UK AND IRISH BANKS
CAPITAL LOSSES –
POST MORTEM

A SHAREHOLDERS' PERSPECTIVE
ON THE FAILURE
OF THE CAPITAL
ADEQUACY
REGIME

Local Authority
Pension Fund
Forum
FOREWORD

Despite the immediate threat to the banking sector receding, the damage to numerous economies around the world caused by this first global financial crisis continues to be felt. At present, the risk of a further recession remains high, and deep fault-lines remain buried within the world economy.

Just as it has become apparent that the bank failures of 2008 were only the first round of the global financial crisis, similarly we must conclude that further reforms to the financial system are likely to be required. Institutional investors clearly have a significant role to play in economic reform and reconstruction, indeed the oversight role of shareholders is, of course, set out in quasi-regulatory terms in the form of the UK Stewardship Code. As an organisation that has dedicated itself to ensuring that shareholders contribute positively to the long-term economic success of investee companies, the Local Authority Pension Fund Forum welcomes this role.

However, if investors are to be part of the reform effort, they first need to understand what went wrong in the banking sector. On reflection, it is striking that the institutional investor sector in the UK has not published a detailed analysis of the bank failures in this country, despite the enormous economic damage that they wreaked. This is problematic if investors are to contribute meaningfully to policymaking. It is particularly important given that in the early stages of the crisis some key decision-makers felt the principal problem was liquidity, rather than the solvency of the banks. This proved to be a disastrously mistaken view. Therefore, by publishing what we have called a ‘post-mortem’ of the UK and Irish banks, LAPFF hopes to address the deficit in analysis from domestic institutional investors.

The Forum’s analysis as set out in this publication leads to some radical conclusions, not least the need for a comprehensive review of financial reporting where we believe there are significant deficiencies. Yet, in reaching this view, we are driven solely by a desire to understand how major financial institutions appeared, on paper, to be solvent at one moment, only to require enormous taxpayer support at the next, just to survive. Again, it is striking that these kinds of questions do not appear to have been asked publicly by institutional investors and their representative bodies in the UK to date, nor serious answers to them sought.

The Forum does not expect other investors to simply accept its analysis, and the reforms that we see flowing from it. Clearly, various factors were at play in the financial crisis, and different groups will put more or less emphasis on different issues. Nonetheless LAPFF does believe that the issues raised in this post-mortem require attention from all those involved in reforming finance, and we welcome responses from other investor groups in the UK and elsewhere.

For the Forum’s part, I believe the analysis contained in this publication provides strong foundations to our ongoing work to reform financial reporting. In doing so, we hope to play our own part in mitigating the risk of another crisis of this nature.

COUNCILLOR IAN GREENWOOD
CHAIR, LOCAL AUTHORITY PENSION FUND FORUM

The Local Authority Pension Fund Forum is a voluntary association of 54 public sector pension funds based in the UK which manages assets of over £90 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders while promoting corporate social responsibility and high standards of corporate governance among the companies in which they invest.

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We would also like to thank those pension fund members of the Forum who gave their comments.
UK AND IRISH BANKS’ CAPITAL LOSSES. DIRECT INVESTOR COST OF THE COLLAPSE, >£150bn OF SHAREHOLDER CAPITAL LOST.

Capital losses in UK and Irish banks 2007-2010, predominantly banking book losses

<table>
<thead>
<tr>
<th>Bank</th>
<th>Amount £bn</th>
<th>Capital &amp; reserves lost*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bradford &amp; Bingley</td>
<td>1.4</td>
<td>114%</td>
</tr>
<tr>
<td>Alliance &amp; Leicester</td>
<td>1.7</td>
<td>89%</td>
</tr>
<tr>
<td>Northern Rock</td>
<td>3.5</td>
<td>196%</td>
</tr>
<tr>
<td>Ulster Bank [itself part of RBS]</td>
<td>6.2</td>
<td>188%</td>
</tr>
<tr>
<td>Bank of Ireland</td>
<td>7.3</td>
<td>155%</td>
</tr>
<tr>
<td>Allied Irish Banks</td>
<td>10.1</td>
<td>234%</td>
</tr>
<tr>
<td>Anglo Irish Bank</td>
<td>16.4</td>
<td>631%</td>
</tr>
<tr>
<td>HBOS</td>
<td>40.8</td>
<td>205%</td>
</tr>
<tr>
<td>Royal Bank of Scotland+</td>
<td>&gt;51</td>
<td>186%</td>
</tr>
<tr>
<td>UK total</td>
<td>&gt;£98.4bn*</td>
<td>183%</td>
</tr>
<tr>
<td>Ireland total</td>
<td>€47.0bn</td>
<td>292%</td>
</tr>
</tbody>
</table>

* % as stated in 2007 accounts, lost in 2008-2010 (Northern Rock, 2006 accounts) + excluding investment banking losses

This table shows the size of losses of particular UK and Irish banks.

Losses were of such a size that the problem was not merely these banks not having enough capital - no rational shareholder would commit capital to fund these levels of losses.

The problem was the inadequate quality of capital that they claimed to have.

The capital that they stated in their accounts was grossly overstated - in one case by more than 600%.
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The accounting standards problem – and the fault is still in the system

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From the perspective of shareholders:
- some banks (Northern Rock) were nationalised to no value,
- some banks had public rights issues, only then to be nationalised or part nationalised with total loss or substantial dilution, (Royal Bank of Scotland, HBOS plc and Bradford & Bingley),
- one bank, Alliance & Leicester plc disappeared off market in a rescue,
- the acquisition by Lloyds of HBOS was a disaster for the shareholders of Lloyds,
- all of the Irish banking sector has been nationalised.

Early stages enquiries reached the wrong conclusions. In the case of Northern Rock, the House of Commons Treasury Select Committee reported in January 2008 on the run on the bank in September 2007. The Committee was very clear in its conclusions that it was a liquidity problem (maturity profile of funding) and not capital (solvency).

“...the Chairman of the Financial Services Authority acknowledged that the events around Northern Rock had been “damaging”. However, the Governor of the Bank of England appeared to be more sanguine about the damage to the UK banking system from the Northern Rock crisis:

“I do not believe that in a year’s time people will look back and say there was any lasting damage to the British banking system. It is very well capitalised, it is very strong, and, as I explained before, although the banks at present are having to pay a bit more for their liquidity than they would wish, they will be able over the coming months to take these vehicles and conduits they have set up back onto their balance sheets and they will be strong.”


A month after the Treasury Select Committee statement, Northern Rock began revealing losses (capital depletion) and went from liquidity support (the Bank of England and Treasury loan) to full nationalisation.

However, Northern Rock was relatively minor; it represented only 0.92% of the total capitalisation of the UK listed banking system in 2007. But, by 2009, 30% of the UK listed banking and 100% of the Irish system had failed. The main factor distinguishing the UK from Ireland was the survival of HSBC.

What the Committee – in common with many/most others at the time – did not recognise, is that a liquidity problem (the inability to obtain or renew creditor funding) is often a consequence of well founded suspicion that the company was not worth the risk of lending to, i.e. it could be harbouring losses by overvaluing its net assets – a capital problem.

However, by June 2011 the Bank of England confirms that the crisis was not a liquidity crisis, it was always a capital (solvency) crisis.

“...an awful lot of people wanted to believe that it was a crisis of liquidity,” Sir Mervyn said. “It wasn’t, it isn’t. And until we accept that, we will never find an answer to it. It was a crisis based on solvency ... initially financial institutions and now sovereigns.”

(Financial Times, 24th June 2011).
It is perhaps an indictment of conflicts of interest in the financial (and regulatory) system that the obvious takes four years to emerge as the true reason for something, when capital markets (equity, debt and money markets) had intuitively deduced the problem in 2007 and reacted accordingly. For a banking crisis to have been confused for four years as a “liquidity” rather than a capital crisis is not an insignificant matter, given that many policy decisions will have been made on a false diagnosis.

