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Strengthening the Resilience of the Banking Sector
The BASEL Issue and the Banking Crisis 2007-2009,
Proposals for Improvements to the December 2009 BASEL proposals,
Proposals for Lower Cost Solutions to Banking Crisis

Dear Honourable Sirs,

This brief note looks at the banking crisis and the role of the Basel Capital Accord ("BASEL"), following the request for comments on publication of the consultative document Strengthening the Resilience of the Banking Sector. I hope some of the observations raised can contribute to consideration of key issues, and especially to facilitate the introduction of a wider range of lower cost alternatives for governments, taxpayers, shareholders, central banks, and the global financial system as a whole.

Its aim is to critically consider whether the BASEL rules supported the financial system appropriately during an emergency period. It looks at the recent proposals issued by BIS in mid December 2009, on capital adequacy and liquidity measures. It ponders the appropriateness of the Basel Capital Accord. It proposes that a wider range of lower cost alternative solutions should be introduced in the context of the emergency.

The first question is whether you believe the current banking regimes under BASEL, and the Bank for International Settlements, have been successful during the financial crisis of 2007-2009.

If you believe the banking regimes have not been successful, I am in agreement with you. And I wonder what changes are being introduced in capital markets, rules and governance to improve matters. Further, it may be worthwhile considering how the BASEL rules may have influenced a) the crisis itself and b) the scope of the range of low cost solutions available and c) the speed of adaptation or resolution of the crisis.

If you believe the banking regimes have been successful, then I beg to differ. I believe that the Central Banks in Europe (and the European Central Bank) should push much more strongly for a wider range of lower cost policies especially to improve BASEL at the Bank for International Settlements, even if it remains "above governments", to further improve capital markets.

I am writing to you to plead for improvements in the range of instruments to be available at lower costs relating to governance of capital markets and capital adequacy. At lower cost. This means questioning the appropriateness of the current BASEL rules.

Current Position

During the last 3 years, there have been numerous bank disasters. Bears Stearns. Lehmans. Wachovia. Washington Mutual. Northern Rock. Bradford and Bingley. HBOS. Hypo. Anglo Irish. ING Bank. Fortis.

Many have required state support. JP Morgan. Citi. Bank of America. Wells Fargo. UBS. Lloyds. Royal Bank of Scotland. Commerzbank. WestLB. Allied Irish Banks. Bank of Ireland.

The banking system did suffer wider collapse than was anticipated. Several banks were seriously damaged in terms of losses, decrease in net worth, lack of ability to raise capital, and in terms of the reliance that was necessary on national governments, and the taxpayer.

Did the Basel Capital Accord or the Bank For International Settlements ("BIS") each play an appropriate role during the banking crisis?

Issues

With the objective of responding to requests for observations on the mid-December 2009 BASEL proposals, this note focuses on one issue in particular, namely the issue of the Basel Capital Accord. The BASEL system was introduced in 1988. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by end-1992. Since 1988, this framework has been

progressively introduced not only in member countries but also in virtually all other countries with internationally active banks. Many of its rules have been adopted under national central bank laws. The capital standards are what are now commonly referred to as capital adequacy requirements, namely setting minimum levels of capital that a bank must have relative to its portfolio.

Did BASEL prevent the crisis? Were its rules appropriate to the circumstances? Did lower weights for residential mortgages have any impact on bank lending policies? Had bank's enough room to manoeuvre? Was the solution of additional emergency capital from governments, the least cost alternative? Can BASEL's appropriateness be improved? Can measures be introduced urgently as part of the effort to rebuild the banking system? Could BASEL introduce measure to enable lower cost supports in the future?

The BASEL rules also allocated a significantly lower capital requirement (risk weighting 50% lower) for residential lending.

Did BASEL contribute to the crisis? The lower risk weighting for residential loans probably encouraged banks to over-grow portfolios for residential loans. Furthermore, the lower capital needed probably facilitated over-expansion of loans for sub-prime customers in the sector, especially in the USA.

Complications

There are many complications involved in the crash. Some complications include over-lending. Some complications include inappropriate portfolio balance in terms of sectoral spread within certain banks. Some include over-trading in particular classes of loans (sub-prime residential loans, property development loans and loans to purchase residential and commercial properties). Some complications include the supervision of the banks by central banks and regulatory bodies. Some complications include the ease at which non-owners can sell shares. Some complications also include the over-incentivisation of inappropriate growth objectives. Some complications include growth rates exceeding prudent levels, especially in cases where no acquisitions had been made.

