Institute for Research in Economic and Fiscal issues

IREF Working Paper Series

The Case for Systemic Banking Reform

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IREF Working Paper No. 201401

March 2014

Institute for Research in Economic and Fiscal issues

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Abstract

Six years after the collapse of western financial systems public confidence in our banks remains at low levels. This paper offers an explanation. The collapse of the system, triggered by the bursting of the US housing bubble, was attributable to a range of factors and it is reasonable to attach differing weights to each factor given the array of institutions and countries involved. But one factor to which insufficient weight has been attributed is banker integrity, in decline owing to a trend of diminishing personal accountability. A possible solution is presented.

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1. Introduction

Having bailed out large banks it was inevitable that governments became determined to present the bailouts as having 'worked'. This meant explicitly designating some banks as systemically too important to fail. The main American legislative response, the Dodd-Frank Act, coined the term "Systemically Important Financial Institution" (SIFI). This paper examines why the SIFI banks of the US and Britain do not enjoy growing public trust and confidence. As the flow of multi-billion fines increases from stream to torrent, many commentators believe things are getting worse. If this is the case, why have none of the efforts to restore honesty and trustworthiness to banking worked?

This paper explains that the true solvency of the banking systems of Britain and the US is worse than is generally believed, based on the development of rules and regulatory yardsticks that continue to generate flattering outcomes for banks. Banks are keen supporters and defenders of these rules, so enthusiastic in the defence of such rules that poor arguments have been advanced.

The story is firstly of subtle misdiagnosis of the original problem, leading to bailouts without the required radical reform of rules and incentives. Absent such reform, the moral hazards leading to systemic collapse have been enhanced rather than addressed.

Section 2 sets out the background to the present policies that are highly supportive of banks. It assesses the literature around Basel regulatory capital rules which are increasingly regarded as a contributory factor to the crisis by providing overly optimistic impressions of solvency.

Section 3 looks at the evolution of accounting standards which has resulted in marking to market, marking to model and concerns about weaknesses in the European IFRS rules and the way they are interpreted by banks and their auditors. An example is presented showing that the IFRS rules appear to have been interpreted by a British bank, RBS, so as to understate its expected losses by about £23 billion in 2011. This and other aspects of IFRS have been the subject of substantial research by a team based at Oxford University. The team has specialised in Asian countries, some of whom are now reconsidering the wisdom of adopting asset/ liability accounting. Both the UK Parliament and the European Commission's attention has been drawn to similar concerns by investor groups, giving some grounds for optimism that these flaws in accounting rules may be addressed.

Section 4 contains a case study showing how recent post crisis "tweaks and nudges" in the Basel regulatory capital and IFRS accounting rules, together with easier central bank provided liquidity, have encouraged exaggeration of profits and capital, and facilitated the hiding of losses.

Section 5 looks at post crisis banking culture. The JP Morgan Chase "Whale" trades are a story of gambling on a large scale in the pursuit of short term profits.

The resulting losses, and how they were hidden and misreported, is now the subject of a detailed Congressional Report which sets out strong evidence of, and draws alarming conclusions as to, the integrity of banking executives at all levels in the firm even after they decided to notify regulators, investors and the media of the problem.

Section 6 summarises the categories of misconduct that have most recently led to conduct fines imposed upon and agreed to by many banks. A recent compilation showed that the most heavily fined ten banks have incurred costs (actual and provisioned) at end 2012 of $235 billion[2]. Nine of these banks are either British or American, the exception being UBS. This figure both reflects the consequences of, and maintains moral hazard; penalties are suffered by banks, not individuals. A by-product is cartelization. Rather than promote or restore healthy competition, the bailouts, and government proclamations of their success appear also to have encouraged cartels.

Two of the misconduct examples are analysed in each of the next sections; Section 7 looks at LIBOR fixing. Section 8 looks at retail banking and summarises risks to customers who complain about electronic banking problems such as ATM fraud. Section 9 looks into a UK specific example of misconduct that was admitted by the industry in August 2013 – Card Protection insurance plans (CPP). CPP is highlighted because it shows that multiple banks deliberately colluded in designing and implementing a customer product that should not have been marketed.

The paper invites taxpayers, customers and stakeholders of banks to remain optimistic. The solution is not more complex regulations, but a simple reform of incentives. Accountability can be restored. A solution is presented in Section 10. This is a February 2012 draft piece of legislation which was submitted to the UK Parliament and drafted by the author and Professor Kevin Dowd.[3] The UK Government did not adopt the legislation, but the framework is on the record and available at any time. The Bill's stated purpose is to minimise the moral hazard by ensuring that those who take risks are held personally liable for the consequences. Its provisions would restore personal accountability by enforcing strict personal liability on directors of financial institutions. Regulatory developments over the last 30 years have focussed on individual conduct, but enforcement has shifted away from individuals and targeted banks themselves. However, banks are inanimate, and the Bill would hold accountable the individuals whose decisions are at fault. The detail of this proposal is unimportant; it is merely set out to deflect potential criticism that the detail had not been considered. Any material increase in management liability would probably achieve the desired result. The universal clamour for banks to clean up their acts would quickly be discharged were governments to implement such legislation.

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2 London School of Economics *Conduct Costs* http://blogs.lse.ac.uk/conductcosts/bank-conduct-costs-results/

3 The Bill was presented to Parliament by Steve Baker MP.

2 – Crisis Causation; Subtle Misdiagnosis and the Role of Basel Rules

There is near universal consensus that the trigger for the GFC[4] was the build up and deflation of a US housing bubble. Peter Wallison, in a recent speech, traced the roots to 1992 US legislation establishing great subsidies for the two government sponsored mortgage refinancing entities (GSE's - Freddie Mac and Fannie Mae), who were able to drive out all competition from the secondary market for middle class mortgages – about 70% of the $11 trillion US mortgage market.[5] The two GSEs' mortgage underwriting standards underpinned the entire mortgage market. However, political pressure to broaden home ownership compelled the GSEs to lower their underwriting standards from 1995 onwards. Having required minimum down payments of 10 percent in 1991, by 1995 the GSEs were accepting mortgages with only 3 per cent down payments, and by 2000, zero down payments were permitted, an admission that these lenders were relying on the continued growth of the bubble.

By 2008, some 56% of all mortgages in the US were sub-prime, and 76% of these were either on the books of the GSEs or other government agencies. As the bubble deflated in 2007 Bear Stearns was the first institution to fail, but another immediate effect was the collapse in the market for all mortgage-backed securities (MBS). Acharya and Richardson[6] explain that by April 2008 US banks held 20 per cent of GSE MBS securities, together with 23% of the non-agency MBS issuance (also termed "Private Label", or "PLMBS"). In a short timeframe confidence among banks in each other's solvency evaporated and the US authorities quickly implemented their $700 billion bailout programme.

These facts are beyond dispute. However what is less clear is the specific bearing which government policies, bank regulations and other incentives had upon the behaviour of banks in building up these disastrous investment positions.

Wallison puts the emphasis on government policy rather than Basel[7]:

Thus, the crisis was not caused by insufficient regulation, let alone by an inherently unstable financial system. It was caused by government housing policies that forced the dominant factors in the trillion dollar housing market—Fannie Mae and Freddie Mac—to reduce their underwriting standards. These lax standards then spread to the wider market, creating an enormous bubble and a financial system in which well more than half of all mortgages were subprime or otherwise weak.

Other commentators put more emphasis on regulatory failings. A senior US regulator, Sheila Bair:

4 Global Financial Crisis
5 Wallison, p3
6 Friedman, Ch 7
7 Wallison p6

"Regulators either did not have sufficient information to understand how concentrated risk was becoming, or if regulators had access to the information, they were unable to understand and identify the risks".[8]

The most relevant regulations are the Basel Accords, specifically the first regime known as Basel 1 that was implemented in the US in 1991. Each variation of the Basel rules has attempted to classify bank assets into differing classes of riskiness. The thinking is that a universal common ratio of capital, originally 8% should be sufficient when applied to the total volume of each bank's assets, adjusted for riskiness.

Dowd, Hutchinson, Ashby and Hinchcliffe provide a comprehensive summary of the weaknesses of the Basel Regime.[9]

"The Basel system suffers from three fundamental weaknesses: first, financial risk modelling provides the flimsiest basis for any system of regulatory capital requirements. The second weakness consists of the incentives it creates for regulatory arbitrage. The third weakness is regulatory capture."

Dowd et al then proceed to note how, as the minimum capital standards were developed over the decades with a main stated purpose of strengthening the safety and soundness of the financial system as a whole, quite the reverse happened, and when it did happen, it took all regulators by surprise.

In a separate book, Dowd and Hutchinson explain the irretrievable flaws in the "Value at Risk" methodology that remains in widespread use as the basis of risk-management and capital adequacy evaluation.[10]

Basel 1 was implemented in 1992, Basel 2 in 2007, and Basel 3 is scheduled for 2019. A 1996 revision was also important. This revision allowed banks for the first time to be assessed for capital adequacy on the basis of their own market risk models. In the case of traditional derivative exposures, the Value at Risk (VaR) models that had become industry standard were grossly underestimating market risk. The assumption that market outcomes could be predicted in the future based on past outcomes underlay these models. Going further and assuming that outcomes would conform to Gaussian distributions was and remains incorrect[11]. However, it was the banks themselves that persuaded policymakers and regulators that Gaussian VaR models were accurate to an acceptable standard.

Dowd and Hutchinson put into perspective the flaws in Gaussian modelling of VaR; specifically that the 'tails' in these normally distributed models slope off rapidly[12]. In practice, bank risk controllers and regulators basically ignore risks that fall beyond the 99th probability percentile. Probabilities of event

8 Bair p 28
9 Dowd, Hutchinson, Ashby and Hinchcliffe
10 Dowd and Hutchinson
11 Dowd and Hutchinson, pp 87-96
12 ibid

occurrences are measured in terms of the number of standard deviations, or "sigma" from the mean. The 99th percentile typically occurs at about 3 sigma. The probability of a 5-sigma event occurring on any day is so rare that it could be expected to occur only once in every 14,000 years. Sigma progression is exponential, and the waiting period for a ten-sigma event exceeds the age of the known universe. And yet a Finance Director of Goldman Sachs, in attempting to explain managed fund losses, stated in 2007:

"We were seeing things that were 25-standard deviation moves, several days in a row."[13]

Bankers are very good at mathematics and have been well aware of the intellectual bankruptcy of Gaussian VaR modelling for decades. The lack of challenges by policymakers and regulators perhaps goes to regulatory capture, or policyholder motivation, or possibly the sheer power of bank lobbying to keep this critical mainstay of trading and gambling in place. However, as will be noted in Section 5, the recent JP Morgan Chase Congressional investigation has raised questions about VaR modelling.

