

The Law of Opposites

Illusory profits in the financial sector

Gordon Kerr

The Cobden Centre
For honest money and social progress



The Law of Opposites

Illusory profits in the financial sector

Gordon Kerr



© Adam Smith Research Trust 2011

Published in the UK by ASI (Research) Limited

Some rights reserved. Copyright remains with the copyright holder, but users may download, save and distribute this work in any format provided that: (1) the Adam Smith Institute is cited; (2) the URLs www.adamsmith.org and <http://cobdenpartners.co.uk/> are published together with a prominent copy of this notice; (3) the text is used in full without amendments (extracts may be used for criticism or review); (4) the work is not resold; and (5) a link to any online use is sent to info@adamsmith.org.

The views expressed in this publication are those of the author and do not necessarily reflect those of the publisher. They have been selected for their independence and intellectual vigour, and are presented as a contribution to public debate.

ISBN 1 902737 83 0

Printed in England by Grosvenor Group (Print Services) Limited, London

Contents

Introduction	5
1 Turning uncertain future cashflows into profits via credit default swaps	8
2 Profit recognition of uncertain future cashflows by marking-to-market	17
3 Profit recognition via mark-to-model, and optimistic modelling	20
4 Perverse rule changes post crisis – failed sale	32
5 Overview of bank regulation – Basel	35
6 Overview of IFRS accounting and under provisioning for losses	44
7 Solution: The Baker bill in context	52
8 Conclusion	59
Appendix 1 Ruritania Technical Note	66
Appendix 2 Baker Bill	74
Appendix 3 RBS	78
References	81

Dedication and thanks

My thanks are due to friends and colleagues who have encouraged me to prepare a document of this nature. Steve Baker MP has been a substantial motivator and I thank him for highlighting these concerns by presenting the Ruritania example to Parliament in March 2011. Tim Bush has patiently filled substantial gaps in my understanding of UK and international accounting rules and helped in particular with Section 6. Kevin Dowd has been of great help as has Alan Rose, a former colleague who was a head derivatives trader at a major bank.

Jamie Whyte's review of earlier drafts has helped, I hope, to keep some of you awake until the end, and I thank him for his edits.

My dear friend Ernest Stone has had no input whatsoever, but has kept me sane by listening to my frustration at my inability to do anything about the matters set out herein over a pint or two most weekends for 25 years.

Finally, I would like to thank my Jurisprudence teacher in my undergraduate law course at Warwick in the late 1970s. William Twining (of the famous tea family) introduced me to the concept of rule gaming with the following limerick:¹

There was a young man from Darjeeling
Who got on a bus marked "To Ealing"
The sign on the door
Said "Don't spit on the Floor"
So he lay back and spat on the ceiling

¹ See Twining.

Introduction

Investors depend on the accuracy of company accounts. If profits are overstated, people will buy a company's stocks and bonds when they would not if they knew the truth – or, at least, they will buy them at higher prices than they otherwise would. By causing such misallocations of capital, inaccurate accounts harm not only investors but society more generally.

The proper functioning of accounting rules is therefore necessary to protect the investment community – and taxpayers, in the case of businesses that may attract state bailouts.

Not everyone, however, benefits from accurate accounts. Those who already own a company's securities and plan soon to sell them benefit from an exaggeration of the company's profits and hence of the value of its securities. And, more importantly, a company's executives, whose performance is typically measured and rewarded on the basis of profits, also benefit from their being overstated. This creates a material threat to the accuracy of company accounts, because executives are directly involved in their preparation. Executives have both the motive and the means to overstate profits.

Banking is an unusually complex and interconnected business, presently operating in a challenging environment. Any failures in the functioning of accounting are especially problematic for banks. Moreover such failures are magnified in banking, since banks take exposure to each other.

Accounting law and the practices of the accounting profession are designed, in large part, to mitigate this risk – the most obvious discipline being the legal obligation for a public company to have its accounts certified by independent auditors. And usually, they are successful; company accounts give investors an adequately accurate picture of what they are buying into.

However, this paper argues that banking has become an exception to this general rule. Recent developments in the accounting rules applied to banks, and in the broader regulatory framework for banks, have allowed bank executives to overstate their profits, feeding through into multi-million pound bonuses for themselves and short-term gains for their shareholders. When it comes to banks, accounting rules fail to perform their role of avoiding deception and consequent misallocations of capital. Given banks' financial inter-dependence, the scale of their assets and their central role in allocating capital across the economy, this failure is of much greater significance than it would be in other industries.

This paper does not lament the forgone age of bank deregulation that allegedly caused the crisis. Its complaints apply to the system of bank regulation and accounting that are in force today and are planned for the future. The rules introduced in reaction to the crisis – rules aimed at making the banking system more transparent and its capital more secure – have retained the International Financial Reporting Standards accounting rules that encourage profit exaggeration. And the updated international rules specifying banks' capital and liquidity minima will only exacerbate the incentives for bankers to engage in business aimed at nothing more than “gaming the system”. As so often, these new policies have the opposite of their intended effect.

There are a number of problems with these accounting standards, not least is their conflict with UK law. Of great concern is that IFRS allows the ‘recognition’ of years of hoped for future income as current profit today. This paper is structured around six important shortcomings in the rules governing bank profit and capital reporting:

- Uncertain future cashflows can be recognised as certain by purchasing a credit default swap (CDS) or similar “protection”, even though the supplier of the protection is likely to default if the insured event occurs;
- Profits can be recognised from the increased value of assets, or decreased value of liabilities, on the basis of a market price, even though the totality of revalued assets or liabilities could not be sold at that price;
- Profits can be recognised from the increased value of assets, or decreased value of liabilities, even when the revaluation of assets is estimated, not by market prices, but by a model built by bank employees. This is the so-called mark-to-model approach to valuation;
- The net present value of uncertain future cashflows can be recognised as profits even when they are estimated using implausibly optimistic forecasts. (This is a variation of the mark-to-model problem listed above);
- The EU’s IFRS accounting system, voluntarily adopted by UK and Irish banks at the banking company level, is inconsistent with UK law
- Banks need not make provision for expected losses when calculating their profit.

Much of the activity in the banking sector is aimed at nothing more than exploiting these accounting rules to register inflated fake profits and hence convert shareholders’ equity and, in extremis, debt-holders’ and taxpayers’ funds into executive bonuses.

In the rest of this paper, I explain the kinds of transactions bankers use to achieve this outcome with these rules. No familiarity with modern finance is assumed. These transactions are explained with a minimum of jargon, sometimes using simplified, imaginary examples to make their basic dynamics clear.

I hope that policy-makers and financial regulators will be among this paper’s readers. For it seems unlikely that they now understand the way bankers game the system to overstate banking profits. If they did, they would not persist with the agenda they have been pursuing at least since 1988 when the first Basel Accord was introduced.

1 Turning uncertain future cashflows into profits via credit default swaps

In order to explain the basic impact of credit default swaps and marking-to-market on falsifying bank profits and capital, let me present an example that illustrates how the entire cash funds in a banking system can be reclassified as bank profit using these rules.

The example now set out, used by Steve Baker MP in a Ten Minute Rule Bill speech in March 2011, shows that if synthetic structuring and mark-to-market rule exploitation was the only activity in a new banking system, the bank would immediately collapse and the depositors lose everything.

For purposes of Mr Baker's short speech it was necessary to gloss over certain structural details. These are explained below and in a Technical Note that appears as Appendix 1.²

Imagine, for the sake of argument, that we discover a little known, unpopulated territory within the EU, on which to establish a colony. Let's call it Ruritania and allow it to use sterling.

² In constructing "Ruritania", great assistance was provided by Professors Kevin Dowd and Margaret Woods.

We establish our fledgling colony on Ruritania with four people:

- A.** A Depositor, Alice, who arrives with £103
- B.** A Builder called Bob
- C.** An Entrepreneur, Matilda
- D.** A Banker (Mallory) with a colourful recent past in Iceland and Ireland.

Interest rates are 0.4% per annum (pa).

Mallory establishes a bank. He persuades the other three inhabitants of the importance of a healthy banking system, so Ruritania's constitution contains a limited guarantee from future taxpayers of £10 in favour of the bank. Under European Banking Authority devolved powers, Ruritania classifies this guarantee as core bank capital.

Bank capital is broadly divided into Tier 1 and Tier 2. Tier 1 is the most solid permanent capital, such as equity. The £10 guarantee is classified as Tier 1.

Alice, seeking to keep her money safe, deposits it in a demand account at the bank. Mallory agrees to pay her a deposit interest rate of 1% pa.

Matilda, the entrepreneur, wants to start a business. She approaches Mallory for a loan. He retains a reserve of £3 from Alice's deposit and lends the entrepreneur, at interest, the remaining £100 of cash deposited by Alice. The loan is agreed on an interest only basis at a rate of 7% pa for 25 years.

The entrepreneur then employs Bob, who wants his year's wages up front. So the entrepreneur hands over the £100 to Bob, which Bob deposits in the Bank on the same terms, 1% pa., as Alice.

At this point you will note that the bank has just doubled the money supply of Ruritania.

The banker now has two liabilities: a deposit of £103 from Alice and a deposit of £100 from Bob. Matching these in his books, he has two assets: a 25-year loan of £100 paying 7% pa (that means a total loan cashflow of £275 over 25 years), plus cash of £103.

Mallory wants a Ferrari, today, which he can buy for £20 (this is not today's Sterling, obviously!). His compensation contract is for 20% of bank profits. He needs to record an instant £100 in profit for his bank, and he knows how to optimise his profits under EU bank accounting rules.

The bank quickly establishes an off balance sheet company, a special purpose vehicle (SPV), which buys the future £275 cashflows of the £100 loan paying 7% interest. The SPV is obliged to pay £100, the market price of the loan on the day of its origination.

Mallory phones GIA, an insurer active in the credit derivatives market, who agree to write a credit default swap (SPV) for a fee of 1% per annum on the 'senior note' which the SPV will issue. This means that, after a first loss buffer of 5%, the risks of the loan are transferred across to GIA for that fixed fee of 1%.

The GIA trade is executed directly with the SPV. The SPV finances its purchase of the loan from the bank by issuing two notes:

- A.** a 95% senior note rated AAA by two US rating agencies because GIA is so rated, and
- B.** a 5% junior or "equity" note.

The bank buys the two notes for £100 in cash. These funds then flow back from the SPV to the bank to settle the purchase contract.

The equity note is a £5 deduction from the bank's £10 Tier 1 capital. This capital is, you will recall, a future taxpayers' pledge rather than hard cash.

Under marking-to-market rules, by holding the senior note on its trading book the bank records an instant but unrealised profit of £105. This figure represents the difference between the present value of the senior note after fees (£205) when discounted at the market rate for long term AAA assets (0.8%) and Mallory's sale price of the loan (£100). After replenishing Tier 1 equity with £5 the bank shows a £100 clear profit. (These calculations are set out in Appendix 1.)

The profit of £100 has been recorded even though the bank has not received any income from the loan. But the banker is not too concerned about that; he has his Ferrari.

The banker and his shareholders have taken £100 of the £103 total money supply of Ruritania, declared it as profit and spent it abroad.

Mallory seeks to grow his bank and obtains liquid funds by pledging the Note at its market value of £205 with his central bank under its “repurchase” arrangements. He receives £205, and uses the fresh liquidity as collateral for further bets, derivatives with other banks and low priced Eurozone sovereign bonds in the hope of more fast profits.

Unfortunately the bank becomes insolvent when Matilda misses a loan payment. The central bank takes ownership of the pledged note. Depositors ask for their funds but the bank cannot pay.

Liquidation position:

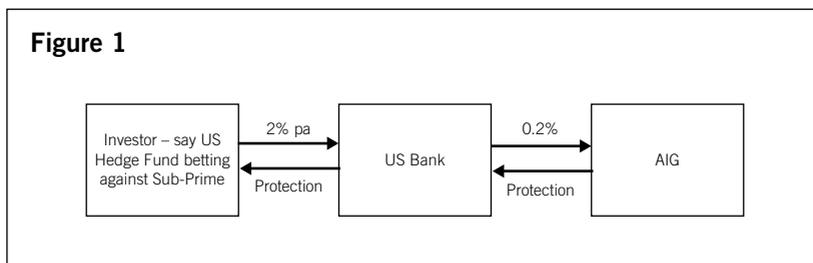
1. Two depositors have claims for £203.
2. There is only £6 in cash – all other cash has been pledged as collateral.
3. Nobody was aware that the senior note had been pledged for funding with the ECB. Under accounting rules amended in 2010 it remained on the balance sheet of the bank.
4. Mallory the banker is either bailed out or laid off, but enjoys his Ferrari.

To explain how the Ruritania example can be compared with the US Sub-prime mortgage debacle we must introduce one other technical term – Collateralised Debt Obligations, or CDOs. The Ruritania example could be classified as a single asset CDO.

The term CDO merely describes the bundling of loans into a securitisation vehicle which then issues debt to fund the asset purchase. The debt is split into different tranches, the tranches being a first claim on the cashflows, then a second, third and so on. When both the sale to the vehicle and the investment are effected via credit default swaps, rather than cash purchase, the structure is termed a synthetic CDO. The US Sub Prime example below shows the dangers of this development.

The Basics of Credit Default Swaps (CDS)

Figure 1 below is an example of a typical CDS arrangement entered into by a US investor seeking to profit from his view that certain portfolios of loans to low-income or even income self-certifying American homebuyers will experience high levels of losses. Such borrowers are termed “sub-prime”.



The middleman in the transaction is a US bank. This bank has persuaded a large American insurance company, AIG, to insure, or in CDS parlance, ‘write protection on’ certain portfolios of sub-prime loans which the investor believes will fall in value. Another expression for the investor’s position is ‘selling short’ the portfolio of loans.

The CDS writing bank buys a risk by promising a future conditional payment. It receives a premium every quarter for, say, ten years. In the event of default by the 'reference borrower' (an entity with which often neither party to the CDS has any connection or financial relationship), the CDS writer promises to pay the buyer a sum calculated as par (or 100% of the loan portfolio's original size) minus the value of the portfolio at the point in time when a default occurs. This would happen if and when portfolio defaults exceed the level specified as the CDS default trigger.

