Why Banks Keep On Failing:

Money, Banking and the Basel II Accord

Michael Schemmann, Bang College of Business, KIMEP, Almaty
Email: michaels@kimep.kz

***Abstract**: Over the past two decades more than three thousand banks have failed, mostly in America and Japan. The five thousand banks operating worldwide today are going to be regulated under the most complex and costly but conceptually flawed regime ever devised: the so called Basel II Accord setting minimum capital requirements to absorb risk. Basel I of 1988 did not prevent the bank failures of the 1990s, and Basel II of 2004 did not prevent the liquidity crisis of 2007 because our century old accounting principles are out of date and touch. A new set of forward-looking super-imposed dynamic generally accepted accounting principles (SuperGAAP) could be the answer.*

Keywords: Basel II, Banks, failing

> *Words ought to be a little wild because they are the onslaught on the minds of the unthinking.*
> John Maynard Keynes

The oldest surviving deposit-taking institution in the world is an Italian bank founded in 1472 as a pawn agency at a time when gold and silver were the only currencies in circulation. The precious metals were either dug out of the ground or confiscated from ancient civilizations such as the Incas by Spanish conquistadors and their entourage of missionaries to replenish the coffers of the Spanish throne for war finance, leaving behind the promise of a new world order promoting brotherly love, compassion and peace.

All of the other banks have come and gone, and they were many, but five thousand have been recreated to run the globalized economies of the WTO, the World Trade Organization. Instead of discounting for gold and silver alone, they are allowed

- to make bookkeeping entries debiting their customers "loans receivable accounts while crediting "demand deposits" (creating so called "bank money") and, of course,
- to use cash printed on paper by the central banks of their various jurisdictions from dollars (German "taler") to pound sterling (denoting "silver"), francs, escudos, baht and tenge to name a few.

It is no wonder that such a privilege of creating something out of nothing must be licensed and regulated to protect the public interest and awe, and to keep the money scarce so as to uphold its value. Alchemists in medieval times tried to make gold and failed. Along came Luca Pacioli disclosing his system of double-entry bookkeeping that was eventually adopted by the goldsmith bankers of Lombard Street in the City of London, the merchant bankers Baring Brothers, and has remained the state of the art to this day.[1]

In classical economics, capital is one of three (or four, in some formulations) factors of production. The others are land, labor (in some versions) organization, entrepreneurship, or management. In finance and accounting, capital generally refers to financial wealth, especially that used to start or maintain a business.[2] Capitalist are hailing private capital and free enterprise to increase it, and the Socialists and Communists (the have-nots) are hailing to labour.

[1] Luca Pacioli. "*Summa de arithmetica, geometrica, proportioni et proportionalita*". Venice, 1494
[2] Wikipedia. "Capital (economics). http://en.wikipedia.org/wiki/Capital_(economics) visited 2nd December 2007

Bank regulators in the capitalist western world, needless to say, regulate financial institutions by linking the banking license to capital. Capital defined broad as shareholders' wealth or "equity” is the residual of assets of an entity in liquidation after the liabilities have been paid. How useful is the residual for an ongoing bank that is not in liquidation is the question.

The BIS

Everyone in Basel knows of the BIS, the Bank for International Settlements across from the *Schweizerische Bundesbahn’s* central train station, the SBB. When I was a young boy growing up in Basel, the BIS was housed in a gray old building behind iron gates, replaced in the sixties by an ultra-modern round high-tower with an impressive copper façade. The group of ten most powerful central banks of Europe and North America including Japan had all the money in the world to pay for it.

The BIS was founded in 1930 as the bank of the central banks in neutral Switzerland at a time when cross-border cooperation began to blossom as an answer to centuries of competitive warfare among nations. The initial idea behind the BIS was to ensure the reparation payments by Germany following the country's defeat in World War I, and to ″foster cooperation among central banks and other agencies in pursuit of monetary and financial stability.″ facilitate the settlement of adverse balances among nations resulting from trade and capital movements. The money center banks in New York, London and Frankfurt and the international financial markets they created proved efficient, so that the BIS fell into disuse, but it didn’t give up. Instead of banking, it began recruiting armies of statisticians monitoring the flow of international funds and the conditions in the various counties, and hired top economists from the member central banks to interpret the data and issue warnings.