Towards the end of 2013 it is hard to find commentators with much confidence in the Basel regulatory regime. In 2013 The Bank of England received UK government permission to change regulatory emphasis onto a 'leverage ratio' an assessment basis that looks at the volume of assets unadjusted for risk weightings. This was a vote of no confidence in the Basel regulatory capital rules. The UK initiative prevailed globally and in January 2014 the Basel regime adopted a Leverage Ratio measure.[14]

Friedman would approve. He attributes heavy weight for the GFC to the old Basel rules. He notes[15] that the regulatory capital required to back a GSE mortgage was 60% less than that for ordinary PLMBS investments, and concludes that Basel 1 *"may help to explain the size of the housing bubble, prime, non-prime and sub-prime"*.

However Friedman only arrives at this conclusion having substantially exculpated "greedy bankers". He concludes that profit based compensation was not a dominant cause of bank failures. Noting there have been only three studies of the corporate compensation explanation, each reaching differing conclusions, he rests his case on essentially three arguments[16]:

i) If bankers were insensitized to risks because they would not suffer in the event of losses, they would have leveraged to the maximum permitted levels. However, in the year before the GFC the average Basel 1 capital ratio of the 20 largest US banks was 11.7%, meaning materially less leverage than the maximum permitted by the then prevailing 10% minimum ratio;

13 Reported in the Financial Times, August 13, 2007.
14 https://www.bis.org/publ/bcbs251.pdf
15 Friedman, p26
16 ibid at p 36

ii) Many top bankers, such as the CEOs of Bear Stearns and Lehman Brothers, remained substantially personally invested in stocks of their firms until very close to the point of failure;

iii) Given that the yields on all MBS were always higher on AA tranches than AAA ones, if executives were driven by greed they would have purchased substantial amounts of risk in AA form. Citing a Lehman Brothers study, Friedman concludes that almost all of commercial banks' holdings of PLMBS were AAA rated.

From personal experience of dealing with financial controllers and risk managers in banking, point i) can be set aside as weak. As will be illustrated (Section 5), the internal risk management systems of banks are rarely the slick and well-oiled information machines that banks outwardly like to portray. Little shocks and re-evaluations occur frequently and without explanation, and these are very large and disparate organisations. The primary concern of financial controllers is to keep above the minimum levels, so operating at 1.7% above this minimum is simply a working comfort margin.

Similarly, the losses suffered by individuals running firms cannot bear heavily on the argument. Many individuals are reluctant to realise investments below their 'high water' marks. Moreover, given the potential public impact on market confidence of CEO sales of stock trades in fragile markets, it is understandable that some individuals might remain invested even when confidence in the wisdom of such decisions might be low.

The third argument is plainly mistaken. By 2007 a headwind had developed behind the credit default swap (CDS) market in mortgage instruments. It is far easier to generate profitable trades from underlying AAA assets than from the lower rated tranches[17]. AAA bonds could more easily be offered to derivative and repo counterparties as collateral. The Basel 2 rules had by 2007 been announced with implementation dates in 2008, and were known to replace the system of specific risk weight categories that had previously applied with adjustments to weights based on internal or external ratings. Under the new rules AAA assets would obviously consume less capital than AA ones.

However most policymakers and regulators have embraced Friedman's conclusions. They prefer the bubble explanation, even if caused by other policymakers, to the notion that bankers, as a class, were becoming less honourable and willing to expose all classes of stakeholders to losses for the upside of substantial personal compensation. On the contrary, bankers maintain that little if anything needs to be changed. Admati and Hellwig:

"They may admit that mistakes were made, but they portray the crisis primarily as a fluke, an accident that is highly unlikely to recur in our lifetimes"[18]

17 Kerr, p60

18 Admati and Hellwig p3, citing US Federal Reserve Chair Alan Greenspan referring to the crisis as a once in a century event

Having analysed a range of specious arguments deployed by bankers to justify changing as little as possible within the rule frameworks, the authors consider bankers' arguments about leverage and capital ratios. Perhaps the most commonly accepted false argument for no change is the:

"claim that higher equity requirements "would restrict banks' ability to provide loans to the rest of the economy" and that "this reduces growth and has negative effects for all"[19]

This argument has been promoted strongly by bank lobbyists such as the Institute for International Finance, arguing that the planned Basel III capital rules *"would substantially raise interest rates ….and lower real growth rates for a number of years"*[20].

Part of the technique is to confuse capital with reserves. Banks often maintain that they are one and the same when in reality they are on different sides of the balance sheet. Banks talk about "holding capital" as if it were a reserve they would rather not hold. Holding too much capital is then presented as an impediment on their ability to make loans and fuel the recovery. This is false. Banks hold assets that are funded by a combination of capital and debt. Shareholders, not banks, hold capital in banks. The greater a bank's capital, the easier it is to borrow funds. Admati and Hellwig's research concludes that higher capital requirements impose no costs at all on wider society.[21]

Why do banks make such incorrect objections to proposed higher capital/ lower leverage rules? It is difficult to escape the conclusion that the simple explanation is perhaps that the present arrangements suit them. Further, these statements are consistent with the primary importance of maintaining the fiction that the GFC was an unavoidable once in a lifetime fluke.

This misdiagnosis lies at the core of the continuing failure to fix the system.

3 – Accounting

Just as with bank regulatory capital rules, the trend in accounting has been one of steady globalisation. In the UK and most of Europe, IFRS[22] accounting standards prevail. In the US, a national accounting standard system called FASB[23] applies.

Bryer has criticised the US FASB rules, attributing the underlying failure of Enron in 2001 to the "asset-liability conceptual framework" rather than management fraud.[24]

19 ibid at p 97,
20 ibid
21 ibid p98
22 International Financial Reporting Standards
23 Financial Accounting Standards Board
24 Bryer

The promoter and originator of IFRS standards is a private entity, the International Accounting Standards Board. The IASB receives its funding from banks, accounting firms, governments and the European Parliament[25]. Its rules are passed into European law after endorsement by the European Financial Reporting Advisory Group, the sole advisor to the European Commission.

Just as bank regulation has become globalised, the appeal of transnational accounting standards is obvious. The IASB maintains that globalised standards are required by international investors. Accounts should be "useful for users"; the standards should prevent profit-smoothing and promote transparency, efficiency and comparability. To many stakeholders, global convergence appears as a "technical, logical, rational, natural course of action."[26] The accounting profession is strongly supportive of IFRS standards, as are presumably the majority of institutional investors. However, concerns have been published by certain, mainly UK based, investors and investor representative bodies, that IFRS standards:

a) are inconsistent with UK law;

b) are inconsistent with EU law;

c) have reduced the scope and rigour of audit, replacing management's judgment with process driven detailed standards.

Addressing point c first, in 2005, Iain Richards, in a paper for Morley Fund Management' argued against importing what he termed "US derived" accounting standards[27]:

"*In essence the US has a very different system based around securities Law, market pricing and regulation, while the UK has a system based around incorporation law, stewardship and governance. What may be appropriate in the US, given their reliance on the Securities Act 1933, is clearly not appropriate in the UK under the Companies Act and may be equally inappropriate in the EU….*"

"We believe that the reduction in the room for professional judgement due to increasingly complex and detailed standards endangers the quality of audits"

Many critics see a link between the adoption of the standards in 2005 and the collapse of certain banks. Professors Shyam Sunder of Yale University and Stella Fearnley of Bournemouth submitted critical testimony in September 2012 to a UK Parliamentary Commission on Banking:[28] A group of British investors and scrutineers wrote to the *Financial Times* in 2010:

25 See annual accounts of IASB for detailed funding breakdown
26 Suzuki, 2010, p7
27 Richards
28 Sunder and Fearnley

"In its commencement phase, the 'fair weather' model significantly overstated bank profits, resulting in excessive dividends...and capital destructive business models. In 'storm' mode it accelerated and exaggerated losses, resulting in taxpayer-funded recapitalisations"[29]

The IASB has been subjected to strong representations to Parliaments of the UK and the European Commission alleging that the rules enable banks to hide losses and exaggerate net assets, therefore perhaps creating the false impression of solvency.

In 2012 a group of mainly British investors complained to the European Commission that IFRS as then adopted by the European Union diverged from requirements of prudence in EU law. Specifically, the investors feared that EU legal protections concerning underreporting of losses and overstating of profits were being avoided by banks using IFRS. Consequently UK banks accounting under IFRS might be making unlawful distributions, out of capital rather than profits.

Case Study – RBS and Underreporting of Expected Losses

One accounting standard featuring heavily in the representations above is IAS 39. The words "losses expected as a result of future events, no matter how likely, are not recognized"[30] appear in the standard.

In May 2011 three senior executives of Royal Bank of Scotland met with Steven Baker MP and two advisers to explain why he had published a press release alleging that the bank had overstated its capital by £23 billion in its December 2010 accounts. The discrepancy was shown in the accounts of a new entity called the Asset Protection Scheme (APS) that had been established at the time of the 2009 government bailout, in order to oversee the winding down of the bank's "bad" assets. The APS reported directly to the UK Government and its accounts were presented to Parliament and regulators. These accounts valued the bad assets at £23 billion less than RBS' own accounts. It seemed in the meeting that RBS had not appreciated that the APS, valuing its exposure as an insurer of the bad assets, was using a different IFRS standard to IAS 39. The APS was marking the assets to market, which exposed the differential.

When this was explained, the three RBS executives quickly fell back on the excuses that their conduct was a) rule compliant and b) no worse than that of French banks.[31]

29 http://faculty.som.yale.edu/shyamsunder/Research/Speeches/UK-Accounts-Lack-Final-Publ-version27Jul2010.pdf
30 IAS 39 the quoted words come from para 59;
http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias39_en.pdf
31 further details about the RBS bailout and detailed minutes of the meeting appear at Kerr from p78

There is no evidence that the main scrutineers of RBS had spotted the overstatement. Neither HM Treasury, the APS, nor the Bank of England have written about this matter. However, this case may have played a role in undermining the Bank of England's confidence in reported accounting profits and capital under IFRS[32].