The US bank engages in as many of these trades as it can because the immediate profit it enjoys is the difference between the premium it charges (2% per annum) and that which it pays to lay off its risk with AIG (0.2% per annum).

The mark-to-market rules enable the US Bank, subject to certain provisions, to recognise multiple years of this differential as profit as soon as the AIG trade is executed.

Key to profit recognition is that, under the present rules, the US bank that writes such a CDS can delete this exposure from its books when it buys the matching protection from AIG – an "equal and opposite" CDS contract.

This rule is fundamentally wrong. It is a mistake to record the risk as sold and profit as banked, as if an ordinary 'real economy' asset had been sold at a higher price than that paid, because the risk has not in fact left the first bank. The risk has not been dealt with by cash payments up front, but by promises that may or may not be honoured when the time comes. The counter to this is that the sale treatment only applies if the second bank has entered into a 'standard' collateralisation agreement, but these agreements seem to fail at the point when most needed – that is – at the point of systemic failure.

The rules assume that the default risk of the CDS subject matter (the reference borrowers) and the default of the counterparty with whom our first bank laid off its risk are uncorrelated. But as AIG and the sub-prime debacle showed,

far from being uncorrelated, the risks were perfectly correlated (a correlation value of 1). As soon as a sizeable chunk of sub-prime borrowers defaulted, AIG was insolvent because it had written protection on so much of this risk.

When banks make loans, rather than write CDS protection, they usually only recognise profit as and when debt service payments are received from the borrower. Further, bank balance sheets are reduced in size by transactions such as the CDS 'hedge' with AIG which was treated as disposing of the risk assumed under the CDS with the investor.

This accounting rule incentivised the banking industry from the late 1990s to convert as much of their loan portfolios as possible into derivative structures in order to enjoy the boost to profits offered by derivative accounting treatment.

Regulators, banks, taxpayers and other stakeholders had no means of discovering that AIG's solvency was perfectly correlated with the CDS default risk it had written. Only employees of AIG and certain external auditors and other professional advisers had access to the relevant information.

It is therefore impossible to regulate banks if CDS continue to be accounted for as derivatives, rather than as loan portfolios.

Now consider Figures 2 and 3.

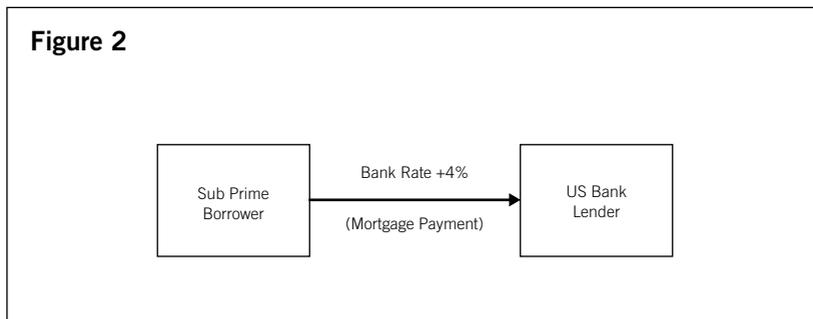


Figure 3

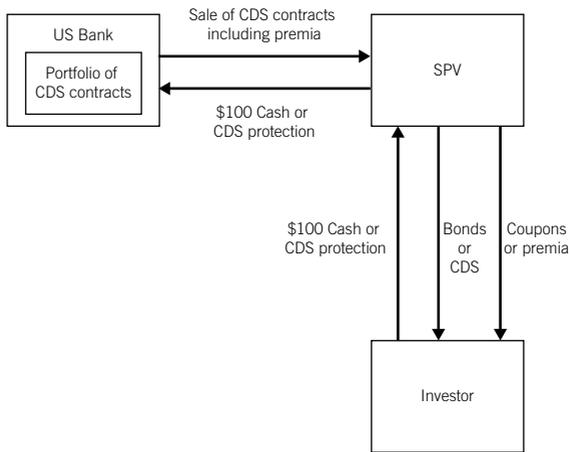


Figure 2 is a very simple representation of any mortgage loan. Note the high coupon on the loan, 4% above the bank rate. This is because the loan is to a high risk borrower.

Figure 3 illustrates how CDOs were structured based purely on CDS contracts. The effect of this was to create a belief in the market that new sub-prime loans were being generated when the origination machine had in fact dried up.

The CDO is based on the cashflows (premium income) from a portfolio of CDS trades purchased by a new single purpose financing vehicle (SPV), which issues the CDO to fund its purchase.

The SPV financed its purchase either by selling cash CDO bonds to investors, or by persuading investors to write CDS protection to the SPV (arrangements of this kind were termed “synthetic” CDOs). The purpose and market effect of this was to create a clone or facsimile of an underlying portfolio of sub-prime loans in order to drive the continued growth of the CDS and CDO related businesses.

The way to understand this is to look at the cashflows in Figure 1. The investor buys protection from the US bank. It pays regular premium in return for a promise of a payment of principal, should the portfolio experience sufficiently high defaults, equal to the par value of the loans minus the value of the portfolio after the default levels had reached the CDS payout terms.

A portfolio of these CDS were assigned to the SPV in Figure 3. It in turn issued a CDO based on the reference assets (specific sub-prime loan pools) because the cashflows from the CDS portfolio owned by the SPV mirrored the cashflows from those specific sub-prime loan pools.

The coupon would be lower than the actual underlying loans, but remember that most of this CDS activity took place in the upper rated AAA and AA tranches of sub-prime CDOs, so the cashflows matched up and the absence of actual further sub-prime borrowers was masked.

The CDO investor's premium receipt (if he purchased synthetically, by writing a CDS in favour of the SPV) or coupon (if the SPV sold a cash CDO) was funded from the CDS premia received by the bank and passed to the SPV. The CDO investor in Figure 3 is exposed to a loss equal once again to the par value of the loans minus the value of the reference loans should the CDS payment be triggered by portfolio defaults.

As Michael Lewis colourfully put it: "There weren't enough Americans with shitty credit taking out loans to satisfy investors' appetite for the end product".³

This explains why the eventual sub-prime losses suffered by the banking system were substantially greater than the volume of the sub-prime market.

³ Lewis p 143

2 Profit recognition of uncertain future cashflows by marking-to-market

Three fundamentally erroneous assumptions underpin the mark-to-market rules:

1. The last traded price is the correct market price for all assets;
2. There are buyers for every asset at this price (infinite liquidity);
3. The absence of fraud.

Let us analyse these flaws by setting out a theoretical example of an ordinary “real economy” business and how it might change if it adopted IFRS accounting. Imagine applying IFRS to perfume counters of department stores. Consider the economic incentives and likely behaviour of the staff under an IFRS variant applied to perfume selling.

Tabitha works on the shop floor of a Debenhams perfume counter. Her contract with Debenhams provides that she earns 10% of Debenhams’ profit. So if the cost price of the average bottle of perfume is £25 per bottle, it is sold for £75, and Tabitha sells 50 bottles each week, Debenhams would earn £2500 and pay Tabitha £250.

Imagine that mark-to-market accounting is introduced, and the Finance Director explains the new rules to Tabitha. He explains that there is a new way

of recording profits, one no longer based on bottles sold but on the market price of her perfume and the number of bottles in stock.

Being a bright woman, Tabitha realizes that this is an easier and more profitable way to do business. All she has to do is buy as many bottles as possible, refuse to sell any and wait for the price to increase on account of her withholding supply.

So, that week Tabitha buys 600 bottles from wholesalers and calls her competitors at Selfridges and other department stores in order to ensure that there is no perfume available for sale.

Then a young man comes in desperate for a bottle for his girlfriend. Tabitha sends him to a small chemist whom she says is the only supplier in town. The chemist charges the young man not £75 but £115 and agrees to confirm to Debenhams' accountants that he sold a bottle for £115. £115 is therefore now the market price.

Under the new IFRS accounting rules Tabitha can now look at her total pool of unsold stock, 600 bottles, and mark them to market. Debenhams now makes a profit of £90 per bottle on 600 bottles = £54,000. The store's managers are delighted; they too earn large bonuses. Tabitha's 10% arrangement entitles her to a bonus of £5,400 rather than £250.

This story illustrates all three weaknesses in marking-to-market identified above. But banks do not need to commit fraud in order to falsify their profits using these rules. The market value of the debt of banks that are making operating losses typically declines. Because rule IAS 39⁴ requires banks to assume that they could repurchase the entirety of their own debt issuance at present market prices, this represents a massive gain for them, often converting an operating loss into an accounting profit. Banks are now publicly complaining that they are forced to falsify their profits.⁵

4 IFRS accounting system will be explained in Section 6.

5 Orlik, R. *Barclays FD Weighs in on Accounting for Debt*, Accountancy Age, November 14, 2011.

Such accounting is absurd but perhaps an attractive “solution” to the Eurozone’s sovereign debt crisis. If Greece adopted the accounting policies used by British banks, it would instantly boost its GDP by a sum equivalent to 50% of its total issued debt.

3 Profit recognition via mark-to-model, and optimistic modelling

Consider the Debenhams perfume business once again, this time under the mark-to-model angle. If Debenhams had been accounting like a “sophisticated” bank in this theoretical example, and if no customer had even tried to buy perfume, this rule would have applied.

Debenhams would then have looked at their predictions for the sale price, say £135 or more.

IFRS allows banks to use this “mark-to-model” form of accounting for precisely those assets that are most difficult to sell, assets for which there is no market. So if no perfume had been bought at all, not one single bottle in that trading period, profits and bonuses would be even higher.

This perfume example is of course an invention.

The actual trade outlined below is one of many the author has experienced in which it is likely that both sides to the transaction have booked substantial profits when in reality any true profit to one side is a loss to the other.

The reason for describing this derivative arrangement is that it is an extreme example of the worst, and as yet unknown, exaggeration of profits and masking

of losses encouraged by the accounting and regulatory capital rules analysed in Sections 5 and 6.

Forgive the length of this example, this was necessary to explain the thinking behind the decisions of practitioners, which led to the creation of financial products such as the 'Redemption Profile Insurance' now described.

This example illustrates the dangers to the taxpayer if future bailouts are to be considered a possible response to future financial sector failure.

The context is the UK equity release market whereby senior citizens fund pensions or cash lump sums from their houses. Equity release is a simple but risky business for financiers.

A cash lump sum is offered to a customer aged 70 or over. In return the customer enters into a deferred sale arrangement whereby ownership of the property transfers to the financier on the earlier date of move out into care, or death.

Sample numbers are as follows. A single man, aged 70, assigns his £1m house to the financier on the earlier event of his death or move out into care, in return for £0.4m today. Leaving aside ongoing obligations to insure and maintain the property, the proposition is very simple. There are only two cashflows. Financier pays the customer £0.4m at the start and hopes in about 16 years to receive £1m adjusted for house price inflation.

There are no intermediate cashflows. This type of transaction is therefore termed a "zero coupon" financial product, since all of the interest is rolled up and redeemed, along with the principal advanced, at the end. Profit or loss to the financier turns on the actual house's value at the point of customer vacation and subsequent sale.

The numbers imply an interest rate over the estimated 16 year term of 6% (fixed) per annum (pa), and a constant house price inflation rate of about 1% pa. Critical to the financier's profit from the transaction is that the customer

does not live too long. The terms assume that the customer will live no longer than 2 years more than the mean life expectancy of his specific cohort of lives as assessed in accordance with industry standards. The standard approach to longevity risk is to take the relevant cohort’s observed life expectancy as provided by the UK’s Continuous Mortality Investigation Bureau (CMIB), and project the life expectancy forward 16 years to take account of anticipated improving longevity.

The financier needs to hedge against three financial risks. Let’s consider the conventional approach to hedging these risks.

1. Interest rates

A conventional interest rate swap for a medium term financing would involve matching flows. A Building Society,⁶ with a natural floating interest rate funding base, that wished to offer 5 year fixed rate customer loans might seek to trade a swap to hedge its exposure. The table below represents such a swap. The Building Society pays the swap counterparty (a bank) a stream of fixed periodic payments⁷ and receives in return a stream of floating rate payments:

Year	Society Pays	Bank Pays
1	5%	Libor plus margin
2	5%	Libor plus margin
3	5%	Libor plus margin
4	5%	Libor plus margin
5	5%	Libor plus margin

Before adjustment for frictional costs and profit the net present values of the anticipated simultaneous payment streams are broadly equal.

⁶ A UK “Savings and Loan” type of entity.

⁷ shown as an annual payment for simplicity.

The difficulty with equity release hedging is the long and uncertain term of this product and the absence of any regular payments. As the label “swap” implies, swaps usually involve two-way cashflows, from swap counterparty to bank and from bank to swap counterparty, on the same periodic dates throughout the life of the swap. A zero coupon swap is simply a loan by any other name.

An example of the zero coupon swap required to hedge interest rate exposure is as follows:

Year	You Pay	Bank Pays
1	0%	£20,000
2	0%	£21,000
3	0%	£22,050
4	0%	£23,153
5	0%	£24,310
6	0%	£25,526
7	0%	£26,802
8	0%	£28,142
9	0%	£29,549
10	0%	£31,027
11	0%	£32,578
12	0%	£34,207
13	0%	£35,917
14	0%	£37,713
15	0%	£39,599
16	£473,150	£41,579

The numbers above demonstrate the effects of compounding and the reality that such a swap is effectively a loan.

2. House prices

A range of house price linked investment banking products exists, but this market is very small. A possible approach is to base the swap or insurance policy around an index, such as the Halifax House Price Index (HHPI). Such a trade will leave the financier exposed to the uncertain price difference between the performance of the index and the price performance of the specific houses in the portfolio. Ideally this swap would be structured as a zero sum game, or self financing. The financier could offer to pay away HHPI in excess of an agreed benchmark, say 2.5% inflation per annum, in return for protection (compensation if the index declines) up to a floor level (say 0% per annum).

