The world will be no safer under Basel III

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The Basel Committee on Banking Supervision is about to introduce its Basel III accords, global regulatory standards which govern how much capital banks are required to hold.

But it's not typically a great idea to introduce huge regulatory increases when the world is on the brink of economic collapse.

And the Institute of International Finance (IIF) suggests Basel III implementation could slice 3.2 per cent of GDP in Europe, North America, Japan and the United Kingdom in the next five years alone, and leave the global economy with 7.5 million fewer jobs.

Sure, the IIF represents more than 400 banks, so they would say that. Governments admit it will slow the economy, but by much less. (They would say that too.)

Basel III was developed in haste after the financial crisis. Like its predecessor, Basel II, its purpose is to ensure banks have an adequate buffer of capital if there is a bank run.

Regulators say capital requirements are necessary because governments insure bank deposits. The idea of deposit insurance is to guarantee depositors won't lose their money if the bank goes under. But the insurance also means banks and their customers don't wear the cost of wild speculation and risky banking practices. So regulators believe banks need to be compelled to be prudent.

In other words, a new regulation introduced to patch up the unintended consequences of older regulations.

The existence of Basel II in the lead-up to the financial crisis has always been a gaping hole in the theory that we should blame a lack of regulation.

But it's worse. The Basel II Accords - designed to keep the banks secure, designed to protect the depositors against excessive risk-taking, designed by some of the world's most intelligent people - were the primary cause of the crisis in the first place.

That is the conclusion of Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation by the political scientist Jeffrey Friedman and the economist Wladimir Kraus. The book was released in October.

Friedman and Kraus's argument complicates both left and right crisis narratives. The causes of the housing bubble are well known: policies to boost home ownership, low interest rates, and Freddie Mac and Fannie Mae's 71 per cent stake of the non-traditional mortgage market.

But explaining the housing bubble is just the half of it. You have to explain how that bubble turned into a banking crisis.

Basel II actively encouraged banks to hoard mortgages. Its capital buffer rules weighted mortgages far higher than business or consumer loans. When the bubble burst, the banks were holding a disproportionate number of dodgy mortgages because they'd been urged to do so.

This is not a completely new story. Friedman and Kraus give it empirical support. They show that American bankers weren't actually that reckless. They favoured what they imagined to be safer, more expensive assets over cheaper, riskier ones. And the banks were nowhere near as leveraged as they had a legal right to be under Basel II.

Furthermore, it wasn't "irrationality" that caused the crisis. That widespread theory assumes bankers and regulators had enough information to know what they were doing was bad, but they all went crazy and did it regardless. The irrationality thesis has no explanatory power.

It was just that everybody - regulators, bankers, politicians, investors - thought highly-rated mortgages were a lot safer than they were.

So how did the banking crisis become an economic crisis? Basel II, after all, was supposed to halt a contagion at Wall Street's edge.

Friedman and Kraus argue that Basel rules are inherently contradictory. The capital buffers which Basel requires aren't buffers at all. The idea behind capital buffers is, again, that if there is a run on a bank, the bank will be able to dip into reserves to survive. But if it uses those reserves, even in a crisis, it will suddenly be under Basel's required capital threshold, and will be legally penalised.

As one economist pointed out, there has been little "consideration of the paradox that the buffer function of regulatory capital is limited because this capital is needed to satisfy the regulator". When the banks hit Basel's capital minimums in the last months of 2008, credit froze, and the "real" economy started to hurt.

So it is sickly perverse that Basel III's main purpose is to raise capital minimums even higher. And analysts from the Cato Institute have argued that it "retains many of the

weaknesses of its predecessors" - particularly "a highly gameable weighting system" that led to the hoarding of mortgages in the first place.

Basel III shows that governments are trying to fix the finance sector's problem before they've figured out what the problem actually is. The first and most important question has to be why the crisis occurred. Answering that takes reflection.

But legislators work faster than academic economists. Already by 2009 politicians were running down new regulatory paths. In February that year Kevin Rudd had concluded that Basel II was "inadequate" and that it needed a successor. This is meaningless. All regulations were inadequate at stopping the crisis.

Anybody who says they've got a handle on the causes of a crisis that big and that complicated in its immediate aftermath is wrong. And they're being deceitful if they say they know how to fix it.

The United States Congress passed the Dodd-Frank financial reform act six months before its own Financial Crisis Inquiry Commission released its report into the causes of the crisis.

Such is the false confidence of regulators and politicians.

Basel III standards are about to be disseminated around the world. There is no reason to believe that the economic system will be any safer or more stable. And it could be a lot poorer.