Basel Committee for Banking Supervision

Sir,

These are comments made in reference to your July 8, 2013 consultation document "The regulatory framework: balancing risk sensitivity, simplicity and comparability"

I would like to begin by clearly stating that for a long time I have completely objected the capital requirements for banks based on ex ante perceived credit risks. I consider these capital requirements to be totally insane and much responsible for causing the current bank crisis, as well as for impeding us getting out of it.

And to that effect I enclose a short opinion recently published in the Journal of Regulation and Risk - North Asia, Volume V Issue II Summer 2013.

That said I would also like, just as an example of what I criticize, refer to the following in the document.

"73. For example, in increasing ex ante risk sensitivity and expanding risk coverage, the framework has progressively sought greater alignment of regulatory capital with economic capital. This approach is implicitly premised on the suitability of economic capital as an appropriate measure for regulatory purposes. But the relationship between economic capital and regulatory capital may need reexamination in the light of the recent shift in the focus of regulation and supervision from ensuring the soundness of individual institutions to, additionally, safeguarding the stability of the banking system."

First, what are you saying? That "safeguarding the stability of the banking system" was not understood to be the role of the Basel Committee for Banking Supervision before? Do those who appointed you agree with that statement?

Second, your regulatory capital based on ex ante perceived credit risk, even in the case of an individual bank, is an utterly incomplete reflection of economic capital, since it does not consider facts like the size of the exposures, meaning the portfolio diversification/concentration, or the duration of those exposures, for instance the interest rate risk.

And then let me briefly and partially answer some of your specific questions

Q1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

No! The core of the current framework, risk-based capital is completely wrong.

For instance, when in 29 you write "These ideas should be assessed against the primary aims of the capital adequacy framework: that is, the capital adequacy framework should…. take into account the effects of capital requirements on banks' risk-taking incentives, eg when faced with regulatory constraints on their capital (and therefore the size of their balance sheet), to seek higher-risk assets as a means of boosting expected returns", you do not seem to comprehend the real problem.

The fact is that banks, “when faced with regulatory constraints on their capital”, primarily seek assets which have a low capital requirement, in order to boost expected risk-adjusted returns on equity

Q2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?

Yes, like the little matter of the purpose of the banks; like that the capital adequacy framework should not be allowed to distort the bank credit allocation to the real economy.

Q3. To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?

To no degree at all, especially since the “greater risk sensitivity it brings” is only a quite arrogant ex-ante presumption.

Q4. Which of the potential ideas outlined in Section 5 offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?

In my opinion, a simple leverage ratio of 8 to 10 percent, complemented by a reporting requirement which includes; a report of risk adjusted leverage based on standardized risk-weights, and issued strictly for approximate comparative purposes; and some additional information on its portfolio diversification and duration, and that can be helpful for the market to get a sense of the risk structure of the bank.

The transition to such a reality though would have to be managed with a lot of intelligence in order not to make things worse.

Q5. Are there other ideas and approaches that the Committee should consider?

Yes!

How did Basel I, II and III evolve? How can we make sure that the serious mistakes in them and that I attribute to incestuous group-think within a mutual admiration club, are not repeated?

There is a need for a critical mass of qualified creditors in the market who know they will not be bailed out automatically from a bank problem.

Who authorized the Basel Committee to act as a risk-manager of our banks and the world?

If you want to do it right, you need to work with a whole set of new regulators who have no vested interest in defending what has been done in the past… remember, neither Hollywood nor Bollywood would ever dream of entrusting a Basel III to those responsible for Basel II flop.

Am I to harsh and impolite in my criticism? Considering the suffering and the millions of unemployed youth resulting directly from your faulty regulations, I do not think so.

Sincerely

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PS. If you want to download the whole journal from which my opinion was extracted you can go to http://www.scribd.com/doc/149858219/Journal-of-Regulation-Risk-North-Asia-Volume-V-Issue-II-Summer-2013

Members of the Basel Committee for Banking Supervision

In July 2013 you issued, for comments before October 11, 2014, a discussion paper titled "The Regulatory framework: balancing risk sensitivity, simplicity and comparability"

In reference to it let me declare that I totally reject, and protest, your whole risk based capital requirement framework. It is based on the absolutely false premise that the perceived risks are not cleared for by banks in terms of interest rates, size of exposure and other contract terms.

This risk based framework, which re-clears for the same perceived risks in the capital (equity), only guarantees that banks will overdose on perceived risk, and makes it completely impossible for banks to help the society in allocating effectively bank credit in the real economy.

That framework is also been the prime cause for the current crisis as it, by allowing banks to make higher expected risk-adjusted returns on exposures to what is perceived as absolutely safe than on exposures to what is perceived as risky, has driven the banks to create excessive exposures to what is perceived as absolutely safe, which is precisely the kind of exposures that have created all major bank crises in history, when the ex ante perceptions turn out ex post to be wrong; in this case much aggravated by the fact that the capital of the banks will also be extremely small when such unfortunate thing occurs.

Your perceived risk framework has also, in my words, castrated the banks and introduced a risk-adverseness that is making of the developed countries, submerging countries.