3. Life expectancy

Natural offsetting positions exist in the life assurance market – life companies offering policies that pay fixed sums on death will gain broadly as the equity release financier loses (as mortality improves) and vice versa. Again this could be structured as a zero sum game, with improvements above a benchmark protected in return for the financier ceding benefits if mortality is heavier than specified. Once again the trade will have to be structured around an index of outturn decrement (actual observed mortality), possibly the relevant Continuous Mortality Investigation Bureau cohort of lives, rather than the actual rate of decrement of the specific lives comprising the financier's portfolio.

Reverse mortgages

Up to this point the financing product described has been 'home reversion financing'. The financier essentially is buying the house.

The development of modern derivative and securitisation techniques has led to a new equity release product, a "roll-up" loan, alternatively called a "reverse mortgage". The maximum borrower liability to the lender is always limited to the actual sales proceeds of the house, so the two products are similar.

However, the reverse mortgage loan product denies the lender the financial windfall enjoyed by the home reversion financier who has purchased the house. Reverse mortgage lenders merely earn their fees and interest up until the date of death. Of course there is no free lunch and loan market terms reflect this, so a 70 year old man might be offered a loan of only £0.3m against his £1m house, rather than £0.4m for selling the reversionary interest.

Although it is obvious from these numbers that the reversion trade is a better deal financially for anyone expecting to reach their normal life expectancy, roll-up loans outsold reversions throughout the 2000s.

Salesmen focussed on the unfortunate early death scenario and convinced senior citizens that a loan product was more advantageous.

However, hedging the three financial risk exposures, interest rates, house price risk and mortality is much more difficult for reverse mortgage lenders than for reversion buyers. Even if death occurs in the first year all the lender can claim from the customer is a year's interest plus a small early redemption penalty, so it has no windfall to offer a hedge counterparty.

Imagine the appeal of a derivative product from a strongly rated US insurer that appears to deal with the bulk of these risks in a single transaction. This product was called Redemption Profile Insurance and was sold to UK lenders as a hedge whereby some profits were ceded if mortality was as expected in return for cover against losses if mortality was too light or heavy.

The summary of detailed commercial terms ran to 100 pages. Cohorts of lives were classified into male, female, and joint. All cohorts are in 5 year age bands at inception. Detailed life expectancy attachment points per cohort were not set out, but the terms were presented as essentially an interest rate swap around 'to be agreed' expected portfolio amortisation. Swap terms were disclosed as pre-specified fixed rate payments against floating interest rate payments at future trigger dates if mortality deviated from expected outcomes.

For ease of understanding the swap terms can be expressed as a borrowing or lending by the insurer depending on decrement.

If mortality turned out to be much lighter than expected the insurer would borrow at 7.6% pa, sufficient to compensate the lender for cashflow lost by the borrower's early redemption of the loan. If mortality was much lighter than expected the insurer would lend at 2% pa. This rate was so low that it represented a future profit stream for lenders who would in these circumstances be experiencing losses.

A prominent UK lender contacted my firm. It was very attracted to this product but could not understand how the insurer could make any money from offering such apparently generous terms.

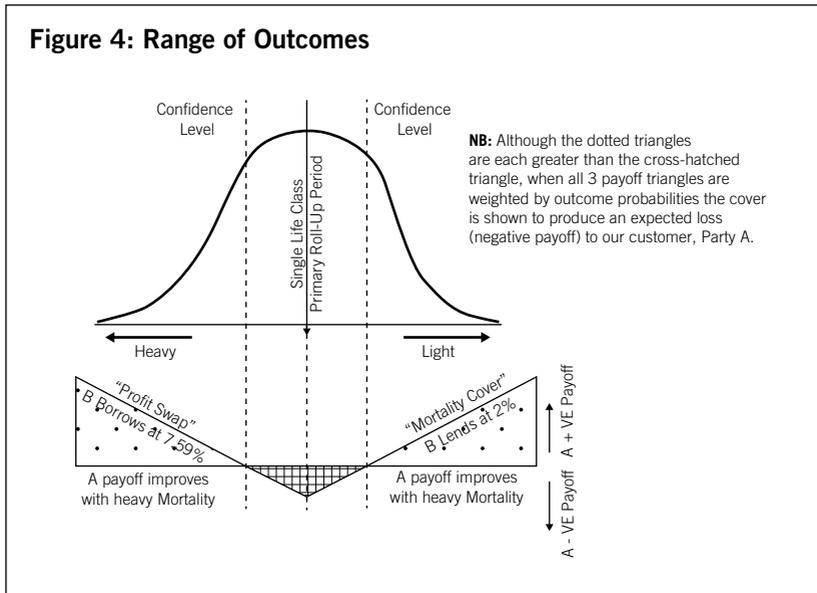


Figure 4 explains this. Mortality is generally mapped as a slightly asymmetrical bell-shaped curve. For simplicity this curve is symmetrical. Nonetheless it shows the effect of the interest rate swaps. On the left hand side it depicts the cashflows should mortality be heavier than expected. The right hand side shows the cashflows falling due if customers live longer than expected.

The lender is Party A and the Insurer Party B.

Key to the structuring of these swaps was the width between the two parameters to the left and right of the central mortality assumption for each cohort of lives, the insurance “attachment points”.

Despite the two shaded triangles “insurer borrows” and “insurer lends” being positive profit enhancers for our client, both swaps included the possibility that the borrowing and lending could be struck against negative notional amounts if the outturn actual decrement were only slightly heavier or lighter than the central assumption at policy inception embedded in the swap contract. Remember that this detail was still at this negotiation point vague – marked “to be agreed”. Borrowing against a negative notional turns a borrowing into a lending, and the apparently generous 7.59% investment would become, for our client, an expensive loan.

We met again with the actuaries at our client and ran a series of probability weighted scenarios. It became clear that our supposition was accurate. The termsheet appeared to give the impression that the price negotiation would be around the swap rates – the borrowing/ investment costs, but this was a red herring. We now knew that the sharp commercial “negotiation” would be the extent to which we could assist our client in resisting the setting of the attachment point banding which we knew the insurer would seek to impose. It was obvious to us that the policy was designed to soak as much value as possible from our client in circumstances shown in the cross-hatched area under the centre of the figure, circumstances in which the most likely mortality outcomes occurred. The policy was not without value, cover was provided at the extremes of mortality outcomes, but the client deemed the cost in the vast majority of scenarios we ran very high.

The policy was in effect, like a car insurance policy with a hidden but costly quirk. With this policy, if you bumped another car, bent a fender or crushed a wing, you would pay the insurer. You would only receive a payout if you drove the car off a cliff or into a river.

When this was explained to the client, they of course abandoned the transaction.

However we were assured by the US entity that a number of UK equity release providers had bought this form of 'protection'. There is no doubt that purchasers of these contracts misunderstood them. So, as their loan books grew and, as, say indexed mortality outturns varied from the banding, lenders would account for their insurance policies as profitable hedges offsetting these exposures. Sadly they would be disappointed when the insurer contacts them to demand a collateral transfer payment.⁸

Profit Recognition

Accordingly, at the time that this particular US entity was selling insurance policies of this kind to UK reverse mortgage lenders, the rules applicable were as follows:

- A.** UK lender, Basel 1 (regulatory capital) and UK GAAP (UK company law), ie. pre adoption of IFRS, which was employed by all UK and Irish banks from January 2005.
- B.** US Entity, Basel 1 (regulatory capital) and FAS 133 (accounting)

Let us consider profit recognition at inception. To simplify one aspect of the illustration, let us also assume that the UK lender is not originating from scratch but enters into the hedges based on a fixed portfolio of £20m of loans. The expected average life, or average decrement, is 16 years. The actual payments will occur based on variation of actual decrement compared with the agreed mortality parameters at inception, but this detail does not affect the initial accounting, or recognition of profits or losses by each side at inception.

⁸ All these sorts of swaps are executed in parallel with Collateral Service Agreements. CSA's are designed to mitigate the credit exposure which each side of the swap takes against the other. Subject to a minimum of say £1m, collateral is posted (lodged) by the party who, on a mark to market basis, would owe the other party should the swap be closed out that day.

The simplified cashflows set out in the table below are a reasonable representation. Were this a single loan portfolio the cashflows under the derivative transaction would occur either on the death of the borrower if he died prior to the 16th anniversary, or on annual payment dates thereafter if the borrower had not died. Although for calculation purposes the portfolio would be broken down into cohorts of lives, and whether the borrower was a single male, single female, or a couple (again sex being relevant; the life expectancies of cohabiting sisters is different from that of brothers) we do not need to go into that detail for present purposes. It is easier to understand and explain by pretending that the entire portfolio was a single loan to one individual.

	Rate	Year	Portfolio Size
			20,000,000
Term Libor	6%	1	21,600,000
Margin	2%	2	23,328,000
Reverse Mortgage Rate	8%	3	25,194,240
		4	27,209,779
		5	29,386,562
		6	31,737,486
		7	34,276,485
		8	37,018,604
		9	39,980,093
		10	43,178,500
		11	46,632,780
		12	50,363,402
		13	54,392,475
		14	58,743,872
		15	63,443,382
		16	68,518,853

At inception, the US entity knows about the cross hatch triangle and will book under FAS 133 the net present value of the size of that triangle, reduced only by standard provisions for market, credit, liquidity and operational risk. Assuming the UK lender agrees to a robust collateralisation agreement, requiring the posting of margin payments when the mark-to-market value of any out of the money obligations breaches a modest trigger point of say £1–3m, the total of these provisions will be modest, perhaps 20% of expected profit.

In practice, because the US entity is confident that its UK customers have not understood the cross hatch triangle, the trigger point will be set at a sufficiently generous level such that a demand for collateral will not be triggered on the actual signing of the derivative contracts.

From the perspective of the UK lender, at inception the derivative arrangement will be regarded as a hedge. Some initial fees and out of pocket expenses should be charged to the profit and loss account, but no expectation of profit to offset any exposures will be booked on Day 1 unless the UK entity believes the US entity has agreed to overly generous mortality attachment points.

However, from that point onward any negative deviation from the perspective of the UK lender (such as borrowers living longer) will be treated as a claim on the policy. The net present value of the claim will be treated as present profit to offset the actual costs of, in this example, delayed decrement. As the table above shows, the compounding effect of loans such as these, which involve no actual cashflows prior to the end of the loan (termed “zero coupon” loans), means that a small variance in an assumption at the outset results in large exposures at the point of payment. A modest underassessment of the death date of a borrower of an initial £20m loan results in about £5m of loss per annum to the lender after compounding (£68mm rather than £63mm).

It is therefore quite likely that within a short period of time after the execution of the contract, both parties will be booking front-ended profits. Of course, just as with any trade or gamble, at any point in time only one party can be

'in the money', and the other party is at that time 'out of the money' to the corresponding extent.

The US entity considers itself pretty well protected by the cross hatch triangle and would book decent profits up front. UK lenders who bought such policies but failed to understand the cross hatch triangle would not account for the corresponding expected future loss under these policies. This ignorance might endure for many years, so the wrong accounting would persist.

The example demonstrates the difficulties faced by regulators and accountants under the old rules, exacerbated now in the UK by the IFRS system.

There are numerous pockets of transactions such as these in relatively small sections of bank balance sheets. Rather like WW2 unexploded bombs they lie in wait, ready to explode when a sharp and honest regulator or manager chances upon them.

4 Perverse rule changes post crisis – failed sale

An understanding of the commercial drivers of banking is essential to any attempt to regulate the industry. Most of the rules now being produced only reveal their authors' lack of such understanding.

One example is the amendments to securitisation rules in 2009 which may have addressed the Lehman 105 scandal. Lehman's exploitation of a repo accounting rule loophole and wilful misdescription of borrowings as sales enabled it to shrink its balance sheet and thus appear less geared over key reporting dates.

Rather than deal with the loophole, rulemakers got caught up in the political narrative of the crisis and created such a sledgehammer to crack this nut that they unwittingly opened up a chasm in the rules now being exploited by a raft of European banks.

Mischievous "slicing and dicing" in the construction of securities out of mortgage portfolios was identified as a root cause of the meltdown. Therefore securitisation rules needed to be tightened up, or so the narrative went.

Unsurprisingly, the 2009 changes, making it more difficult to achieve off balance sheet treatment for securitisation structures, simply prompted the emergence of a slew of new products that would further encourage the masking of losses and exaggeration of profits and solvency.

Failed Sale

What is a Failed Sale and why are these transactions important?

Let's deal with the second question first. Just as bank runs were a traditional market regulator of fractional reserve banking, so the interbank market has been a traditional regulator of banks. Central banks and other government regulators could easily identify banks that were in difficulties because markets often discover these problem banks before state employees, and react by denying unsecured credit to them. The post crash rule changes designed to fix a non-existent securitisation problem have simply blunted this important market discipline and enabled insolvent banks to stay in business by pledging assets which bank stakeholders falsely still believe are unencumbered.

These "Failed Sale" arrangements work as follows. A pledge of prime assets by the borrowing bank is accompanied by a repurchase option. Pledging the prime assets enables a bank that can no longer access the traditional unsecured interbank market to raise funds and continue in business.

The accounting for these long dated secured funding arrangements now follows that used for the 'repo' market. The repo market is part of the fabric of the securities lending business that enables banks to hedge their exposures to, for example, interest rate risks by borrowing and short selling government bonds.

Disclosure rules in the UK do not identify the specific assets pledged under repo and therefore Failed Sale deals enable weak banks to perpetuate a mirage. Repo disclosure rules reveal the quantum of repo'd assets, but do not specify precisely which have been committed. Since repos are associated with "ordinary" hedging activities, a boost in repo activity does not represent a warning flag for regulators.

The repo'd assets now do not leave the borrower's balance sheet, so nobody is the wiser. But when the borrowing bank fails, its liquidator will be unable

to recover these prime quality assets because they will be claimed by the mortgagee – the lending bank.

Prior to the rule change, the assets sold and subject to a repurchase option would have left the balance sheet. After the change they remain on balance sheet and provide false comforts to stakeholders, scrutineers and other prospective lenders.

These new rules have thus encouraged and legitimised what we have treated for many years as fraud, the technical term under our Companies Acts being “fraudulent preference”.

