Firstly, I welcome the Committee's undertaking to introduce any changes in a manner that will not be disruptive for outstanding capital instruments (page 5) and with appropriate grandfathering arrangements to avoid any further stress in the near term (page 13). After recent experience, there is a global demand for better (and where necessary more severe) regulation, but our recovery from the crisis is as yet unconvincing and we must remain cautious of piling on new burdens onto still frail financial institutions in the near term. Having said that, a path and timetable of reform will be easier to agree now, when crisis is fresh in the minds of many and commitment to reform is forthcoming.

I will address the discussion documents under its own 4 headings.

Raising the quality, consistency and transparency of the capital base.
The stratification of capital into two tiers for going concern and gone concern loss absorption is interesting. It draws on our recent experience of a liquidity crisis endangering multiple institutions and claiming a few due to the belief that much capital was only realisable on a gone concern basis.

I would like to submit, that apart from dividing capital into these 2 tiers, it would also be worthwhile to look at ways of disencumbering Tier 2 (i.e. gone concern) capital. Much of the liquidity crisis was exacerbated by the drawn out procedures for assigning compensation to the creditors of failed businesses. Perhaps the most celebrated case was Lehman Brothers, where after the failure of the bank, other institutions did not seem to know to what extent they would be compensated for their exposures. This caused uncertainty and speculative attacks on several other institutions while the disorderly winding up process was in progress. It would be worthwhile for the Committee to examine methods for speeding up the reallocation of the assets of gone concern businesses, as otherwise, valuable liquidity is tied up in administration after a bank failure –which is usually a critical time of financial stress in any case.

However, the primary focus should be on Tier 1 (i.e. capital absorbing losses on a going concern basis), and in particular branding this as high quality and dependable. The requirement for a majority of Tier 1 to be Common equity is reassuring, but it could be fleshed out a little bit more with some more direct reference for what will and will not be permitted in Tier 1 alongside common equity. I appreciate that the Committee has included a set of detailed criteria on pages 20 and 21 of the discussion document, but this could be supplemented with a blunt (ideally it should be borderline obtuse) definition. My reasoning is simple; much of Basel II came into disrepute, not because it was poorly designed, but because creative financial institutions found ways to circumvent its complex provisions with off-sheet accounts etc.. Therefore, I would like to see very blunt, simple language used in the new rules (alongside and in addition to more detailed specifications) which will provide minimal room for legal and accounting wizards to wiggle around. The definition of Tier 1 capital is a key area to ensure genuine compliance.

Risk coverage
CCR is a key area for reform. Indeed, if our institutions had been properly secured against CCR, then the risk of contagion (through speculative attacks on their

counterparties) would have been severely curtailed. This in turn would have meant far fewer of our banks would have been deemed to be “Too big to fail” and the massive intervention of public funding would have been unnecessary.

I have already noted that after major bank failures, other institutions did not know how much of their exposure they would be able to recover, but far worse than this was the revelation that many institutions did not seem to know the extent of their own exposure to counterparties (or to categories of counterparties, such as “sub-prime” borrowers”).

Measuring CCR seems to be something of a joke if institutions cannot even identify their exposure to counterparties. I believe that this is an area for relatively intensive reform. It is clear that banks are not undertaking anything approaching due diligence on many of their instruments and indeed some instruments are so complex that this is an unachievable aim. As radical as it may sound, I do not believe this is a model we can permit to continue. We must move to compel institutions to identify their counterparties and their exposure to them and submit same to the authorities (ideally to the public). If this means that some more complex instruments are phased out then that is to be welcomed rather than mourned. The presence of these fathomless pools of risk created pockets of fear everywhere in the system at exactly the point of downturn (financial WMDs in one investor’s memorable phrase).

Not only should we require banks to identify and assess their own exposure to all of their large counterparties (and categories of counterparties), we should also include a specific requirement that they must hold sufficient reserves to survive the failure of any single counterparty. Much of the distrust of financial institutions in the depths of the crisis arose from rumours –many unfounded- that individual banks were exposed to other failed institutions, or other categories of counterparties. This inability to identify the exposed parties arising from a default, and in parallel with this, the fear that the (unidentified) exposed parties could themselves be caused to fail on account of the default caused panic. It was not so much a case of contagion from one institution to the next, as it was a cascade failure where all banks, exposed and unexposed became equally suspect at the same time. This must be the key area for reform.

If it can be agreed that all banks must identify their counterparties and secure against failure of even the biggest counterparty, then I believe we will have done much to reduce uncertainty in a crisis and prevent the immediate and pervasive transmission of pressure from one failed institution to all other players in the entire financial system.

Leverage ratio

I am sure that the Committee will receive many submissions seeking lower permissible leverage ratios, and I will certainly support this.

More importantly though, and as I have said earlier, it is important that the final language is simple, blunt and leaves minimal room for creative interpretations after the fact. Off-sheet vehicles and other chicanery allowed some institutions (certainly in Europe anyway) to escape the leverage requirements agreed to at Basel II. Simple, blunt language –impossible to reinterpret differently is necessary to have proper

compliance. In fact, I think this is even more important than lowering the leveraging ratio (though that must follow too).

Secondly, it is very important that this deleveraging is done over an extended timeframe, with a firm, but gradual tightening of standards. In particular, current conditions prohibit any sudden immediate hike, but I think that the level and schedule of deleveraging should be agreed now while there is will to take the issue seriously. This process will be very expensive and will be a constant drag on economic growth for its duration. We should aim to keep it evenly spread out and at a manageable rate of progress.

I feel unable to say what a safe level of leveraging is, although I have seen the figure 8% mentioned in the media repeatedly. But it would be nice to think that we could have a level sufficient to remove doubts about our system even at times of the greatest stress (e.g. 1930s, 2009, 1890s).

Not only will deleveraging make our banks more stable, it will reduce the levels of default. As requirements become more and more exacting, and the supply of credit becomes less, shortage of funds to loan will encourage banks to cast a more sceptical eye over proposed loans and more fully appreciate the relationship between risk and reward. This is something of a mixed blessing and the balance between securing the system, while keeping credit available to borrowers must be at the core of the proposed new leverage ratio.

I leave it to greater minds than mine to hazard a guess at the inestimable –the appropriate leveraging ratio.

Procyclicality

Sadly, I must remain sceptical of all talk of countercyclical action. It is human nature that causes us to lose fear when times are good and greed is rewarded, just as our own fears overwhelm us when greed is punished and we flee for security. The best we can hope to do is create a system with sufficient strength to last in all conditions. It is beyond us to "time the market" as a successful investor has noted.

Additional comment

One possible area to expand your proposal would be to look at the commitments of borrowers. At the moment, lenders are regulated relatively tightly (although not tightly enough as we have learned), but the commitments of borrowers (whether institutional or personal) not to take on insupportable loans is less developed. Even some simple measures in this direction could lay the foundation for a whole new field of financial regulation if it was begun now. At the moment, the only restrictions on borrowing are almost exclusively contractual with the only oversight being conducted by lenders who often have a vested interest in expanding business. Perhaps we should be seeking to have borrowers submit some details of their intentions and means to regulators before permitting them to borrow reasonably. This would increase the useful intelligence available to regulators if nothing else.