Risk-Based Bank Capital Requirements
and their role in our downfall

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Not normal: UK base rate @ 0.5% is currently at one quarter of the previous 315-year low of 2%, or 5σ below log normal

Source: Bank of England
UK GDP is already 15% below pre-crisis trend after the first 4 years.

Bank loan contraction forces the savings rate up, not down keeping consumption growth in the doldrums.

QED: fiscal austerity = slower growth

Source: Bank of England
The first £200bn of UK QE was required just to negate the shrinkage of bank lending up to the end of 2011

“We aim to buy mainly from non-bank private financial institutions, not from banks, as is sometimes erroneously claimed.”

Charlie Bean, 21st Feb 2012
After more than 3 years and $6trn of deficit and QE stimulus (≈ 40% of GDP) US nominal personal disposable income is already approx. $2trn or 15% below trend.
Bank lending *only* contracts after a financial crisis requiring bank B/S repair; in which cases it *always* does.

During the recession — from December 2007 to June 2009 — household income fell 3.2 percent.

Between June 2009, when the recession officially ended, and June 2011, inflation-adjusted median household income fell another 6.7 percent, to $49,909.

Source: Census Bureau data
Saving = converse of borrowing. If bank lending contracts, the savings rate must rise; so GDP depends on govt. deficit spending.

Caveat:
Public and private sectors can’t both run a surplus.
As long as the banks are contracting private sector lending, the private sector will be running a surplus.
The external sector apart, if the public sector doesn’t run a deficit, nominal incomes must therefore deflate.
From June 2004, Basel II allowed banks to risk-weight their own assets. RWA dropped from 53% of total assets to 33% in 4 years.

“If you only look at the riskiness of the assets, you are ignoring the fact that you can be wrong about the riskiness of the assets.”

Lloyd Blankfein, Chairman & CEO, Goldman Sachs

Source: Independent Commission on Banking
Basel II propelled Eurosystem bank assets (incl. derivatives) to 3X total US commercial bank assets (figs. in US$trn)

“$379bn in CDS represents derivatives written for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation.”

AIG 2007 Annual Report
Basel’s distorted incentives: US banks’ RWA/total assets = 53% (like UK banks pre June 2004) whilst many European banks’ RWA/TA ratios are still < 30%

The math: if European banks can’t raise €114.5bn of capital, a 9% K/A ratio requires shedding €1.27trn of RWA, which = €3.8trn of actual assets

Source: Bank of England
RWA-based capital requirements led to regulatory arbitrage, extreme leverage and dangerously thin capital buffers

Liquidity risk can never be completely distinguished from solvency risk at a point of stress.”

Paul Fisher, BoE Executive Director, Markets, Sept 2010

Source: Companies’ regulatory filings, Westhouse Securities
Contagion: non-core (foreign) assets are less profitable with higher variance, and so get shed faster; 3X faster in the case of UK banks to date

Source: Bank of England
US cumulative bank losses now = $833bn vs. starting capital of $560bn. But remaining est. losses of ≈ $500bn are now approx. half current capital