The aim of these rules ought to be to expose financial health or lack of it, protecting the interests of the unsecured bank stakeholder rather than leaving that to Governments and deposit insurance schemes. This rule change reveals a staggering failure to understand repos, bank funding, and the cause of the systemic failure.

5 Overview of bank regulation – Basel

Regrettable though it has been that the development of global banking rules from Basel 1 to Basel 3 has progressively encouraged excessive bank risk taking, the most important point is that Basel 2 (2004) marked the effective transfer of compliance from the regulators to the banks themselves.

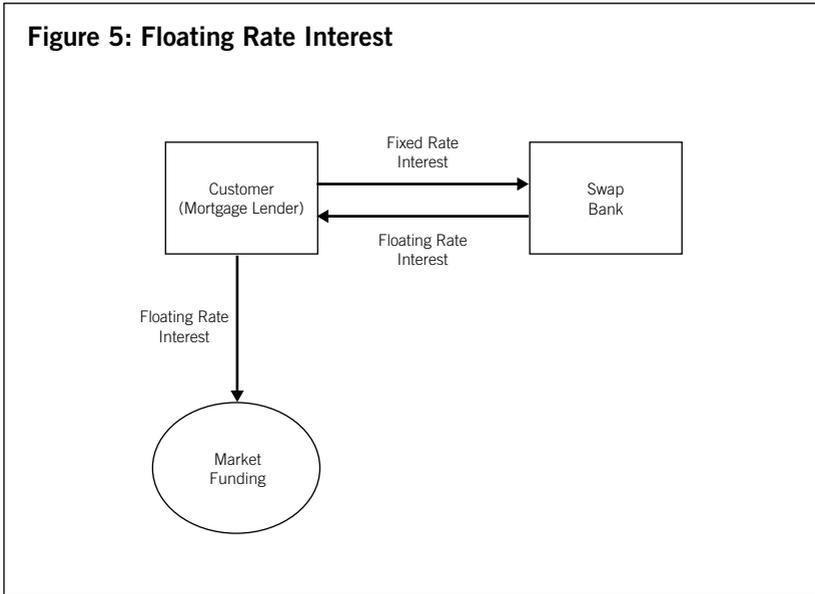
Or, more accurately, to those banks about whom we are most concerned. Only the most “sophisticated” banks – those that have been described as “too big to fail”, “too big to save” or even “giant vampire squids” are treated as sufficiently “sophisticated” as to need no external validation of their self-certification compliance. They are effectively authorised to be the judges of their own performance.

Unsurprisingly, given the managerial incentives identified above, their managers exaggerate their performances and have constantly lobbied to change rules when their continued ability to describe losses as profits was threatened.

Let us review the development of Basel and how this led to the creation of optimistic models, mark-to-market rules, and ultimately credit default swaps.

The trend to falsification of profits and capital started in the early 1980s with new rules that were considered at the time appropriate for newly emerging derivatives.

Figure 5: Floating Rate Interest

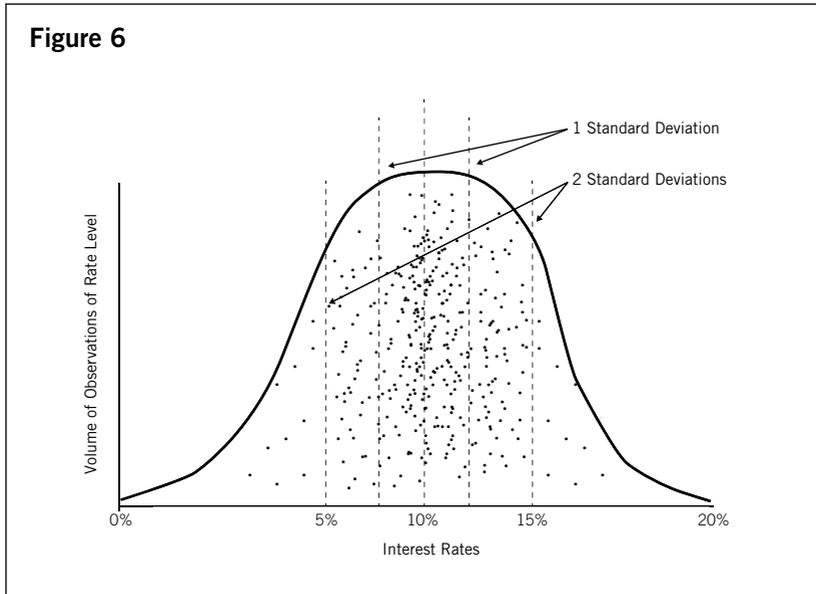


The above figure shows a basic interest rate swap agreement between a bank and its customer. The customer, perhaps a UK Building Society, has a natural floating rate funding base but wants to borrow on a fixed rate basis so as to match fund its fixed rate mortgage loan business.

By entering into this agreement the customer achieves this. Customer pays a fixed rate coupon to the bank and in return the bank services the floating rate obligation the customer owes to its existing lender.

Because, back in the early 80s, banks were able to argue that socially useful activities such as the provision of fixed rate mortgage loans to consumers would be inhibited if the full 8% capital charge were applied to the nominal value of the interest rate swap as well as the loan, complex mathematical formulae were produced which used probability analysis of historic interest rate levels to support the argument that capital for derivatives should be lower than that for loans. Indeed the term “derivative” was coined for swaps, based on the derivative calculus underlying these arguments.

Figure 6 shows this argument:



The argument ran that, projecting forwards based on observed historic data (in this example, interest rates) 67% of the risk, was contained in the area measured as one standard deviation from the norm, and 95% of such risk was represented in the area captured by two standard deviations from the norm. To be consistent with loan regulatory capital requirements banks argued that they should only set aside capital for a portion of the derivative exposure that was at risk (“Value at Risk”). Broadly, this was similar to the two standard deviation test. The formulae presented to regulators argued, based on this analysis, that swaps such as the example above should attract only about 1/16 of the loan capital charge. This lower capital charge was justified on the ground that the derivative exposure was supposedly lower risk.

Because the capital level differential was so great, derivative practitioners began their gradual process of converting nearly all forms of financial activity into derivative format because of the advantage of such treatment. This growth concerned regulators who felt the solution lay in global co-ordination.

The first such system, Basel 1, was implemented in 1992.⁹

This provided that banks hold capital equal to at least 8% of their "risk weighted" (RW) assets. The RW detail tends to get overlooked by commentators, but it is extremely important. OECD Sovereigns were considered risk free, so their RW was zero. Housing was regarded as safe, so a 50% RW applied. Loans to the real economy, companies and businesses, enjoyed no concession, in other words they qualified for an RW of 100%. These rules shaped banks' lending decisions and sewed the seeds of housing bubbles and the present sovereign debt crisis.

In 1996 a significant amendment, the Market Risk Amendment, was made. This standardised capital quantification for bank positions in other assets such as foreign exchange, equities, and most importantly, many more derivatives. It formalised global regulatory approval of the Value-at-Risk (VaR) approach to calculating bank exposure, which has been exposed by the recent crisis as inconsistent with market meltdown scenarios.¹⁰ VaR, as everyone in the industry knew at the time, would consistently lead to lower estimates of risk and hence lower capital charges and greater leverage of the financial system.

Further, the extraordinary expansion of the scope of derivatives qualifying for the low capital charge (about one sixteenth of that for loans, roughly 0.5%) led to a massive boost in the credit derivatives market, which now stands on a netted basis at an estimated \$15 trillion, or about one third of global GDP.¹¹

The banks, who had pushed for these changes, were pleased. Corporate and other SME loans that were previously relatively expensive to hold were either converted into bonds and sold physically or synthetically (via credit default swaps), or even sold internally to bring forward future hoped for profits and increase the ability of the bank to leverage itself.

⁹ Dowd, Hutchinson, Ashby and Hinchcliffe, pp 7-10.

¹⁰ Dowd, Hutchinson, Ashby and Hinchcliffe and also Hughes at pp 85-94.

¹¹ Guerrero, F., Wall Street Journal, 15 November 2011 p 23.

If a bank could procure CDS protection for its assets from a suitably rated or collateralised counterparty bank, under Basel 1 an arbitrage existed because the capital required to back swaps was only about 1/16 of that for loans. The reason for this distortion was that the 8% multiplier was in the case of swaps only applied to the swap's VaR.

In an article entitled “How to Destroy the British Banking System”¹² the author described how, in 2000, this very arbitrage was exploited artificially to bolster the regulatory capital account for the UK bank for whom he worked. This “fake capital” product immediately swept through European banks like wildfire, and the author subsequently realised the entire banking system was at serious risk of collapse because the regulators assumed that the banks had far more capital than was indeed the case.¹³

It appears that the Bank for International Settlements (BIS – the progenitor and custodian of the Basel rules) became aware of this arbitrage, but instead of revisiting the fairly soft treatment for derivatives, BIS removed the advantage simply by slashing the capital requirements of loans and other non-synthetic assets. No clearer example of the Law of Opposites exists.

The CDS (credit default swap) market grew from inception in the late 1990s to its non-netted 2007 level of \$62 trillion,¹⁴ greater than the sum of global GDP, because of the regulatory arbitrage provided by Basel rules. As Janet Tavakoli predicted in the early days of the CDS market:¹⁵

“The driving force for this revolution in banking [credit derivatives] is the fact that the BIS [Basel] risk weighting of the trading counterparty will become irrelevant. The magnitude of the credit exposure as expressed by trading

12 Kerr “How to Destroy the British Banking System” <http://www.cobdencentre.org/2010/01/how-to-destroy-the-british-banking-system/>.

13 The author wrote to and met with the FSA in 2002 to impress this likelihood upon them and to offer advice on heading off the impending crisis but to no avail.

14 Gross estimate of aggregate nominal value of all contracts, source Dowd and Hutchinson p 177.

15 Janet M. Tavakoli, “Credit Derivatives: A Guide to Instruments and Applications.” Wiley, New York, 1998, p. 241.

models will determine regulatory capital requirements. All banks will have an incentive to figure out ways to move assets from the bank book to the credit derivatives trading book. ... The regulatory capital charge in the trading book is a fraction of the charge in the bank book, and exposure netting makes trading book management viable.”

While this substantial activity was taking place, the UK’s own regulator, the FSA, published a paper “Cross Sector Risk Transfer”, in which they admitted that they did not understand these drivers and simply asked bankers for the answer:

“There is a split of opinion between the various market participants on the drivers of credit risk transfers for originating banks. Some think that regulatory arbitrage is the main driver – the banks want to free up regulatory capital. Evidence of such deals abounds, and regulators themselves grudgingly admit to it. In contrast, some think that economic capital models and balance-sheet management ...are increasingly important.”¹⁶

To the extent that Basel may at some point in its genesis have performed any useful function for regulators, the recognition that a fundamental driver of the growth of the CDS market was to negate the functioning of Basel appeared obvious to not only Tavakoli but also the Federal Reserve:¹⁷

“Banks use credit derivatives both to diversify their credit risk exposures and to free up capital from regulatory constraints” noted Bomfim, citing a simple example showing a reduction in regulatory capital of 80% merely by switching the format of the risk from loan to derivative.

Basel 2 was implemented in June 2004 to consolidate and overhaul in the wake of the boom in credit derivatives. It comprised three “Pillars” of regulation:

¹⁶ FSA Discussion Paper May 2002 para 3.65 at p 23.

¹⁷ “Understanding Credit Derivatives and their Potential to Synthesise Riskless Assets” JEL Classification G13 G20, Antulio N. Bomfim, July 11, 2001, p4.

Pillar 1: minimum regulatory capital. This could be based on banks' own risk models if the bank was sufficiently 'sophisticated';

Pillar 2: supervisory appraisal of banks' internal risk modelling;

Pillar 3: market discipline via transparent reporting of risks and positions

As the next Section will show, accounting developments have made accounts so unreliable as to entirely negate the objectives of Pillar 3.

As for the other two pillars, when the noble language is overlooked in favour of analysis of the substance of the development of the rules, Basel 2 simply resolves to greater deferment of the regulatory function from regulators to bankers. Regulation is lighter the more "sophisticated" (ie. larger) the bank, and for big banks Basel 2 effectively amounts therefore to self-certification.

Let us consider the consequences of the 2004 implementation of Basel 2 and the arbitrage around the low derivatives capital charge. This, as stated above, was removed by simply reducing the capital charge for the best quality assets to the same level. If a non-sophisticated bank has a portfolio of AAA rated assets, that measure applied.

Under Basel 2, the RWs of such highly rated assets became so small that, applying the 8% multiplier would result in the same regulatory capital charge of 0.56%. Therefore Basel 2 (and the Basel 3 variants) despite planning to increase the 8% numerator, result in lower regulatory capital backing of assets and positions given the steep reductions in the value of the denominator owing to the application of either internally determined or rating agency driven assessments of the quality of the assets.

Vast amounts of US sub-prime mortgage assets were rated AAA prior to that market's collapse. Under Basel 1, even if the housing classification of 50% RW had been applied, the regulatory capital charge applied should have been

4%, yet under the Basel 2 rules the level of reg cap “consumed” by such assets would reduce by about seven eighths.

The latest solution is Basel 3. This will be dealt with briefly since it is liable to change given the parlous condition of banking as this paper goes to print.

Basel 3 is a good example of spin over substance in rulemaking. It comprises three elements:

- A.** A minimum high quality core capital requirement of 4.5% of RW;
- B.** A “conservation buffer” above this of possibly a further 2.5%. Banks satisfying the core requirement but with less than the conservation buffer may be constrained as to distributions;
- C.** A “counter-cyclical” buffer above the conservation buffer. This is designed to apply when regulators consider that “excessive growth” is occurring. How stakeholders can derive any comfort that regulators know when times for banks are good or bad escapes the author.¹⁸

As an astute financial blogger commented when the rules came out:

“The things to be calibrated are therefore A) the minimum, B) the conservation level, C) the maximum counter-cyclical add-on, D) the credit conditions that trigger this add-on, and E) the schedule of restrictions on earning distributions as a function of where your capital level is within the buffer.”¹⁹

The evidence that Basel has only encouraged derivatives at the expense of real economy banking activity is strong.