Shortly after the meeting RBS announced that it intended to accelerate disposal of the assets covered by the APS. In October 2012[33] RBS cancelled the APS insurance, stating that, because the volume of assets had been reduced from about £250bn at the time of the meeting to about £105bn, it was no longer good value for money. RBS had '*transformed*' its balance sheet "*from one that had become dangerously large and unstable into one that is more conservative, resilient, and sustainable"*.[34]

RBS' management expressed hopes that the bank be refloated on the public stock market within a year or so. However in June 2013 the UK Government stated that the bank was in far worse shape than it had previously thought, and a new ring fence for its bad assets was needed. There was a pause whilst consultants were employed to advise on the nature of this ring fence, and at the end of October 2013 it was announced that £38 bn of assets would be placed in an internal bad bank. Also, results for 2013 would be worse than previously indicated.[35]

The 2013 developments are consistent with confidence in the accuracy of the higher expected loss figure contained in the APS accounts (discussed at the May 2011 meeting). Furthermore, the rapid reduction in the APS assets had the effect of inhibiting the scrutiny afforded by the publication of APS accounts. Management in 2012 decided to cancel a state provided insurance policy covering 90% of future losses[36] at a moderate cost, well below market CDS[37] pricing, of less than 1% per annum.[38]

Fifteen months after the May 2011 RBS meeting, Baker and his advisers met with the IASB to discuss both the RBS case (now in the public domain) and the concerns about IFRS rules enabling the hiding of losses by all UK banks . Agreed minutes of the meeting (August 22 2012)[39], state that IFRS profit numbers should not be used as the sole basis for distributions to shareholders. Other factors, according to the IASB, such as overall liquidity and capital levels, should be used by management to constrain excessive distributions. However, the problem in RBS' case is that, since rescue, the bank has consistently made a loss

32 http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9025642/New-bank-accounting-rules-needed-to-avoid-another-crisis-says-BoEs-Haldane.html
33 http://www.investors.rbs.com/ir/rbs/ir.jsp?page=news-item&item=1183909882655691
34 ibid
35 http://www.investors.rbs.com/download/announcements/Full_Q3_IMS_2013_3_5_13.pdf
36 after a cumulative deductible of £60bn, but this figure now looks certain to have been exceeded had the insurance not been cancelled.
37 Credit default swap
38 see Kerr p79
39 http://cobdenpartners.co.uk/papers - see "Reports" column, first item

and paid no dividends, and therefore the incentives upon managers to underreport losses are not linked to this point about distributions.

Yet surely this is a similar point to the above wording quoted from IAS 39 regarding the loan impairment test? Presumably the IASB also believe that bank managers should not apply a narrow interpretation to the words *"losses expected as a result of future events, no matter how likely, are not recognized"* .

However, in the case of RBS, the general provision for bad and doubtful debts as shown in the accounts declined from 2.1% (2001) to 1.1% (2006)[40].

The Bank of England appear to share the concerns highlighted by this case study. In April 2013 minutes were released of a recent meeting at which the unrealistic levels of asset valuations, as well as the underreporting of expected losses, were both mentioned as matters for which accounts of banks should be adjusted[41]:

"drawing on work by the Financial Services Authority (FSA), ***it needed to assess the scale of adjustment*** *that it was appropriate to make to measures of banks' capital* ***to reflect a realistic assessment of asset valuations*** *and future conduct costs, as well as prudent risk weights."*

" The Prudential Regulation Authority (PRA) should assess current capital adequacy ***using the Basel III definition of equity capital*** *but after: (i) making deductions from currently-stated capital* ***to reflect an assessment of expected future losses*** *and a realistic assessment of future costs of conduct redress; and (ii) adjusting for a more prudent calculation of risk weights."*

The IASB might counter that a balance sheet struck today is a different concept from a regulator's concern to look to future events. Perhaps the nub of the debate is just this, the extent to which accounting standards should compel management to be forward looking.

Stakeholder Impact Case Study – IAS 41 and Palm Oil Plantations

Professor Tomo Suzuki's Oxford based team has conducted extensive research into the impact of IFRS standards on a wide group of stakeholders in the Indian sub-continent and in Asia. After twelve years of research Suzuki believes such an accounting method is damaging to stakeholders and that companies' performances and values are better understood in a framework of "locally tailored" accounting.[42]

In a separate paper on the specific standard IAS 41, he compares the accounts of three major businesses in Indonesia that grow and market palm oil. IAS 41's fair value rules record the bulk of the profit that is expected to be earned over a 25 or 30 year palm oil tree life, in the year the trees are planted. Only modest profits

40 Kerr p 82
41 Bank of England, at para 9 onwards
42 Suzuki (2010) p 31

will then be recorded over the actual revenue generating part of the life cycle.[43] Auditors of these companies are interviewed and admit that the fair value discounting process produces unrealistically large first year profits. Different auditors then attempt to reduce the year one profits by arbitrarily using either very high discount rates (as high as 19% per annum over 25 years), or by using a very long term historical average market price for spot crude palm oil sales ($502 per tonne in 2009)[44], which was only about half of the actual market spot price at the time of preparation of the various accounts cited.

Suzuki and his research team have presented their findings to several governments in their target region. The response of the Malaysian Minister of Plantation Industries and Commodities, Tan Sri Bernard Dompok, is quoted[45]:

"This is Enron Accounting for Agriculture…The only difference is that it was a scandal at that time; now it is mandatory".

Suzuki highlights growing concerns as to the business ethics of the main accounting firms in the selling of IFRS. The only reason many interviewees could come up with to explain the fervour behind the desire to implement the new rules was the extra fees to be derived from a change in accounting methodology.[46]

The Malaysian government has persuaded the IASB to review IAS41. This clearly makes sense, and the IASB is to be respected for acknowledging the problem. The same applies to IAS 39. A new standard, IFRS 9, has been proposed by the IASB to recognise that IAS 39 should be improved, and to address one widely broadcast shortcoming that IAS 39 allowed/ mandated banks to record profits when the fair value of their own debt declined. IASB chair Hans Hoogervorst acknowledged in December 2013 that the standard led to this "bizarre result"[47]. Yet these acceptances by the IASB of sub-optimality of what has prevailed before are also a cause for concern. Which other standards needs to be improved, either because of apparent defects (IAS 41) or because their ordinary and natural application is leading to counter intuitive accounting (IAS 39 and fair valuing of own debt)?

4. Case Study – IFRS combined with Credit Default Swaps facilitates concealment of losses and inflation of regulatory capital. European Parliament Presentation, May 2013.

The financial structure set out below was prepared in 2010 to show how a British bank could "derecognise" (hide) about £1bn of mark- to- market losses. A diagram appears at Appendix 1. The structure was also presented at a Brussels

43 Suzuki, 2012
44 ibid at p5
45 ibid at p1
46 Suzuki (2010) at p78
47 http://www.ifrs.org/Alerts/Conference/Documents/2013/Hans-Hoogervorst-ICAEW-speech-December-2013.pdf at p4

event on May 8th 2013. The event was hosted by two MEPs[48] considering whether IFRS require fundamental reform, and sponsored and organised by one of the large global associations of accountants, ACCA[49].

The assets specified in the structure were housing related loans which had fallen in price in 2010 because credit spreads had widened, hence the mark to market (MTM) loss problem.

By subordinating 25% of the assets, ownership of which could be retained by the bank, an AAA rating could be procured for the senior 75% tranche. This tranche could, because of the rating, be pledged to the central bank for funding at near zero interest cost, considerably below the bank's own funding cost. The mark to market (MTM) loss would disappear on execution because the portfolio would be sold not at the lower MTM price but at par. The assets would be sold to a trust, allowing legal and economic ownership to be split but effectively enabling the bank to remain in control of cashflows sufficient for the aims to be achieved.

There was no intention or need to remove any of the assets from the balance sheet of the bank, the accounting would show no net disposal since the economic risk would be retained by the bank. However, by selling the assets to a trust, a transaction would be booked recording the price as par for MTM purposes.

An extra feature in the structure involved regulatory capital arbitrage. The purpose of SPV2 would be to create (or "cease to consume") about £340 million of capital for Basel regulatory purposes.

The arbitrage would work as follows. An economically pointless SPV (SPV2) would be formed which would write CDS protection on the most risky, first to default 5% slice of the £10 bn loan portfolio. This would only work if SPV2 was highly rated, which would not be the case when the arrangements were first put in place. Therefore the pricing of the CDS was designed to extract all surplus portfolio earnings (interest payments on the loans minus the tiny funding cost of the central bank repos, minus the actual cost of the bank's funding of the 25% junior tranche). Surplus cashflow on the entire loan portfolio would be allocated to SPV2 until its obligations were fully cash collateralised such that it would qualify under the bank's internal rules for AAA risk classification and the full capital relief could be booked. For this to be achieved SPV2 could not be consolidated in the books of the bank, so sufficient expected profit would be scheduled to remain in the vehicle to persuade a third party hedge fund or collateral manager to take ownership of and management responsibility for it.

The only purpose in establishing SPV2 and entering into the CDS contract would be to exploit the most recent variant of the Basel rules. The structure is circular. No genuine third party insurance would exist. The cash collateral would be provided by funds that would otherwise just have flowed into the books of the lending bank itself. The regulatory capital position would be enhanced by £340

48 Syed Kamall of London and Theodor Stolojan from Romania,
49 Association of Certified Chartered Accountants, with over 500,000 professional members

million at the expense of a portion of the original loan interest margin and set up fees.

The author's presentation of this at the Brussels event was received in silence. The participants (mainly accountants) presumably appreciated that it demonstrated that the plethora of regulatory "tightening up" since the onset of the GFC has been peripheral only. Core and fundamental weaknesses created by Basel and accounting rules remain.

Leaving aside relatively sophisticated structuring, a more fundamental systemic threat remains posed by the basic, and wrong, accounting rules for CDS. These rules allow risk that is written by banks via CDS to be treated as sold when a matching and offsetting CDS is purchased from a market counterparty for an equal or longer maturity date. Because no purchase monies are exchanged, risk has not left a bank that purchases CDS protection, even under MTM collateralisation arrangements.