There is also the complication of payments of bonuses during an emergency, and during reliance on government support. This note will touch upon some of these, but rather than allocating blame, it looks for some solutions that may encourage lower cost alternatives to emerge.

Other complications include the urgency of fixing capital adequacy ratios for banks incurring losses. For some lenders a loss of $1bn meant that they had to pull back lines of credit of around $25bn.

The capital adequacy rules can have a large inverse effect during a downturn in profits or when banks incur losses. In general, with the assets that require 8% capital adequacy ratios, the down-pull is 12.5 time the losses incurred. Very sizeable indeed. This could be even more severe for residential or sub-prime losses. So a capital adequacy requirement of 4% for residential lending (a 50% weighting) implied a down-pull ratio of 25:1. Again, these ratios could have huge impact downwards in credit availability for banks. And between banks. And for the global economy.

The knock-on effects were potentially very large. Other institutions, faced with similar losses, also had to curtail credit significantly. Even with a capital adequacy ratio of 8% the downsize factor was 12.5 times the amount of any loss.

So bank after bank faced with property portfolio losses each were faced with the same dilemma. All at the same time. But most property portfolio assets are not that liquid. It can take a year or more to sell a commercial property. It would be unusual to sell a residential property in less than 3 months. (Most legal systems would take that time to process the transfer of title). So it was not that easy to downsize illiquid assets. This leads to a key question as to whether the capital adequacy rules are really appropriate in such circumstances.

Then look to investors. So a bank is going to make a loss. Will it be able to pay dividends? Will dividends be cut? Will depositors feel secure? Investors become nervous. Supplies of capital are not available. But banks still have to meet BASEL capital adequacy rules. And the time frame is tight. So the need can become extremely urgent. And the need did become extremely urgent. And extremely widespread.

However, this could be a great opportunity for some. Namely hedge funds. And, of course, short-sellers. Short-sellers are mostly non-owners of shares. They can make substantial gains in a down market. They can increase the volumes of sales of shares substantially. So what can a bank do to defend against short selling? Very little in the absence of some profits or good news.

The BASEL rules probably help short-sellers in a financial emergency. Short-sellers know capital is scarce. They know capital markets are not functioning in favour of banks. They know the banks MUST raise capital. With urgency. Do the current BASEL rules, which require banks to obtain new capital to replace losses, help to steady the down wave?

Scope for Action

Looking at a few banks in the USA, the volumes of shares traded in during 2008 appear very high.

	Wachovia	Regions Financial	Citi	National City Cp	Exxon Mobil	Pfizer
Date	23/10/08	22/10/08	23/10/08	23/10/08	24/10/08	24/10/08
Market Cap.	12.5bn	$6.9bn	$71.1bn	$5.9bn	$350.1bn	$112.2bn
Share price	$5.8	$9.99	13.07	$2.81	$67.40	$16.65
Share Price High	$47.17	$27.5	$43.11	$24.83	$96.12	$24.75
No. of shares outstanding	2,158,855,014	694,800,000	5,445,393,308	2,100,000,000	5,194,003,020	6,740,994,347
Volumes						
4 weeks	2.35bn	0.29m	2.97bn	2.74bn	1.08bn	1.54bn
13 weeks	6.56bn	1.06bn	7.67bn	4.04bn	2.34bn	3.42bn
26 weeks	10.79bn	2.24bn	13.87bn	5.80bn	4.05bn	6.54bn
52 weeks	14.39bn	3.09bn	26.24bn	7.80bn	7.08bn	11.4bn

The characteristics worth noting, with a view to introducing a wider range of correction instruments, include: -