Because the banking crisis was in truth a capital crisis, there has to have been a systemic failure in the capital adequacy regime, making what was, in truth, capital consumption appear like capital generation.

One of the consequences of that is that long-only shareholders (those still invested in banks rather than those that were avoiding them) were working on the false premise that they had plentiful shareholders’ funds, as stated in the accounts of banks, when in fact they did not have capital at all. The accounts did not give a true and fair view for the purpose set out in law.

The problem is rooted in accounting standards (International Accounting Standards – “IFRS”). The “true and fair view” in British and European law entails a capital maintenance function, i.e. not overstating assets so as not to overstate capital and reserves. That was articulated prior to IFRS as the specific requirement of ‘lower of cost or net realisable value’, i.e. the recoverable amount of the asset, whether it is held to maturity, to recover that value, or the value is obtained by selling.

International Accounting Standards instead require holding loans at their cost, less an amount called “impairment”. However, the method in the standards to determine “impairment”, rather than looking at factors before the event to reflect the value of the loan (its recoverable amount), was instead looking at factors after the event, thus not taking into account the risk of the borrower not paying, due to his income status or lack of asset cover. Instead of building risk into the value of the loan, the IFRS model waited until the customer stopped paying, i.e. bad loans are structurally overvalued and the higher the risk the higher the overvaluation.

Put another way, accounts can be signed off, in accordance with IFRS, despite there being a fundamental uncertainty whether the balance sheet can, in fact, be realised at the stated amount. Given that a bank that will not recover its balance sheet at the stated amount is likely to become insolvent, this is a significant hazard. Prudent accounting is in a sense a “stress test”, it is reducing the value of loans for the non-collection risk inherent in a loan. IFRS required leaving this risk out. In doing so it closes down lines of inquiry that should be hard-wired into the systems of a bank in order to get the audited numbers right. A stressed loan is the product of a stressed customer.

There was, therefore, regulatory sanction (the method by which IFRS was adopted) for overvaluing loans. With the capital of a bank generally being in the range 3-5% of its total assets it is clear that overvaluing loans by merely that amount will be creating the impression of capital that is not actually there. In plain English, money can be shipped out of the door, and the accounts will be indicating that it will be coming back when it isn’t going to.

Because loan portfolios are built up incrementally, by gearing up with new loans off the capital inherent in existing loans and the new loans, overstating any loans will not recover the capital that appears to be invested. In reality, the bank will be running on an increasingly consumptive capital base.

Capital is not merely a regulatory matter (the relationship between banks and the state). It is a contractual matter directly relevant to the quality and reliability of the accounts that members of the company who fund the capital had been receiving in general meetings. True and fair accounts are about the relationship between the banking company and its providers of capital. It is capital that shareholders put up (invest) and take out part or all of the return (as dividends), and over time may be asked to put in new funds (rights issues). These are corporate finance decisions on which the shareholders give their assent. The rest of this analysis examines the implications:

- whether accounts were issued that reflected their statutory purpose, to inform the shareholders to the standard expected by the law of contract, “a true and fair view”;
- whether rights issue prospectuses were misleading, due to a mode of compliance with standards that may have been “in accordance with standards” but did not give a true and fair view;
- why the FSA, Bank of England (and the public) were so systemically misled about the capital position of particular banks for so long, i.e. why did the capital adequacy regime fail?
- for how long was corporate governance failing due to the numbers being wrong, i.e. management pay and tenure being based on a perception of financial governance that was far from reality? If the accounts are not true and fair, how can pay and reward be either?
- was the systemic collapse of the banking system not merely a failure of the regulation in place, but caused by it?
- how insightful was the analysis used for the Walker Review of 2009 into corporate governance reform? Did it actually offer anything new or useful, given that it was done at a time that the official line was that the problem was a liquidity problem? And, the Review then recommended liquidity solutions.*
- how did two independent but adjacent countries, the UK and Ireland, experience a joint and quite idiosyncratic failure of their banking capital adequacy regimes?
- if an incomplete analysis of problems with those banks that failed has led to inaccurate policy decisions, has the wrong medicine since been applied to those banks that did not fail?
- why was the warning of both the Bank of England and the Treasury Select Committee in the wake of Enron to the Accounting Standards Board about upholding the “true and fair view”.* Why has the EU not measured up IFRS against its intended objective purpose under true and fair view;
- why have so many “investors” - whom the International Accounting Standards Board claims to serve – nor “regulators” not noticed a simple arithmetical error with a fundamental assertion of the IASB?

* a consequence of the “liquidity” diagnosis was a policy decision for banks to hold more sovereign debt.
UK AND IRISH BANKS CAPITAL LOSSES – POST MORTEM

CONCLUSIONS

A relatively simple error was introduced into the financial accounting system in 2005 (International Financial Reporting Standards "IFRS") that both normal financial governance, and then regulatory oversight, had depended.

The EU endorsement of IFRS by the EU Commission was not in accordance with the legal framework specified by the IAS Regulation of the Council and Parliament. It has run contrary to the objective functional requirements of the true and fair view. This then had considerable impact on the UK and Ireland which adopted IFRS more comprehensively than other parts of the EU. The US applied a similar standard.

The refinancing of the UK and Irish banking systems has been predominantly to finance losses on banking books (ordinary lending) rather than investment bank trading book losses.

The total loss of capital of UK and Irish banks has been in excess of £150bn. Investor losses (as normally banks trade at more than the amount of the invested capital) are in excess of that.

IAS 39 and the IFRS framework (in permitting IAS 39) is not fit for purpose. The core problem with IAS 39 has still not been addressed.

Accounting standards are an anodyne area; the accountability for standard setting is confused. The standard setters' model is intellectually flawed.

The IFRS model is inconsistent with the going concern basis of preparing accounts as it can be impossible with a set of IFRS compliant accounts to determine whether the drivers of being a going concern, capital and profits, are in fact real or not.

Not identifying accounting standard setting as a root cause of the initial phase of the banking crisis has led to several misdiagnoses, for example, the early analysis that the crisis was a "liquidity problem", resulting in banks holding more sovereign debt.
CHAPTER ONE

THE SCALE AND LOCATION OF BANK LOSSES IN THE UK AND IRELAND

This table sets out the scale of the losses in banks which failed with catastrophic losses. It includes Alliance and Leicester which would have failed if it had not been rescued by Santander. The average capital lost is 183% of what had appeared in the accounts of these banks as capital, i.e. bankruptcy (the catastrophic loss of banking capital) has occurred on a massive scale.

In summary, whilst these banks appeared to have total capital of £54bn (with an approximate market capitalisation of 1.5-2 times that of £81bn-£108bn) they were harbouring losses totalling £98bn. Due to the fact that these banks were recapitalised whilst harbouring losses, losses ended up exceeding the share capital.

### BANKS THAT DID NOT FAIL

However, the following British banks survived, and were going concerns throughout the period, none of them incurred capital critical losses:

- HSBC Holdings plc
- Standard Chartered plc
- Barclays plc
- Lloyds TSB (would have survived excluding the impact of the acquisition of HBOS)

### Failed UK Banks 2008-2010

<table>
<thead>
<tr>
<th>Failed UK Banks</th>
<th>2008-2010</th>
<th>Extent of rescue required</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shareholder capital per accounts 31 December 2007* £m</td>
<td>Losses £m</td>
</tr>
<tr>
<td>Northern Rock</td>
<td>1,778.3</td>
<td>3,500.3</td>
</tr>
<tr>
<td>Bradford &amp; Bingley</td>
<td>1,210.8</td>
<td>1,378.0</td>
</tr>
<tr>
<td>HBOS (Bank of Scotland)</td>
<td>21,849</td>
<td>40,838</td>
</tr>
<tr>
<td>Alliance &amp; Leicester</td>
<td>1,715</td>
<td>1,533</td>
</tr>
<tr>
<td>RBS</td>
<td>27,324</td>
<td>51,000#</td>
</tr>
<tr>
<td>Ulster Bank (RBS)</td>
<td>3,264</td>
<td>6,162</td>
</tr>
<tr>
<td>Total</td>
<td>53,877</td>
<td>98,249</td>
</tr>
</tbody>
</table>

* Northern Rock (31 December 2006 accounts)

Source: Annual Report and Accounts 2006-2010, # HMG Asset Protection Scheme Accounts – September 2010 (excludes investment banking losses)
The position of banks which did not fail is set out here.