These accounting rules for derivatives were based upon the assumption that the default risk of the underlying reference assets and that of the protection providing counterparty are uncorrelated. However, experience of the notorious US sub-prime CDS trades revealed that the dominant provider of protection was AIG. This meant that when the underlying reference assets defaulted AIG was itself insolvent but for the TARP bailout. Put another way, there was a very high correlation value between the default risk of the assets and of the protection provider[50]. It is not possible to observe and regulate this correlation risk because of multiple intermediation. The accounting treatment should require the bank to record the two positions, not net them off as a sale of the first.

However, regulators continue to miss opportunities to address this. In June 2013 the Basel Committee published a consultation paper on a new bank supervisory yardstick called the "Leverage Ratio". The Committee's stated justification for the new Leverage Ratio framework acknowledged the shortcomings of the Basel regulatory capital rules identified in Section 2 above:

> *An underlying cause of the global financial crisis was the build- up of excessive on -and off – balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while apparently maintaining strong risk -based capital ratios.*[51]

The Leverage Ratio will require banks to report their liabilities - "Exposure Measure" and demonstrate that their shareholders own pure capital (termed "Tier 1" capital) at least equal to 3% thereof. During the six months between a June 2013 draft, and the final January 2014 version, various changes were made. Details relating to cash collateralisation were tweaked, and the quantum of risk for written CDS was restated as equivalent to that of ordinary loans. However, no attention was paid to the correlation point above, and the ability to delete

50 Kerr 2011 pages 12 - 16
51 http://www.bis.org/publ/bcbs270.pdf at page 1

written CDS risk from the exposure measure by purchasing an offsetting CDS from another market counterparty was affirmed[52].

5. Trading and Culture – JP Morgan Chase "Whale" Losses.

The previous sections have provided an overview of the regulatory frameworks governing modern banking, and highlighted alleged weaknesses. Of course it is generally assumed that these rules, flawed or otherwise, are complied with by banks. Is this generally the case?

A London based unit of JP Morgan Chase, called the Structured Credit Portfolio (SCP), started to disclose substantial losses in early 2012 on positions it had taken using credit market index trades. The positions were so large that when the SCP eventually wanted to close them out they discovered that other market participants had managed to distort the market against SCP, the other firms suspecting that SCP may be forced to close positions at virtually any price it could get.

This paper will neither analyse the trading strategy nor test speculation as to whether such trades, even when cumulatively net short positions on various credit indices, could ever have been intended to hedge the natural "long credit" exposures that JP Morgan Chase maintained merely by virtue of being an ordinary bank. Instead, the research available is now summarised in the context of questions about the integrity of management and their reactions to bad news; did they make a clean breast of trading problems or mislead investors and scrutineers?

The research cited is entirely taken from the US Congressional Committee's report of March 2013 (the Levin Report). The purpose of the enquiry was to investigate the circumstances of trading activity that resulted in losses estimated at $6.2 billion. JP Morgan Chase had at the time of the Report €2.4 trillion of assets and was the largest bank in the US. It was also the largest derivatives dealer in the market and the largest participant in the credit derivatives market.

The Levin Committee's research was extensive, involving analysis of 90,000 documents, the transcription of over 200 recorded telephone and instant messaging conversations. The Congressional Committee's own summary of its 301 pages of analysis and conclusions is stark:

"The Subcommittee's investigation has determined that, over the course of the first quarter of 2012, JPMorgan Chase's Chief Investment Office used its Synthetic Credit Portfolio (SCP) to engage in high risk derivatives trading; mismarked the SCP book to hide hundreds of millions of dollars of losses; disregarded multiple internal

52 Basel Committee on Banking Supervision Consultative Document Revised Basel III leverage ratio framework and disclosure requirements June 2013 at para 32 https://www.bis.org/publ/bcbs251.pdf

indicators of increasing risk; manipulated models; dodged OCC oversight[53]*; and misinformed investors, regulators, and the public about the nature of its risky derivatives trading. The Subcommittee's investigation has exposed not only high risk activities and troubling misconduct at JPMorgan Chase, but also broader, systemic problems related to the valuation, risk analysis, disclosure, and oversight of synthetic credit derivativesheld by U.S. financial institutions".*[54]

Of particular note is the Committee's conclusion that some of the most senior managers of JP Morgan Chase not only misled regulators and investors up to and including 13 April 2012 when a conference call to investors and analysts to explain the trades took place, but also, continued to do so:

"Given the information that bank executives possessed in advance of the bank's public communications on April 10, April 13, and May 10 [2012], the written and verbal representations made by the bank were incomplete, contained numerous inaccuracies, and misinformed investors,regulators, and the public about the CIO's Synthetic Credit Portfolio."[55]

The matters regarding which investors and scrutineers were misled were extensive. They included:

i) Mischaracterisation of the involvement of firmwide risk managers. the bank's Chief Financial Officer (CFO) stated on the April 13th call that "all of the positions were put on pursuant to the risk management at the firm-wide level". This was untrue. *"The evidence indicates, however, that in 2012, JP Morgan Chase's firmwide risk managers knew little about the SCP and had no role in putting on its positions."*[56] When the risk managers became aware of problems with the SCP positions, rather than reduce the activities they reacted by either disregarding the breaches of various risk metrics (such as VaR), by raising position limits to end the breach, or by changing the risk evaluation model.[57]

ii) Being fully transparent with regulators. This assertion was made on the 13 April 2012 conference call by the bank's CFO, but the Committee concluded that this statement "had no basis in fact"[58]. Taking the example of the risk model changes, management omitted to disclose to investors that in January 2012 changes were made to the VaR model applied to the SCP portfolio that had the effect of reducing the measure of capital regarded as at risk for maximum foreseeable daily losses from over $120 million to about $60 million.[59] This VaR figure looks particularly modest against a trading portfolio with notional

53 Office of Comptroller of the Currency, the bank's main regulator
54 Levin Report p 3. Please note that neither the author nor IREF has had any access to the underlying documents and materials reviewed by the US Senate Permanent Subcommittee on Investigations which prepared and published the Levin Report. All of the points made in Section 5 of this paper are based on the Levin Report, and no responsibility can be taken by the author or IREF for any errors or inaccuracies in the Levin Report.
55 ibid at p 11
56 both quotes ibid at p265
57 ibid p 266
58 ibid p 269
59 ibid p 290

exposure of €157 billion. Indeed on various days losses were experienced considerably in excess of the VaR figure. On March 30th 2012 losses of $319 million were suffered; on April 10th a further $415 million.

iii) Investors were told on April 13th that SCP investment decisions were made "on a very long term basis". On the contrary, from evidence that had been presented to senior management including the CFO the Levin Committee concluded that the SCP trades had *"the shortest investment horizon of all the portfolios in the CIO"* .[60]

iv) Mischaracterising the SCP portfolio as a hedge. If the SCP was net short credit risk the bank would seek to argue that this offset the risk of its lending, or 'long credit' exposures. On the April 13th call the CEO stated that these trades "offset" other risks of the bank, and yet the manager to whom the SCP reported had informed the CFO in writing on April 5th that the SCP had moved into a net long position[61]. A month later, May 10 the CEO stated "*[T]he synthetic credit portfolio was a strategy to hedge the Firm's overall credit exposure, which is our largest risk overall"*[62] .

v) Asserting that SCP trades were consistent with the 'Volcker Rule', section 619 of the Dodd- Frank Wall Street Reform and Consumer Protection Act. This provision sought to prohibit proprietary trading but to allow banks to trade where risk was being mitigated, where risk was being hedged. The CFO again on the April 13th call[63]:

"*we believe all of this is consistent with what we believe the ultimate outcome will be related to Volcker*"

The Committee again took a poor view of the reliability of this statement[64]:

"*The basis for Mr. Braunstein's prediction that the SCP's trading activities would be found to be "consistent with" the Volcker Rule is unclear. When the Subcommittee asked JP Morgan Chase if it had any legal opinion examining how the Volcker Rule would affect the bank's business, including the SCP, it responded that no such analysis had been performed.*"

Vi) In its concluding comments the Congressional Committee reached an unambiguous verdict on the nature of the underlying activity and the integrity of the most senior managers of the banks when purportedly disclosing the full facts to investors, regulators and other interested parties.

"The bank's initial claims that its risk managers and regulators were fully informed and engaged, and that the SCP was invested in long-term, risk-reducing hedges

60 both quotes ibid at p 269
61 ibid p274 footnote 1557
62 ibid p 273
63 ibid p 285
64 ibid p 286

allowed by the Volcker Rule, were fictions irreconcilable with the bank's obligation to provide material information to its investors in an accurate manner."[65]

It is also worth noting the useful light cast by this Report on the earlier criticisms made in this paper on the worth of the VaR risk metric system. Consider the $60 million VaR figure for the SCP positions that was reported after model changes at the end of January 2012. The actual losses were $6.2 billion. Reported VaR, albeit a daily loss exposure metric, turned out to be less than 1% of the actual losses from the positions to which it related. The Committee's opinion of the significance of this is clear:

"The JPMorgan Chase whale trades provide a startling and instructive case history of how synthetic credit derivatives have become a multi-billion dollar source of risk within the U.S. banking system. They also demonstrate how inadequate derivative valuation practices enabled traders to hide substantial losses for months at a time; lax hedging practices obscured whether derivatives were being used to offset risk or take risk; risk limit breaches were routinely disregarded; risk evaluation models were manipulated to downplay risk; inadequate regulatory oversight was too easily dodged or stonewalled; and derivative trading and financial results were misrepresented to investors, regulators, policymakers, and the taxpaying public who, when banks lose big, may be required to finance multi-billion-dollar bailouts.