<table>
<thead>
<tr>
<th>Securities</th>
<th>$bn</th>
<th>Assets Sept-08</th>
<th>Assets Sep-11</th>
<th>% Change</th>
<th>Stress test loss rate (%)</th>
<th>Stress test est. loss</th>
<th>IMF (e) loss rate (Q410)</th>
<th>IMF loss forecast</th>
<th>FDIC charge-off rate to Q3</th>
<th>Gross bank losses to Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-4 family residential</td>
<td>2,095.0</td>
<td>2,058.1</td>
<td>(1.8)</td>
<td></td>
<td>10.7</td>
<td>224.1</td>
<td>6.8</td>
<td>142.5</td>
<td>6.9</td>
<td>144.7</td>
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<td>Secured by first liens</td>
<td>1,325.5</td>
<td>1,391.2</td>
<td>5.0</td>
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<td>8.5</td>
<td>112.7</td>
<td>4.7</td>
<td>62.6</td>
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<tr>
<td>Secured by junior liens</td>
<td>193.2</td>
<td>112.0</td>
<td>(42.0)</td>
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<td>25</td>
<td>48.0</td>
<td>14.7</td>
<td>28.4</td>
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<td>Home equity loans</td>
<td>576.3</td>
<td>555.0</td>
<td>(3.7)</td>
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<td>11.0</td>
<td>63.4</td>
<td>9.3</td>
<td>53.8</td>
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<tr>
<td>Consumer Credit</td>
<td>1,345.9</td>
<td>1,192.3</td>
<td>(11.4)</td>
<td></td>
<td>16</td>
<td>215.1</td>
<td>16.2</td>
<td>218.0</td>
<td>15.3</td>
<td>208.5</td>
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<td>Credit cards</td>
<td>695.8</td>
<td>814.3</td>
<td>(8.2)</td>
<td></td>
<td>20.0</td>
<td>134.0</td>
<td>23.6</td>
<td>158.2</td>
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<tr>
<td>Other loans to individuals</td>
<td>676.6</td>
<td>578.0</td>
<td>(14.5)</td>
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<td>12.0</td>
<td>81.1</td>
<td>8.7</td>
<td>58.8</td>
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<td>Commercial Real Estate</td>
<td>1,846.3</td>
<td>1,570.8</td>
<td>(14.9)</td>
<td></td>
<td>12.0</td>
<td>221.6</td>
<td>7.8</td>
<td>144.0</td>
<td>5.7</td>
<td>105.9</td>
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<td>847.7</td>
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<td>9</td>
<td>84</td>
<td>3.1</td>
<td>29.0</td>
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<td>Construction and loan development</td>
<td>552.1</td>
<td>234.9</td>
<td>(57.5)</td>
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<td>18</td>
<td>100</td>
<td>12.4</td>
<td>68.5</td>
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<tr>
<td>Multifamily residential real estate</td>
<td>149.9</td>
<td>157.7</td>
<td>5.0</td>
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<td>11</td>
<td>16</td>
<td>4.1</td>
<td>8.1</td>
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<td>Foreign, Farm &amp; Farm land</td>
<td>190.2</td>
<td>135.4</td>
<td>-7.0</td>
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<td>30.0</td>
<td>19.0</td>
<td>3.8</td>
<td>2.3</td>
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<td>Other real estate owned</td>
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<td>45.1</td>
<td>141.2</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Corporate (C&amp;I) and SME’s</td>
<td>1,707.5</td>
<td>1,501.0</td>
<td>(12.1)</td>
<td></td>
<td>8.0</td>
<td>136.6</td>
<td>5.5</td>
<td>94.1</td>
<td>4.9</td>
<td>84.1</td>
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<tr>
<td>Commercial and industrial loans</td>
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<td>1,216.2</td>
<td>(15.0)</td>
<td></td>
<td>18</td>
<td>100</td>
<td>5.1</td>
<td>73.3</td>
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<tr>
<td>Other loans</td>
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<td>284.8</td>
<td>2.9</td>
<td></td>
<td></td>
<td></td>
<td>3.9</td>
<td>10.8</td>
<td></td>
<td></td>
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<tr>
<td>Others</td>
<td>316.5</td>
<td>318.0</td>
<td>0.5</td>
<td></td>
<td>7.0</td>
<td>17.0</td>
<td>1.5</td>
<td>4.6</td>
<td></td>
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<tr>
<td>Bank loans and acceptances</td>
<td>135.6</td>
<td>146.8</td>
<td>8.1</td>
<td></td>
<td></td>
<td></td>
<td>0.0</td>
<td>0.5</td>
<td></td>
<td></td>
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<tr>
<td>Lease financing receivables</td>
<td>124.9</td>
<td>97.1</td>
<td>(22.2)</td>
<td></td>
<td></td>
<td></td>
<td>3.3</td>
<td>4.1</td>
<td></td>
<td></td>
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<tr>
<td>Loans to municipalities</td>
<td>54.1</td>
<td>75.9</td>
<td>40.3</td>
<td></td>
<td></td>
<td></td>
<td>0.0</td>
<td>0.0</td>
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</tbody>
</table>

| Loan Loss Provisions       | (139.8)| (185.0)        | 32.3          |          |                           |                       |                          |                      |                         |                        |
| Total loan assets          | 7,098.6 | 6,397.0         | (9.9)         |          | 11.4                      | 814.3                 | 8.3                      | 598.6                | 7.8                      | 558.8                  |
| Trading Acc. & private securities | 1,390.8 | 1,206.1         | (13.4)        |          | 20.2                      | 328.45                | 18.2                     | 298.0                | 16.9                     | 274.2                  |
| Govt. securities/risk-free assets | 3,854.3 | 4,600.8         | 16.8          |          | 0.9                       | 31.2                  | 0.0                      | 0.0                  | 0.0                      | 0.0                    |
| Total assets               | 12,343.7 | 12,102.9        | (2.4)         |          | 9.5                       | 1,174.0               | 7.2                      | 894.6                | 6.7                      | 833.0                  |

* Addition of $204bn per FAS 1567 Adjustment Q1 2010

Source: FDIC, Arbulu
US banks are more than 3X further advanced on loan loss realisation than continental European banks, which are paralysed by a shortage of capital.

Cumulative loan loss provisions as a % of peak loan assets

- Big 14: Cont EU banks (to date) - 3.7%
- UK big 4: current crisis (to date) - 5.7%
- US FDIC all commercial banks (to date) - 7.8%
- UK 1989-1993 (non-crisis recession) - 8.5%
- 10% "typical" single country crisis - 10.0%
- US LATAM debt crisis (inc. Brady Plan) - 10.5%
- Big 4 US Banks (to date) - 11.7%
- Nordic (synchronous) crisis - 15.0%
- Japan - 20.2%

Source: Companies data, Arbuthnot
5 more years: Euro Area bank balance sheet repair has only now just begun – with negative implications for lending, money supply and GDP
4-Speed Europe: an un-restructured periphery, repaying debt under punitive rates, is condemned to extended depression – and QE will only make things worse
Endgame

“After a bad opening, there is hope for the middle game. After a bad middle game, there is hope for the endgame. But once you are in the endgame, the moment of truth has arrived.”

- Edmar J. Mednis (Chess Grandmaster)
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