Dexia / Soros - Basel III and the Importance of Faith

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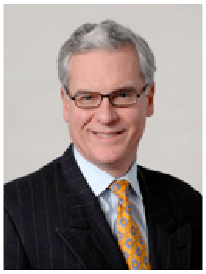

While Europe is sorting through Dexia's assets, it is worth exploring Dexia's fall in light of Basel III. As mentioned here previously, Dexia had been reporting Tier I capital of roughly 10%. Well done! That would clearly meet the proposed capital requirements to be phased in over the next year. So what went wrong?

Dexia had pursued a strategy of aiming to be the largest player in municipal financing. It owned gobs of sovereign debt. Down-grades and write-downs of that sovereign debt have now left Dexia well short of its Tier I capital requirements (to the tune of 1.7 billion Euros).

This is hardly a man bites dog story. The Gnomes of Basel, and pretty much everyone else, misjudged the perceived credit risks of sovereign debt. Basel I (and, to be honest, II and III) encouraged the holding of sovereign debt by assigning the lowest risk-weight to such assets, meaning a reduced capital requirement. So, the banks bulked up and then: Off the cliff we all go! Is there still a warm glow of knowing one had met international norms?

Dexia has now unloaded nearly half of its exposure to troubled sovereign debt and reduced its risk-weighted assets through the sale of its units in France, Belgium and Turkey to find additional Tier I capital.

Other European banks will need to raise nearly 120 billion Euros in the first half of 2012 to meet the new 9% Tier I capital requirement. Without help in recapitalizing from the ECB (not happening, per Mr. Draghi), these banks will need to unload assets or raise equity. While the US banks broadly sought new equity, the Europeans seem more comfortable embracing asset sales. If every bank does the same thing at the same time, we'll see cascading cycles of lower prices requiring more sales, producing fewer Euros or dollars, requiring more sales, etc., etc.

The dirty secret is, of course, that no policy nostrum, no level of enhanced capital, no enhanced prudential regulatory regime will save the banking system in Europe or, indeed, anywhere around the world if faith in the value of risk assets is not restored. Gold bugs may rail against the failings of fiat currency, but all assets depend upon a level of faith that you and everybody else agrees that the assets have inherent value. If that collective belief system breaks down, nothing prevents the abyss.

But that's not gonna happen, right? Right. It cannot and will not, but this whistling by the graveyard experience should chasten markets, and that's probably good. Faith functions best when the suspension of reality required to maintain it is not too great.

In the meantime, there's plenty to do. Loss of confidence coupled with regulatory intervention and uncertainty will create terrific arbitrage between the perceived value of financial assets in the hands of those who have lost faith or might, by reason of regulatory pressure, be a seller of necessity and those who can manage both the real and perceived risk and attendant liquidity issues. George Soros is the poster child of this arb, having just purchased $2 billion worth of MF Global's sovereign portfolio. Toxic for MFG, home run for Mr.Soros.

So there is fun to be had for the brave and liquid and those of us who midwife the trades. I'm feeling good about 2012!