The aggregate volume of on-balance sheet derivative exposure of UK banks is analysed in a paper by Ewen Stewart of Investec:²⁰

18 For a detailed demolition of the counter-cyclical buffer concept see Whyte, J. <http://www.cobdencentre.org/2010/01/the-kindness-of-geniuses/>.

19 Greycap, September 2010.

20 Stewart, E. (Investec Securities) “A Bubble on a Bubble”, April 2011.

2005: £300 billion

2008: £2.5 trillion

2009: £1.5 trillion

2010: £1.7trillion

Compare these figures with the 2010 total of UK banks' combined credit exposure to businesses and consumers, which might otherwise be expressed as total loans to the 'real economy', which was £3 trillion. After a brief respite in 2008 while the banks failed, their pursuit of derivative business resumed its inexorable rise.

6 Overview of IFRS accounting and under provisioning for losses

Especially in the case of banking, accounting rules should err on the side of caution. Two reasons for this are:

1. Prudence – traditionally this has been the dominant accounting driver and has been associated with assets being valued at the LOWER of cost and net realisable value (as opposed to “marked-to-market”);
2. Because every person in banking who is close to the numbers has an incentive to misrepresent and exaggerate valuations, and hence profits and capital.

RBS is an example of a bank that does not exercise prudence but, on the contrary, under provides for expected loan losses. How do we know this?

UK taxpayers insure its junk portfolio and Her Majesty’s Treasury valued (mid 2010) the expected losses at £25bn higher than RBS employees. This stems from the under provisioning for losses mandated by IFRS and voluntarily adopted by banks in the UK. The extent of under provisioning is hard to estimate, except in the case of RBS whose junk portfolio is insured by HM Treasury’s Asset Protection Scheme (APS).

Both the APS and RBS use IFRS accounting. The £25 billion difference in the two entities' valuation of the same assets is because:

RBS uses IAS 39 *as a lender* and only recognises losses when an 'event' occurs;

APS uses IAS 39 *as an insurer* and "fair values" or marks-to-market based on best estimate of the actual worth of the assets, it takes into account expected future loan losses.

The APS is clearly more reliable. RBS are still bound by UK company law and should certainly not distribute or pay bonuses based on overstated profits and capital.

The author and others met with RBS in May 2011 to explain their concern that RBS was overstating its profit and capital by about £20 – £25 billion. We were not satisfied with the explanation. A letter was sent to RBS setting out the concerns and recording the meeting shortly after. This letter, and an analysis of the capital destroyed by RBS before and after the bailout, appears in Appendix 3.

Let us summarise how these deeply flawed accounting rules have come into existence.

Development of IFRS

IFRS regulations emanate from the International Accounting Standards Board (IASB). Prior to 2000 the IASB was known as the IASC (the International Accounting Standards Committee). It had no powers and was effectively a think tank owned by a confederation of accounting financial institutions from around the globe.

The Accounting Standards produced by IASC were known as International Accounting Standards, or IAS. When the EU adopted IAS the IASC's name

was changed to the IASB and the accounting standards already in issue remained, the last of which in numerical sequence was IAS 41. The first IFRS standard that would be issued became IFRS 1 and so on.

At about the time of the EU's adoption of the IASB and their standards, Enron's collapse brought accounting integrity into high profile. European supporters of IASB claimed that Enron's collapse was the fault of weaknesses in US off balance sheet tests and failure of auditors to spot fraudulent activity by executives.

The IASB supporters won the day with these arguments and the EU duly adopted IASB regulations in 2002. Rather than confer rule making powers directly onto the IASB it set up EFRAG (European Financial Reporting Advisory Group) as a rule quasi-franking mechanism reporting to the EU directly.

The IASB's new rules were called IFRS. They were criticised in advance as "an extension of US the style 'tick box' approach with the aim of demonstrating that the auditor has not been negligent."²¹ This merely weakens the reliability of the audit. Peter Wyman, a past President of the Institute of Chartered Accounting for England and Wales has said "Rules encourage avoidance, principles encourage compliance".²²

At the outset of IFRS, Iain Richards also highlighted the danger of prescriptive, process driven standards. He cited Lord Penrose's report of the Equitable Life inquiry. Even though commenting on the accounting standards was outside the remit of the Inquiry, Penrose was evidently very concerned that poor rule formulation had erected barriers which effectively nullified the regulatory process:

"The auditor's independent obligation to report to the regulator could in appropriate circumstances, involve investigations into the reserving policies

21 Association of Chartered Certified Accountants submission on the DTI consultation on "Director and Auditor Liability" (March 2004), quoted by Iain Richards, at p9 of "*Undermining the Statutory Audit*" published by Morley Fund Management, June 2005.

22 Extract from a speech at ICAEW/ ICAI joint conference 2002, quoted by Richards p 9.

and practices of the actuary. But the obstacles in the way of the auditor have at all material times been significant”²³.

Richards then concluded that the formulation of prescriptive standards and thresholds meant that an auditor could only justify reporting concerns to the regulator in “extreme” circumstances.

Although the EU’s IFRS accounting standards have been passed into UK law, the rules have not overridden the Companies Law the test for distributions, known as “capital maintenance.”

Let us examine how UK banks, despite their preparation of IFRS compliant accounts, have breached this capital maintenance test.

UK Companies Act 2006 Parts 18 and 23 require accounts to be materially correct in order to ensure that any distribution made based on those accounts is lawful. The law stresses that the use of audited annual accounts is compulsory. The test of lawfulness is the common law. The common law test for distributions is based on realised profits less realised and unrealised losses.

The law is worded so as to override even the requirement to provide a true and fair view. Even incomplete skeleton accounts are permitted, provided that the assets and liabilities and provisions in the accounts show the correct numbers. The statute law refers to numbers “as stated” in the accounts.

The effect and intent is that three classes of company overseers should be working from the same reliable information:

- A.** directors who sign off accounts and declare dividends,
- B.** any new board members that were appointed after the accounts were signed,

²³ Report of the Equitable Life Enquiry, the Rt Hon Lord Penrose, HMSO ISBN: 0-10-292688-3 (ref:Ch 11, para 76).

- C.** shareholders who approve dividends and reappoint directors at the AGM based on the audited accounts presented to them.

Shareholders and any new directors are entitled to trust that the directors and auditors who signed off the accounts discharged their duty to the company. That duty means that accurate accounts have been prepared, that they traded and distributed profits lawfully based on those accounts. The same dynamic applies within a group, a holding company board (as shareholder investors) are entitled to rely on the accounts of their subsidiaries, when they receive dividends and then pass them up.

Under the common law:

- 1.** a realised profit is a profit earned on the basis of legally having swapped an asset for something that is cash (or near cash equivalent).
- 2.** a realised loss is a contracted loss, or a provision against a likely fall in value of an asset, or a provision against a contingent liability.

Part 23, without prejudice to the underlying common law, legislates these rules. The statute further provides that for public companies, unrealised losses (such as downwardly revalued loans or bonds) must also be disclosed.

The essence of this 'capital maintenance' rule is that because dividends are paid out in cash, sufficient value remains in the company to meet liabilities to creditors, after such cash dividends. For a bank, this means that there are two interlinked economic conditions:

- A.** the balance sheet is not insolvent (it has not already destroyed its capital. If distributions were permitted in these circumstances shareholders would be incentivised to leave company losses to its creditors rather than its shareholders);
- B.** the bank is a going concern (it is not already insolvent, it is not destroying capital and it has a viable business model).

If either of these tests is breached, creditors fund dividends. This is the defining characteristic of a Ponzi scheme.

Under UK law the ‘going concern’ opinion is forward looking and applies for a year from the date that the accounts are signed, immediately prior to the AGM of a public company.

The law is extraterritorial (Section 386 Companies Act 2006). A UK incorporated company has to ensure that any non-UK Companies Act undertakings produce accounting information sufficient to enable the company to comply with the Act. This is particularly relevant given the outward focus of London registered holding companies. The main asset of a holding company is its investment in the equity of subsidiaries, which in turn is reliant on the robustness of those subsidiaries.

Preparing accounts

These rules are contained in Part 16 of the 2006 Companies Act, a consolidation of similar rules in existence since 1947.

“Companies Act accounts” provisions are set out in the Companies Act (Section 396). This section stipulates that accounting formats and valuation methods consistent with the Common Law are employed. This means that the standard of preparation of accounts must be consistent with the standard required by Parts 18 and 23 above.

Bank loans must be at the lower of cost and net realisable value. The same applies to intercompany loans. There is an explicit cross reference to Part 18 and Part 23, meaning that provisions for bad and doubtful debts, as stated in the accounts, must satisfy Part 18 and Part 23 rules. Section 396 requires a “true and fair override”.

All these rules apply to company accounts. Only companies are incorporated, with capital, not groups.

The European Union's IFRS accounting rules are only compulsory for consolidated, group accounts of listed companies. The EU allowed constituent nations the option to use EU-IFRS accounts for companies. In 2005 The UK and Ireland exercised that option.

Having exercised that option, IFRS accounting rules apply but do not override the Section 396 rules and related common law tests regarding distribution of profits, and therefore as a matter of UK law the Companies Act and common law tests prevail.

Set out below is a summary of critical areas where IFRS directly conflicts with UK law. In order to comply with UK law our banks, whilst preparing IFRS accounts must nevertheless only distribute, or presumably treat as profits for bonus purposes, based on the capital maintenance provisions of Section 396 accounts.

1. IFRS expressly leaves out credit losses, "losses no matter how likely are not recognised".
2. IFRS includes as 'profits' unrealised profits that may be marked-to-market or even marked to a spreadsheet model. This may mean that both opposing parties to a zero sum transaction (for example the earlier reverse mortgage insurance example) show a profit.
3. IFRS combines Master Trusts (e.g. Northern Rock's "Granite" Master Issuer) with holding companies (i.e. Northern Rock plc) as one reporting entity, despite the fact that the Granite Master issuer and Northern Rock plc may have competing interests. In late 2008 there was a contingent call on the capital of Northern Rock plc by Granite Master Issuer of £3 billion.

It is worth noting that the Northern Rock debacle parallels that of the Equitable Life disaster; in both cases the two classes of members were pitted against each other. In the Equitable Life case the promises underlying 'guaranteed annuities' had created a superior claims for certain members. The IFRS accounting for Master Trusts has resulted in the same problem for Northern Rock plc. The superior interest of the Master Trust is masked by the accounting.

Usually, the holding company would prepare accounts as simply a stand alone company, showing any contingent relationship with each related party. Separate consolidated accounts would incorporate the Master Trust. However, in the case of Northern Rock, both sets of accounts incorporated the Master Trust, silent as to contingent liability risk, and ignoring the bad debt provisions of the consolidated Granite.

4. IFRS omits from accounts firm commitments and contingent likely promises such as deferred bonuses.
5. IFRS is an inflexible model. It has been implemented as a maximum harmonisation measure. EU member states cannot add additional requirements – other than those outside of the scope of the IFRS Regulation. The consequence for UK law is that our common law is overridden at EU level but applies in the UK. Therefore we have a conflict of laws. This approach, antithetical to UK common law, means that accounts prepared under IFRS are acceptable for all purposes other than the “capital maintenance” provisions for solvency and distributions. Therefore it is lawful for banks to prepare IFRS accounts but not to pay dividends (or presumably bonuses) based thereon.

IFRS rules therefore allow a bank to produce accounts showing that the bank is profitable when it may in fact be deeply insolvent. Such accounting rules render normal investor analysis meaningless and explain why banks remain dysfunctional.

As Steve Baker observed about IFRS in June,

“Accounting Standard setters have partly owned up to their standards being ‘procyclical’. However procyclical is an inaccuracy. It implies that IFRS-using banks get back to where they started. A more accurate description is that IFRS creates a death spiral. Banks silently destroy their capital under the guise of profit, then they require taxpayer support, then the process starts again. The prolonged destruction of banking capital is disturbing normal credit intermediation and once again threatening the financial system.”²⁴

²⁴ Steve Baker MP, press release June 8, 2011.

7 Solution: The Baker bill in context

“Of all the many ways of organising banking, the worst is the one we have today” Sir Mervyn King (2010).

Stinging criticisms of the nature of the western banking system by senior politicians and even those charged with managing it such as Sir Mervyn abound. And yet, four years from the start of the crisis that has been overseen by so many of these senior stewards of the system, no positive measures have been implemented to address its deep flaws.

Steve Baker MP has tried. He used his 10 Minute Rule Bill slot in March 2011 to attempt to bring simple legislation that would have revealed the extent of mark-to market and mark-to model banking activity. The Bill was not adopted by Government and failed to be allocated time for a second reading.

Should marking-to-market be abolished?

Shareholders, creditors, regulators and other users of accounts do benefit from seeing a netted off mark to market position of a bank. That is why, when drafting Steve Baker’s Bill, Tim Bush, Kevin Dowd and the author did not seek to abolish the practice, but to highlight it and restrict its use for profit falsification, banker compensation and other unsuitable purposes.

The Bill would require parallel accounts showing true capital (as opposed to capital boosted by the aggregation, for example, of unrealised marking-to-market) and profits.

The principal author of the Bill was Tim Bush, and his elegant drafting succeeds in achieving this effect in only three pages of Parliamentary paper. It is set out in full with a clause-by-clause commentary at Appendix 2.

Since the introduction of the Bill, it has emerged that the IMF and Irish Central Bank are exploring mitigating the problems of IFRS accounting.

The Bank of England is also sufficiently worried about the impact of IFRS on the overstatement of bad loans, that it is taking advice on moving loan loss provisioning off the IFRS system from July 2011.^{25 26}

We have also learned that the IMF has expressed concern that UK banks are understating bad loans. This is because IFRS masks loans in forbearance situations from provisioning, irrespective of how likely losses are.²⁷

The context of this bill, the banking crisis hierarchy

The banking system in the UK is in deep trouble. Enactment of the Baker Bill is an essential first step in addressing the UK's banking crisis. It will not fix the whole system however.

It is therefore important to explain where the matters set out in this Paper, and the Baker Bill, sit in the hierarchy of the banking crisis. This hierarchy has evolved and accelerated rapidly on three levels.