As a private citizen I do not have the time or the resources to repeat all my arguments over and over again and so I refer you to my blog:

http://subprimeregulations.blogspot.com/

And in which, for a starter, you might find especially illustrating the following post

http://subprimeregulations.blogspot.com/2012/12/the-basel-ii-roulette-manipulation.html

And to follow up, you might want to read what was recently published in

the Journal of Risk North Asia, Volume V, Issue II, Summer 2013

And please, before you regulate our banks one iota more, tell us what you think the purpose of our banks should be, to see if we agree.

Respectfully yours, sort of,

Per Kurowski

A former Executive of the World Bank (2002-2004)

PS. If I sound a bit disrespectful, forgive me, but I have been trying, for more than a decade now, to make you see the light. I do not ever shout in capital letters on the blogs, I am a

grandfather with a serious cv., but there has to be a way by which an ordinary citizen can get some answer, even from a Basel Committee

http://subprimeregulations.blogspot.com/2013/04/questions-on-bank-regulations-which.html

The "Mistake" that dare not speak its name

Per Kurowski, a former World Bank executive director, lambasts the Basel Committee for castrating banks.

IN an Op-Ed I wrote for the *Daily Journal of Caracas* in November, 1999, I opined that: "The possible Big Bang that scares me the most is the one that could happen the day those genius bank regulators in Basel, playing Gods, manage to introduce a systemic error in the financial system, which will cause its collapse". Fast forward to June 2004, and that "systemic error" I'd railed against was duly introduced by the Basel Committee via the Basel II Accord – which introduced capital requirements for banks based on perceived risks, like those reflected in credit ratings, ignoring the fact, that these risks were already being cleared for by the markets.

Under Basel II, with its emphasis on risk-weighted capital requirements, the Basel Committee had unwittingly laid the foundations for the "perfect storm", which unleashed the North Atlantic financial crisis of 2007-08. Despite causing great damage to the global economy, central bankers and policy-makers have temporarily cushioned us from most of its costs by means of kicking the can down the road. Today, almost six years after the first rumblings of the financial crisis were heard, our friends in Switzerland seem as blinkered as ever in their inability to recognise their "mistake", never mind address it. Perhaps it is just too big for the regulatory establishment to acknowledge!

Mark Twain, wrote that: "A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain". And the weatherman could predict sunshine or rain, and he could be right or wrong. If rain was announced and it rained, no problem for the banker, as he had either never lent the umbrella or had already taken it back.

If rain was announced, but the sun shined, the banker may have lost some good tanning opportunities, but that's about all. If sunshine was announced, and the sun shined, there are of course no problems for the banker. But, if sunshine was announced, and it rained, then the bankers would be in serious trouble. And this could be why Mark Twain also said: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so".

But our global bank regulators, the Basel Committee, and its sister organisation, the Financial Stability Board, they too loved sunshine and hated rain. And they felt, perhaps to be on the safe side, that they should also layer on their own preferences and fears on top of those of the bankers themselves.

Hubris dosed wisdom

And so even though all major bank crises to date have resulted from excessive bank exposures to what was perceived as "absolutely safe", and never ever from excessive exposures to what was perceived as "risky", the regulators, in their much hubris-dosed wisdom, decided to safeguard our banking system, by requiring the banks to hold much more capital against those assets perceived as "risky" than against those assets perceived as "absolutely safe".

And this allowed the expected risk and cost of transaction adjusted margins of the banks, when lending to or investing in "safe-sunny" zones, to be leveraged immensely more than the same margins when operating in "risky-rainy" areas. And that of course translated directly into much higher expected risk-and-regulatory adjusted returns on bank equity when bathing in the sun, than when dancing in the rain.

Lower risks - higher returns

In other words, before the establishment of the present global regulatory environment, banks decided who to lend to, depending on who produced them the highest risk and cost adjusted margin, and of course, as long as that margin could be leveraged to exceed the bank's cost of capital. Those were the days when one unit of risk and cost adjusted margins paid to the bank, meant the same, no matter who paid it. But now, because of these capital requirements – more-risk more-capital, less-risk less-capital – banks have come to prefer giving a loan to a borrower who provides it with a lower expected risk and cost adjusted margin than what other borrowers offer, only because they are authorised by the regulators to leverage the first many times more than the latter.

In other words, banks have already adjusted for perceived risks in the "numerator" in the asset side of the balance sheet, by means of interest rates, the size of the exposure and other contractual terms. And so, when regulators forced banks to also adjust for perceived risks in the "denominator", in the liabilities and equity side of the balance sheet, with capital requirements based on this, they caused the whole risk-adjusting equation to enter a state of chaos.

Wheel of fortune

In other words, all roulette bets have exactly the same expected pay out. But some bets, such as those made on a number, usually take you out faster from the game than those made, for example, on colour. So what if the regulators decided that playing for a longer time was the equivalent of playing it safe, and that therefore the pay out of any bets on colour should be increased considerably? Forget about roulette as a viable betting game.