The Basel Committee on Banking Supervision

The BIS’ finest hour came with the Herstatt Bank crisis of 1973 (a bank whose name now signifies transfer risk), and the massive bank failures during the Savings & Loan crisis in the United States of the 1980s when 3,000 banks failed and had to be resolved at a cost of $160 billion to the taxpayer, not to mention significant others in countries from the UK to Norway and Spain.[3] Following Herstatt, the governors of the central banks of the Group of Ten, who own the BIS, mandated an overhaul of banking regulations to be imposed on internationally active banks by creating a standing committee of its top bureaucrats and called it the Basel Committee on Banking Supervision with a permanent secretariat at the BIS. The BCSB didn’t waste time and started publishing an impressive list of conformist papers on the BIS’ website: www.bis.org.

In 1988, the BCBS issued the Basel I Accord on minimum regulatory capital requirements which were set at 8% of internationally active banks’ credit and market risk exposure. The Basel II Accord under the flamboyant title of “International Convergence of Capital Measurement and Capital Standards” was adopted by the Group of Ten in June 2004 with effective dates that have been postponed from time to time, the latest being January 1, 2008.

The BCBS holds seminars for banking supervisors to train them in the highly complicated mechanisms under Basel II. Private banks continue to dedicate resources to train their staff. The word is that training and final implementation of Basel II will cost banks worldwide the sum of $50

[3] Michael Schemmann. 2007. “MBA Handbook 2008.” *The Financial System and Bank Failures*. Nakon Ratchasima: ThaiSunset Publications, pp. 158-168

billion. The BIS has reclaimed its status of neglect by turning simplicity into complexity, so complex that it is not only feared but outright hated by international bankers it is intended to supervise.

Did the Basel I Accord Fail?

In a paper entitled "Bank Failures in Mature Economies", the BCBS seems to admit that illiquidity rather than capital inadequacy causes bank failures. For example, Continental Illinois (1984) had $2 billion net worth when the FDIC closed it down ("the pitfalls of illiquidity" - BCBS). During the UK small banks crisis (early 1990s), the affected banks' capital positions were intact.[4]

The Group de Contact (1999), cited in the BCBS' summary, concluded "that the vast majority of failed banks showed intact capital positions when problems emerged".

Basel I failed to prevent the banking crisis in Japan where 180 deposit-taking institutions were dissolved because of non-performing loans, inadequate market discipline and banks' capital positions mainly resulting from real property lending, the crises in Norway, Sweden and even Switzerland; nor did it prevent the spectacular failure of two hundred year-old Baring Bank of London in 1995. Baring was Her Majesty the Queen's private banker.[5]

Misconceptions

The misconception that bank capital is a protector of bank deposits stems from the misapplication of commercial and industrial accounting to banking. According to the BCBS paper, "Bank Failures in Mature Economies", bank capital is a buffer against bank failures.[6] The official text of Basel II even claims that available capital protects depositors.[7]

When a bank's capital is measured in terms of money that the bank itself created - or another bank for that matter - the measure in terms of such money may not be assessed independently and therefore becomes questionable. Moreover, banks are securities underwriters, at least in Europe, and by subscribing to each others' share capital, no liquidity is generated, no cash changes hands according to the motto: "You scratch my back, I'll scratch yours."

A bank's Achilles heel is its need to redeem customers' deposits either in cash – today impossible giving the small amount of cash in circulation as a percentage of total money supply (about 5%) – or by transfer to another bank.

Capital is on the wrong side of the balance sheet - liability side – and therefore not a liquid asset to pay out deposits or to accomplish their transfer, unless the depositors take the bank's stock or some other assets as payment in kind.

