April 16, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002, Basel, Switzerland

Re: *International framework for liquidity risk measurement, standards and monitoring* and *Strengthening the resilience of the banking sector*

Thank you for the opportunity to provide comments on the December 2009 consultative documents referenced above. I commend the Basel Committee on Banking Supervision for its consideration of these important matters. Attached are my specific comments. If you have any questions, please let me know.

With best regards,
Eleanor Bloxham
CEO, The Value Alliance and Corporate Governance Alliance
614-571-7020
ebloxham@thevaluealliance.com

Re: *International framework for liquidity risk measurement, standards and monitoring* and *Strengthening the resilience of the banking sector*

My comments are based on my experience in developing internal risk based capital models and my experience working with banks and boards of directors.

I believe that the issues the Basel Committee on Banking Supervision ("the Committee") is seeking to address are critical. My comments for the Committee at this time are high level and will focus on issues which I think the Committee must seek to address carefully as they set out new approaches.

1. **Role of the boards of directors**. In the areas covered by both documents, the Committee should outline the role of the board of directors of banks in ensuring effective oversight with respect to liquidity risk measurement and monitoring, the strength of capital adequacy, and the integrity of financial reporting. The Committee should do this not in vague terms but as specifically as possible to address the shortcomings of the crisis and what boards of directors should be reviewing on a regular basis going forward. For example, the Committee should address actions the boards should take to ensure they are not putting undue pressure on the management for short term profitability at the expense of liquidity and capital adequacy concerns. The guidance should include specific reviews boards should be making and recommendations on the timeliness of those reviews. Pillar 2 directions to supervisors should include regular reviews of the adequacy of board oversight and monitoring with respect to these critical areas.

2. **Transparency and disclosure**. Transparency and disclosure is paramount with respect to stability of economies, the banking system itself, as well as for customers and capital providers. Therefore, I am highly supportive of IV.4 in the *Liquidity Risk consultative document*.

3. **Reasons for the crisis and the need for new requirements.** I agree with the Committee's assessment that "excessive on and off balance sheet leverage" and "insufficient liquidity buffers" fueled the crisis. (*Strengthening the resilience* p. 1) I am therefore very supportive of the liquidity standards. I am very supportive of the proposals to enhance risk coverage, including capturing major on and off balance sheet risks, stressing inputs on counterparty risk, systemic risk from interconnectedness, etc. (*Strengthening the resilience* p. 5 - 6) and supportive of the disallowance of netting (*Strengthening the resilience* p. 61, par. 206). I also agree that "It is critical that banks' risk exposures are backed by a high quality capital base." (*Strengthening the resilience* p. 4) That said, I think the Committee needs to take a much more careful look at some of its thought processes on these topics and therefore also on its proposals.

a. **High quality capital**. While "it is critical that banks' risk exposures are backed by a high quality capital base" it is also critically important to understand what that entails. I completely understand what would drive one to want to tweak the definition of high quality capital base and carry forth with a tweaked measure. But I believe this is insufficient and based on a false premise that will only cause difficulties going forward: the presumption that common equity is a good measure of high quality capital.

Here's one example of why not. Under current fair value accounting standards, when the credit rating of a bank drops, its earnings and equity values rise. This increase in the value of common equity should not be used as a measure to confuse customers, regulators and capital providers into believing that the bank is now more safe than it was before the drop in its credit rating. This is just one example – one that is easy to explain.

Here's another reason. Forthcoming in the Journal of Economic Perspectives 2010*,* in *"Did Fair-Value Accounting Contribute to the Financial Crisis?"*, Christian Laux and Christian Leuz state: **"**We also find little support for claims that fair-value accounting leads to excessive write-downs of banks' assets. If anything, empirical evidence to date points in the opposite direction, that is, towards overvaluation of bank assets." If that is the case, again, accounting equity would seem to be a poor measure of high quality capital. In fact, using accounting equity as the measure of capital adequacy would tend to incent the overvaluation of bank assets, particularly in down cycles.

Although the Committee is recommending some regulatory adjustments to the equity numbers (*Strengthening the resilience* p. 13, par 62 item 1), its statements do not indicate a realization of the problems noted above. Based on the examples it would not be correct to say "It is this common equity base which best absorbs losses on a going concern basis." (*Strengthening the resilience* p. 13, par 62 item 1) The reason I believe for this incorrect statement comes from a desire to not re-think the major issues. But re-thinking is what is needed now.

Rather than getting muddled up in tweaking the existing structure, I believe it would be much more effective long term to set out a calculation that truly measures the level of high quality capital a bank must have to take it through a major business cycle, capital backed by unencumbered low volatility assets which are liquid and subject to few changes in valuation.

In sum, what the Committee should be attempting to address is the level of high quality capital available over the cycle and therefore it should come up with a measure of that that is separate from accounting numbers. Accounting numbers are handy but they are not sufficient. Particularly using fair value, they are point in time measures which do not provide a good measure (a) of the ability to handle obligations – or (b) of the bank's safety and soundness.

The Value Alliance. 6834 Willoughby Ct. Westerville, OH 43082 USA www.thevaluealliance.com
Eleanor Bloxham. 614-571-7020. ebloxham@thevaluealliance.com

b. **Safety and soundness – not accounting reality**. Along similar lines, I would encourage the Committee to think consistently about the economics and safety and soundness rather than the use of accounting. For example, I am highly supportive of the items outlined in the section on capital conservation because these address real issues with real benefits with respect to safety and soundness. (*Strengthening the resilience* p. 9, par 48 – 40) I think, however, that the thought processes around forward looking provisioning need to be re-thought. (*Strengthening the resilience* p. 8 - 9, par 35 – 37) Accounting provisions do not change economic reality or safety and soundness. They merely move dollars from one accounting bucket: equity to another: allowance for loan losses. In the sense of economic reality, safety or soundness, this accounting "maneuver" is not what matters. Further, I believe this concern about the level of provisions is driven, in part, by the lack of adequately defining what high quality capital means. If the measure of high quality capital were done irrespective of accounting, this attempt to change accounting behavior would not be necessary. See "a" above.

Another example of using accounting rather than safety and soundness as the guide can be found in *Strengthening the resilience* p. 61, par. 206: "securitisation exposures should follow the accounting measurement." I disagree. Accounting rules come and go. The potential economic exposure should be reflected, irrespective of the accounting.

c. **Risk capital calculations.** There are several issues which I think are worthy of note. One, related to the use of probability of default models for economic risk capital modeling, my book (*Economic Value Management*, Wiley Finance Series, 2002, John Wiley and Sons) presents evidence that the use of standard probability of default models in measuring economic risk capital systematically (and falsely) lower the estimation of risk capital deemed to be required. Given the impact of the financial crisis, this is something the Committee should understand and try to address in its thinking, as well as in the thinking of bank supervisors and bank risk modelers.

Second, in thinking about risk correlations, the Committee should also seek to address the correlations between different risk types including credit and operating risk. My book *Economic Value Management*, Wiley Finance Series, 2002, John Wiley and Sons also addresses this.

Finally, there are several references to expected losses in the consultative document. It is important to always keep in mind (as I also mention in my book, Economic Value Management) that the measure of expected to unexpected losses varies widely product to product and therefore little about total risk can be assumed by merely understanding even forward looking expected losses.

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