<table>
<thead>
<tr>
<th>Surviving UK Banks</th>
<th>2008-2010</th>
<th>Extent of rescue required</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shareholder capital per accounts</td>
<td>Losses £m</td>
</tr>
<tr>
<td></td>
<td>31 December 2007 £m</td>
<td></td>
</tr>
<tr>
<td>HSBC</td>
<td>$128bn @0.61 £78bn</td>
<td>In no year was there a loss reaching into capital, i.e. loan losses were absorbed by current year income</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>$20.8bn @0.61 £12.6bn</td>
<td>In no year was there a loss reaching into capital</td>
</tr>
<tr>
<td>Barclays</td>
<td>£23.3bn</td>
<td>In no year was there a loss reaching into capital</td>
</tr>
<tr>
<td>Lloyds TSB</td>
<td>£13.4bn</td>
<td>In no year was there a trading loss reaching into capital, however</td>
</tr>
<tr>
<td>Total</td>
<td>£127.3bn</td>
<td></td>
</tr>
</tbody>
</table>

Source: Annual Report and Accounts 2008-2010 # HMG Asset Protection Scheme Accounts – September 2010

But there is also the example of NatWest Bank plc, its accounts show that it (as distinct from the rest of the RBS group it has been a part of for 10 years) did not make capital critical losses.

The total capital of all UK listed banks listed above as at 31 December 2007 can be summarised as follows:

| Total capital of failed banks    | £54bn | 30% of whole sector capital failed |
| Total losses of failed banks     | £98bn | 51% of capital of whole sector consumed (as shareholder losses have exceeded capital) |
| HSBC included above              | £78bn | But, 43% of whole sector, was HSBC. Itself being 61% of capital of that part whole sector which did not fail. 87% of the capital of the whole sector, ex-HSBC was lost |
| Total sector ex-HSBC             | £113bn |
| Total sector capital prior to collapses | £181bn |
In short, shareholder losses have amounted to 86% of the capital of the UK banking sector, ex-HSBC. Given the size of the numbers involved, it is useful to compare it to the United Kingdom’s national debt as at 31 December 2007, not least as new debt has been issued in order to recapitalise Royal Bank of Scotland and Lloyds-HBOS.

UK Government Debt - 2007

<table>
<thead>
<tr>
<th>Conventional gilts</th>
<th>£337.9bn</th>
<th>Index linked gilts</th>
<th>£136bn</th>
<th>Treasury bills</th>
<th>£10bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total National Savings</td>
<td>£83.8bn</td>
<td>Bank of England advances</td>
<td>£13.4bn</td>
<td>Total government debt</td>
<td>£599.7bn</td>
</tr>
</tbody>
</table>

UK government debt was 44.2% of 2007 GDP

In the Republic of Ireland losses in the three main banks have amounted to 100% of the sector capital lost, with losses of approximately 300% of 2007 sector capital. This has been largely borne by the state, amounting to 125% of 2007 Irish government debt, due to the government guaranteeing all creditors in late 2008.

<table>
<thead>
<tr>
<th>Irish Banks</th>
<th>2008-2010</th>
<th>Extent of rescue required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder capital per accounts 31 December 2007</td>
<td>Losses £m</td>
<td>% Loss by reference to capital</td>
</tr>
<tr>
<td>Anglo Irish Bank</td>
<td>£3,622m</td>
<td>£22,872m</td>
</tr>
<tr>
<td>Bank of Ireland</td>
<td>£6,484m</td>
<td>£10,095m</td>
</tr>
<tr>
<td>Allied Irish Banks</td>
<td>£5,973m</td>
<td>£14,010m</td>
</tr>
<tr>
<td>Total</td>
<td>£16,079m</td>
<td>£46,977m</td>
</tr>
</tbody>
</table>

Source: Annual Report and Accounts 2007-2010

Total Irish government debt 31 December 2007, £37,559bn* (25% of GDP). Losses are 125% of 2007 government debt. Losses are 31% of GDP, banking capital was 10.7% of GDP.

*Source: National Treasury Management Agency.
The losses of capital in the UK and Ireland of the bankruptcy relative to the size of the capital of the bank itself can be shown.

**LOSSES AS A % OF 31ST DECEMBER 2007 CAPITAL AS SHOWN IN ACCOUNTS**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Losses as % of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALLIANCE AND LEICESTER</td>
<td>89</td>
</tr>
<tr>
<td>BANK OF IRELAND</td>
<td>155</td>
</tr>
<tr>
<td>ROYAL BANK OF SCOTLAND</td>
<td>186</td>
</tr>
<tr>
<td>NORTHERN ROCK</td>
<td>197</td>
</tr>
<tr>
<td>HBOS</td>
<td>204</td>
</tr>
<tr>
<td>ALLIED IRISH BANKS</td>
<td>234</td>
</tr>
<tr>
<td>ANGLO IRISH BANK</td>
<td>631</td>
</tr>
</tbody>
</table>

The total losses of capital in the UK and Ireland in absolute terms are:

**LOSSES IN UK AND IRISH BANKS (£bn)**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Losses (£bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BRADFORD AND BINGLEY</td>
<td>1.4</td>
</tr>
<tr>
<td>ALLIANCE AND LEICESTER</td>
<td>1.7</td>
</tr>
<tr>
<td>NORTHERN ROCK</td>
<td>3.5</td>
</tr>
<tr>
<td>BANK OF IRELAND</td>
<td>7.3</td>
</tr>
<tr>
<td>ALLIED IRISH BANKS</td>
<td>10.1</td>
</tr>
<tr>
<td>ANGLO IRISH BANK</td>
<td>16.4</td>
</tr>
<tr>
<td>HBOS</td>
<td>40.8</td>
</tr>
<tr>
<td>ROYAL BANK OF SCOTLAND GROUP</td>
<td>51.0</td>
</tr>
</tbody>
</table>

This analysis has not been extended to non-listed banks in the UK and Ireland, however, the problem in banks extends to the mutual building society sector, including the Irish Nationwide and the Dunfermline Building Society.

There are also some interesting geographical nuances apparent in the above. All of the surviving UK banks, Lloyds, HSBC, Barclays, Standard Chartered, and the NatWest part of RBS are London based. The failure rate of London based banks is 0%. The collapse of listed banks outside London including all of Ireland is near universal.

Further, only one of the collapsed banks, RBS, contained investment banking operations. None of the UK and Irish collapses included above can be ascribed as a global problem, the scale of losses are a problem of domestic lending in both counties and considerable cross border lending between the two states.

The scale of collapse, relative to the economies of the UK and Ireland, is different between the two states because:

- Five large UK banks survived relatively unscathed (including the NatWest part of RBS), including the very large HSBC, whereas no Irish banks survived.
- Anglo Irish Bank, was an outlier even amongst failed banks, with losses >600% of capital.