- The volumes of shares transacted could exceed the number of outstanding shares in 4 weeks.
- The volumes of shares were such that the total market capitalisation of a bank could be traded within a month, without any take-over. And, it seems, without any significant changes in ownership.
- This volume multiple was, in several cases, 3-6 times the outstanding number of shares during the year. This turnover is substantial on an annual basis.
- The volumes traded for banks appear significantly higher than for certain non-bank shares (relative to the number of shares outstanding).
- The volume figures help to show that shares were traded several times for each institution in the year of the collapse.
- We postulate certain shares were sold or short-sold, over and over by similar sellers.
- It is possible, as well as probable, that some of the sellers may never have owned physically a single share in the bank, via short selling and hedge funds.
- Long-term holders of shares lost significant wealth.
- If one was to allow for the share price in tandem with the volumes indicated, the turnover can amount to very substantial sums over time.
- The trading may be regarded as excessive relative to the no. of shares outstanding and relative to the bank's valuation.
- Yet, it is likely that brokers, short-sellers and hedge fund supporters will probably argue that between 0.3% and around 1% is the daily volume of shares traded, and this is necessary for liquid markets. With the volumes traded, the values are substantial, so too the brokers commissions and vested interests.
- A key point is that, unchecked, the system, and especially non-owners of shares, can wreak havoc on the capital markets to the significant disadvantage of long-term shareholders, investors and pension funds. And to the disadvantage of governments, and taxpayers who ultimately have to support the system.
- Capital adequacy rules were not effective in defending against such a manoeuvre.
- Central banks, governments and banks need better defences and controls urgently to change these circumstances.
- The stock exchanges do not appear to be appropriate bodies to introduce sufficiently appropriate self-control measures on account of the potential gains for vested interests. The SEC did introduce some curbs, but they were relaxed quite quickly. Some other bodies also took action on short selling, however, without a better co-ordinated global approach, access to non-limited markets can still be used to contribute to a down-wave.
- The new BASEL proposals do not adequately address such issues such that they could prevent a recurrence, so even with new capital adequacy and bank liquidity rules, the global financial system continues to remain exposed.
- The new BASEL proposals could be much improved were they to include a wider range of lower cost measures.

It may be useful to consider an analogy case relating to short selling, for example the case of houses. If my house could be short-sold, or even all the houses in my neighbourhood could be, how would that be likely to affect the price of my house. It is difficult to imagine that my house could be sold 5 or 6 times over in a year, but short selling would allow this. By someone that does not own the property. By someone that did not maintain it. By someone that did not help me buy it. By someone who would not help me grow it. OK, if they could be short-sold, there would be more houses being "virtually" bought and sold – but does this really help to increase the price of my house. I don't think so. I could perhaps exit more quickly, but almost invariably at a price lower than if fewer of such short-sellers were around. I am not convinced that I should let non-owners profit from my house, when the likely effect is mainly to reduce

prices. It is far from clear whether the long-term house owner in this case as well as the house itself (or the stock-owner as well as the bank in the financial crisis) obtains any significant benefit. Accordingly, it is appropriate to question whether there is a compelling case to control, curtail or tax short selling.

Adding an underlay of capital adequacy requirement to the analogy helps to show how the system got significantly de-stabilized. If I needed to maintain a capital adequacy level for my house, or a certain gearing level – even though I may have been able to meet commitments on debt, I would have been forced to raise equity when values deteriorated (or losses were realised). But when everyone else was suffering similarly, no one would provide more equity. Chaos results. House owners would have to lose their houses. The state would have to bailout the system, at cost to the taxpayer. Further losses, would put more strain on the new owners. Such a system is probably unduly penal on owners.

However, such a system does nothing to punish the managers who may have over-grown the problem, and who currently would be allowed to continue to collect bonuses and excessive remuneration in certain cases.

The analogy helps to crudely show that capital adequacy rules/ratios are highly inappropriate in such circumstances. So much so that the complete usefulness of the BASEL Capital Accord now should be highly questionable.

That stock markets faced a substantial decline is not contested.

Index	Date	Peak (approx.)	Date	Low (approx.)
Dow Jones	Q3 2007	14,000	Q1 2009	6,700
FTSE 100	Q3 2007	6,700	Q1 2009	3.800
CAC 40	Q2 2007	6,100	Q1 2009	2,700
DAX	Q2 2007	8,000	Q1 2009	3,500
ISEQ	Q2 2007	16,000	Q1 2009	3,300

So what happens when financial markets are severely disrupted? Pressure on banks increases. Pressure on credit lines increases. Pressure to reduce credit increases. Investors respond negatively. Lenders respond negatively. Depositors respond negatively.

The downward spiral drives governments to consider urgent measures of support. Central banks make lines available, but with limits. The risk of system failure moves from the private sector to the state and to taxpayers. Depositors obtain government guarantees to prevent runs on banks. However, the inter-bank market is on a very shaky base.