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[4] "Indeed the small UK banks that would subsequently fair were well capitalized in June 1991, as most had risk-weighted capital ratios well above the 8% Basel minimum." *Bank Failures in Mature Economies.* BCBS Publication No. 13, April 2004, p. 68

[5] The Duc de Richelieu in 1818 listed the six great powers of Europe: England, France, Prussia, Austria, Russia - and Baring Brothers. Barings had mediated the purchase of the Louisiana Territory by the United States from France in 1802 by discounting United States government bonds and paying the proceeds of $8,831,250 in cash to Napoleon. The bank established ties with King George V, beginning a close relationship with the British monarchy that would endure until Baring Bank's collapse in 1995.

[6] "Bank capital is meant to be a buffer during periods of economic instability and increasing capital levels or making capital more sensitive to the risks in banks should help stabilize the banking system, decreasing the incidence and cost of bank failures." BCBS Publication No. 13, p. 1, *supra.*

[7] "Further, as one of the principal objectives of supervision is the protection of depositors, it is essential to ensure that capital recognized in capital adequacy measures is readily available for those depositors. Accordingly, supervisors should test that individual banks are adequately capitalized on a stand-alone basis." BCBS. 2004. *International Convergence of Capital Measurement and Capital Standards* (commonly referred to as the "Basel II Accord"), p. 7

As demonstrated above, banks can, or even typically, fail although their capital positions are intact. This fact alone proves the misconceptions and failures of Basel I and II in a nutshell, and the current credit or better, the world-wide banking liquidity crisis of 2007, is the best example.

The financial markets' liquidity crisis is caused by investors' refusal to rollover their short-term investments in commercial paper, including those of special purpose vehicles (or "structured investment securities" – SIVs) created by banks to generate commission income without having to finance the investments direct which would reduce their capital adequacy.

As the present liquidity crisis continues, banks are forced to take the SIVs securities onto their own balance sheets.[8] In that sense, Basel II may succeed indirectly as a deterrent by punishing the banks' risky business practices of the past, but does not directly protect current depositors' liquidity needs.

In fact, Basel II does not regulate liquidity requirements directly, but assesses a charge against regulatory capital for banks that provide liquidity facilities.[9] A working group for liquidity management was only established in 2006.[10]

Accounting Reform

A prominent member of high finance who as chairman of the Federal Reserve in the early 1980s shocked two digit inflation out of the U.S. economic system, Paul A. Volcker, told the European Commission, that "the United States has long hailed its own accounting standards, U.S. GAAP, as the model for the rest of the world to follow... but obviously what may be relatively best is not good enough."

> "Everything is on the table – the structure of the auditing profession, the accounting standards, our enforcement mechanisms, and even the style which accounting standards are set out – whether the emphasis is on matters of principle or detail. The silver lining in the Enron crisis in the U.S. is that we have an opportunity for real reform."[11]

The resulting Sarbanes-Oxley Act, creating a Public Company Accounting Oversight Board (PCAOB), has turned accounting into a dream profession and a nightmare for small and medium-

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[8] "HSBC plans to wind down two bank-sponsored funds known as structured investment vehicles, or SIVs, and take $45 billion in mortgage-backed securities and other assets owned by the funds onto its balance sheet. The bank which has $2.15 trillion in assets and has suffered significant losses on subprime-mortgage investments in the U.S., said the move would have little impact on its capital adequacy or ability to lend. HSBC's decision illustrates the challenges facing SIVs, which hold about $300 billion in securities, as a group of the world's largest banks puts together a plan to bail them out." (*The Wall Street Journal - Europe*, November 27, 2007)

[9] The Basel II framework requires banks that provide liquidity facilities and/or credit enhancement in the form of program wide credit enhancement (PWCE) to ABCP conduits to hold regulatory capital against these exposures. The regulatory capital charge is calculated as follows: Regulatory Capital = CCF x RW x 8% x bank's exposure. Where: CCF is the Credit Conversion Factor for off-balance-sheet exposures; and RW is the Risk Weight based on the rating of the exposure." Securitization.net. "What Effects Will Basel II Have on the Global ABCP Market?" Reprinted from RatingsDirect. 11 October 2004. Viewed at http://www.securitization.net/pdf/sp/Basel_Global_11Oct04.pdf 2nd December 2007.

