Banks' new £40bn capital bombshell

24 February 2012 | By Mike Phillips

Industry feels Financial Services Authority's June rule change will make debt even more scarce

The UK's banks are in crunch talks with the Financial Services Authority over a regulatory change that could require them to raise up to £40bn of capital to cover losses from bad property loans.

As part of tightening bank lending regulation of in response to the global financial crisis, the FSA is due to bring into force a regime from June that will require "slotting" — a stricter classification of loans and the amount of capital held by a bank against them.

Property Week can reveal that the FSA has been told by representatives of the banking and property industries that its new accounting regime would have required banks to raise between £20bn and £40bn to bolster capital ratios.

One banker explained, for example, that the changes as laid out by the FSA said a loan that could not be refinanced on "current market terms" should be classified as "weak". De Montfort University's last survey of property lending, in December 2011, showed that £114bn of property loans fall into this category so, on that basis, more than £30bn would need to be raised to fill banks' capital gap.

The British Bankers' Association is leading the talks with the FSA, and banks and property bodies are working towards alterations to reduce a "shock" impact.

Banks are worried the changes will exacerbate difficulties of raising capital and shoring up their balance sheets in the face of depressed share prices.

The British Property Federation has been involved because of the knock-on effect on property borrowers. The need to raise capital will make property lending even more scarce and expensive.

One top property banker said that FSA changes could mean the margins on property loans double from their already historically high levels.

The Bank of England Property Forum has also discussed the matter with the Treasury.

But the primary impact will be on FSA-regulated banks — UK lenders and overseas banks that lend in the UK — who will need to raise new capital to set aside to mitigate against potential losses on loans made in the boom. The increased capital ratios, being discussed by the FSA with banks on a case-by-case basis, will have to be met by shrinking balance sheets, cutting back lending, increased margins or by shareholders.

The new rules will affect both the Royal Bank of Scotland and Lloyds Banking Group, which this week were expected to reveal combined losses of more than £4bn for 2011, much of it on property lending. JP Morgan estimates potential future losses of more than £18bn on their legacy loan portfolios.

Under existing regulations, most banks use their own internal models to determine "risk-weighted assets" — essentially deciding how much capital to set aside against individual loans.

But the FSA feels that these models were not adequate to ensure banks had properly assessed their loans and provisioned against losses in the downturn.

“Slotting” is a more prescriptive system that places loans into one of five categories: strong, good, satisfactory, weak and defaulted.

If a loan is reclassified as “weak” rather than “satisfactory”, more than double the amount of capital must be put aside as provision against losses.

Under the definitions of “satisfactory” and “weak” loans, set out by the FSA when it began consultation on the proposals last June, many more loans would be classified as weak, vastly increasing the amount of capital banks would need.

Banks will have to “slot” their loans into one of the five categories, but discussions are ongoing with the FSA on the factors that will decide the strength of the loan.

This could lead to overarching guidelines for banks, or individual banks agreeing with the FSA on how they classify their loans. The British Bankers’ Association and individual banks will go back to the FSA with the proposals by June.

The FSA declined to comment.