And of the five large UK banks which did not collapse:

- Standard Chartered operates ex-UK and Ireland
- HSBC has the bulk of its operations in Asia
THE UK BANKING COMPANIES THAT FAILED IN MORE DETAIL

Looking at the failures from the perspective of the specific banking companies (as distinct from groups), the failing banks (and where they are located) are:

- Royal Bank of Scotland plc (i.e. RBS ex NatWest) (Edinburgh)
- Ulster Bank (part of Royal Bank of Scotland) (Belfast)
- Bank of Scotland plc (Edinburgh)
- Northern Rock plc (Newcastle)
- Bradford & Bingley plc (Bingley)
- Alliance & Leicester (Leicester)

Also, the following bank holding companies were bankrupt:

- Northern Rock plc (as a former building society, the bank itself was the holding company)
- Bradford and Bingley plc (as a former building society, the bank itself was the holding company)
- HBOS plc (due to Bank of Scotland)
- Royal Bank of Scotland Group plc (due to Royal Bank of Scotland plc)

Whatever was going on in the UK was remarkably similar to Ireland – the loss rates of two of the three Irish banks being well in the range of the loss rates of UK banks despite the following differentiating factors:

- Ireland being in the Eurozone (with artificially low interest rates), the UK not,
- the UK FSA not regulating Irish banks (other than where Irish banking companies operated in the UK), and vice versa,
- the Irish banks have no substantial investment banking operations

What is quite clear is that in both the UK and Ireland the capital adequacy regime failed absolutely in the case of Ireland and systemically in the case of the UK. This is because the capital adequacy regime was based on the audited accounts, upon which normal financial governance and accountability to shareholders had also depended.

ROYAL BANK OF SCOTLAND'S PUBLIC CAPITAL RAISING

In 2008, RBS did raise money in a rights issue, but that subscription was to an essentially worthless entity, given that the losses in the loan book have vastly exceeded what was then claimed to be capital. Indeed the only value to the subscribers of that issue has been the positive impact of a share of the new money subsequently put in by HMG later in the year.

<table>
<thead>
<tr>
<th>Royal Bank of Scotland</th>
<th>£bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claimed capital at time of rights</td>
<td>27.3bn</td>
</tr>
<tr>
<td>Losses inherent in book (not including investment banking losses)</td>
<td>(51.0bn)</td>
</tr>
<tr>
<td>True capital of RBS before rights (£23.7bn), a nil shareholder interest</td>
<td>nil</td>
</tr>
<tr>
<td>New capital in public rights issue of spring 2008</td>
<td>12bn</td>
</tr>
<tr>
<td>True capital of RBS post rights (11.7bn), a nil shareholder interest</td>
<td>nil</td>
</tr>
<tr>
<td>HMG reserve capital</td>
<td>57bn</td>
</tr>
<tr>
<td>Net capital (27.3bn -51bn + 12bn + 57bn)</td>
<td>45.3bn</td>
</tr>
</tbody>
</table>

A focus on the source of losses also dispels a misconception that Royal Bank of Scotland collapsed because of its acquisition of ABN AMRO. It is quite clear that RBS had sufficient losses to have already destroyed its capital base, i.e. acquiring ABN AMRO merely made an already bankrupt bank even worse.

That such a large part of RBS losses is not in fact ABN AMRO is also revealed in the accounts of the government’s asset protection scheme. It has taken on an insurance role for the worst part of the RBS portfolio.
Table 8 below provides a summary of the APA’s base case loss forecasts across APS asset classes, which was based on portfolio data as at 31 December 2009 as provided by RBS. It is important to emphasise that these loss forecasts are not deemed to be generally representative of the risks across these asset classes in the wider economy. This is for two reasons: first, the Covered Assets were originated by RBS at a time when the bank was aggressively seeking to increase market share, and secondly they were deliberately adversely selected as described in Section 4.

Annual Report 2009-10 of the Asset Protection Scheme.

“Aggressively seeking to increase market share” is somewhat different to an aggressive and poorly judged acquisition.

RBS INVESTMENT BANKING LOSSES

The accounts of RBS are particularly opaque, however, despite that it is difficult to conclude that investment banking activities lost more than the ordinary banking, as shown above, in fact the investment banking losses break down as follows (“credit market” is the business segment that included structured credit):

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit market losses gross</td>
<td>(£6,152m)</td>
<td>(£10,095m)</td>
</tr>
<tr>
<td>Total investment banking income net of credit market losses</td>
<td>£3,806m</td>
<td>(£8,829m)</td>
</tr>
</tbody>
</table>

Source: RBS Report and Accounts

The net loss from investment banking trading activities was £5,023m, which put in perspective is 10% of the amount of other losses which have been £51bn.

£5,023m represents 18.3% of the 2007 capital base of £27bn, which was then supplemented by the £12bn public rights issue.

That compares to the losses on the banking book that amount to 183% of the 2007 capital base.

Putting the above losses into the context of the business model of a bank; if a bank is earning a 20% return on capital (annually) then exceptional losses of 20% of capital will be absorbed by the annual income (as in the case of Barlays and HSBC investment banking divisions) and the bank still breaks even. That is market disruptive, given that lack of growth of banking capital, has a knock on impact on the ability to lend, but it does not actually bankrupt a bank, i.e. it does not wipe out the shareholder interest. There is for a bank a tipping point beyond which not only are creditors not protected by the current shareholder interest, but they are not protected by the shareholders also being incentivised to put in new money to refinance.

ABN AMRO

There is a further £34bn goodwill write down in RBS, i.e. the amount by which RBS overpaid for ABN-AMRO, which is clearly an additional shareholder loss over and above the tangible losses above. Goodwill is not a tangible asset relevant for the purpose of determining whether the shareholder still has a positive interest in the tangible net assets of the bank. Writing off goodwill in itself does not cause bankruptcy. However, if ABN AMRO was carrying unsustainable profits (and overstating assets) by £3.4bn, than that itself would imply an overpayment of £34bn (on a, say, 10x multiple of earnings justifying the acquisition).

The fall of RBS can therefore be summarised:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claimed capital at 31 December 2007 at time of rights issue</td>
<td>27.3bn</td>
<td></td>
</tr>
<tr>
<td>New capital in rights issue of spring 2008</td>
<td>12bn</td>
<td></td>
</tr>
<tr>
<td>Net investment banking losses in 2008 and 2009</td>
<td>(5.0bn)</td>
<td>(5.1bn)</td>
</tr>
<tr>
<td>Losses inherent in book (not including investment banking losses)</td>
<td>(51.0bn)</td>
<td></td>
</tr>
<tr>
<td>HMG capital</td>
<td>57bn</td>
<td></td>
</tr>
<tr>
<td>Net position post losses, post recapitalisation</td>
<td>40.3bn</td>
<td></td>
</tr>
<tr>
<td>Total losses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment banking losses</td>
<td>5.0bn</td>
<td></td>
</tr>
<tr>
<td>Banking book losses</td>
<td>5.1bn</td>
<td></td>
</tr>
<tr>
<td>Losses of capital (tangible net assets)</td>
<td>56bn</td>
<td></td>
</tr>
<tr>
<td>Loss of goodwill (mainly ABN AMRO)</td>
<td>34bn</td>
<td></td>
</tr>
<tr>
<td>Total shareholders’ loss (including goodwill)</td>
<td>90bn</td>
<td></td>
</tr>
</tbody>
</table>
CHAPTER TWO

THE ANALYSIS OF THE PROBLEM NOW IS DIFFERENT TO THAT IN 2007/8

Despite incorrect conclusions in the Treasury Select Committee Report of January 2008, some of the evidence was in fact pointing right at the real problem being capital adequacy.

"In its profit warning of 27 June 2007, Northern Rock stated it was suffering from a 'structural mismatch between LIBOR [London Interbank Offered Rate] and bank base rates' and its share price fell by 10% on that day."

Put more simply, Northern Rock’s lenders in the interbank market were charging it more than it could charge its customers. The logical reason for that is that lenders were beginning to express doubt whether they were going to get their money back despite what the accounts were showing the financial position of the bank as being. Also, in the Treasury Committee report is this statement:

"I have said before that regulators should concern themselves not just with institutions that do not appear to be doing terribly well but also with institutions that do appear to be doing terribly well because, if they are out of line, it may be they are doing a very good job but they ought to just be sure that that is the case."

The Chancellor Rt. Hon. Alastair Darling to the Committee.

