Gaga – or Garbage in, garbage out.

UKSA members will be aware of a recent comment by Andy Haldane, chief economist at the Bank of England, about the Bank's 'Michael Fish moment'. In response to this Natasha Landell-Mills of Sarasin and Partners LLP wrote a letter to the Financial Times which was published on 12th January 2017 and which was countersigned by, among others, UKSA. In her letter, which is reprinted below, she notes that despite significant intervention by regulators in the UK, Europe and elsewhere to strengthen the capital base of banks, there remains a deeper problem – namely, the poor quality of the numbers that are used to tell us what the banks' capital actually is.

In this age of 'big data' and with enormous computing power at the disposal of most organisations it seems absurd that regulators and others who oversee the banks and the wider financial services industry cannot define accurately what it is we need to measure and obtain reliable information to enable measurement to take place. Without this, systems of regulation will remain fatally flawed. Worse still, there is a real risk that the regulators will sit there enjoying the autumn sunshine (or maybe just their own reflected glory) as the next tornado sweeps in to engulf the banking system.

We reproduce the following letters to give you the full picture.

Peter Parry

Clearer picture of banks' capital is required to help avert crises

Sir,

Last week Andy Haldane, chief economist at the Bank of England, admitted that economists had failed to predict the financial crisis, and compared the situation with that of ill-informed weather forecasting in 1987—the "Michael Fish moment".

Sir John Vickers (Letters, January 10) added that, aside from better forecasting, the government must also "weatherproof" the banks by ensuring sufficient capital is held for the inevitable "rainy day".

But better forecasts and better weatherproofing both depend on a deeper problem being resolved: the poor quality of the numbers we are relying on to tell us what banks' capital actually is. Is the stated "capital" in fact capable of absorbing lending or trading losses that inevitably come in a downturn?

At the heart of the crisis would appear to sit faulty accounts and unreliable audits. In the EU alone,
between September 2008 and the end of 2010, more than 300 banks went cap in hand to governments for support—in the form of capital injections, asset relief, liquidity aid or debt guarantees. Few banks were identified as having insufficient capital at the time.

The fact is that bank accounts — drawn up according to IFRS accounting standards—showed "profit" and "capital" that overstated their true strength. Supplementary regulatory disclosures of capital under the Basel framework help little as they lean heavily on these faulty accounting numbers, and are

themselves unaudited.

The government's green paper to strengthen corporate governance provides an opportunity to tackle these problems: unless accounting rules are changed (or supplemented) to ensure a reliable—and not overstated—view of companies' profit and capital, it will be hard to improve executive accountability, ensure appropriate pay and promote long-term stewardship.

Specifically, companies must disclose what profit has been realised and what hasn't, and therefore what can be safely distributed as dividends without eating into capital (cash resources and regulatory requirements permitting). Without these changes, how will we be able to see the next crisis coming?

Natasha Landell-Mills, Sarasin & Partners LLP

Councillor Kieran Quinn, Local Authority Pension Fund Forum

Eric Tracey, GO Investment Partners LLP

Roger Collinge, UK Shareholders' Association

Robert Talbut, Pension fund and charity trustee

Frank Curtiss, Pension fund and charity trustee

In response to which the Financial Times published the following:

Sir,

The letter from Natasha Landell-Mills and others makes the point that "unless accounting rules are changed (or supplemented) to ensure a reliable – and not overstated – view of companies' profit and capital, it will be hard to improve executive accountability etc…"

Faulty accounts and unreliable audits did not help during the 2008 financial crisis however. Disturbingly it appears, in the case of the HBOS takeover by Lloyds, that the Regulators knowingly allowed Lloyds to treat as core tier one capital an "own credit" adjustment of £15.4bn. This was generated from the purchase of HBOS debt instruments which of themselves were not eligible for core tier one capital. HBOS's publicly listed debt was, at acquisition, trading at significantly below par because of market concerns as to its ability to repay its debts and so Lloyds effectively took over HBOS debt instruments at market value whereas it retained the obligation to repay the debt at par on maturity through the profit and loss account. This remarkable device enabled Lloyds to create the £15.4bn. "own credit" adjustment. This was totally illusory and wholly unsuitable to be treated as core tier one capital which GENPRU 2.2.9 defines as having the following characteristics:-
1) It is able to absorb losses
2) It is permanent
3) It ranks for repayment upon winding up, administration or similar procedure after all other debts and liabilities; and
4) It has no fixed costs, that is, there is no inescapable obligation to pay dividends or interest.

The "own credit" adjustment meets none of these criteria. In particular, it fails to meet the first two key tests.

The Prudential Regulation Authority's response to this is that under IFRS this is perfectly acceptable when plainly under GENPRU it is not. One would like to think that regulators could apply some common sense and see that in the instance referred to, applying IFRS was a nonsense. It is precisely in times of financial stress and crisis that prudential regulations should be applied. In this instance, they were interpreted to suit the Tripartite Authorities and shareholder interests were ignored.

Yours faithfully
Paul Sanders