The JPMorgan Chase whale trades provide another warning signal about the ongoing need to tighten oversight of banks' derivative trading activities, including through better valuation techniques, more effective hedging documentation, stronger enforcement of risk limits, more accurate risk models, and improved regulatory oversigh."t[66]

6. Industry wide Misconduct - From Libor fixing to Retail Banking

In the past five years there has been a series of revelations of serious banking misconduct, some of which are listed below. These activities range from high level reporting and disclosure malfeasance, they include fraudulent behaviour in wholesale markets, treatment of ordinary business customers (SMEs), and include both intimidation and defrauding of retail customers. No category of customer, stakeholder or engageee of banks is exempted from the list. The main items are:

- Failure to advise regulators and stakeholders of changes to risk models which substantially underreported exposures (JP Morgan Chase, above);

- Mis-selling of insurance products alongside personal loans. The collective term is Payment Protection Insurance. PPI is not explored here. British banks estimate their combined liabilities for this at the time of writing at £18 billion;

65 ibid p300

66 ibid p 1

- Mis-selling of Card Payment Protection insurance (selling an insurance policy that offered zero cover) to 7 million UK customers;

- Mis-selling of derivative products to small and medium sized businesses[67];

- Allegations of falsifying financial information to investors in a capital raising exercise (RBS, April 2008, now the subject of a £3.5bn civil lawsuit);

- Industry wide submissions of knowingly false evidence of automatic teller machine (ATM) system impregnability to UK regulators, ombudsmen and courts;

- Dishonest submissions of banks' own funding levels to the Libor compiler (Liborgate);

- Manipulating the daily (4pm) published foreign exchange 'fix' rates (fixing the fixes).

- Exploiting the insolvency process for small business customers in the UK, see Tomlinson Report November 2013[68].

This paper maintains that there is strong and growing evidence that bank customers and the general public are right to have grave concerns as to the decline in the integrity of the British, and parts of the US banking system. In the interests of brevity only three items from the above list are analysed.

The analysis will show that these activities cannot be dismissed as the actions of the odd "rogue" banker or two. Rather, the detailed examples of Liborgate, CPP and ATM bank disputes reveal how dishonesty, deception and fraud have become ingrained in the culture of British banks. The significant number of bank employees involved in activities such as CPP and PPI (not detailed here) is inconsistent with "rogue" explanations and shows that these deceptions were carefully designed. Many staff were trained on maximising the deception of customers so as to derive the greatest possible short-term 'profit' for the bank. Whilst it is obviously possible for a "rogue" trader to cause material financial loss to a bank, decisions to enter business lines such as CPP, and on bankwide litigation policy in the case of ATM disputes are generally taken at very senior levels of management. The evidence about rate fixing varies from bank to bank, but here again it is admitted that a very senior manager of at least one bank has been involved.

67 For a detailed list of such misselling techniques see Das
68 Commissioned by Department for Business, Information and Skills. www.tomlinsonreport.com

7. Case Study – Libor Fixing

The most notorious item on the above list is Liborgate - the submission by at least 20 of the largest banks in the world of dishonest funding rate levels to the central authorities that calculate LIBOR and EURIBOR[69]. LIBOR is a traditional pricing benchmark which banks have used when funding each other's short-term deposit and borrowing needs[70].

Two entirely different types of dishonest activity are coupled within the term "Liborgate":

i) Banks seeking to manipulate the day's averaged rate to maximise their profits on marked to market positions the values of which are discounted using LIBOR as a reference point;

ii) Barclays Bank submitted artificially low numbers in 2007 when Northern Rock became the first of the UK banks to collapse, a year before the main systemic collapse[71]. According to the Commodity Futures Trading Commission, the motivation for the low rate submission was to embellish the general market perception of Barclays' financial health to other market participants. In 2007 the unsecured interbank lending market was still operating broadly normally, and any indication of a bank's funding level rising above that of its peers would be taken (correctly) as a sign of market worries as to Barclays' solvency.

Both activities are fraudulent, both involve the "deliberate deception" of another "in order to gain unjust [financial] advantage"[72]. Millions of bank customers, either individuals with mortgage loans or businesses with interest rate swap agreements were swindled in the first case; creditors of Barclays were the losers in the second if indeed they were misled as to the bank's financial health.

The LIBOR scandal entails five items of evidence relevant to the assessment of the degree of trust and confidence that customers can reasonably be expected to place in banks and bankers. These five also inform the degree of reliance that customers can have in external regulators to protect them:

a) Scale; the BIS estimates that $450 trillions worth of contracts were corrupted.

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69 London Interbank Offered Rate

70 Technically LIBOR is the offered side of the mid price, the rate at which a bank with surplus funds offers to lend

71 http://www.cftc.gov/PressRoom/PressReleases/pr6289-12 "The Order also finds that throughout the global financial crisis in late August 2007 through early 2009, as a result of instructions from Barclays' senior management, the Bank routinely made artificially low LIBOR submissions to protect Barclays' reputation from negative market and media perceptions concerning Barclays' financial condition."

72 New Shorter Oxford Dictionary

b) The number of banks involved. This is small but continues to grow[73]. The penalties are substantial (typically in the order of one billion sterling or euros per bank so far) and published regulatory condemnations to date have been damning;
c) Did senior managers know, actively encourage, or were they innocent? At least one of the most senior managers of a bank has admitted manipulating LIBOR;
d) Regulatory involvement. Regulators knew about the widespread nature of the practice and contrived justifications to take no action;
e) For how long has this been going on? Evidence of LIBOR fixing dates from 2005 to the second half of 2012 in the case of Rabobank. Now, 9 years later, regulators appear only part way through negotiating fines, with other banks such as Deutsche Bank announcing provisions for future fines.

In addition to these three items, Liborgate also evidences collusion and cartelisation by banks. Most importantly, the scandal demonstrates the level of integrity that had become the norm as long ago as 27 May 2005. One of the email exchanges between a Barclays trader and a market counterparty[74]:

Submitter: "Hi All, Just as an FYI, I will be in noon'ish on Monday [...]".
Trader B: "Noonish?
Who's going to put my low fixings in? hehehe"
Submitter: "
[...]
[X or Y] will be here if you have any requests for
the fixings".

There is still confusion and disagreement as to what should be done. Many authoritative commentators appear not to accept that collusion evidences cartelised behaviour, which it surely does.[75] Others, in their understandable enthusiasm not to overstate the problem urge a calm response:

"it is important that UK regulators and politicians do not go too far in their outrage. What is required is judicious regulation to prevent a repetition of the problem and suitable penalties for wrongdoers."[76]

Yet 'judicious regulation', in London, meant ignoring the problem until the US' Commodity Futures Trading Commission[77] stepped in and fined Barclays $200 million because of the US impact. That decision alerted UK regulators. International regulators appear to be working more in tandem now, as the Rabobank reports below indicate. Although the speed of the regulators in

73 At the end of October 2013 Rabobank of Netherlands became the fifth bank to admit its role and pay $1.07 bn to various international authorities. The others are Barclays, UBS, RBS and the broker ICAP.
74 IEA Libor Reader, p 8
75 see P Booth IEA Reader, at pp 18
76 Ken Okamura, IEA Libor Reader, p 15
77 http://www.cftc.gov/PressRoom/PressReleases/pr6289-12

"negotiating" the fines appears slow (usually using threats of criminal investigations to secure deals), it is steady and continuing. Furthermore, regulators are not the only claimants. At the start of November 2013 the US mortgage agency Fannie Mae filed suits against nine international banks claiming $800 million in compensation.

Can the banks recover or are the losses so large that the claims will eventually drown them? How much in civil claims could these banks be exposed to? Regulators have published little. In most legal codes the penalties suffered by wrongdoers are linked in some way to the amount of money misappropriated. How great were the sums over the estimated seven-year life of LIBOR manipulation? The Bank for International Settlements' (BIS) estimate that $450 trillion of contracts were linked to LIBOR is only a starting point. The detail underlying such a vast number of contracts whose terms banks manipulated on certain dates makes calculation of a reliable estimate impossible. Most commentators suggest that industry wide liabilities could run to the tens of billions. The liability of British banks is hard to break out of the figures. Together with fines it seems unlikely that the industry total will exceed $100 billion, or 1/7 of the 2008 TARP bailout of US banks.

A key question remains about the knowledge and involvement of senior managers. There is little published evidence. However, in his testimony before a UK Parliamentary enquiry on 16 July 2012, Jerry del Missier who had been the Chief Operating Officer of Barclays, stated that his Chief Executive had directed him to order the submission of a false rate[78]. That Chief Executive, Bob Diamond, denied the charge. He, another board member, and del Missier all resigned at about this time.

As for the regulator's knowledge of the activity, and failure to act, the Bank of England showed little concern about Libor manipulation when it met in September 2009. The Money Markets Liaison Group's September 2009 minutes recorded "errors in the inputting of LIBOR submissions". Was this any cause for alarm? No it was not. The minutes continued: "fixings would not be recomputed unless the process as a whole had been compromised".[79]

Releases of emails and regulatory minutes are consistent with the actors having changed their belief systems to accept that manipulating the rate submissions was standard industry practice and normal activity. The Bank of England minutes cited above were in no sense secret and are written up as if the activity were an everyday minor concern about which nobody should be too worried.

78 IEA Libor Reader at p 11

79 quoted by Conaghan, City AM, republished in IEA Libor Reader at p 27

8 Case Study - Electronic Banking: ATM Fraud – Jane Badger

Electronic banking, including ATMs and internet banking, is a large and growing area which retail customers have little choice but to use. High street bank branches have been pared and customer-facing staff cut back.

The impression given of electronic perfection is false. Most electronic banking systems are known to be prone to errors and breakdowns.[80] RBS' retail banking systems have failed three times since June 2012, most recently at the start of December 2013, disrupting millions of customer payments and resulting in customers being unable to withdraw cash at all.

When ATM disputes occur, most banks will conduct an internal investigation which supposedly involves checking its computer records of the card's use. Almost invariably the result is that the bank's technology was in good working order and the bank usually confirms that the actual card and PIN were used, and therefore the customer is notified that he is liable for the disputed funds.

Should the customer not accept this verdict he/she faces an arduous struggle. He will first be advised by the bank to destroy evidence helpful to him[81]. Every card contains an Application Transaction Counter (ATC) which increases by 1 each time the card is used. This is an important piece of evidence because if the reading of the counter does not match the evidence of card use submitted by the bank it can help to establish that the card was not used for the disputed transaction(s). It is standard practice for banks to advise customers as soon as they report disputed transactions to destroy (by cutting up) the card. Often the ATC is destroyed.

Next, the customer will be invited to think hard about whether he wishes to dispute the bank's verdict. The bank will typically state that the actual card and PIN was used, then may suggest that somebody (not necessarily the customer) will be attempting to defraud the bank if the claim is taken further. In case the customer is slow to understand the bank's point, the bank may typically state that it is considering involving the police to investigate either the customer or his/her partner/ family members.