Or, put that another way, if a bank appears profitable and it is not able to get funding, then in all probability the market may know what is not universally recognised, due to the appearance of capital and profits in the public accounts, a bank is carrying its loans at more than their recoverable amounts, and it has a bad debt provisioning problem. The comments of the former chancellor are apposite. Barings Bank had also appeared remarkably profitable when it collapsed in 1995, but in reality it had been containing a growing fraud for three years, overstating its assets – albeit by a different motive – but with a similar economic effect.

This statement in the Bank of England Financial Stability Review of June 2011 says:

"Inadequate bad debt provisioning can lead to an overly sanguine view of the resilience of the banking sector. It can also tie up funding in assets generating low returns, potentially impeding the allocation of capital to the real economy."

"Much of the improvement in banks’ profits since 2009 has been the result of a fall in provisions made against loans."

Given that the problem of inadequate bad debt provisioning is a reflection of new accounting standards applicable from 2005 it is quite clear that the phenomenon of overstated profits and overstated capital, intertwined the accounting standard. Even in 2011 the problem, according to the Bank of England above, is still not fixed.

Furthermore, this clause in the legislation nationalising Northern Rock in February 2008 is particularly interesting. It is suspending directors from their normal legal and fiduciary duties.

Proceedings against directors of Northern Rock
11.-(1) No director of a relevant undertaking shall be liable for any act or omission of the director, acting in such capacity, which occurs while Northern Rock is wholly owned by the Treasury and accordingly no proceedings may be brought (or in Scotland, raised) against any such director in respect of such matters.

The Northern Rock plc Transfer Order 2008

Given that it is a matter of liability for a director to trade whilst insolvent, or produce accounts that mask insolvency, it is interesting to consider quite what other breaches of law could have been relevant to warrant that specific and highly unusual clause in the legislation. In other words was that Order envisaging that Northern Rock may have, despite its accounts showing something else, have actually been insolvent, i.e. did not have the assets backing its capital?
THE LISTING REGIME AND LENDER OF LAST RESORT

There is a further interesting nuance regarding the Listing Regime. Whereas a loss of capital is Stock Exchange notifiable, the provision of lender of last resort funding (for UK banks by the Bank of England) is not required to be disclosed to the market. (See Glossary regarding lender of last resort lending).

This is logical as the formal terms permitting lending as last resort by the Bank of England are to solvent (capitalised) banks. The Bank as lender of last resort is stepping into the breach to assist banks with debt maturity (cash flow problems, in not being able to roll over term funding) or has a sudden outflow of customer deposits.

Therefore, lender of last resort lending is not necessarily a shareholder relevant matter, provided their capital has not been eroded; there is no need for them to know about it, the Bank lending is merely a bridge. If the Bank always lends in accordance with what it is allowed to do, then that will always be the case.

Similar provisions exist in Company Law, where for a public company an EGM of shareholders must be called if there has been a sudden loss of capital to the extent that net assets are less than half of called up share capital, something which is inevitably the case with a bust bank. This is because so long as a bank has assets > liabilities, even if most capital has been lost, it should almost always be a positive investment proposition for current shareholders to refinance it (or sell their rights to refinance).

Fundamentally, the capital solvency position of a bank is dependent on the numbers in its accounts being right, because if the numbers are not right then rational capital providers will seek to model the true condition to calculate the true position. But, if the market is deducing what the bank is not, then the bank is not discharging its obligations to only lend to its shareholders (Company Law), nor is it enabling the Bank to fulfill its obligations only to lend to a capital-solvent bank.

However, as Chapter 3 explores, particular parts of IFRS do in fact not only allow, but require not accounting for capital critical leaving losses ‘no matter how likely’ out.

In consequence the reliance on IFRS accounts, (or management accounts prepared in accordance with IFRS) can create a scenario, whereby the Bank of England is in danger of providing lender of last resort funding to, what in truth is a bank with no capital, i.e. one that is insolvent. That creates a significant problem if, as may well be the case, creditors in an open market may be more in touch with the economic reality than the boards of the banks involved or regulators, as creditors undertake analysis from a true risk based perspective (based on economic reality), rather than rely on “compliance” with intellectually faulty standards.
A bank loan is a long term contract for which a principal risk is not getting the money lent back. Therefore, establishing the true profitability of a bank requires an assessment of how much money will be coming back.

For the bank there is a double aspect to the loss when a customer does not pay. The bank no longer gets the interest margin (the profit) and the capital sum of the loan still outstanding needs to be written off the bank's balance sheet. However, the bank will have its creditors to whom it still owes their principal and interest. To the extent that a bank has made any loans for which there is a reasonable economic likelihood that some or all of it will not come back, then the capital of the bank itself is already diminished by that expectation of the loss. Put another way, if the loss of capital is material, a rational supplier of capital to the bank (creditors or shareholders) would regard their interest under threat or even lost: the creditors due to the reduction in the capital buffer against further losses being lost, exposing them to loss, and the shareholders given that their interest in the capital is already lost.

EXAMPLE AND EFFECT OF FALSE ACCOUNTING – SUPPLIERS OF CAPITAL ARE MISLED

A rational investor putting up £100m capital into a banking company, for which loans of £1,000m are then made and £900m deposits are taken, is at an information disadvantage to the managers of the bank (if the bank’s managers have taken such steps as to know) that there is likely to be a £50m loss from the particular type of lending but have not reflected this in the accounts of the bank.

The investor is at risk of both rewarding the managers of the bank for profits that are not sustainable but will turn into capital scale losses, and he is assenting to the maintenance of their tenure, and potentially continuing with the same business model. False accounting upsets a chain of proper accountability.

Further, if the managers themselves are not aware of the problem then the false accounting basically upsets a chain of proper accountability and control.

It is unlikely that such a situation will continue for ever. If the company’s shares and debt are traded in a secondary market, and even if the shareholders and managers of the bank are unaware of the problem, then only part of the secondary market needs to be aware of the problem for the true condition of the bank to be reflected in the share price, i.e. the market is taking things from other sources, that properly ought to be in the accounts but aren’t. The bank may still believe it is profitable from its accounts and behave accordingly, as may its shareholders. It may appear in its accounts as healthy as other banks not in the same predicament. It may even try to raise new capital. However, if the issue succeeds, the subscribers will have been misled, or as may well be the case, the issue will not succeed. The market will have an expected return for any bank, and also deduce the risk attached to that bank, by whatever means markets deduce things, and refuse to finance, thus capital raisings are all or nothing.

This dynamic can be seen in UK banks from 2007 (from the fail of Northern Rock) to 2008, well before any trigger from the collapse of Lehman in the USA.

INTERNATIONAL ACCOUNTING STANDARDS (INTERNATIONAL FINANCIAL REPORTING STANDARDS “IFRS”) – HAVE LEFT OUT LOAN LOSSES HENCE MADE UP NON-EXISTENT CAPITAL

Despite the economics and control and accountability that is instilled from proper bad debt provisioning (not overstating assets and not overstating capital) the accounting standard most applicable to banks, IAS 39, positively forbids the anticipation of loss. The standard goes so far as to give an example of not anticipating a precisely anticipatable loss. This is directly from the standard itself:

AG80 “As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity’s group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died.

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

EU Endorsed- IAS 39
The IAS 39 question “what is the permitted impairment by the IASB’s criteria?” is very different to the plain simple question “what is the recoverable amount of loans?”. The bank will not recover the expected loss that IFRS is leaving out. A loan with IFRS is therefore always carried at more than its recoverable amount. The error in IFRS requires only basic mathematical knowledge to understand. In a fractional reserve banking system, this basic flaw is catastrophic.

In the early months of a poor loan, with high rates of interest, the loan may appear extremely profitable by the test of profit created by the IAS 39 model above. What can be reasonably estimated as an expected loss, and what IAS 39 is booked, creates not merely an overvaluation of the loan book (and overstatement of capital and profit), but it creates internal management issues; managers will appear to be creating profit and new capital, and reward themselves and gain kudos for that.