25 <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8555745/Irish-banks-may-have-to-declare-extra-losses-under-accounting-rules-change.html>.

26 <http://www.independent.ie/business/irish/banks-may-be-forced-to-frontload-billions-in-losses-2665095.html>.

27 <http://www.telegraph.co.uk/finance/economics/8560840/IMF-warns-on-UK-banks-masking-bad-debts.html>.

1. fractional reserve banking when combined with deposit insurance;
2. marking-to-market and marking-to-model accounting rules;
3. credit default swaps.

The Bill will only start to impact Levels 2 and 3.

1. Fractional Reserve Banking (FRB) COMBINED with deposit insurance

Much has been written about the merits and demerits of our system of banking, whereby banks take deposits and lend them out many times over. This is called Fractional Reserve Banking or FRB. The history of this has been documented by distinguished scholars.²⁸ An alternative system of banking favoured by scholars such as Huerta de Soto is one in which banks would either not be able to lend out deposits, or would only be able to do so with the depositor's express permission. The umbrella term for this is '100% reserve banking'.

As someone inclined to the so-called 'free banking school' which would encourage FRB banks to compete openly with 100% reserve banks, the author has no fundamental objection to FRB. Regrettably the proponents of our deposit insurance rules appear to have failed to realise the perverse incentives they have created for banks. Icelandic authorities are presently preparing criminal charges, alleging fraudulent management, against many of the stewards of Glitnir, Landsbanki and Kaupthing.

However, because of its membership of the European Free Trade Association, Iceland's banks were able to raise deposits in the UK and other EU countries with the benefit of, in our case, UK taxpayer backed deposit insurance. Which UK saver, acting rationally, would have chosen to deposit their £30,000 life savings with Barclays who offered a 5% interest rate, rather than Kaupthing

²⁸ Huerta de Soto, Dowd & Hutchinson, Schlichter.

who offered double that rate, since both deposits were backed by the ultimate authority of the UK Government?

The presence of deposit insurance therefore drags funds away from healthy banks and encourages weak and/or fraudulent banks. Yet this is a modern phenomenon. There used to be a powerful regulator – the market. The market regulator of this activity was the risk of bank runs. The fear of runs encouraged banks to keep their reserve levels high enough to fend off speculative attacks. Deposit insurance has entirely negated this powerful regulator and ensured a ‘race to the bottom’. The previously ‘good’ banks realised that they could not prevail and have developed business models far closer to those of the Icelandic troika than politicians or commentators appear to appreciate.

2. Wrong accounting rules culminating in marking-to-market and marking-to-model

Banking regulation went global with Basel 1 agreed in 1988. The Basel system is meant to protect bank stakeholders by ensuring that banks are backed by sufficient capital. The main flaws in Basel 1 were the low and admitted arbitrariness of the minimum level of capital, 8%, and the assumptions of riskiness of asset classes. Assets were bucketed into classes such as housing loans, interbank, sovereign debt and so forth, and then given arbitrary risk weights. OECD Sovereign exposure was deemed riskless.

Poor though Basel I was, it has all been downhill since then. The main driver behind Basel II was that banks should have their regulatory capital requirements determined by their own risk models. This of course results in over-optimistic models which undermine capital requirements and, as the recent crisis confirms, leave the banks very vulnerable to failure.

The most recent example of this was the Franco/ Belgian Dexia Bank, which not only produced reasonable Basel capital numbers but also was pronounced

safe under stress tests operated by the European Banking Authority in July 2011 before being declared insolvent in October.

3. Credit Default Swaps (CDS)

The conception and development of this market has caused greater confusion than any other branch of banking. CDS are cashless transactions²⁹ that transfer the cost of a future borrower default between the CDS counterparties. However, this risk transfer had no bearing as a commercial driver of the emergence and subsequent development of the CDS market.

The driver of this market was profit exaggeration for the benefit of the managers of the financial institutions involved. The key difference between traditional, real economy bank lending and derivative activity is that in the former, profits are recognised periodically when the borrower services his loan by paying cash to the bank; in the latter the bulk of the hoped for future profits of the loan are recognised on the day the CDS is executed.

Derivative transactions enjoyed far lower capital requirements than traditional loans, generally about 1/16 for the same 'nominal' maximum risk exposure. The benefits to bankers of the application of the generous derivative accounting rules to loan books when converted into derivative format were greatly enhanced by the ability to transact 16 times as much business for the same amount of regulatory capital, creating unimaginably powerful incentives for structuring engineers to design instruments in order to exploit these new rules.

CDS thus rapidly developed as regulatory capital and profit falsification tools, so destabilizing the banking system.

²⁹ Although collateral often changes hand after the fact, ie. after market movements.

Ruritania was designed to highlight the relationship of marking-to-market and CDS in this crisis hierarchy. With present CDS rules, the problems of fractional reserve banking combined with government deposit insurance substantially increase. Ruritania demonstrates that far from serving any necessary purpose, CDS are a primary driver of systemic banking failure.

CDS are a significant cause of the banking crisis because of the failure of rulemakers to understand them. If they have, then they have indeed been “captured” by the banking profession. As Ruritania shows, CDS combined with simple structuring, is the easiest way for bankers legitimately to declare all the cash they hold as profits and consume it as compensation, relying on future banking activity to generate profits necessary to redeem depositors. These are the defining characteristics of Ponzi schemes.

The rating agencies have been wholly complicit and pliant throughout the growth of this value destructive market. If the application of Gaussian copulas to market risk outcomes did not represent stretching plausibility into the realms of fantasy³⁰ mapping loan defaults historically and claiming that such data form a basis for predicting future defaults is simply nonsense.

Moreover, no genuine market demand drove the emergence of CDS. From the mid 1980s loan selling and trading grew into a prominent activity for banks and investment banks. Different forms of legal transfer contract emerged covering all conceivable buyer/ seller legal relations post sale. Two examples are absolute loan sales (called “novations”), whereby the buyer becomes the lender of record and directly faces the borrower, and sub-participations, whereby, like CDS, the original lender/ borrower relationship is unchanged. With a sub-participation arrangement the buyer would put up his loan principal to the extent of his portion of the loan purchased (up to 100%) and receive back payments of interest and principal as made by the Borrower. No deficiency in legal detail or documentary competence led to a demand for credit derivatives.

30 See Dowd and Hutchinson, pp 87-110.

Whatever the benefits to society of derivatives, and there are many, better reporting and accounting rules should have been developed. The rules for credit default swaps are the worst kind of rules operating in this failed banking system, since they create the appearance of constraint and regulation but in fact encourage quite the opposite.

8. Conclusion

This paper has argued strongly that banks have driven the deterioration of the banking system by pressurising scrutineers to introduce rules that have maximised their compensation at the expense of taxpayers.

This view is not universally embraced. Jeffrey Friedman argues that the evidence supporting this is mixed. Friedman notes that reported regulatory capital ratios of US banks were strong. He also notes that US banks' holdings of CDOs and risky mortgage backed securities were concentrated on the lowest yielding AAA tranches.

Friedman's conclusions are that banks were heavily pressed by the Federal Government to lend to non-creditworthy borrowers, and were probably ignorant of the weakness of the credit quality of the AAA assets they were buying.³¹

There is no doubt his first conclusion is correct and is mirrored in the UK and many European countries. Governments and banks form a very close alliance, no closer than at times of crisis. This alliance can translate into pressure on banks to make lending decisions they would prefer to avoid, just to placate the government.

In the UK this Government pressure now worryingly produces conflicting policies towards the banking system. Basel 2, to recap, taxes banks by

³¹ Friedman, pp 34-39. See also Smith, Chapter 5.

imposing a higher capital charge on loans to unrated small or medium sized enterprises (SMEs). Our Government champions Basel. However, so disappointed has the Government become at the volume of lending to SMEs that it announced in November 2011 that it would subsidise bank loans to SMEs, thus negating the Basel rule.

But Friedman goes too far in exculpating bankers. Friedman failed to appreciate that the CDS market is primarily an AAA market. Generous rating agency rules allowed typically 80% of US Sub-prime CDOs to be rated AAA. Billions of CDS contracts were struck on these AAA tranches, and a substantial volume on AA tranches. The CDS market needed substantial issuance of AAA rated CDOs to drive its growth. The combination of CDS protection with CDO structuring produced front end profits which immediately generated compensation and enhanced Tier 1 regulatory capital. CDS and CDOs have been defended on the ground that they are a modern form of traditional lending activity. This is false. At the consumer level CDOs worked so well for bankers that they incentivised the creation of loans to very weak borrowers purely to drive the CDO engine as shown in the Sub-Prime example in Section 1.

At the corporate level they encouraged loan recycling, not new loans. By 2006 a great percentage of newly issued Eurobonds were no longer purchased by capital markets investors. They were bought by the investment banks that had brought them to market. The bonds were then packaged together and reissued. Ratings agencies wrongly concluded that default risks were lowered (ratings raised) if chunks of bonds from different industries were bundled on the ground that default probabilities of different industries were not “correlated”.

By 2000 the non-correlation theory was gaining prominence. Ratings agency softness encouraged the design of CDOs, cash and synthetic. This was so profitable for everyone that even facsimile portfolios were created. Scrutineers should have worked out that the rules needed tightening. The systemic failure exposed the emptiness of the non-correlation theory. The agencies have post-crash downgraded by 5 notches (from AAA to say B) about 4500 CDO transactions.

Far from addressing its true cause, regulators and politicians simply froze at the point of the crash. They blamed unpredictable shocks such as the collapse of US sub-prime mortgages. This is a false explanation. As Sir Mervyn King said in June this year, 'it was never a crisis of liquidity but one of solvency', meaning the capital claimed in the accounts of British and other countries' banks simply did not exist.

Rushed and poorly thought through bailouts took place. Creditors that could have taken losses were made whole. When its credit default swap liabilities had brought AIG into trouble, AIG was negotiating with its CDS counterparties to accept 60 cents on the dollar. Unsurprisingly the creditor banks were better poker players than the guardians of US taxpayer funds and the banks won a 100% TARP³² bailout, or \$62billion in respect of these AIG swaps.³³

Regulatory, accounting and political responses continue to miss the cause of the crash by a country mile.

Since the crisis there have been universal calls for better regulation of banks and an intense focus on Basel 2 and 3. In July the Cato Institute published a paper by Kevin Dowd arguing that the entire Basel regulatory capital regime is pointless.³⁴

Irrespective of the merits of some form of parallel bank risk measure (which is in essence all that BASEL can ever claim to be), the formal accounts of any company, bank or not, are surely of vastly greater importance than a theoretical BASEL measure. Accounts should be the managers' and auditors' honest statement of the bank's financial position. Once they cease to be an honest reflection of the business' financial position chaos ensues. BASEL becomes ever more pointless since it in turn relies on published accounts.

32 Troubled Asset Relief Program – the US euphemism for Government bailout.

33 Johnson and Kwak pp 169, 170.

34 Dowd "Policy Analysis" CATO institute July 2011.

There has been remarkably little attention to the poor accounting by banks in general and the IFRS regime in particular.

Yet Irish, UK banks and the ECB, have implemented the EU-wide IFRS regime unconditionally at the banking company level. IFRS requires wrong accounting³⁵. Even those European countries who do not allow IFRS for their actual banking companies (ie they employ IFRS only at the consolidated level where it can do far less harm) appear oblivious to a major root cause of the 2008 systemic banking failure, wrong accounting for credit default swaps.

True and fair accounts, based on principles not processes, are an essential first step in addressing the crisis. The Baker Bill should be enacted forthwith. Unless we end false accounting, bank regulation will remain impossible and pointless. The Basel rules themselves are poorly enough drafted, but even if a perfect system of bank regulation were in place today it would be ineffective given that compliance or otherwise is driven by virtually meaningless financial reports and accounts.

Until such legislation is enacted regulators will remain emasculated – the audited accounts upon which they rely conceal rather than reveal the “true and fair” view of the financial soundness of our banks and therefore distributions based on these reports given the specific examples cited are breaches of UK Companies Law.

Present treatment will, unaffected by proposed EU amendments, enable banks to take substantial risks, chalk them off the balance sheet by entering into trades which actually constitute enhancement of risks, and then report as profit today years of hoped for income which will disappear when the banking system crashes again and no bailout is possible.

Another of Sir Mervyn King’s post crash noteworthy apothegms is “banks are global in life but national in death’. The consequences of Ruritania activity are

³⁵ For more detail see Bush.

effectively a large scale conversion of bailout funds into bankers' wallets. This is socially and politically unacceptable, and has simply strained the banking crisis to breaking point once again.

It is not too late to address the systemic banking failure which persists today, but to do so it is necessary to understand how the system has become what it is and what measures must immediately be implemented to begin to fix it. Understanding these drivers is the key to solving these problems.

As the Failed Sale example in Section 4 illustrates, the present system of rules merely presents further opportunities for rational bankers, acting largely legitimately in a capitalist society, to adhere to the rules yet maximise their earnings by driving the system repeatedly over the cliff.

Even as this paper goes to print, news is breaking of two further examples of the fundamental weakening of rules meant to protect taxpayers and depositors:

1. Various banks have announced³⁶ that they intend to defraud the already weak, self-certificatory regulatory regime by fixing their risk assessment models. This is explained as necessary to demonstrate compliance, and has been labelled by the banks as “Risk Weight Optimisation”;
2. Goldman Sachs and Morgan Stanley are considering, for certain “relationship clients”, changing their reporting basis to the historic cost of assets³⁷. This is a blatant admission that under mark-to-market, or even the weaker mark-to-model accounting rules the firm is unable to mask substantial losses so the rules must be changed to permit this by enabling assets which have fallen in value to be reported at the original purchase price.

In addition, reports are appearing daily about the recent collapse of MF Global. Managers of this large New York based brokerage firm appear to have perpetrated the classic Ponzi fraud of raiding supposedly segregated

36 <http://www.americanfuture.net/category/european-commission/>.

