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Strengthening the Resilience of the Banking Sector
The BASEL Issue and the Banking Crisis 2007-2009,
Proposals to ensure loss absorbancy of regulatory capital at the point of non-viability

Dear Honourable Sirs,

You have recently requested views on your consultative document with your latest proposals. This note wishes to raise the role of the Basel Capital Accord ("BASEL") in relation to the latest proposals and the banking crisis. I hope some of the observations raised can contribute to consideration of key issues, and especially to facilitate the introduction of changes to BASEL to put it on a more sustainable, and far less costly, future foundation.

It seems apparent that a greater understanding of the role of capital, and subordinated debt, in the context of the BASEL rules may assist the consideration and urgent introduction of a wider range of lower cost alternatives for governments, taxpayers, shareholders, central banks, and the global financial system as a whole.

In terms of ranking of financial instruments for a company, the ranking is usually as follows:-

1. First secured debt has a call on secured assets
2. Second secured debt has a call on assets left after the first secured debt.
3. Monies owing in relation to taxation usually rank after this
4. Unsecured debt and unsecured creditors relies on any surplus assets
5. Shareholders rely on any remaining balances thereafter.

Other instruments that are potentially open to priority ranking policy improvements in a capital crisis include the following: -

1. Principal balances
2. Interest
3. Dividends
4. Bonuses
5. Remuneration.

This note proposes that there is scope for new regulations. These can be broadened to instruments that provide much greater scope for using other low cost alternatives for governments. This note argues for more improvements to BASEL, especially for circumstances when banks become under threat, illiquid or insolvent.

For banks (governments and taxpayers), it is the BASEL rules that make capital a critical issue. This arises because of the fixed ratios that BASEL requires, in correlating assets and capital. During the crisis, and until now, BASEL rules, along with the need and desire to sustain banking systems have forced governments and central banks to accept the fixed links between assets and capital. One of the problems to be addressed is the rigidity of the links and rules in circumstances like deposit guarantees, or rescue programmes that forces taxpayers to stand in for any shortfall in capital (or losses), when capital is no longer available from investors or the market. It is important for regulators and central banks to understand that the approaches adopted by governments is quite strongly driven by the BASEL rules and the fixed ratios they impose on banks. Reforming the ratios, making the links more adaptable in a step-down situation or in a crisis, and having available a wider, and less costly, range of financial instruments, in addition to more appropriate capital adequacy requirements in crisis conditions are key factors to finding better solutions.

So the current proposal to making other tiers of capital convertible into equity, may increase the capital base, in certain circumstances. It seems reasonable to argue, as BIS does, that if such tiers are treated as capital, they should be more closely related to capital. And should be loss-bearing in certain circumstances. However, on its own, this proposal appears to be too limited and too narrow a solution. In banks using tier 2 capital, the range relative to assets generally would range between say between 2% and 4% of a banks asset base. Therefore, the impact is limited relative to the scale impaired assets and losses of loan principal incurred in the recent crash. Therefore, it appears that the proposal still would not provide a sufficiently large buffer to deal

with the latest crash, to make a significant reduction in the burden on governments and taxpayers. Furthermore, once a central bank calls a trigger event to convert tier 2 instruments to equity, this would increase the chance of runs on banks. Further, withdrawal of support for government bonds would be undoubtedly heightened. This note argues that BIS needs to address this more to provide a wider range of alternative solutions, especially with lower cost implications (for central banks, for governments and for taxpayers).

The BASEL proposals are expressed in a way that seems to assume that if tier 2 instruments have a greater relationship with true capital, the prudence of corporate governance in a financial institution is likely to be improved. This note questions whether such an assumption is supported by sufficient evidence to be accepted as valid. The link between corporate prudence and capital rules in the banking crash only seems to be sustained from the fact that having BASEL capital adequacy weightings of 50% for loans for residential property led to imbalanced portfolios, excessive property development lending, and higher risks in banks. Lack of prudence, bank governance and BASEL rules appear to have been contributory factors in the crash. The problem is that the BASEL rules still appear to leave the global economy as vulnerable now as in 2007-2008, and it seems difficult to notice sufficient improvement in providing lower cost alternatives (for central banks, for governments and for taxpayers).