There are two possible dimensions to the loss that is left out:

a) either management knows and the shareholders do not what the loss is. But the business at least has the opportunity to be under control.

b) or, as the information is not reported externally, it does not get measured in the first place, i.e. both management and shareholders do not know what is going on.

In the UK and Ireland, IAS 39 (and an IAS 39 copy, FRS 26) was adopted in banking company accounts as well, rather than only for consolidated accounts (which was the EU compulsion for IFRS). This fact is absolutely critical to the then failure in the capital adequacy regime. Fractional reserve banking is conducted in banking companies, which prepare their own accounts, and in the UK and Ireland IAS 39 or FRS26 were the standards for all banks.

PROPER PROVISIONS FOR BAD DEBTS PROTECT THE CAPITAL OF A BANK
Basle regulation determines the amount of capital to be held. It is the IAS 39 (where used) method of accounting for capital that determines whether the bank in fact has it.

The illogicality of this approach can be seen by just thinking about insurance as an analogy. If a bank, to protect its shareholder’s capital and creditors, instead of suffering loan losses itself, took out insurance, so that the insurer covered the loss of loans, then, the insurer’s capital would be at risk, and the insurer would make a periodic charge to the bank for the cost of cover. In such a case, the profit of the bank would have an insurance cost instead of a bad debt charge. In essence, most banks self insure, and the banks’ capital is at risk. The economics of the pre-IFRS regime was that the general bad debt provision reflects the loss risk to the portfolio, and the change in the provision represents the cost to the profit and loss account. If a bank grows and takes on increasingly risky lending then there is a volume as well as a risk charge to the profit of the bank.

However, IFRS had led to the converse. It is clear that UK and Irish banks were releasing even those provisions that they had had, at a time that the books were growing and risk was increasing.

THE “THINKING” OF THE IASB
The error occurred as there has been a dogmatic school of thought in the IASB that making provisions in any company is linked to the manipulation of earnings. But, in being dismissive of something as simple as a general bad debt provision in banks, the accounting standard setters have overlooked the economics of what provisioning was achieving in respect of the capital position.

What the dogmatic school had totally overlooked was that in a bank, moving provisions is an essential tool of transparent risk management and capital protection. The impact of IFRS has been that the most dysfunctional banks appeared the most profitable. A dysfunctional apparently profitable bank, as it will be growing, is a bigger public hazard then an apparently loss making bank, as the transparently loss making bank will at least be shrinking.

Such a situation could prevail because rather than having a climate of conservative standard setting, a climate of standards selling became the mode of operating due to a coincidence of interests in the matter. Indeed the sophistication of the selling has exceeded the competence of the setting. Very often large groups of people will agree with an inappropriate answer due to the way that the question was phrased.

Even as late as 2010 standard setters were still pushing the flawed IAS 39 model on the basis:

– it is more relevant to see losses as they arise
– capital is a matter for regulators not accounting standard setters.

The first answer is foolish: a loss is incurred when a loan is made to a poor credit risk, not merely when the customer stops paying; anyone can pay the first few instalments from other borrowed money. The second answer also overlooks that in signing off a set of accounts on a true going concern basis, the auditors and directors need to know what the true capital is, and that is not achieved by leaving losses out.
IF IAS 39 IS NOT USED IN BANKING COMPANIES

If IAS 39 is not used in the accounts of banking companies, then neither situation in a) or b) above will prevail, if the alternative accounting regime is picking up the risk of loss and not overvaluing loans. External parties will know what the number is from the separate accounts of the banking company, and, management themselves will know the number and are managing the business on that basis, the appropriate financial discipline is in place in order to get the numbers right.

This evidence from the FSA in 2011 indicates that it is the situation in b) that has prevailed, and due to an incredibly delayed reaction in sorting out the problem, it is still occurring. This is from an FSA consultation document in 2011.

"Recognition of impairment in internal reporting

Firms reporting on potential impairment indicators, impairment and individual assessment of loss risk associated with these accounts was, in our view, found to show potential for considerable improvement within firms. Firms should review their reporting to ensure that they move to a position where impairment within the book and its associated loss risks are fully assessed and accurately and transparently reported through committee and Board reporting, and, that executives are informed when making business decisions.

Poor practice [example]
The firm does not comprehensively report on the incidence of potential impairment indicators and customer impairment. These loss risks are not assessed or reported to executives who are not aware of the overall loss risk to the business."

Forbearance and Impairment Provisions – “Mortgages”
FSA May 2011.

The accounting is allowing people to turn a blind eye to things as the IFRS system does not require it to be reported, and, in the short run at least, the impact of not doing so is very profitable to insiders, as strong external profits are the outcome in the short run, if one is making risky loans and not booking provisions against non-recovery.

The final nail in the coffin for British and Irish banks was the further concession by the UK FSA, mirrored in Ireland, that banks could use IFRS as the basis for periodic regulatory returns also - rather than maintaining proper management accounts picking up prudent data and discipline, hence the situation in a) above could prevail. Nothing was booked internally.

Remarkably, this aspect of IAS 39 was sufficiently controversial that the IASB which set this standard had a ready reply at the time, that earnings "volatility" (in plain English a series of large loan write downs after a period of apparent profitability) was merely providing "transparency". The fatal flaw in that argument being that there is no transparency when risk is building up and something would be done to manage it, and profits and capital would be reduced, thus adjusting the way that business is done. Whereas for management and directors, the number has been an "unknown unknown" (neither the amount or the issue), it was in the end a sufficiently intelligent part of the market, surmising what losses could be in the offing (by modelling from the outside looking in) and withdrawing support, creditors assume that capital is depleted, and shareholders, where there are rights issues, may well surmise the same and the issue will fail.

The problem with a banking crisis is that what appear to victims of a crisis - the banks themselves being uncapitalised - are in fact the cause of it. On the way up, by lending out of synchronisation with true capital growth in the rest of the economy and on the way down, by a more rapid reversal, a credit crunch.

IFRS has been admitted, even by the IASB itself as being "procyclical" i.e. likely to accentuate a cycle. That is in fact a mis-description as the word is grossly misleading. IFRS as a model destroys capital, it misallocates it to borrowers and insiders, and the cycle does not rapidly return to where things started, if at all. In fact the "procyclical" has no reversal phase, as IFRS exaggerates the value of capital and hence the amount of capital a bank has at all parts of a "cycle".

Further “regulatory capital” is one of the most inappropriate measures to even think about for running a bank. A business has natural capital, which is connected to real economic outcomes and effects. Regulatory capital is merely a safeguard to establish a level of capital in the event that a bank has failed. A bank’s capital is there to deal with unexpected events. The IFRS model has objectively left out expected losses of loans by not carrying them at their expected recoverable amount.

THE PROBLEM WITH COPYING IAS 39

The above analysis demonstrates the peculiarly bad level of lending losses in UK and Irish banks, due to near identical implementation of IFRS in both countries due to having taken the same option under EU law, and sharing the same national accounting standard setter, the Accounting Standards Board. The Accounting Standard Board seems to have been the only standard setter, other than in the USA, to have directly copied the offending part of IAS 39 into national (non IFRS) standards; the result of which was that even if the IFRS option was not taken, the fault in IAS 39 was still applicable.

However, the problem with copying the standard is even more marked than that. Had the standard not been copied, then the properly functioning alternative would have itself exposed the intellectual flaw in IAS 39, basically there would have been a functioning reference point making it less likely that so many banking institutions in the UK and Ireland and their auditors would have unquestioningly applied a faulty standard.