The BASEL rules remain like a vice around the system. Down pressure continues. Short-sellers pause, or are paused, but are allowed back into the market again. Governments are forced to meet the laws they introduced to meet the BASEL requirements. In the meantime, bank values have fallen significantly and some banks fail. Capital markets are not supportive of financial institutions, especially banks. More reliance on government intervention. Capital supports the governments provide to banks involve potentially large exposures for taxpayers. Significant dilution in shareholders interests occurs. The owners take the hit. Dividends are curtailed. However, most of the managers get excessively remunerated, as well as bonuses on top. Large drops in pension values. Burdens on governments to cut expenditure. Burdens on taxpayers to finance capital shortfalls. Disimprovement in country credit rating. Catastrophic consequences. Questionable rules.

The current BASEL does confuse capital adequacy with liquidity. Having capital adequacy ratios does not provide much assurance of liquidity.

The current BASEL system seems like a vice that has had a strangulating effect. It is not sufficiently flexible. It does not grant sufficient time. It is inappropriate in an economic crash. If BASEL had worked as it was originally intended, then there would have been a lower probability of bank collapse, both at the individual bank level and across several markets. But the banking crisis appears to show the current BASEL's appropriateness is questionable. Firstly, this leads one to question the usefulness of capital adequacy under BASEL as a means of maintaining bank solvency. Secondly, the costs of sustaining capital adequacy under BASEL appear to be inordinately high in such circumstances. Thirdly, the timing factors that require urgent re-alignment of capital adequacy under BASEL seem to be questionable. Finally, the overall suitability of BASEL as a means of preventing bank collapse in terms of cost, timing, narrowness, and making available a wider range of alternatives must be considered.

The new BASEL proposals appear to confuse liquidity with a suitable solution. What doe BASEL propose to allow time for a bank to re-align its balance sheet in an emergency? How does the new BASEL enable governments to reduce the potential need for capital? How do the new BASEL proposals enable the taxpayer reduce its potential exposure to a collapse. Do the BASEL proposals outline any policy initiatives on the priority ranking between payments of dividends or other forms of discretionary payments like bonuses?

Does the new BASEL take account adequately of the nature or priority ranking of certain bank payments? Just as in the case of dividends, there are two sides to payment of bonuses. On is the ability to pay when profitability is adequate. The other is the obligation on boards of directors to conserve resources for financial stability. A bonus is not just subject to an employee's performance. It is also subject to the institutions performance, regardless of the individual. If a board of directors decide that dividends cannot be prudently paid or require to be cut, BASEL ought to provide guidance that bonuses should rank in a lower priority.

Could the new BASEL proposals be improved by the inclusion any guidance on portfolio balance? Such guidance would be likely to assist bank boards as well as regulators. There is a solid case that such matters could be added to the proposals to improve banks in the longer term.

The current new 2009 BASEL proposals could be significantly improved: -

1. by the inclusion of time-lines for correction.
2. By being wider in scope
3. By providing wider guidance
4. By not merely focussing on capital adequacy and liquidity
5. By proposing a wider range of lower cost alternative solutions

Some time-lines for correction could apply to extended periods for corrections of:

- Capital adequacy imbalances
- Liquidity imbalances
- Portfolio imbalances
- Treasury imbalances
- Government support/withdrawal of government support
- Over-extended dependence on customers/depositors/inter-bank borrowing.

The absence of appropriate times for correction may have been a factor during the crisis. Some banks (e.g. Lloyds/HBOS) appear to have been forced into urgent decisions on mergers without appropriate adjustments being done prior to the merger. The new BASEL proposals should address such issues more.

Should BASEL operate in such a costly manner? Should there be a wider range of lower cost alternatives available for governments? Should there be a better more flexible, more appropriate range of policy alternatives available to governments, central banks and taxpayers within a BASEL framework?

It seems that liquidity may be a more suitable measure of a banks ability to withstand market forces in a downturn. Perhaps, the founding fathers of BASEL meant liquidity when they were talking about capital ratios.

The new BASEL proposals introduce new proposals on liquidity. But after our recent financial crisis, they may still be deficient. Some suggestions are advanced below to help strengthen a new BASEL, and to widen the range of alternatives for systemic management.