There are several grounds to consider the BASEL capital adequacy requirements as being in need of urgent and significant reform. Current BASEL regulations say a bank cannot survive a loss, unless more capital is inserted. And inserted urgently. The challenge this imposes is immense. Some of the grounds for better and broader BASEL rules include:

- The impact on economic growth, incomes and unemployment has been immense.
- Extra costs arise for government borrowings (in terms of interest, and gilt yields).
- Extra costs arise for business (in terms of higher margins and costs of raising finance).
- Lower income revenues are generated for the public sector.
- Taxation revenues decrease.
- A downward cycle occurs that leads to economic depression.

The Irish government to-day has indicated it will cost over €29 billion in capital for the bail-out of one bank, Anglo Irish Bank. (The total cost to date for the Irish banks is around €46bn). The need for finance has been almost immediate. The case of Ireland (as well as US, UK, Spain, France, Germany and Greece) shows that the burden of addressing BASEL rules, in their current format, contributed a significant liability for the government and for taxpayers. This is not right. The changes in the BIS latest current proposals may save a few billion of this, at best. It is still not right, and will continue to be not right until the BASEL capital adequacy rules are more fundamentally improved.

On of the add-on impacts of BASEL on governments in supporting the banking crisis is that government borrowing has become more expensive. The cost of gilt yields, for example, as at 29 September 2010, were as follows:-

- German 10 year 2.23%
- US 10 year 2.47%
- UK 10 year 2.89%
- Italian 10 year 3.89%
- Spanish 10 year 4.11%
- Greek 10 year 10.50%

While some of these rates appear low, one should bear in mind that the interest rates charged by central banks are at historical lows. For example, in the UK, the Bank of England base rate is currently 0.5%. The US Fed funds rate is under 0.2%. The ECB refinancing rate is 1% (deposit rate 0.25%). Yields on medium-long term gilts in Ireland currently are around 7%. Therefore, quite large premia can be payable for exchequer funding. So citizens, through their taxes, will be forced to carry significant burdens of funding bank capital for many years.

The reader is invited to agree that there must be a better system that could have far less costly outcomes for economies that could be devised by the Bank for International Settlements.

Indeed, the reader is further invited to consider whether the current BASEL capital adequacy requirements have been of any significant support to the financial system at all during a financial crisis.

The conclusion to be drawn is that capital adequacy regulatory requirements as currently framed are extremely burdensome and expensive. If a bank incurs losses, under current regulations, BASEL is the framework that forces the bank to require more capital. Take away the BASEL current framework, and a huge element of the problem could become potentially more manageable. Or indeed, they could become manageable in other less costly ways. For example, less costly alternative solutions could include some of the following: -

- Better priority ranking policies in relation to certain payments in crisis conditions could be included under BASEL. These could relate to policies and ranking relative to dividends, bonuses, remuneration, and interest in a crisis.

- When capital is scarce, when state support is relied on, and when dividends are not paid, and when further capital rationing appears called for, a policy is now emerging from BASEL on tier2 capital – but a bank can save capital itself (or could be ordered to do so – under better new rules - by a central bank) at less cost, and perhaps with less widespread financial impact if bonuses were reduced in the first instance. The BASEL approach to tier2 in the current proposals seems to imply a greater system risk for central banks in forcing a conversion of tier2 on a bank, than in suspension of bonus payments as a line of first action or remedy. It is surprising that BASEL has not tackled this issue as a lower system cost.
- Does it make more sound economic sense to tackle the more discretionary and downward elements first in a crisis, rather than putting a country's whole financial system under threat by an enforced tier2 capital manoeuvre?
- Reduction in or cessation of bonus payments could be imposed;
- Extensions of time could be allowed to remedy defects;
- Extensions of time could be allowed for portfolio re-balancing;
- Extensions of time could be granted to reduce dependency on excessive reliance on inter-bank financing;
- Ratchet systems could be introduced to obtain improvements in positioning over a more extended period of time, even with penalties;
- Freezing of balances, especially principal balances, could be implemented;
- Interest costs could be frozen;
- Interest rates, at the level of the particular bank concerned, could be scaled down for the duration of the difficulties;
- Curtailments on pay rates for staff could be implemented;
- Lock-in or lock-out arrangements could be made to deal with new creditors;
- Ratchet-ups and scale-downs of supports/remedy measures on a phased basis could be adopted.

This implies that a new revised BASEL system could be framed in such a manner that they could be less expensive for governments, for taxpayers, for existing shareholders, for pension funds to implement over time, but which could still restrict the parties that have not operated sufficiently prudently in the past. Why the Bank for International Settlements and the world's central banks have not pressed for more reform of this appears to be contrary to the on-going global experience that appears to be continuing, even after the 2007-2009 crash.