Ironically that situation did prevail in Northern Ireland. The regulator of Northern Irish credit unions identified that the mirror standard (FRS 26) was imprudent and was not consistent with his requirements. Therefore despite the systemic banking failures in Great Britain and the island of Ireland, there was no failure in Northern Irish Credit Unions. Prudent accounting tends to correct imprudent lending at source.
HBOS, Northern Rock and Bradford & Bingley were already failing well before the September 2008, ‘Lehman crisis’. It was the quality of their loans that was the causation of their problem with the market – rationally – not wishing to buy any more of their securitised assets, to lend to them or to recapitalise them.

However, there is a global dimension. The USA did apply IFRS methodology in a similar way in banking books and experienced similar subprime lending crises to the UK and Ireland with loans that were held on banking books with the IFRS methodology. By definition, loans tend to be held on banking books in the place of their origination by the bank of origination. Therefore, UK, Irish and US banks were carrying poor loans on their books at overvaluation. As a result credit in these countries was substantially mispriced.

Chapter 1 demonstrates that the UK and Irish banks problems did not result from “the global financial crisis”, rather, the banks were substantial contributors, already weakened in such a way to the extent of not being able to take losses at all. They were essentially Ponzi Schemes, i.e. taking in money (equity and deposits) with no ability to ever pay it all back.

There were two quirks in IFRS that allowed this:

- the suspension of the principle that rather than being the sum of the parts, all assets accounted for should be looked though to the fundamentals. IFRS required the masking of the poor quality loans and allowed taking credit for insurance, allowing a valuation net of contingent insurance. This tolerance of netting has had the double impact of obscuring:
  - the poor quality loans themselves (which were rapidly deteriorating)
  - the systemic dependence on a few insurers whose risk was increasing

- mark up to market. This suspended the principle that one only makes a profit when one has sold something (i.e. transferred the risk of ownership in exchange for cash). With IFRS one can make a gain from holding and call it a profit. IFRS goes so far as to ignore the fact that market prices are set at the margin, for normal daily activity. But, just as in any other industry, large pools of assets will not be sold for the prevailing market value of marginal sales.

In short, for UK, Irish and US housing, commercial lending and property lending markets, there was a voracious supply of mispriced credit. Both banking books and investment bank trading books were literally magnets for taking up bad credit.

UK AND IRISH BANKS CAPITAL LOSSES - POST MORTEM  19

**CHAPTER FOUR**

**THE ACCOUNTING STANDARDS PROBLEM – TRADING BOOKS**

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In short, for UK, Irish and US housing, commercial lending and property lending markets, there was a voracious supply of mispriced credit. Both banking books and investment bank trading books were literally magnets for taking up bad credit.
It was the same crisis, the origination of bad loans in states where the problem was systemic (the UK, Ireland and the US) where the double option of poor accounts on banking books and trading books existed. Mispriced securitised credit does not stand out as unusual where there is mispriced banking book credit.

Many saw the banking crisis in total as literal 'market failure', this issue is actually more simple than that. The failure was that there was a magnetic attraction by banks to bad assets, and that is tightly related to the fact that quirks in the accounting for the banking system, for originate and hold, and originate and distribute, made that dysfunction look attractive.

The unfolding of the crisis was set in chain a few years back, 2005 in the case of IFRS in the UK and Ireland, and even earlier in the USA.

**TIMESCALE OF THE UNWINDING**

**July-August 2007**
The 'global liquidity' problem was that the investment banks had been hoarding assets, they were overstocked. Investment bank assets are funded like inventory in most business models, by short term debt, they could not expand their inventory, and they could not sell without reducing the price, but they were holding up to their creditors the marked up price.

Alliance & Leicester did get a large securitisation away (i.e. it sold it to an investment bank) however Northern Rock failed to get it's securitisation sold, and it was unable to get funding to hold it on its banking book. Irrational buyers (investment bank trading books) had stopped taking the securitisation, and then rational creditors then would not fund Northern Rock for holding these assets.

**September 2007-February 2008**
Banks no longer lent to other banks. Losses were beginning to be realised on CDOs and MBS, largely on trading books, but also in some banks' treasury books (for which only non-temporary losses are booked against profit and capital).

**March 2008-September 2008**
Other UK banks begin to fail (banking books), they are unable to raise new capital. US bank are similar. The Irish banking system still looks healthy, is then given 100% backing by the Irish state, and then begins to fail.

**September 2008-March 2009**
Storm phase. Suspension of mark to market in the USA and EU (see Chapter 5.)
In theory, a market price, subject to the cyclical upside problems referred to in Chapter 4 with mark up to market accounting, should in most cases be equal to ‘net realisable value’, which was the test of pre-IFRS accounting if assets needed to be written down.

However, there is an important difference, if you do not intend to sell an asset immediately then holding a loan asset for the long term is different to holding an asset at current market price, if for some reason there is a distressed market. In 2008-2010 there were very distressed markets.

Problems exaggerating matters were hardwired into IFRS, by the very tight linkage of:
- liquid assets to market values (level 1)
- rarely traded asset to observable market inputs (level 2)
- wholly illiquid assets to other inputs (level 3).

IFRS thinking has been largely based on ‘efficient market theory’ of ‘one value one price’. However, elements of efficient market theory have since been discredited or modified, particularly relevant to asset prices on the way down.

Akerlof obtained a Nobel Prize for ‘Market for Lemons’ in which he postulated that there would be a difference between price and true value if there was information asymmetry between the buyer and the seller. If the seller knows that goods might be faulty, then that suspicion with the buyers will tend to lower the price to the extent that holders of good assets will not put them in the market at all, causing prices to spiral down to that of the lowest quality put into the market, hence market prices not actually being a proxy at all for assessing the value of second hand cars as a whole.

This is what happened in late 2008. Those banks unwinding overloaded trading books to pay down debt funding those assets, were distressed sellers, those holding similar assets on treasury books were not. With the opacity of the instruments, and their accounting, the bubble not only deflated quicker than it had built up, elements of it overshot.

When asset values are falling, in no small part due to accounting standards overvaluing them in the first place, the worst methodology for valuing them on the way down is that which was in IAS 39, as both level 1 and level 2 require all similar assets to be valued by analogy to other market inputs. In other words, if the market is falling irrationally in a ‘market for lemons’, all assets are tainted by the same irrationality.

Late 2008 and early 2009, there was essentially a ‘market for lemons’. Similar assets were valued under IFRS (and the US equivalent) equivalently irrationally low.

However, it is noteworthy in the UK, with three large domestic investment banks, HSBC, Barclays and RBS, only the latter required support, and as recently evidenced, RBS was only partly an investment banking failure (its own investment bank and acquiring ABN AMRO).

Barclays and HSBC were able to absorb investment banking losses within their annual income, i.e. they broke even, or still made a profit. Without the ABN AMRO acquisition, RBS investment banking may have not been significantly different, i.e. by far the worst part of the RBS losses have been the banking book and the acquisition of ABN AMRO with the problems on its trading book.

By Autumn of 2009, the US and the EU (which endorsed IFRS) suspended mark to market accounting (the US under pressure from Congress) the IASB under pressure from the EU Council (Heads of Government).

The extent to which the IFRS methodology was systematically overstating losses of some assets in early 2009 can be seen in the accounts of HSBC. The accounts of HSBC show that it was holding assets in treasury at £2.4bn (IFRS) less than their inherent value, and the HSBC long-term valuation was that which prevailed.

THE LAROSIERE REPORT
The above analysis from the EU about the IFRS element of the global crisis has been well covered in the Larosiere Report for the EU and the Turner Review in the UK but neither reports picked up the idiosyncrasy of the UK and Ireland applying IFRS more comprehensively and copying the defective standard into national GAAP in the same way that the US had.
This is partly due to the fact that the “storm” phase of the investment banking part of the crisis (a large part of which did reverse), masked the rather different nature of the losses in the UK and Irish banks in particular.