The December 2009 new BASEL proposals may be an improvement. However, some suggestions for further improvement are included below: -

1. In a crisis, a wider range of supports should be available to national governments, and central banks. By adhering to a one-dimensional BASEL, which focuses on capital adequacy primarily, it seems that the support system for correction is too narrow and too costly. The new BASEL 2009 proposals widen this a bit to include liquidity and conservation of capital. However, this note suggests their scope should be much wider and less costly.

2. The BASEL proposals could consider a liquidity ratio and capital ratio grid that correlates both systems. A bank that is highly liquid should not require as much capital as one that is highly illiquid. A bank with 100% capital adequacy can be highly illiquid.

3. Do the new 2009 BASEL proposals look too narrowly at a bank? The funding or treasury side appears to be addressed in the liquidity proposals. But the lending side is not covered to the same extent, nor the quality of the invested portfolio. This appears to be a possible weakness that could be corrected at this stage.

4. A way of further strengthening the new 2009 BASEL proposals is to take more account of certain aspects such as the sectoral spread of a banks business. We have seen banks that concentrate lending in too narrow a range of sectors are more highly exposed to failure risk, than banks with wider sectoral diversity. Anglo Irish Bank was probably always a fundamentally weak bank because its sectoral focus in lending was quite narrow – although some investors saw it as fundamentally strong based on its now apparent excessive growth. This could also be said to be likely in the cases of Northern Rock (UK), Bradford & Bingley (UK), HBOS (UK) and Hypo (Germany).

5. The new 2009 BASEL proposals seem to look at the funding side of banks in particular detail. This is probably too narrow for prudence. Consideration needs to be given to the lending side also. Many of the banks in the above paragraph may have met the new BASEL proposals in terms of capital and liquidity, while their portfolios remained structurally weak in terms of concentration of lending in property sectors. An old rule of thumb for banks was that not more than 15% of assets/advances should be in any one sector. If the original BASEL had included this, the damage to many banks may have been significantly curtailed. Perhaps a new BASEL should include some sectoral spread rules.

6. Capital adequacy weightings applicable to different types of loans may encourage imbalances in advances. If a bank needs less capital to expand advances to residential properties, banks will look to grow such lending inappropriately. Sectoral limits or balances should be considered in cases where risk weights apply such that instances of inappropriate portfolio growth are curtailed. The new 2009 BASEL proposals could address this more.

7. Central banks need wider scope to allow a graduated convergence back to capital adequacy, when capital adequacy rules are not met. Longer correction times for capital, for portfolio correction, for adaptation should be permissible. To ensure other more prudent banks are not disadvantaged, the non-compliant bank may be charged fines, levies, fees or taxes pending rectification. The new 2009 BASEL proposals could take such factors into account more.

8. Defences to short selling should be strengthened – measures that could be considered include suspension, ownership rules, cooling-off periods, volume limits, volume monitoring and reporting, hedge fund regulation, control, and taxation. The new 2009 BASEL could give more guidance.

9. Monitoring systems for publicly quoted banks should include volume statistics. Volume statistics can indicate over-trading in an institutions shares. When one looks at volume statistics for shares like Citi, or Wachovia, or Bank of America relative to non-bank shares like Exxon Mobil or Pfizer during the crisis, it seems that volumes increased sharply and short interest positions were also more significant in the banks. Such proposals could broaden the new 2009 BASEL proposals to include more early warning signals.

10. There may be a need for better control systems for stock exchanges, or to bring them within central bank control. They should also have greater capabilities to request/propose measures that could defend the wealth of nations during a crisis too.

11. Time to re-align should be introduced into the new BASEL proposals. Central banks and regulators need more scope to obtain time for a re-orientation or re-alignment of a bank's portfolio or funding. A bank that has become over-exposed to imbalance either in its funding or in its portfolios, needs more time to adjust than merely one year. The advantage of this is that it may reduce pressure on governments for support, and may make it more difficult for market speculators to predict the outcome. Including such measures at much lower potential cost to governments could significantly enhance the new 2009 BASEL proposals.