37 Wall Street Journal. November 11, 2011, Rappaport, L. (p25) and Reilly, D. (p32).

customer deposit funds to post collateral to industry counterparties thus remaining afloat for just long enough to pay themselves bonuses before admitting insolvency to the tune of over \$6 billion. The only doubt appears to be the level of the customer thefts, ranging somewhere between \$600 million and \$1.2 billion.³⁸

Regrettably the fundamental insolvency of big banks does not appear to be understood. Bailouts cannot save such banks and brokerage firms without a fundamental reform of the rules to remove the incentives to defraud bank depositors, other stakeholders and ultimately taxpayers. Bailouts without such rule changes merely hardwire this activity into the DNA of present and future managers. Unfortunately, this hardwiring happened in 2008.

Insolvent big banks were bailed out and their managers expressed their warm thanks to taxpayers by engaging in every regulatory and accounting shenanigan imaginable to plunder the bailout funds for personal benefit.

Markets know that this, which is why the interbank markets remain frozen. No other investors will lend to these failed banks on an unsecured basis. Nor will these banks lend to the “wider economy” because such activity cannot be reported as anywhere near as profitable as the activities described in this paper, and also because loans require the disbursement of cash. It is far easier to declare fake profits under cashless, or “synthetic” transactions.

The consequences of continued failure to fix the banking system will be the fundamental destabilization of our societies.

Most banks know they are too big. The problem today is not only are banks no longer allowed to fail, but neither can they shrink. The UK banking system has grown from 60% of GDP in 1960 to 460% today. Banks are fully aware of the points made in this paper, that on any ordinary “true and fair” view they are insolvent, and most bank assets are for sale as they try and shrink. This

³⁸ Wall Street Journal, November 22, 2011, Strumpf, D. (p1).

is effectively a liquidation process, but a process being run by managers not with the interests of taxpayers at the forefront, but their own.

This liquidation process should be encouraged by the UK Government but put under independent control. If this does not happen then, just as the Euro appears on the verge of collapse under the weight of its own contradictory rules,³⁹ there is no doubt that the remarkable incentives for bankers to report fake profits will bring down state finances in a way that will threaten the continued existence of the currency.⁴⁰

This will not be a crisis of capitalism but a failure of statism.

39 For a comprehensive analysis at the outset, see Siedentop.

40 For macro-economic analysis of the threat to the currency see Dowd, Hutchinson and Kerr, and Schlichter. For a day-to-day account of the experience of paper money collapse, see Fegusson.

Appendix 1 – Ruritania technical note

The Ruritania example illustrates the Law of Opposites operating at several levels. Although this paper is only concerned with rules, allow but one macro economic point. The response to the crash has been to reduce interest rates to near zero levels. This has merely massively inflated the false profits of banks via Ruritania structures. Because the discount rate post crash is now so low, bank assets are inflated to maximum levels when present mark-to-market rules are applied. Had rates remained at about 5% over a 25 year yield curve the 'profit' would have been very small indeed.

To recap:

Four people arrive in Ruritania. Alice has £103. That is the total cash in the banking system. At the end of Day 1 Alice has deposited the cash with the banker. He has lent it to the entrepreneur who has paid in advance the builder who redeposits the money in the bank.

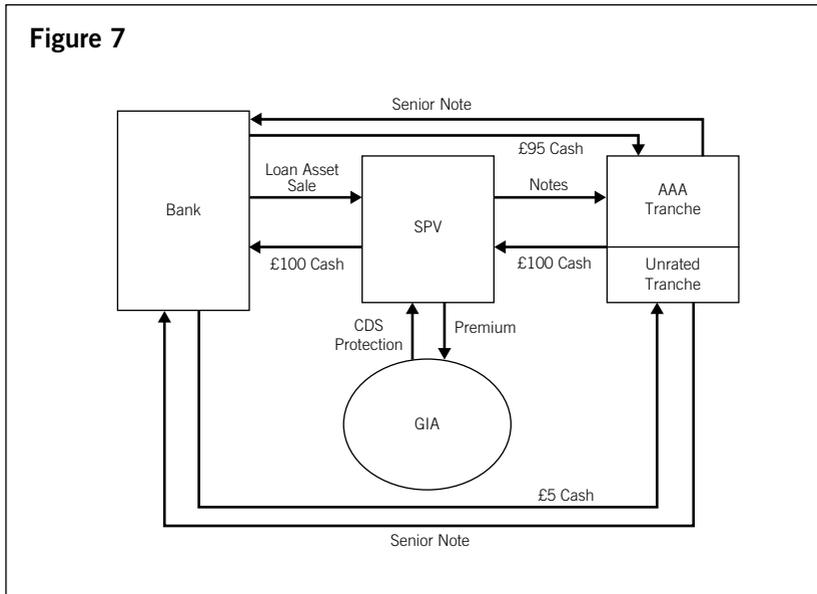
So:

The banker has 2 deposit liabilities totalling £203 paying 1%.

Entrepreneur has a 25 year loan costing 7% per annum. The total contracted possible cashflows owed to the bank over 25 years are £275.

Banker wants to claim £100 of the £103 cash as his profit and buy a Ferrari.

How can he claim all the cash as profit at the end of Day 1?



The 25 year loan cashflows total £275 over time.

The loan is sold to the SPV for par. The loan is £100, therefore the sale price is £100.

The structuring occurs within the SPV.

The SPV purchases a credit default swap (CDS) from AAA rated GIA for a price of 1% per annum on the senior ranking 95% portion of the loan's cashflows. This is not out of line with the prices charged by AIG to insure senior pools of sub-prime mortgages.⁴¹ The SPV issues 2 tranches of debt to finance its purchase, £95 and £5.

⁴¹ See Lewis 2010.

Bank buys both tranches so the SPV is cash neutral – it is merely a vehicle that exists to enable the splitting of the cashflows and consequent division of liabilities. This is the kernel of securitisation activity; maximising the benefit available from the rating agencies' arbitrary criteria for issuance of its revered AAA rating category.

If this can be achieved, then water becomes wine. Ordinary assets such as the Ruritania loan, or throughout the 2000s several billion dollars worth of sub-prime US mortgage loans, will, subject to the subordination of relatively modest percentages of the contracted cashflows, be easily sold to an investor fraternity that appears to have happily abdicated its credit analysis scrutiny function to these agencies.

Pricing and structuring notes:

The bank owns the junior 5% note, representing the first to default 5% piece of the loan. In our example the interest rate on the two tranches is similar:

The Senior AAA Note pays bondholders a coupon of 6%, equal to 7% minus the 1% premium to GIA on the CDS

The coupon similarity of the senior and junior tranches is justified by an option or warrant over the future upside of Matilda's business that has been granted to the bank.

If Matilda pays only £6.65 of the £7 interest owed at the end of the first year then all of the cash goes to make the coupon payment on the senior note.

The junior noteholder, the Bank, is owed $7\% \times £5 = 35$ pence but would receive nothing in such scenario because payments on this tranche are subordinated to the senior note.

All the profits created by marking-to-market have been banked and spent.

The AAA note has been pledged to raise further funding. The holding of the junior note was already deducted from the Bank's Tier 1 capital, so from a regulatory capital perspective this default does not strain Basel compliance.

The bank would nevertheless suffer two problems arising from Matilda's 35 pence default:

- A.** Bank will lack the cash needed to make the interest payments to the two depositors – remember bank pays $2 \times \text{£}1$ per annum (slightly more to Alice – $\text{£}1.03\text{p}$)
- B.** On a write down of the asset there is a problem. An honest accountant would mark down the value of the junior note, say by half to $\text{£}2.50$, so stakeholders looking at interim accounts would see losses which, if the marked-to-market gain on loan sale were adjusted out, would show the bank verging on insolvency.

Consider the impact of IFRS accounting. Let us consider a scenario in which things were not going well for Matilda. Her building business never gets off the ground. Nothing is constructed and it is obvious to all citizens of Ruritania that she is going to have a problem paying her loan interest at the end of the first year.

Under IFRS, IAS 39 positively prohibits the Bank from recognising any diminution in the value of either of its notes before a "payment event" (IFRS language for "default") has occurred. Reasonable expectations of future loan losses must not be recorded as accounting provisions against these assets. In case there is any doubt, the text of the actual IAS 39 standard drives this point home with an example:

"AG90. As an example of applying AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that

year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died.

It would be appropriate for an impairment loss to be recognised for these “incurred but not reported” losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not occurred.”⁴²

The EU has thereby mandated false accounting in precisely the circumstances now posited. Stakeholders in Mallory’s bank, should they inspect the accounts on any of the quarterly reporting dates prior to the first anniversary of the loan, will be presented with figures showing two perfectly performing bond assets, even though everyone in Ruritania knows that the interest payment will not be made.

Synthetic Securitisation – No cash transaction takes place

The creation of the SPV is therefore an essential intermediary step. The senior bondholders’ concerns are always assuaged by the rating, which in turn depends upon the priority ranking of the claims of AAA bondholders over the claims of the junior noteholder in any liquidation/ insolvency of SPV. Senior (AAA) bondholders will be paid out in full before junior bondholders get a penny.

Cashflows on Day 1. The cash passes from the bank to SPV and back to bank instantaneously. Circular trades of this nature are common.

Now let us consider the accounting. Under IFRS and Basel rules the senior note for which the bank paid the SPV £95 is now worth £205. It is a claim

⁴² EU Endorsed IAS 39, para AG90.

on 95% of the £275 less frictional costs and the CDS premium. All flows are discounted at the present very low market interest rate.

Therefore, via a simple subordination of 5% of principal combined with a credit default swap purchased from AAA rated GIA on the senior piece at the market price of 1% per annum we have created what is called a “synthetic” securitisation, because, when the circular flow is resolved, no money changed hands.

No investor bought anything. The sole purpose of this structuring was to enable the banker to record the instant profit of £105.

GIA have been inveigled into the transaction by soft rating agency default estimates. Their compensation compares favourably with premia they secured on US sub-prime mortgages.

What about the Basel rules? They exist ostensibly to protect bank depositors and other stakeholders. They bite here by requiring the bank to write off the junior piece against its equity because the junior piece is unrated.

Unfortunately for the customers, the rules are muzzled by the structuring. The AAA rating on 95% of the loan is achieved thanks to GIA’s high rating and other rating rules.

If the ratings agencies’ assessment techniques and models had logical credence, neither AIG nor any of the US monoline insurers, MBIA, FSA, FGIC and so forth would ever have engaged in this sort of activity. For several years these entities competed for business against the structuring technique of cashflow subordination by offering to ‘wrap’ or insure the senior bonds in precisely the way now demonstrated. Assuming the theory of no arbitrage, the cost that the rating agencies should have applied to GIA’s own rating if they had insisted on wrapping the cashflows in this example as indicated should have been so great that GIA would have declined the invitation so to wrap. The same applied throughout the creation of the sub-prime bubble, primarily with AIG.

The Basel rules require the junior note to be deducted from the bank's Tier 1 core capital. The structuring process therefore seeks to minimise the size of the junior note. In the example it is only £5. Therefore only £5 of the £105 instant profit is diverted from profits and used to replenish Tier 1 equity.

This still leaves £100 pure profit for the bank.

The bank has in this way taken nearly all the cash out of Ruritania's banking system as profit.

Cashflows, Coupons and Tranching	
Loan Interest Rate (Matilda)	7
Tranching:	
Senior tranche	95
Junior Bond	5
GIA Premium (Senior Only)	0.95
Cash Available for Coupon (Senior)	5.7
Total Senior SPV outflows	6.65
Senior Coupon expressed as pct	6%
Junior SPV outflows (plus unspecified warrants to justify closeness of coupon to senior yield)	0.35
25 year swap rate	0.4%
AAA bond – margin	0.4%
PV by discounting flows at	0.8%
Mark-To-Market Value	£206.53
After fees of 1.5%	£205.03
Projected Note Cashflows:	
Senior Bond projected coupons	142.5
Senior Principal	95
	237.5
Junior Bond projected coupons	8.8
Junior Principal	5
	13.8

	Senior AAA Bond	Junior Bond	Premium GIA	
Issue Amount:	£95.00	£5.00		
PV before fees	£206.53		£21.58	
1	5.7	0.35	0.95	
2	5.7	0.35	0.95	
3	5.7	0.35	0.95	
4	5.7	0.35	0.95	
5	5.7	0.35	0.95	
6	5.7	0.35	0.95	
7	5.7	0.35	0.95	
8	5.7	0.35	0.95	
9	5.7	0.35	0.95	
10	5.7	0.35	0.95	
11	5.7	0.35	0.95	
12	5.7	0.35	0.95	
13	5.7	0.35	0.95	
14	5.7	0.35	0.95	
15	5.7	0.35	0.95	
16	5.7	0.35	0.95	
17	5.7	0.35	0.95	
18	5.7	0.35	0.95	
19	5.7	0.35	0.95	
20	5.7	0.35	0.95	
21	5.7	0.35	0.95	
22	5.7	0.35	0.95	
23	5.7	0.35	0.95	
24	5.7	0.35	0.95	
25	100.7	5.35	0.95	
Total Cashflows	237.5	13.75	23.75	275

Appendix 2 – The Baker bill. Comparison of IFRS accounts with UK common law and Companies Act accounts

Let us consider the salient provisions of the draft Bill together with an explanation of each clause:⁴³

1. Parallel accounts – prudent accounts of true capital and true profits

1. Where a financial services company has chosen to prepare IAS accounts for its individual annual accounts under Section 397 Companies Act 2006 that company shall also prepare Companies Act individual annual accounts according to the regulations from the Secretary of State prescribed under Section 396 Companies Act 2006 and these accounts shall be known as the “prudent accounts of true capital and true profits”.

43 This is the version that Cobden Partners submitted to the Bills office, who made various technical changes. The 2nd Reading ‘final’ version can be found at http://www.publications.parliament.uk/pa/bills/cbill/2010-2012/0162/cbill_2010-20120162_en_2.htm#l1g1.

(Consequential amendment: Companies Act 2006 Section 397, insert new sub-clause 397(b) “and where the company is any financial services company regulated under the Financial Services and Markets Act 2000 as amended the directors shall also prepare additional individual accounts according to Section 396 and these additional individual accounts shall be known as “the prudent accounts of true capital and true profits” and these accounts shall be the relevant accounts for the purposes of Part 16 and Part 23 of the Companies Act 2006.)”