Governments, taxpayers and perhaps central banks have had to carry significant costs in bailing out or rescuing banks. There is a direct correlation between this need for capital, and the capital rules. Sticking to such inflexible and narrow-ranged BASEL rules, following the experiences of the bank crash, in a totally vice-like rigid manner appear to reflect flawed bank-structure policies, and, moreover, seems to invite further economic hardship on governments, taxpayers and citizens into the future.

The proposals in the consultative document tinker with subordinated debt being converted into equity.

Of greater importance, and more urgent need, would be for BIS to totally revamp the BASEL capital rules (which only came into being in 1988). Much stronger and enhanced proposals more appropriate for crisis management could be introduced or considered. Some of the key elements that need to be taken into account for revising BASEL include the need to address issues that can assist any of the following issues:-

- Ways of lessening the dependence on governments for funding in crises. The proposals need measures to reduce further the potential exposure and burden on governments. The current proposals still leave the system
    - overwhelmingly vulnerable, and
    - are too limited and are not sufficiently broad in scope,
- The potential exposure to substantial costs on taxpayers is still considerable, and needs to be reduced at lower cost,
- Convertibility of tier 2 capital to equity is unlikely to impact sufficiently on bank governance to materially improve it,
- Banks can still chase low-rated assets for BASEL risk weightings,
- Adherence by regulators to over-see and apply appropriate bank structures is not significantly improved,
- Sectoral spread or imbalances in bank balance sheets are not given sufficient time to adapt,
- Dependence on inter-bank markets can still leave the financial system unstable,
- The ranking of staff bonuses to rank in terms of priority behind dividends to capital providers (i.e. no dividends no bonuses) as a way of reducing capital requirements has not been advanced.
- The need for capital does not seem to be given sufficient seniority by bank regulators, even in terms of priority ranking vis-à-vis other creditors such as employees/bonuses, especially while a bank avails of "rescue" assistance from governments,
- Improvements to controls on the bank's speculative behaviour or that of other competitors, may have a greater and less costly impact.
- Scope for "earn-out", principal freezes and curb-interest costs, time to rectify, or other less costly remedies need to be addressed more.

Other less costly remedies and solutions would probably have a greater impact in terms of savings for governments and taxpayers, rather than the current narrowly-ranged-rigid capital adequacy rules.

The proposals currently are neither sufficient in scope nor sufficiently appropriate to reform one of the key elements underlying the banking crash, namely the BASEL capital adequacy rules.

The Bank for International Settlements can surely make better, sounder, stronger and more appropriate proposals in the future.

The proposals may provide marginal assistance to a central bank or government, to the extent of tier2 relative to a banks assets (this is likely to be less than 5% in most cases, so the problem to be addressed based on the current crisis is likely to be much broader and more significant than this). However, the proposals could have devoted more thought to exit mechanism and exit approaches, if only a temporary designation was required by a central bank. Further, if a central bank calls on the tier2 debt to be converted to equity, what impact will this have on other tiers of creditors, or on the credit rating of that government's debt?

Conclusion

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

We invite the reader to question whether capital adequacy rules in their current form should continue as a pillar of the BASEL system. How appropriate are the current solutions? Are there any other less expensive alternatives? How well has BASEL worked? These questions are left for the reader to ponder. Certainly it appears to be a system that needs to be radically improved. It appears highly costly. Its appropriateness in a crisis is very questionable. The proposals currently made by BIS are too narrow to improve matters to any significant extent.

Should capital adequacy rules be phased out altogether and be 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 provides appropriate support to any sufficiently meaningful extent. This note invites you to agree that the current proposals could be more meaningful in scope, could widen the ranges of instruments, to provide more comfort for governments in the future.

The capital adequacy provisions and the new BASEL August 2010 proposals are not sufficiently appropriate in scale, or range to curtail the current potential exposures for bank losses or a crash in the global financial system. The current rules and the new 2010 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 sufficiently appropriate for emergency capital market conditions, especially when capital markets are not supportive.

Clearly, other factors contributed to the crash, and local factors (including significant regulatory failure, tolerance of "maverick" style banks over sustained periods, and build up of imbalances in funding and lending portfolios) also played a significant role.

Nonetheless, I trust the reader can accept that there is scope for a much broader range of lower cost improvements in bank regulatory reform. You are invited to agree that the Bank for International Settlements can and should embody policies for central banks (for governments and for taxpayers) possessing a much better, wider and enhanced range of lower cost instruments for the future. Urgently.

Yours sincerely,

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