12. The role of bonuses needs to be considered more. The variances in approach by banks to this matter have been disappointing. For more consistency, perhaps guidelines should be incorporated into the new BASEL proposals. A ranking guidance should be considered. A global approach probably would be preferable. Should bonuses be payable when state intervention is required to support a bank? Should bonuses rank ahead of or behind dividends? When a bank is in difficulty, should anyone be allowed earn a bonus. Financial prudence would suspend bonuses during any financial difficulties. A sign of financial difficulty is when dividends are not paid. There are cogent grounds for dividends to rank ahead of bonuses. If profits are not adequate to reward investors, then it is questionable if bank executives and management, who after-all are not entrepreneurs, should obtain bonuses or additional discretionary payments. Should it be the case that if those who provide risk capital are not rewarded, then any discretionary rewards to bank staff should not be payable. BASEL imposes requirements on investors. Is it appropriate that BASEL requirements curtail returns to investors, while bank management bonuses may operate to the disadvantage of the providers of capital. Especially, should BASEL have a favoured position regarding the ranking of bonuses or dividends in the matter of bank solvency?

13. The new BASEL proposals should consider the inclusion of a wider range of remedies for central banks in controlling their national banks. These could include measures that encourage the governments/central banks to properly seek compliance, with breaches being subject to fines or levies pending correction, suspension of bonuses, dismissals, or curtailment of licences. The authorities being rewarded for discovery, and the parties which breach the new BASEL proposals being penalised for non-compliance.

14. At the BIS level, and almost certainly at nation-state level, perhaps a system of standards/fines/levies should be considered on central banks to ensure improved compliance with a new system of standards.

Conclusion

Current BASEL requirements dictate that banks need a minimum amount of capital. Current experience poses significant questions as to whether the BASEL Capital Accord is an appropriate system. Has BASEL failed? It does not seem to have succeeded between 2007-2009, other than in delivering catastrophic consequences for credit systems, unemployment, governments, and taxpayers.

Should capital adequacy continue as a pillar of the BASEL system? How well has BASEL worked? These questions are left for the reader to ponder. Certainly it appears to be a flawed system in its current state. It is highly costly. Its appropriateness in a crisis is very questionable.

Should capital adequacy rules be phased out altogether and replaced by other instruments? In the light of recent experience, there are strong grounds for considering this. This note argues for lower cost alternative solutions to be introduced into any new BASEL system. National central banks, and governments, need to consider whether the price/costs of BASEL, and its apparent inflexibility is worthwhile continuing.

The capital adequacy provisions and the new BASEL December 2009 proposals are not sufficiently appropriate to curtail the current potential exposures for the global financial system. The current rules and the new 2009 BASEL proposals will not stop banks from failing. The rules have been very costly in terms of capital to date. This does not appear to have changed much. The rules do not seem appropriate for emergency capital market conditions, especially when capital markets are not supportive.

This note respectfully wishes to assist the deliberations on any new proposals. The following list suggests a wider range of matters that should be considered to improve the stability and resilience of the banking sector: -

1. Lower cost remedies to bank imbalances should be a cornerstone of any new BASEL proposals.

2. It seems appropriate that any new BASEL proposals should allow for correction of imbalances, remedies, capital shortages or liquidity issues over a longer period of time. The current proposals could be improved in this regard.

3. Consideration to the introduction of a wider range of instruments, at lower cost, should be built-in to the proposals. The new BASEL 2009 proposals do not appear to provide sufficient lower cost alternatives, following the banking crisis.

4. The inclusion of liquidity policies is probably more preferable to inclusion of capital adequacy policies. Whether the currently proposed combination of liquidity policies and capital adequacy policies is less costly is doubtful. By retaining the old capital adequacy rules largely unchanged, the suitability of the new proposals is questionable in the light of recent banking experience.

5. The suitability of capital adequacy rules for bank resilience is now highly questionable. Perhaps consideration should be given to whether they should be replaced or phased out in the context of their unduly high costs.

6. Consideration should be given to whether any new BASEL proposals should include policies to address portfolio balance in terms of lending, rather than just measures for the funding/treasury side of banks.

7. Treasury portfolio balance (within the classes of funds) also needs to be considered to avoid dependencies or imbalances on the funding side of banks. The BASEL proposal to tighten counter-party credit exposure capital requirements may help. Nonetheless, other qualitative factors such as the spread, concentration, sectoral distribution, scale and volume can also be considered.

8. The new BASEL 2009 proposals seem to adopt certain funding guidelines within the liquidity requirements, but they need to cover both sides of the balance sheet more (namely the lending or investment side as well as the funding/sources side).