In the 2007 case of Jane Badger this is exactly what the bank did. The case was well publicised and has no doubt deterred a number of other ATM fraud victims from coming forward. The case demonstrates the difficulties faced by complainants.

Ms Badger was a customer of a British bank called Egg. She complained that her bank statement showed deductions from her account that she had not authorised, and in respect of which she asked the bank for reimbursement. She also worked for the police.

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80 See Mason
81 Mason p4

Egg bluffed strongly, asserting the usual arguments. Their systems were perfect, the actual card (not a cloned one) had been used, and Ms Badger must have been negligent with her PIN. Ms Badger maintained her claim. Egg staff called in the police and Ms Badger was charged with attempted fraud. On the day of her criminal trial the judge ordered a verdict of not guilty.

The evidence that the bank submitted in order to persuade the Crown Prosecution Service (CPS) to file charges is published by Stephen Mason[82]. It is summarised by Professor Ross Anderson of Cambridge University. He and his colleagues at the Cambridge University computer science laboratory have researched card cloning and testified in trials that cards can be cloned, contradicting banks' testimony.

[Ms Badger] faced a bank (in her case, Egg) claiming that as its systems were secure, she must be trying to defraud them; …she faced police expert evidence that was technically illiterate and just took the bank's claims as gospel.

In her case, Egg said that the transactions must have been done with the card issued to her rather than using a card clone, and to back this up they produced a printout allocating a transaction code of 05 to each withdrawal, and a rubric stating that 05 meant "Integrated Circuit Card read – CVV data reliable" with in brackets the explanatory phrase "(chip read)". This seemed strange. If the chip of an EMV card is read, the reader will verify the signature on the certificate; if its magnetic strip is read (perhaps because the chip is unserviceable) then the bank will check the CVV, which is there to prevent magnetic strip forgery. The question therefore was whether the dash in the above rubric meant "OR", as the technology would suggest, or "AND" as the bank and the CPS hoped. [83]

It is clear from this description of the bank's ambiguous printout that the evidence offered was not actual proof of whether or not the actual card was used.

Tactics hardly vary from bank to bank. There appears to be a cartel in this case not to fix prices, but a tacit agreement to intimidate anyone who complains. In another case when a different expert from the same Cambridge University computer science laboratory, Dr Stephen Murdoch, testified that he had cloned the actual card that was at the heart of the dispute, the judge found in favour of the bank.[84]

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82 Mason is also the author and general editor of two of the leading legal text books on the subject: *Electronic Evidence* (3rd edn, LexisNexis Butterworths, 2012), covering: Australia, Canada, England & Wales, European Union, Hong Kong, India, Ireland, New Zealand, Scotland, Singapore, South Africa and the United States of America, and *International Electronic Evidence (*British Institute of International and Comparative Law, 2008, covering Argentina, Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Latvia, Lithuania, Luxembourg, Malta, Mexico, Netherlands, Norway, Poland, Romania, Russia, Slovakia, Slovenia, Spain, Sweden, Switzerland, Thailand and Turkey.

83 Anderson R. http://www.lightbluetouchpaper.org/2008/01/31/justice-in-one-case-at-least/

84 Alistair Kelman, Job v Halifax PLC (not reported) case number 7BQ00307, *Digital Evidence and Electronic Signature Law Review*, 6 (2009) 235 – 245.

Of course banks cannot encourage customers to draw cash at ATMs and then try and trick the bank into restoring drawn funds to their account. But they should not continue to maintain that their systems are never at fault when they know these submissions to be false, and yet they do[85]. Stephen Mason again:

"where the bank refuses to reimburse the customer for the loss claimed, the bank invariably claims that the customer was grossly negligent, by asserting that either the PIN was written on the card; or that when the card was stolen with other items, the PIN was recorded on one of the other items in such a way that the PIN was obvious to the
thief. This tends to be a statement made by the bank that purports to prove a fact, but has no basis in actuality, and there is no evidence to support the claim."[86]

The problem is not confined to the UK. In Norway,[87] the mere assertion by a bank that its computer systems were checked annually was astonishingly accepted by a judge as proof that complaining customers must either be liars or in denial of their gratuitous gifts of cards and PIN numbers to thieves.

"Given that the purpose of a trial is to test the evidence before the adjudicator reaches a decision, it is astounding that a judge would assume that the standard security systems used by the bank were effective; and accept untested assurances that audits actually take place."[88]

9. Case Study - Card Protection Plans

In August 2013 a British barrister, 35 year old Nadine Wilson-Ellis, was jailed for 7 months for committing a "calculated, deliberate and planned fraud"[89]. Whilst owning two properties in Nottingham where she worked as a law lecturer, she posed as an unemployed single mother of two, forged bank statements and made a false claim in Bristol for a taxpayer subsidised apartment. The Bristol housing authority fell for the deception, granted her a low cost lease on a property, which Ms Wilson-Ellis promptly sub-let, earning a profit of £10,000 over three years.

Two days later the new UK consumer banking regulator the FCA[90] announced that it had persuaded 16 banks and credit card companies to agree to pay out an estimated £1.3 billion to consumers who were "mis-sold" insurance policies protecting against identity theft and fraudulent use of credit and debit cards (collectively "cards"). From inception in 2005, some 23 million policies were sold to 7 million customers. Whilst there is arguably some small value to the

85 Mason, p3
86 Mason, 'Electronic banking and how courts approach the evidence', *Computer Law and Security Review*, Volume 29 Issue 2 (April 2013), 144 – 251, at p 144
87 Maryke Silalahi Nuth, 'Unauthorized use of bank cards with or without the PIN: a lost case for the customer?', *Digital Evidence and Electronic Signatures Law Review* 9 (2012) 95 – 101.
88 Mason, 'Electronic banking and how courts approach the evidence', page 147.
89 Sentencing words of Judge Longman http://www.bbc.co.uk/news/uk-england-bristol-23771643
90 Financial Conduct Authority, formerly a limb of the FSA but now part of the Bank of England

identity protection policies, there is no value to the fraud cover policies, and this case study therefore deals only with these.

All fraud cover policies were mis-sold because, save in exceptional circumstances, the bank or other card issuer is liable for fraudulent misuse of the card, not the customer. The 'exceptional circumstances' in which banks are not liable are those where the customer has either given away the card and PIN[91] or recklessly failed to keep the number confidential and the card in his possession. But in these circumstances the CPP policy disclaimed cover, therefore it was truly of no value to anyone.

For the consumer, the announcement of a compensation fund and simplified claim process is doubtless good news. But most reports missed the core point. Merely paying back the money does not absolve a fraudster. Why have the police not become involved? Why has the treatment meted out to Ms Wilson-Ellis not been applied to those senior bankers behind these decisions?

Fraud is a form of theft, the "deliberate deception" of another "in order to gain unjust [financial] advantage". Ms Wilson-Ellis clearly deceived the Bristol housing authority and enjoyed £10,000 of personal gain. Is there a distinction?

These insurance products were carefully designed and marketed. All of the banks and credit card companies agreed to the same method of marketing. From 2005 cards were sent to customers bearing a sticker with a telephone number. The sticker and accompanying documentation instructed the customer to telephone the number in order to activate the card. This was not true, the card was in fact valid when it was posted so there was no need to make the call. But millions of customers did as instructed and called the number. Telephones were answered by employees of the insurance company presenting themselves as employees of the bank.

After some security questions the employee stated that the card 'could now be used'. As the customer was on the point of ending the call the sales pitch began. Did the customer know how high the level of card fraud had become? The customer was given the impression that he was at risk. However, for £30 he could purchase a one year policy that would insure this risk away. Did the banks know how misleading this sales pitch was? It was a requirement of all UK bank's internal compliance rules that they review and approve all marketing material for every bank product, and take reasonable steps to audit the actual marketing so it is highly likely that they knew. Even if banks slipped up on their compliance, they knew that a product was being offered to their customers that had no value at all. This is surely sufficient to justify the description of the conduct as fraudulent.

The reason why card protection policies came into existence in 2005 was the ease with which bankers believed that customers could be deceived into paying for valueless insurance. This generated instant and riskless additional profits.

91 Personal Identification Number

The motivation was the continued personal employment under generous salary and bonus contracts of the bankers who designed, managed and rolled out these products.

Banks, in their own defence, may claim that there were some ancillary benefits to card protection insurance, even though it is universally admitted that the insurance cover itself was of no value. An example of such ancillary benefit might be a 'one call' service such that a consumer could cancel all his cards if his wallet was stolen, saving the drudgery of calling each card issuer singly. This point may be true, but it neither diminishes nor rebuts the charge of fraud.

Mis-selling is different from fraud. This paper terms the CPP scandal fraud. The bank lobbying industry has succeeded in persuading nearly all commentators, regulators and policymakers to describe CPP and other activities as "mis-selling". If something is merely mis-sold, the level of culpability the ordinary person ascribes to the bank or banker is lower than if the term fraud is used. Which is correct?

The term "mis-sell" means to "sell (something) to a customer on the basis of misleading advice"[92]. An example of misselling would be the actions of a salesman who persuaded a wheelchair bound female octogenarian to purchase a tandem parachute jump. Having endured the requisite training and completed one scary solo jump, the author can confirm that even a tandem professional would refuse to jump out of a plane with such a lady strapped to his chest. It is possible that the salesman could be unintelligent. He may be also a fraudster, but there is no proof, unless we can demonstrate that he knew how old and frail the lady was. The term "mis-sell" should therefore be used to describe what went wrong with such a contract.

Sellers of CPP card fraud protection policies can claim no such exculpation. The design and sale of these card insurance policies crossed the line from mis-selling to fraud. There exists not a single customer who could have benefited from the insurance. Fraud is defined as one party deceiving another into handing over money under false pretences, for example by paying for something that is then not delivered, and when the fraudster had no intention of delivering fair value for the payment. The solicitation of fees for valueless insurance policies appears just as fraudulent as the case of the barrister at the start of this Section.

By choosing the softer "mis-selling" term, the layman's conclusions as to culpability are diminished. Reducing public perception of culpability is important. By reducing public perceptions of culpability, bankers hope also to keep the regulators from excessive scrutiny.

Is it purely coincidental that the most glaring example herein cited of widespread, collusive retail banking fraud, Card Protection Plan insurance policies, involved fraud? Senior bankers know how traumatic is the process of trying to reclaim improperly deducted funds.