[10] Question: "Is it possible to have uniform standards for liquidity like there are uniform standards for capital? Reply by Nout Wellink, Chairman of the BCBS: "My ultimate goal is not by definition to harmonize everything in the world. But the crucial [standards] for liquidity management, especially for cross-border banks, should be harmonized. [But] it's a long way, I'm afraid. We created [a working group last year], and they will report on their activities to us in December [2007], and then we will have a discussion. One should [also] realize that up till now we could cope, more or less, with the present situation. Banks had to absorb very substantial amounts of taking back onto their balance sheet. It's not ideal … but having said that, they could cope with it till now." *The Wall Street Journal online,* October 23, 2007 http://blogs.wsj.com/economics/2007/10/23/632/

[11] Volcker. P. A. 2002. Chairman of the Trustees, International Accounting Standards Committee Foundation. "Accounting in Crisis." Address to the European Commission.

sized enterprises. Sarbanes-Oxley is certainly a factor in creating the present shortage of qualified accountants.

What may be needed now is a type of *Sarbanes-Oxley Act* ("SOX") for banks, the law passed by the U.S. Congress in 2002 in response to the $80 billion Enron and similar debacles. SOX took the power of promulgating Generally Accepted Auditing Standards (GAAS) away from the public sector and conferred it upon the PCAOB under the Securities & Exchange Commission, the "SEC". After an initial outcry and protest by the affected listed public companies over the cost and the complications caused mainly by Rule 404's internal control requirements, the industry and investing public are beginning to accept SOX as an effective safeguard against greedy financial engineers who are "cooking the books".

SOX is accounting-driven, resulting in a fee- revenue bonanza for the accounting profession that created the crisis in the first place.[12] Auditing fees doubled and tripled, and accounting professionals are in short supply.

What shall be the techniques, the standards, applied to measure and control unbridled credit creation by banks in order to protect depositors? The remedies may include:

- To separate the deposit function from the lending function as advocated by Irving Fisher (1935) in his book "100% Money", whose name, unwittingly, the BCBS has given to one of its institutes.[13]
- To develop Superimposed Dynamic Forward Looking Dynamic Generally Accepted Accounting Principles (SuperGAAP) promoted by the *International* Institute of CPAs (www.iicpa.com), authorizing and mandating the publication of forward-looking dynamic (as opposed to historical and static) financial statements, that fully reflect the past, but more importantly, report management's reasonable expectations for the entity's prospective (1) financial position, (2) results of operations, and (3) cash flow; audited as to the past and reviewed for reasonableness as to the future, not only by accountants but an interdisciplinary panel comprised of accountants, financial analysts, economists, lawyers and other experts as needed.

SuperGAAP would increase audit fees but fully replace the ineffective regulatory nightmare of Basel II, if only the accounting profession will abandon its infatuation with past events and begin to embrace the future.

[12] The accounting firm Arthur Andersen went out of business following Enron's and other clients' insolvencies.
[13] "If bankers wish to retain the strictly banking function - loaning - which they can perform better than Government, they should be ready to give back the strictly monetary function which they cannot perform as well as Government." Irving Fisher (1935), *100% Money.*

Thomas Jefferson (1813) lamented a century earlier: "Bank paper must be suppressed, and the circulating medium must be restored to the nation to which it belongs. It is the only fund on which they can rely for loans; it is the only resource which can never fail them and it is an abundant one for every necessary purpose. *Jefferson Cyclopedia. A Comprehensive Collection of the Views of Thomas Jefferson*. John P. Foley, Editor. New York: Funk & Wagnalls, 1900, p. 5619