9. Undoubtedly, the new BASEL 2009 proposals could be improved more in terms of suitability to banking crises. It should be possible to include policies and instruments in any new BASEL proposals that are less costly to implement. One cannot help feeling that there may be some confusion between liquidity and capital. One can have 100% capital adequacy (i.e. no gearing, and in the form of common equity) and still be highly illiquid, depending on what form the capital is invested in. The quality of Tier 1 capital is not necessarily improved by being in common shares and retained earnings. Again, it depends on what the resources have been invested in. In this regard, the suitability of "capital buffers" is desirable, although questionable in the BASEL context – because their composition, following investment, is probably of much more relevance. Funding derived from owners of common shares and retained earnings can be highly illiquid, depending on what they become invested in within a bank.

10. The BASEL proposals for conservation of capital with individual bank minimum capital conservation standards appear to have some prudence. However, this note would favour a liquidity rather than capital conservation policy, because the latter has been discredited. The matter of inclusion of bonuses as proposed has merits, and could be further strengthened by a ranking priority that reflects risk and returns more to support the provision of external capital in the long-term. Giving priority to bonuses or share buy-backs ahead of dividends would lessen the attractiveness of banks for investors.

11. The approach to provisioning for future losses is a management tool. However, it can be used wisely as well as used imprudently, especially by remuneration-hungry executives. Used wisely, it can allow some scope for financial manoeuvre in a crisis. The inclusion of such policies is to be welcomed. This note supports and argues for a wider range of policies and instruments to be included in any new BASEL proposals **as a necessity**.

12. The BASEL 2009 proposal for a 30-day liquidity coverage requirement is a step forward. However, it appears it may be too short in the light of recent experience. The withdrawal of support for certain banks was quick, but for others lasted more than 3-6 months, and for others around a year. Therefore, how sufficient is a 30-day liquidity coverage ratio? What happens if the ratio is not met? What happens if financial support is not available? What remedies are available to central banks, or to governments if the coverage falls?

13. The BASEL 2009 proposal for a longer-term structural liquidity ratio is also a step forward. However, what are the costs of correcting an imbalance? How would such liquidity ratios ensure that a bank's lending portfolio is not too narrow, or too risky, or improperly balanced? Would such a ratio play a role in remuneration-driven targets of bank executives? What penalties or fines for non-compliance apply? BASEL needs to consider this further, in terms of costs, scope for action, duration to correct, flexibility, and availability of other alternatives.

14. The BASEL 2009 proposals still leave the costs of adjustment firstly with owners (as under the current rules), then with governments and taxpayers, in the event of a crisis. This can be improved.

15. The BASEL 2009 proposals still leave the costs of adjustment at very high levels in the event of a crisis. This can be improved.

16. The BASEL target implementation date of end 2012 for new BASEL proposals seems to merit a much higher priority. Does this indicate the flexibility for changes to BASEL could be improved?

17. The BASEL committee seems focussed on "monitoring metrics". Monitoring metrics may provide early warning signs (arguably one can argue the warning signs existed for certain banks long before their crash). Metrics may help to foresee a failure. However, in a crash environment, monitoring metrics will do little to support the resilience of banks. Regulatory jargon did not strengthen the resilience of banks. Regarding assessing the PD [probability of default] "the UK Financial Services Authority (FSA) has proposed an approach aimed at providing non-cyclical PDs in IRB requirements through the application of a scalar that converts the outputs of a bank's underlying PD models into through the cycle estimates". It is difficult to see how this can stop a crisis. Statistics won't stop a crisis. How they are used, interpreted or published might. How they were used, interpreted or published in the past did not stop the crash. Some models and metrics can yield fantastic results. Too good to be true, one might say. So governments will still require remedies. Therefore, there is an even greater necessity for a range of instruments that can help to remedy defects in capital, liquidity or structures with a lower burden of adjustment in terms of cost, capital, and unemployment. The new BASEL proposals can and should include additional alternatives at lower cost that should enhance bank resilience policies in this regard. A focus on instruments and policy remedies, in priority to monitoring metrics, would assist in the search for lower cost alternative solutions.

18. Consideration should be given to whether BASEL (and probably national governments) needs to address the longer-term interests of investors, governments and taxpayers. (It seems appropriate that such policies be considered at BASEL level to ensure competition between banks is on a common platform). The BASEL proposals on capital conservation measures and forward looking provisioning may help, but again it depends on where the resources become invested, and how liquid or how realisable they are. An observation in this regard is that taxation policies tend to discourage forward looking provisioning in some jurisdictions at least.