92 http://www.oxforddictionaries.com/definition/english/mis-sell

Nobody wants this trauma. Some may therefore consider the description of CPP card insurance as 'fraudulent' to be overstated. Such analysis would be wrong. Banks cannot argue that insurance against the risk of a different kind of malpractice by which they might decide to misappropriate customer funds, itself a fraud, undermines the statement that the CPP product was fraudulent.

10 – A Proposed Solution; The Restoration of Personal Accountability

The Legislative Proposal submitted to the UK Parliament on 29 February 2012 appears in full as Appendix 2. In summary its provisions would:

- enforce strict liability on directors of financial institutions
- enforce unlimited personal liability on directors of financial institutions
- require directors of financial institutions to post personal bonds as additional bank capital
- require personal bonds and bonuses to be treated as additional bank capital
- make provision for the insolvency of financial institutions

The purpose of the draft legislation is to minimise moral hazard, some consequences of which have been illustrated in this paper. Despite its non-adoption by the UK Government it remains on the file ready to be activated when the UK crisis stewards realise that their hopes for banks to repair themselves are forlorn. The banking system is now dysfunctional. Banks do not trust each other; the paucity of unsecured interbank lending so confirms. New rules run the risk of either gaming, non-enforcement, or simply being ignored. The legislative proposal was designed to address all these concerns.

Six years after the onset of the GFC there is no evidence of banks becoming healthier or trustworthiness in banks being restored. None should pretend that this proposal is perfect, but it would be a sensible starting place. Those who take risks should be accountable for the consequences.

11 Conclusion

This paper has set out sufficient examples of the dysfunctional present nature of banking for the reader to draw his own conclusions as to whether present regulators and, perhaps more importantly, present regulatory structures and protocols, are capable of restoring integrity to banking. Such is the scale of the problem, so powerful and successful has bank lobbying become, that few policymakers have shown a willingness to confront the problem. Few individuals have been held to account. The penalties have generally been financial levies on banks. As the 'Conduct costs' tally continues to rise, the IMF's estimate of the £1.2 trillion[93] cost of the UK Treasury's subvention of the banking system as at April 2009 is likely to prove a substantial understatement.

93 IMF Staff Position Note, 2009, quoted in Engelen et al, p29

The paper attempts to aid understanding of the condition of our present system of banking; some large banks may be insolvent; bankers' submissions to regulators and scrutineers cannot be assumed to be trustworthy. As the Card Protection Plan case study showed, a nadir has been reached when bankers design and implement mass customer marketing programmes of products whose only raison d'etre is to defraud their customer base. Such banks are the last resort of willing savers and borrowers. Users of banks are willing to pay for honest and trustworthy banking. Today's problem is that is very hard to find such banks because the extent of state intervention and state protection of the existing failed institutions is so great.

Admati and Hellwig admit to being surprised that radical reform to the banking system, which seemed inevitable in 2008, has disappeared from every agenda. "There was no serious analysis of how the financial system might be made safer."[94]

Instead, the US enacted the Dodd Frank Act. The *Economist* had this to say about it early in 2012:

"The law that set up America's banking system in 1864 ran to 29 pages; the Federal Reserve Act of 1913 went to 32 pages; the Banking Act that transformed American finance after the Wall Street Crash, commonly known as the Glass-Steagall act, spread out to 37 pages. Dodd-Frank is 848 pages long. Voracious Chinese officials, who pay close attention to regulatory developments elsewhere, have remarked that the mammoth law, let alone its appended rules, seems to have been fully read by no one outside Beijing (your correspondent is a tired-eyed exception to this rule). And the size is only the beginning. The scope and structure of Dodd-Frank are fundamentally different to those of its precursor laws, notes Jonathan Macey of Yale Law School: "Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies." Like the Hydra of Greek myth, Dodd-Frank can grow new heads as needed."[95]

One way to ensure that the system will not be fixed is to swamp it with rules. In the immediate pre-crisis years the pre-eminent US derivatives regulator, the CFTC[96], would adopt perhaps ten new rules per year. Dodd Frank require them to adopt about 200 new rules a year. The size of this task is not simply immense, it is unachievable. Friedman agrees[97]:

"*A regulator cannot possibly know how a contemplated [new] regulation might interact with previously enacted regulations, since no human being can master the code of Federal Regulations. ..The Code contains more than 150,000 pages and grows by thousands of pages a year. A competent systemic regulator would also have to master the state, local and international equivalents of the Code*"

94 Admati and Hellwig p ix
95 Dodd Frank Act, Too Big Not to Fail, The Economist, 18 Feb 2012
96 Commodities Futures and Trading Commission
97 Friedman, p 57

New regulations have failed to address the moral hazard behind the decline in banker behaviour. The establishment of a framework of simple rules ensuring probity, integrity and accountability would reverse this. An example is set out in Section 9 and Appendix 2. Culture will change very quickly after the enactment of such legislation.

Admati and Hellwig appear to agree[98]:

"With the right focus and a proper diagnosis of the problems, highly beneficial steps can be taken immediately",

Their book was published several months ago, when the 'conduct costs' tally suffered and provisioned for by ten banks[99] as at year end 2012 stood at $235 billion. As this figure continues to appear if anything conservative, it is to be hoped that policymaker attention is drawn to some of the points made in this paper; the misdiagnosis of the GFC, the influence of the banks themselves in promoting and maintaining the flawed global rule systems of Basel and IFRS, and the unreliability of bankers' views about systemic problems and fixes.

98 Admati and Hellwig, p xii
99 see London School of Economics

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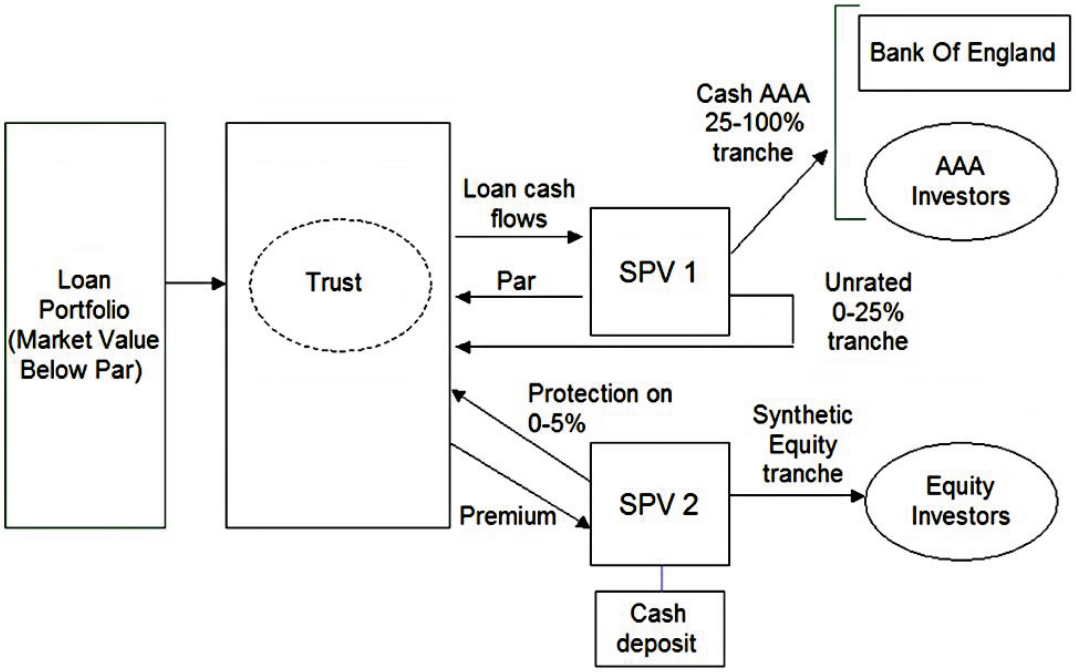
Appendix 1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Unrated
0-25%
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Synthetic
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Premium
SPV 2
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On 24 February 2012, Steven Baker MP submitted the following statement of provisions to the UK Parliament.

Financial Institutions (Reform) Bill – Definitive Statement of Provisions

The purpose of the Bill is to implement a series of mutually reinforcing measures to resolve the financial crisis and minimise the chance of a future crisis. The underlying principle is to make the bankers liable for their own actions, so reining-in rampant moral hazards and excessive risk-taking. These measures would remove the most flagrant abuses and restore the integrity of the financial system; they would also address the widespread indignation over bankers' behaviour and meet the public demand for accountability and justice in modern banking.

Put simply, the main purpose of the Bill is to minimise moral hazards within banking, by making those who make or preside over risk-taking as liable as possible for the consequences of that risk-taking. Since rules are usually gameable, a secondary principle underlying the Bill is systems redundancy, i.e., mutually reinforcing measures that minimise scope for evasion.

1. Liability of bankers

1.1 Board members of financial institutions would be strictly liable for any losses reported by their institutions.

[Note: strict liability means that they are held to be liable without the need to prove fault on their part, i.e., "it wasn't my fault" excuses don't mitigate liability.]

1.2 Board members of financial institutions would to be subject to unlimited personal liability for any such losses.

[Note: This means that their own personal wealth - all assets, houses, pensions, etc. - is to be at risk if their banks make losses.]

1.3 Board members of financial institutions would be required to post personal bonds that would be potentially forfeit in the event that their banks report losses.

[Note: This measure ensures that board members provide a form of additional core capital of known value that would be easily seizeable to cover bank losses.]

1.4 The value of the bonds posted for each person concerned should be the higher of £2m adjusted for future RPI or 50% of the person's net wealth.

[There needs to be a simple formula to determine an effective bond requirement and RPI is a better choice than CPI for adjusting the £2m for future inflation.]

1.5 Any board members who resign would still be subject to unlimited personal liability and the requirement to post bonds for a period of 2 years following their resignation.

[Note: This is to prevent directors running away from recently incurred but not reported losses by resigning before the losses are reported: hence this requirement means that if the roof should just happen to fall in any time within 2 years of their leaving, they are still liable, no excuses. This should take care of the common problem of soon-to-retire execs deferring problems until they themselves had just got out of the door. The 2-year expiration period would also counteract short-termism by giving board members an incentive to ensure that they are replaced by responsible successors].