What about a handicap system that awards good golfers like you more strokes than bad golfers like me? Forget about golf as a viable competition game. First and foremost the consequence of what was much more mis-regulation than de-regulation; was

that it introduced a huge distortion which makes it impossible for banks to help the economy by assigning economic resources efficiently. The result is that now, more than the markets, the regulator´s hand guides the banks. In turn banks create excessive exposures to what is perceived as 'absolutely safe', whilst holding very little capital.

Mind-boggling leverage

From a regulatory point of view, this is as bad as it gets. I repeat, in banking, the really big bangs result from excessive exposures to what was ex-ante perceived as absolutely safe but that, ex-post, turned out to be very risky. And it will cause any perceived safe-haven to become, sooner or later, dangerously overpopulated, and therefore risky. Just reflect on the fact that Basel II allowed banks to lend to Greece, or to buy AAA-rated securities collateralised with mortgages to the subprime sector, holding only 1.6 per cent in capital. The implication of an authorised leverage of 62.5:1 is indeed mind-boggling.

Favouring the "infallible", those who are already favoured with lower risk premiums results de-facto in an odious discrimination against the "risky", i.e., those who are already discriminated with higher risk premiums. The "risky" will then have even less access to bank credit, or need to pay more in interest, so as to make up for that competitive regulatory disadvantage in order to deliver the same returns on bank equity as the "infallible".

Castrated lending

This increased regulatory aversion against perceived risks, figuratively castrates the banks, affecting most those agents who operate on the fringes of the real economy, those who usually most need access to bank credit, and those who usually find themselves among "The Risky", such as medium and small businesses and entrepreneurs. And that is a true disaster for a real economy which, needs "The Risky" risk-takers to help it move forward, as well as for all our young who anxiously wait for a new generation of jobs. We do not sing "God make us daring!" psalms in our churches for nothing.

And some minimalistic capital requirements also provided the banks with the most potent growth hormone, which helped many of them to grow into "too-big-to-fail" globally active financial institutions. Also, since banks are required to hold the least capital against debts of "infallible sovereigns", this translates into a subsidy of the interest rates they pay, which causes the proxies for the risk-free rate, such as U.S. Treasuries, to emit the wrong signals.

Not a laughing matter

Given ones levity thus far, the fact remains that this is no laughing matter - quite the reverse in fact. As such, regulators, elected policy-makers, senior civil servants, central bankers and international financial bodies need to take a deep collective breath in order to address what is to be done to combat this onerous piece of global regulatory oversight. If banks are given specially rewarded access to "absolutely safe" investments, are we the citizens, our pension funds, our widows and orphans, supposed to take care of the needs of funds of the "risky"?

Is it not the banks that are supposed to do this, leaving us others with the option to invest in what is safe? Of course, it can

only help to widen the gap between the haves, the past, the developed, the old, "The Infallible" and the have-nots, the future, the developing, the young, "The Risky".

A capital "Mistake"

Many argue that the problem originates with the credit rating agencies. Not so. The problem resides with regulators using credit ratings excessively. In January 2003, in a letter published by *Financial Times*, I wrote: "Everyone knows that, sooner or later, the ratings issued by the credit agencies are just a new breed of systemic errors, about to be propagated at modern speeds". With Basel II, the regulators bet our banking system on risk models and credit ratings being correct, while in fact their responsibility should be to prepare for when risk models and credit ratings are incorrect, something which will happen, sooner or later. For sure, these capital requirements for banks are not a minor mistake, but rather, a capital "Mistake." From a regulatory point of view, by just looking at the empirical evidence, one could even make a case for higher bank capital requirements for exposures perceived as "absolutely safe", over exposures perceived to be "risky".

Saving face

This is why someone very close to the regulators, on hearing my arguments, told me bluntly that the real problem was how to find a way for regulators to save face. But surely the need is not for regulators to save face, but rather to be held truly accountable, in order to make it less possible for global initiatives, like the Basel Accord, to develop anew with little scrutiny, and within what effectively amounts to small mutual admiration clubs. Something needs to be done, urgently. It is not the role of the Basel Committee to act as risk manager for the world, which now seems to be digging us even deeper into the hole. With Basel III, where capital requirements are still based on perceived risk, it wants to add liquidity requirements, which are also based largely on the same perceived risks. Let´s face it: Hollywood would never authorise a Basel III production using the same scriptwriters and directors responsible for a Basel II box office flop.

Single capital requirement

If a certified financial advisor was offering the same advice to a wealthy developed old retiree than to an undeveloped poor young professional, he would have his certification immediately revoked. And yet the Basel Committee does just that when expecting banks to act in the same way for both constituencies, and seemingly favouring more the "après moi le deluge" constituency. By means of a very careful transition we need, with a Basel IV, to move to one single capital requirement for any bank asset, around 8 to 12 per cent, depending on where the different economies might be in their economic cycle. And I mention this because I can think of few things that are as pro-cyclical as current capital requirements.

But if bank regulators cannot refrain from meddling, why then not base the capital requirements on job-creation-potential-ratings, or environmental-sustainability-ratings? At least then the banks would have a purpose. As present, the banks are only performing better for those who possess good credit ratings, "The Infallible", leaving all rest, "The Risky", out in the cold. •