditionally focused on so-called ‘solvency’ ratios, which ultimately lead to increased requirements in terms of equity capital ratios. Strangely enough, the liquidity risk, which is at the heart of banking activities, had never been directly addressed by the regulators. This has now changed. For the first time, the Basel Committee has introduced the concept of liquidity reserves. In order to reduce their vulnerability to liquidity crises (as in 2011 for example), banks must now set up reserves consisting of securities that can be easily sold in case of turmoil.

Therefore banks must now hold at all times a portfolio of high quality liquid assets (HQLA²), mainly composed of government bonds. According to ECB figures, European banks have increased their holdings of sovereign debt by €550 billion since 2008, to €1,700 billion at the end of 2013.

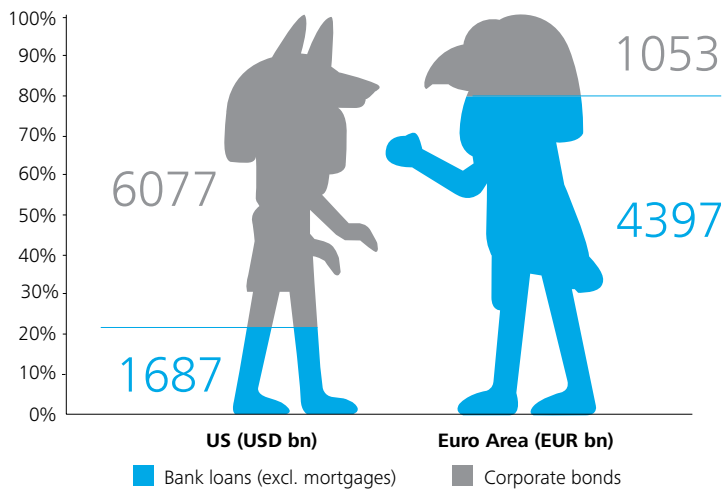
Figure 1: Holdings of government securities by euro area monetary financial institutions (MFIs)



Source: ECB, Lyxor

² High Quality Liquid Assets. See Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (<http://www.bis.org/publ/bcbs238.pdf>)

Figure 2: Sources of non-financial corporate financing (%): the 80/20 rule



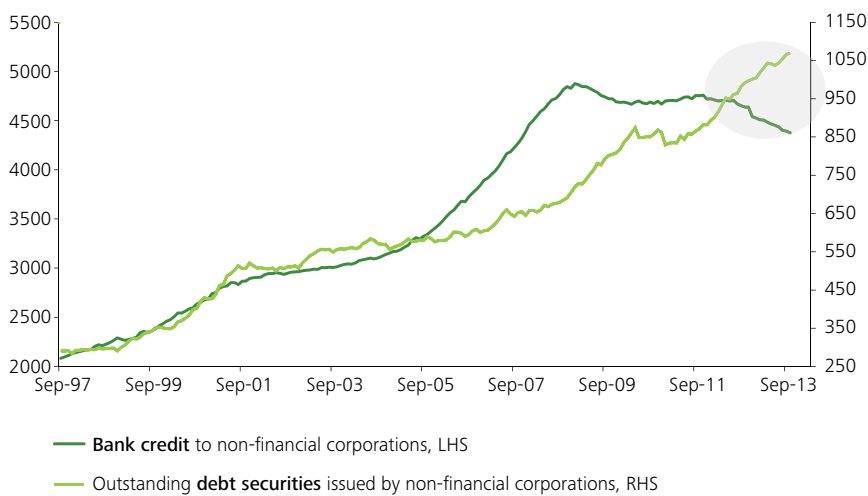
Data for Q3 13. Source: ECB, Federal Reserve, Lyxor

By way of comparison, according to EIOPA figures, the European insurance companies currently hold €1,600 billion of government debt. This illustrates the massive impact of Basel III on long-term interest rates and the new link that has been created between banks and sovereigns.

European insurance companies are now entering the corporate finance area

By reinforcing liquidity requirements for banks, regulatory authorities and bank supervisors are also reducing the level of bank intermediation. This is particularly the case in Europe. While 80% of the financing of non-financial corporates has been disintermediated in the United States, the situation is the opposite in Europe, where €4,400 billion of bank loans to non-financial companies represent 80% of their sources of funding. A 10% point increase in disintermediation would therefore represent a market totalling around €450 billion.

Figure 3: The process of corporate funding disintermediation has accelerated in the euro area (EUR bn)



Nominal value of debt securities, all currencies combined, excluding financial derivatives. Source: ECB, Lyxor

Under the impetus of two powerful drivers, the transition towards a lower degree of bank intermediation is now underway in Europe. On one hand, the change in regulations, by increasing capital requirements, de facto reduces banks' balance sheet capacities.

On the other hand, low yields on government debt are pushing investors to look at higher yielding and therefore riskier assets. In France, the publication of a decree in August 2013 modifying the insurance code has authorised insurance companies (under certain conditions) to make direct loans to companies for up to 5% of their balance sheet total. What is more significant is that conditions are attractive. Loans offer higher yields than sovereign debt and are safer than high yield bonds³: senior loans, high recovery rate, fewer defaults, protection against a possible increase in interest rates through a floating rate structure (Euribor + 450 basis points in some cases).

Additionally, this disintermediation trend is giving insurance companies the possibility of investing in non-financial sectors such as infrastructures, energy, real estate, etc. We are therefore seeing a transfer of assets, and even expertise, from banks to insurance companies.

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The specialist asset management companies: key players in the transformation

The banks which will have to hold substantial quantities of government debt on their balance sheets, are facing completely new challenges. They must act in such a way that these sovereign debt portfolios do not excessively weigh on profitability, without however accepting concentration risk on the most vulnerable countries, as these assets must be sellable when liquidity dries up.

Neither Basel III (which refuses to distinguish between countries based on their financial solidity) nor the rating agencies (whose history has demonstrated that they have been less responsive than the markets in crisis situations) will be helpful to the banks here.

There are concerns for long-term investors (particularly the insurance companies), while the major players have the ability to set up in-house teams to manage and invest in loans made directly or through funds, this is not the case for other players. This requires substantial human and financial resources as well as expertise in credit analysis.

Consequently, new players seeking to enter the private loan segment will also be well advised to make use of asset management firms specialising in the management of loan portfolios.

Similar to the construction of the Aswan dam, the adoption of effective regulations is a project that will run for more than a decade (2008-2019). It requires considerable resources and will lead to changes that have not yet been identified at this point. These types of changes require specialised players capable of satisfying the new needs in a constantly changing world. In light of these regulatory changes, asset managers will have an important role to play in this evolving world.

To the point:

- The banks must now hold risk-free securities. This is creating demand for sovereign debt similar to that from insurance companies
- The real economy is turning to new players for financing. This is *de facto* creating a new asset class, loans, for institutional investors
- Little affected by these regulatory changes, specialists asset managers have an important role to play by accompanying players impacted by these new measures