1.6 Why a 2-year period and not longer? A long expiration period would impair the market for board members (making skills and experience less easily transferable, also leading to loss of skills whilst former board members sat out their 'waiting periods' before moving on). Hence the period should be long enough but not excessively long, and 2 years seems reasonable

2. Bonus payments to be deferred and liable

2.1 The payments of any bonuses that are awarded in any given year would be deferred for a period of 5 years.

2.2 The amounts involved ('bonus pool') would be invested on beneficiaries' behalf in an escrow account. Where the bonus takes the form of stocks, these would typically accumulate dividend payments over time. Where they include stock options, such options would be exercised on maturity if they expired in-the-money and so then convert to underlying stock positions, and if they expired out-of-the-money they would become worthless. Where the bonus takes the form of cash, these cash amounts would be invested in an independent money market mutual fund with a horizon period equal to the period when the original 5-year deferment has lapsed and payments can then be made to beneficiaries.

2.3 The reason for this requirement is that bankers and traders are good at creating personally lucrative time bombs that blow up years later when the individuals responsible have long since departed with their bonuses etc., and under current rules past remuneration cannot be retrieved by the bank when the damage is eventually revealed. The deferment period therefore needs to be a fairly long one.

[Notes: (1)These provisions would ensure that the control of the bonus pool is outside the hands of either the beneficiaries or the bank that paid the bonuses. This helps prevent either party 'gaming' the bonus pool for their own ends.

(2) The provisions for stewardship of the bonus pool should be uncontroversial: those who hold stock are entitled to receive dividend payments on their stock holdings, and those who hold options would wish them exercised on maturity if they expired in the money. The proposed provisions for the stewardship of cash bonuses are conservative and reasonable.
(3)The provisions regarding stock options also have important additional benefits by stopping well-known stock-option abuses by banks. (i) Banks are often evasive about the details of stock options, and this allows them to hide their true value and hence cost. (ii) Such evasiveness has often enabled them to tinker with stock options after they have been awarded (e.g., quietly replacing underwater options with above-water ones to transfer stock option losses to other bank stakeholders). However, such shenanigans are only possible while the bank itself 'holds' the stock options. The escrow requirement will stop such abuses because it would require the actual options to be handed over to the party that manages the bonus pool and this party would be independent of the bank: this would make stock option positions more transparent and put an end to ex-post 'tinkering' in favour of stock-option beneficiaries.
(4) So for example, bonuses awarded at the end of 2013 would be eligible for distribution to beneficiaries at the end of 2018, etc.
(5) The total current value of the bonus pool at any given time will be equal to the sum of the current values of the invested bonuses for each of the last five years. The total current value of the bonus pool at any time is also easily ascertainable, and the pool itself can be easily and rapidly liquidated at low cost.
(6) To avoid a potential source of confusion: once a bonus is awarded the awardee has a claim on it independent of subsequent employment status i.e. whether he/she continues to work for the bank.]

2.4 The bonus pool would provide an additional form of core capital that would be used to make good any reported losses.

[Note: The beneficiaries of the bonus pool include not just board members, but also, e.g., traders. Thus, the traders' bonuses are also at risk - and of course, the bigger the traders' bonuses, the more they have at-risk. This will help to discourage traders from excessive risk-taking, as their own accumulated bonuses would be in line to cover any losses.]

3. Use of personal bonds and bonus pool to make good bank losses

3.1 Should a bank report losses over any period, these losses would be made good in the first instance by drawing from the bonus pool.

[Note: This will further help to discourage traders from excessive risk-taking, as their own accumulated bonuses would be not just in line but first in line to cover any losses].

3.2 So if a bank reports a loss equal to 50% of the value of the bonus pool, then 50% of the bonus pool would be liquidated and transferred to the bank to cover

those losses, and each beneficiary of the bonus pool would lose half his/her claims on it.

3.3 Should a bank report losses that exceed the value of the bonus pool, then the whole of the bonus pool would be forfeit to the bank to make good the losses. The difference remaining - the difference between the reported loss and the value of the bonus pool - would then be made good by drawing from the board members' personal bonds. Should their bonds prove insufficient to meet the whole of the remaining loss, then all their bonds would be liquidated to offset that loss, and any subsequently remaining losses would be passed to shareholders.

[Notes: (1) In short, any losses in the first instance are borne by beneficiaries of the bonus pool; further losses are borne by board members and made good from their posted bonds. Any further losses are then borne by shareholders in the usual way.
(2) This means that we would have three different types of bank core capital, with the bonus pool being the most junior, the personal bonds being the second most junior, and equity capital being senior. The most junior capital absorbs any initial losses until that level of capital is wiped out, the second most junior capital absorbs any further losses until it is wiped out, and so forth.
(3) The reason why the bonus pool is made most junior is to ensure that the traders bear the first losses, thus giving them the strongest incentives not to take excessive risks, bearing in mind that they would not be subject to the personal liabilities to which board members are subject].

3.4 In the event that board members' personal bonds are forfeit to the bank, board members would be required to replenish their personal bonds within a specified short period. Failure to meet this obligation would trigger personal bankruptcy.

4. Definition of core capital

The core capital of the bank would be the sum of the shareholder equity capital, the current value of the bonus pool and the current value of the personal bonds of the board members.

[Note: This is a robust measure of core capital, and is far better than the core capital definition of Basel II, which is open to widespread abuse. Note, too, that we need a clear definition of core capital when coming to the question of determining whether a bank is, or is not, solvent. See section 6 below.]

5. Accounting standards

5.1 For the purposes of the Bill, all relevant figures (measures of profit, loss, capital, bonuses, personal bonds posted, etc.) would be obtained using the parallel accounting rules (i.e. UK GAAP under Companies Act legislation).

[Note: This was proposed in Steve Baker's Ten Minute Rule Bill last year: The Financial Services (Regulation of Derivatives) Bill]

5.2 The values of board members' personal bonds and remuneration, all bonuses awarded and the current values of the bonus pool would to be reported in full.

[Note: This information obviously needs to be in the public domain.]

6. Bank insolvency

6.1 Should the ratio of a bank's core capital to its assets fall below 3%, then the bank would be deemed to be insolvent.

[Notes: (1)This sets a clear solvency standard: a 3% ratio of core capital to assets is an absolute minimum. (And it is to obtain a clear solvency standard that we need a definition of core capital hence section 4 above.) A bank with a core capital/assets ratio below 3% is essentially a zombie, i.e., not a going concern, and as such should not be allowed to continue in operation.
(2) Why 3% particularly? (i) 3% means that a loss equivalent to 3% of asset value means that the bank no longer has the assets to repay its creditors in full, even on paper: this is a very vulnerable bank. (ii) Even the Basel regime regards the 3% ratio as equivalent to a basket case, although it calls for intensive supervision, support, intervention, etc. instead of the more obvious bankruptcy. (iii) We should be more conservative than Basel].

6.2 The Secretary of State would be required to place any insolvent bank into receivership.

[Note: This deliberately leaves no room for discretionary judgment.]

6.3 In the event of insolvency, the bonus pool and the personal bonds of board members would immediately be forfeit to the creditors of the bank. Board members themselves would be deemed to be personally bankrupt and court proceedings would be instituted to recover their remaining personal property. This property would then be liquidated and the proceeds would belong to the bank creditors.

7. A New Fast-Track Receivership Regime for Banks

The Secretary of State would be required to propose a new fast-track receivership regime to handle insolvent financial institutions. The purpose of this regime would be to ensure that future bank insolvencies are handled expeditiously.

[Note: An insolvent financial institution would either be quickly broken up and marketable parts sold off, or else it will be quickly reorganised in receivership

and put back out into normal operation. There have been calls for a fast-track bankruptcy regime for banks for years.]

8. End of State Support and Return of Financial institutions to Normal Operations

8.1 The Secretary of State would be required to present to Parliament a Bill outlining a programme (including a timetable) leading to the end of all state support for financial institutions.

[Note: This would lead to the liquidation or reorganization of any banks currently on state support and the return of any reorganized banks to normal activity.]

8.2 For the purposes of the Bill, state support would be deemed to include: all bailout support, all lender of last resort support, public shareholdings in banks, central bank holdings of any bank assets and any form of state-supported deposit insurance.

[Note: This might pave the way for a later reform of the Bank of England.]

8.3 Future state or central bank support for financial institutions would be prohibited.

[Note: Implicitly this also covers UK state support for overseas banks, so it would prohibit the Bank of England or HMG from supporting EU measures to prop up EU banks.]

9. Authorisation to Operate

9.1 Any banks that operate in the UK would be required to obtain UK authorisation. This means, in effect, that the UK would unilaterally withdraw from the EU 'passport' system under which financial institutions established in one member state can operate in other member states with no further authorisation requirements.

[Note: Consider the alternative. If the current passport system were to continue to operate, banks could evade all the provisions of this Bill simply by obtaining non-UK authorisation and then operating here under the passport scheme. Furthermore, UK-authorised banks would be at a competitive disadvantage relative to non-UK authorised banks, because the former would operate under the more onerous restrictions of this Bill and because the latter would be in receipt of state support that would be denied to the former.]

10. Criminal Investigations into Problem Banks

10.1 The Secretary of State would be required to set up a new Financial Crimes Investigation Unit to investigate financial crimes, and whose focus would be crimes committed by senior bankers and financiers.

10.2 The Secretary of State should direct the new FCIU to begin investigations into possible criminal offences committed in all financial institutions that have failed since 2007 and/or been in receipt of state support (e.g., bailouts).

[Note: This is not a call for retroactive legislation, only the establishment of criminal investigations into possible wrongdoing.]

10.3 Should a financial institution fail, the FCIU would be required to open an investigation into possible financial crimes committed by the senior management of that financial institution.

[Note: A serious financial crime investigation unit would make financial regulation, e.g., the FSA, obviously redundant: the FCIU would be looking for evidence (e.g., incriminating emails etc.) instead of the pointless box-ticking of the FSA].

11. Criminal liability of parties referred to in this Bill

Any failure on the part of any of the parties mentioned in the Bill to fulfil their obligations in full should be deemed to be a serious crime as defined in the Serious Crime Act 2007.

[Note: Serious crimes include, e.g., fraud, money laundering etc. so classifying these financial crimes as "serious" is not an exaggeration.]

12. Definition of Financial Institution

For the purposes of the Bill, a financial institution would be any company regulated under the Financial Services and Markets Act 2000.