19. It appears appropriate that new BASEL proposals are needed to consider addressing capital markets and stock markets support for banks, and to adopt policies (preferably at low cost) that may curtail or remove bottlenecks that exacerbate the down-wave.

20. It seems appropriate that BASEL needs to introduce more instruments for penalising or incentivising compliance. This could be imposed in relation to individual banks, to regulators, to central banks.

21. In the light of the recent crisis, it seems appropriate that BASEL should address the ranking of remuneration for capital vis-à-vis remuneration for management, especially in rescue conditions. Some banks have argued that bonus payments are not discretionary. If this is so, should they be included as liabilities in the banks accounts? Alternatively for banks asserting the non-discretionary case, should bonuses (or accruals for bonuses) also be deducted from Tier 1 capital like defined pension fund liabilities?

22. On similar but inherently different matters, BASEL could consider new policies to re-balance the interests of owners vis-à-vis management. Bank management that produce results that are contrary to BASEL guidelines or that imperil system risk, currently can obtain excessive rewards relative to the outcomes for owners, governments, and taxpayers. The interests of management can be out-of-sync with the best interests of owners. For example, management can adopt bonus systems that encourage over-trading in its worst sense. In this regard, the system of allowing bonuses to continue in priority to payments for capital is imprudent. It is inappropriate, especially when a bank is obtaining any form of rescue support, or during time allowed for remedies to capital or structure. Such a priority ranking could be a disincentive for investment in banks in the long term.

23. BASEL needs to include measures that bank management carry some potential exposure for inappropriate decisions, like excessive credit growth. The current BASEL system imposes most of the adjustments/costs of imprudence on parties that are not involved in decision-making. This is not sufficiently appropriate for prudence in banking management. Banking management have used the budgeting and bonus system to encourage excessive growth rates in credit. Frequently, banks targeted growth rates far in excess of economic growth. Doubling times of 5 years were used (implying compound annual growth of 15% p.a.) as lending targets when growth of 5%-8% would have been more consistent with prevailing economic conditions. Permitting bonus payments in such circumstances does little to promote greater fiduciary responsibility. In this regard, alternative policies could allow national governments to apply liquidity ratio top-ups, bonus-fines, suspensions, taxes or levies could be added to the range of lower cost alternatives to make banks more resilient.

24. Perhaps a reader will now agree that any new BASEL proposals should include a wider range of lower cost alternative solutions for governments, for central banks and for regulators to make the global financial system much more secure. Firstly, we trust this note helps to show that there is a wider range of alternatives that could be considered. Secondly, we trust that this note shows the costs of some of the alternatives would be considerably lower to implement than the current BASEL capital adequacy rules. Thirdly, we trust that the economic position of banks, central banks, governments, taxpayers and citizens can be improved if a wider range of policy tools were available at lower cost.

Under the new 2009 BASEL proposals, the move towards liquidity measures is probably an improvement. Especially in preference to capital adequacy rules. Perhaps, in implementing the liquidity measures, the capital adequacy rules should be scaled down. However, one might question whether the costs of rectification in a crisis would be any lower under the new BASEL 2009 proposals than under the current BASEL system. Policies that facilitate lower costs of rectification need to be built-in as alternatives. The proposals would benefit from more scope for flexibility, and for more instruments for supportive action. The requirement is for lower cost alternatives. By holding onto the old BASEL capital adequacy element, within the new proposals, they appear to preserve the high cost and unsatisfactory nature of the old BASEL. Further improvements are needed urgently. Especially, improvements that embody lower costs.

I would hope that by airing the issues in this note, that the system to strengthen resilience for banks can be improved, widened and bolstered more appropriately for the future. If BASEL is to continue, then there is an urgent need to improve the BASEL proposals. Perhaps, based on the crash, the old capital rules should be phased out entirely, and possibly replaced by way of introduction of some emergency measures or instruments with a wider range of alternatives than merely capital and liquidity to deliver sounder and stronger capital markets for all citizens in the future.

If the BASEL committee does not agree that a new BASEL should widen the range of measures in the current round of proposals, then I hope that some of the issues may be considered to enhance the resilience of national governments in dealing with the banking system on less costly terms and more appropriately, pending any lengthy BASEL process, as a matter of priority.

Yours sincerely,

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