Explanation: Where companies have chosen to prepare IAS (IFRS) accounts this clause requires companies to prepare parallel accounts on a pre-IAS basis, i.e. UK Companies Act accounts. Very few companies have chosen to switch to IFRS precisely due to the problems with profits, distributions and capital maintenance. The few that have include banks. The regulations from the Secretary of State (SI 2008 409 and 410) specifically require bank loans and other financial instruments to be stated prudently and at net realisable value after deducting provisions for contingent liabilities and other losses. IFRS does not.

- 2.** The prudent accounts of true capital and profit specified in Section 1(1) of this Act shall be the relevant accounts for the purposes of distributions and capital maintenance for Part 16 and Part 23 of the Companies Act 2006 replacing IAS accounts.

(Consequential amendments: Companies Act 2006, insert Section 836(1)(b)(iii), “or where the relevant accounts are prudent accounts of true capital and profits under Section 397(b), provisions of a kind according to the regulations from the Secretary of State prescribed under Section 396. Companies Act 2006, insert Section 712(2)(b)(iii), “or where the relevant accounts are prudent accounts of true capital and profits under Section 397(b), provisions of a kind according to the regulations from the Secretary of State prescribed under Section 396.)”

Explanation: Where companies have chosen to prepare IAS accounts this clause ensures that only the parallel accounts are used for capital maintenance and

profit distribution purposes. Section 1 is outside of the scope of EU legislation. The IAS Regulation is only compulsory for the consolidated accounts of listed companies

2. The right to return to preparing Companies Act individual accounts where the option to produce IAS individual accounts was previously exercised.

A company that has previously decided to prepare IAS individual accounts may change back to preparing Companies Act individual accounts under Section 396 for so long as individual accounts prepared in accordance with the EU IAS Regulation fail to comply with the Companies Act and common law.

(Consequential amendment Companies Act 2006 Section 395, insert Section 5(d), “accounts prepared in accordance with Article 4 of the IAS Regulation would not comply with Section 831, 832, 853(4), Part 16 and Part 23 of this Act”)

Explanation: There are currently only limited circumstances in which a company that opted to use IAS accounts can switch back to Companies Act accounts, these are listed in Section 395. This clause enables companies to switch back to Companies Act accounts due to the clashes between existing EU-IFRS and the Companies Act and common law. This has the deregulatory impact of not then requiring two sets of accounts.

3. Cessation of effect in the event that the EU-IAS Regulation produces accounts that comply with the Companies Act and common law.

This bill shall cease to have effect in the event that the EU-IAS Regulation 2002 produces accounts that in the opinion of the Secretary of State comply

with and are consistent with: the Regulations from the Secretary of State, Sections 831, 832, 853(4) and Part 16 and Part 23 of Companies Act 2006, in particular the requirement for amounts stated in accounts to be prudent, to include no unrealised profits, to make provisions for likely contingent liabilities and for loans and other financial instruments to be stated at the lower of cost and net realisable value.

Explanation: Company Law accounts have followed the basic principles of common law “ascending authority” as set out in Section 853(4) (a common law clause). The EU, a descending authority, has approved IFRS standards that do not match with the common law, or existing EU Accounting Directives that were derived from common law consistent UK Companies Act accounting requirements (the 2nd Capital Maintenance and 4th Accounting Directives).

The Regulations from the Secretary of State both follow common law (i.e. the Regulations are prudent and realistic), and allow any derogation to comply with common law “apply or explain”. If the EU reasserts (as it did in 1978 and 1982) the principles of common law as the basis for EU accounting, then the need for this Bill is redundant.

4. Definition of certain financial institutions

For the purpose of Section 1 of this Act a financial services company is any company regulated under the Financial Services and Markets Act 2000 as amended.

Appendix 3 – Example of a dysfunctional UK bank – RBS

The 2007 accounts of RBS claimed shareholder capital and reserves to be £27bn.

Base case expected losses according to the UK's state insurer of failed bank assets, the Asset Protection Scheme (APS), have been inconsistent with RBS' own accounts. The APS' accounts published by HM Treasury showed, as at March 31 2010, expected losses to be taken by RBS of £57bn and £51bn. The methodology of the APS is to treat the insurance as a derivative and use a fair value "expected loss" model. This approach is an assessment of net realisable value and is consistent with UK common law.

To recap, after RBS failed capital was raised as follows:

2008, public offer	£12.0bn
2008, HMG	£19.7bn
2009, HMG B shares	£25.1bn
Total	£56.8bn

Thanks to the publication by the UK Government of the accounts of its bank bailout insurer, we can conclude that IFRS has been employed to justify overstating its 2010 profits and capital by between £19 and £25bn.

A core component of the UK's bailout mechanism was the establishment of the APS. In return for an annual premium to be paid to the Treasury, RBS receives insurance against losses on their books of loans and other assets. The UK felt compelled to provide APS insurance in order to ensure compliance by the failed banks with EU rules requiring national governments only to allow a bank to operate if the bank's creditors were demonstrably protected.

In the case of RBS, the essential terms of the arrangement are as follows. RBS pays APS £700m each year until 2011 and £500m thereafter. The APS insurance bites after the first £60bn of losses have been absorbed entirely by RBS. 90% of losses above £60bn are insured by the taxpayer, with a 10% vertical slice retained by RBS to address moral hazard, the risk of the bank having no motivation to prevent losses once the insurance has been triggered.

In its 2010 accounts RBS values the losses it expects to incur on its insured portfolio as £32bn, well within the £60bn insurance deductible. However, the UK Treasury, in its 2010 APS accounts values the very same expected losses at £51 – £57 bn. Why do the two sets of audited accounts differ by £19bn – £25 bn?

The UK Treasury uses prudent expected loss accounting. RBS has exercised its right under UK Company Law to opt out of preparing Company Law accounts ("UK GAAP") in favour of IFRS, the EU's favoured accounting rules. Under IFRS, a bank may only write down a loan if an "incurred loss" model is observed. This is a less conservative accounting standard than UK Company Law, which necessitates looking forwards. Under IFRS only if an 'event', such as a payment default, can be seen in the rear view mirror may a bank record any loan value impairment.

The result of IFRS accounting is starkly shown in these two sets of accounts and the result is that RBS' Basel 2 core capital figure is at least £19bn greater than its true capital. The IFRS approach in this way creates an illusion of capital.

If this aspect of IFRS 'fair value' accounting has raised an eyebrow, the treatment of the ongoing value of the policy by RBS will curl a toe or two.

In the same 2010 accounts, RBS 'fair values' the benefit of the policy, otherwise expressed as the value of its right to claim on the APS for 90% of any losses incurred above £60bn, at £700m. This figure is shown as an asset, despite the fact that it can only be realised if losses are so high that they will have destroyed the bank's stated capital base by a further £28bn.

It is absurd that IFRS accounting rules permit a bank to declare profits based on these two spurious accounting entries. Firstly it has inflated its assets by at least £19bn, and secondly it has augmented this value of its assets (in its present, ostensibly healthy, condition) by the addition of a policy benefit that can only be enjoyed if it fails.

This accounting treatment may be rule compliant but is clearly wrong. Imagine that two schoolboys board a train. One has £10 in his wallet and is concerned about losing it. The other has £5 and feels the train to be safe from robbers. In exchange for a sweetie the second schoolboy offers to hand over his £5 if the first schoolboy loses his £10. Under RBS' interpretation of IFRS accounts the first schoolboy would record his assets as £14.

May 31st 2011

Messrs:

Andrew Friel – Head of EU Public Affairs

Richard O'Connor – Head of Investor Relations

280 Bishopsgate, London EC2M 4RB

Richard Wild – Deputy Scheme Head, Asset Protection Scheme

135 Bishopsgate, London EC2M 3UR

Gentlemen,

Private Members Bill – Steve Baker MP and others.

Royal Bank of Scotland and International Accounting Standards (“IFRS”)

At the meeting on 24th May 2011, several important points were raised.

1. You queried the basis of the £25 billion included in the press release from Steve Baker MP for losses not included in the accounts of Royal Bank of Scotland. You agreed that RBS has taken £32 billion in losses in its audited accounts as at 31 December 2010, but the audited Asset Protection Scheme (“APS”) Accounts show an expected loss of £57 billion on RBS’s APS covered assets.

The Asset Protection Scheme is therefore recognising £25 billion more in losses than RBS has taken in its accounts. That is 50% of what RBS claims to have as core Tier 1 capital. That means on a prudent basis RBS has a basic capital ratio (leverage on total assets) of 2.75% rather than 5.5% as stated due to that factor alone.

2. Mr O'Connor stated that EU law both prevents the Bill working, and prohibits French banking companies from ceasing to use IFRS.

I refer you to Note 1 of the 2010 Soc Gen accounts, parent (holding) company balance sheet.

Those accounts state that Soc Gen uses French GAAP as applicable to banking companies for the holding company accounts and French

subsidiaries. It also states that for non-French subsidiaries the accounts in local GAAP are translated back to French GAAP as applicable to banking companies.

France is able to do this because the EU IAS Regulation is only compulsory for the group (consolidated) accounts.

RBS therefore chose to use a less prudent accounting framework than either that which the French are using, or that provided by the UK Companies Act. IFRS was only an option for companies in the UK. Taking that option meant that RBS group chose to use IFRS for its banking companies.

Steve Baker's Private Members' Bill requires parallel accounts. Such accounts would show RBS's true financial position on the basis of Companies Act accounts. Company Law forbids recognising unrealised profits.

The Bill also allows companies to switch back from using IFRS so as not to have to prepare two sets of company accounts. That would put the United Kingdom in the same position as France whose banks do not use International Accounting Standards.

3. Mr Bush stated that around the year 2000 the normal level of bank provisioning was about 2%, and you disputed that.

However, the accounts of NatWest Bank Group, then the largest part of RBS, show for 2001 bad and doubtful debt provisions of 2.1%. The figure was 1.9% in 2002 and 1.9% in 2003. But by 2006, under IFRS, this had fallen to 1.1%, despite, as we know, risk going up.

4. You also stated that there was minimal impact on transition to IFRS because UK GAAP (Companies Act Accounts) and IFRS were similar.

Mr Bush and I stated that the objective of Companies Act accounts is that loans should be carried at the lower of cost and net realisable value, inclusive of general provisions.

We have obtained the RBS transition statement.

<http://www.investors.rbs.com/download/slides/TradingUpdateJune2005.pdf>

That states:

“Under UK GAAP provisions for bad and doubtful debts are made so as to record impaired loans at their ultimate net realisable value. Specific provisions are established against individual advances or portfolios of smaller balance homogeneous advances and the general provision covers advances impaired at the balance sheet date but which have not been identified as such. Interest receivable from loans and advances is credited to the income statement as it accrues unless there is significant doubt that it can be collected.”

“IFRS require impairment losses on financial assets carried at amortised cost to be measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows discounted at the asset’s original effective interest rate. There is no concept of specific and general provision – under IFRS impairment is assessed individually for individually significant assets but can be assessed collectively for other assets. Once an impairment loss has been recognised on a financial asset or group of financial assets, interest income is recognised on the carrying amount using the rate of interest at which estimated future cash flows were discounted in measuring impairment”

It is clear that IFRS is less prudent in this regard than UK Company Law and the interpretation of that which RBS applied before, which interpretation seems to be perhaps less prudent than what the Companies Act actually specifies. Company Law states that loans must be carried at the lower of cost and net realisable value. That means that loans will not be stated at more than their recoverable amount.

IFRS not only excludes general provisions, but for collective assessment it is qualified with the term “can be assessed”. That is optional, and clearly for a bank with an aggressive growth strategy, as the accounts of the APS reveal RBS had, that creates the incentive and the ability to grow the loan book without provisioning for risk. Loans are thus significantly above their ultimate realisable value. If you note from the accounts of Soc Gen, French GAAP as applied to banks creates specific provisions and general provisions

for “depreciation” – based on historical experience for the risk of the lending – and it calls the result “charges for the cost of risk”.

Under IFRS, RBS clearly was not charging its profit or capital for risk. It is therefore reasonable to assume that had RBS been subject to the same financial accounting and auditing constraints as French banks, what is described in the accounts of the Asset Protection Scheme as “aggressive growth” would have been checked as the accounting would have reflected the inherent risk of the lending.

We welcome your comments or concurrence.

Yours Sincerely

Gordon Kerr

Cc: Steve Baker MP

David Davis MP

Tim Bush

References

Bush, T. (December 2011) *UK and Irish Banks Capital Losses – Post Mortem*.
Local Authority Pension Fund Forum

Dowd, K., (July 2011) *Capital Inadequacies, The Dismal Failure of the Basel Regime of Bank Capital Regulation* CATO Institute <http://www.cato.org/pubs/pas/pa681.pdf>

Dowd, K., and Hutchinson M. (2010) *Alchemists Of Loss*. Wiley

Dowd, K., Hutchinson, M., and Kerr, G.A. (November 2011) *The Coming Fiat Money Cataclysm* CATO Institute

Fergusson, A. (1975) *When Money Dies*. Publicaffairs

Friedman, J., and Posner A. (2011) *What Caused The Financial Crisis*. Penn

Huerta de Soto, J. (2006 edition) *Money, Bank Credit, and Economic Cycles*.
Ludwig von Mises Institute

Hughes, A.D.B. (2011) “*Risk Management Revisited*” pp 85 – 94 of *Asset Management Tools and Strategies*, , Bloomsbury

Johnson, S., and Kwak, J. (2010) *13 Bankers*. Pantheon Books

Lewis, M. (2010) *The Big Short*. Penguin

Schlichter, D.S. (2011) *Paper Money Collapse*. Wiley

Siedentop, L. (2000) *Democracy In Europe*. Penguin

Smith, D. (2010) *The Age of Instability*. Profile Books

Twining, W. and Miers, D (1976) *How to Do Things With Rules*. Weidenfeld and Nicholson



23 Great Smith Street
London SW1P 3BL
www.adamsmith.org