However, once it is appreciated that there was a territorial problem of UK and Irish accounting standards (IAS 39 and the copy of it as FRS 26), it is then only one further step to identify that other than those two states, the “common standards area” is not merely those two sovereign states that are part of the common standards area, but, that other independent crown dependencies (and not part of the EU):

- Isle of Man
- Jersey
- Guernsey

all follow the same accounting standards (the same IFRS-FRC-ASB combination) and auditing standards, and as can clearly be seen with offshore deposits in these states, and there were systemic banking collapses in these places too. Again, this is indicative that the common factor in banking collapses is not the national financial services regulators but the common thing that all of the regulators depended on, as did the boards of the banks, the accounting standards. Essentially regulation and governance was being attached to false statistics.

Further, it is also clear that one other state had large scale banking losses, Iceland. Its large banks were little more than holding companies, for what to Iceland was offshore activity, operating banks largely in the same common standards area, the UK, Ireland and the crown dependencies.

Just as an E Coli outbreak is traced back to “who ate the same food from which shop?”, what has not been widely applied as a methodology in looking at this crisis, is “who followed the same standards in the same way?”. It is quite clear that there are significant vested interests in the accounting standards not being responsible and for the blame to be passed to “regulators”.

The problem with accounting standards being in the frame is not merely that this then brings auditors into the frame, as to whether they implemented the standards properly, but also it draws attention to how the standards became what they were in the first place.

Had accounting standards merely become another manifestation of pleasing management? The genesis of IAS 39 is particularly interesting. It was first approved in the immediate period after the collapse of Enron, when some US auditing firms in particular were in a clear state of capture by the their clients’ management.
That is the position of the law, a true and fair view of the profit, the balance sheet and the state of affairs.

1.1 ANNUAL ACCOUNTS
The law sets out the objective of the audit, “the contractual expectation of auditors. The legal position is that the audit is attached to accounts in order to provide reliable intelligence to:

– hold the board to account and be able to reward it properly,
– protect the company itself, from fraud, or error, such as paying dividends out of capital,

In law that is a governance function, essentially that capital is still there and profit is real, i.e. the accounts are a suitable basis for the approval of the reward for directors (and retrospectively that of managers and staff).

If accounts do not show that a dividend can be legitimately paid with reasonable assurance, the shareholders are in the ludicrous position of:

– sanctioning something illegal (a distribution from capital) without knowing it.
– reappointing directors, who, even in ignorance may be destroying capital, whilst the accounts are showing the creation of it.

1.2 PROSPECTUSES AND RIGHTS ISSUES
In the case of rights issues the objective of the prospectus is to ensure:

– that there is not a transfer of value from subscribers of shares to the company (the existing members), such as funding undisclosed losses,
– making inaccurate statements generally that might boost the offered price

Provided annual accounts have been prepared properly, the first of these prospectus objectives should be met by the second accounting objectives.

LAPFF has for many years seen audited annual accounts as central to shareholder protection, as well as shareholder information in order to exercise class rights.

1.3 THE AGM CYCLE - GOING CONCERN – PERCEPTION AND REALITY
Shareholders vote on the annual report and accounts (in addition to their also being audited), reappoint directors, and approve and set the conditions for remuneration. If accounts are in any way covering up losses (that the directors are hiding or have not detected) then the whole process of accountability is based on a perception that is not the reality, and so is the approval of dividends. But as importantly, so is any gearing based on false retained profit (i.e. false reserves).

It is a by product of directors having to tell shareholders the truth (under audit) that there is then no excuse for the directors themselves not knowing (provided the audited accounts are correct) where the company is truthfully at. That is a protection for directors too.

This regime was put in place in 1879 as a result of the collapse of the City of Glasgow Bank. It had been trading for over three years on the false assumption that it had capital. Precisely what has recurred in the period up to 2007/2008. City Of Glasgow lost money on poor loans, and then falsified gold reserves to make up the difference.

What has occurred this time is no different economically.

However, this time, instead of making up gold reserves, banks had misled themselves that they had not lost the money in the first place. But so far as the capital of a bank is concerned, a bank has made a loss the moment it has extended finance to a customer that won’t pay.

1.4 FAILURE OF OUTCOMES
It is quite clear in terms of the sheer number of banks that failed that annual accounts have been defective, and in terms of rights issues where losses were then made, that the prospectus regime has failed, both regimes being dependent on reliable accounts.

(A detailed breakdown of financial governance failure by bank is given in the Appendices for the UK banks.)
Given that the provenance of accounts in Company Law is to protect banks by showing their true capital position, ever since the 1879 Companies Act, it is logical that regulators would take accounts as the basis for regulating banks.

The capital adequacy regime is about what happens once a bank has already gone bust, it is a “gone concern” model. It is a perfectly sound objective, as a fall back. What is clear is that something caused banks to fail in the first place to such an extent that virtually no normal amounts of capital could absorb the level of losses being incurred in UK and Irish banks. It is quite clear that the FSA did not have an understanding of the step prior to failure, the protection of the capital interest in the first instance.

The objective that the FSA seems to have neglected is indeed the governance objective of company law, one of showing the progress of capital, not just a question of the regulatory amount of capital, but the genuineness of what is there, and the ongoing creation of it. From the position of a bank as a going concern, the “capital adequacy” calculation (of the FSA) is not particularly relevant. It is clearly a requirement to meet. But the business risk to capital is not captured by that.

It could be said that the FSA was not working from the perspective of the shareholder class or creditors, but a contingent undertaker. The FSA position was a very limited view on the utility of accounts for shareholders and creditors.

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Were a bank in such difficulty aiming to support the central bank’s position by raising new money from public shareholders without the public subscribers being aware of the problem then shareholders would clearly be misled. There is therefore an all pervasive conflict of interest – in matters of new capital raising - between banking regulators and central banks (depositor protection) and public shareholder protection.

THE FSA AS MARKET REGULATOR

Post 2000, the FSA not only acquired the role as the banking regulator (protecting creditors), without being in the position of being a contingent creditor (i.e. lender of last resort) but the FSA also accepted the position of the Listing Authority (including protecting the subscribers for shares), i.e. the FSA accepted a quite difficult conflict (at times of stress) of protecting shareholders of banks as well as creditors. However, just as the “regulatory capital adequacy” objective is somewhat limited in its view of the utility of accounts “one number for a dead bank”, the “market confidence” objective is also somewhat confused in what has been executed.

This is an FSA Discussion Paper in 2004 on the implications of changing from UK GAAP (Companies Act accounts) to IFRS.

“The first and most complex reason why prudential supervisors might consider departures from results produced by IAS accounting is that the purposes of prudential regulation and accounting standards are not the same. Financial statements are intended to provide shareholders and other stakeholders with information as a basis for making investment and other economic decisions about the reporting regulated institution. This perspective has certain consequences that may not be consistent with the objectives of banking supervisors.

“Under the IASB accounting framework, capital is regarded as the residual difference between assets and liabilities [as defined by standards]. Matters that particularly concern supervisors – such as the permanence and loss-absorbency of capital – do not explicitly feature in such a framework.”


Quite remarkably the FSA was not only arguing against what a logical banking regulator would want assurance on, the permanence and loss absorbency of capital, but:

- it was arguing against what a rational shareholder would want assurance on too. Shareholders would rationally want:
  - profits that are true and reliable (not least so that management and directors do not overpay themselves),
  - product is not mispriced (i.e. an under reflection of cost is met by under pricing),
  - dividends that are reliable and sustainable,
  - value is not destroyed due to bankruptcy,
  - value is not destroyed by the current shareholder interest being diluted by emergency bailouts or full nationalisation

- and, perhaps even more remarkably, the FSA was also arguing against what is in fact the law:

Section 837 of the Companies Act states that accounts must be prepared properly, to give a true and fair view, subject only to matters not material as to whether a distribution is lawful (capital maintenance). The statute is explicit that it is the numbers in the accounts that are relevant for that purpose. Capital maintenance is embedded in the law but only works if what is in the accounts is addressing the permanence and loss absorbency of capital.

What appears to be the case from this policy paper is that the FSA was directly setting policy for both functions; banking regulation and market confidence, that was subordinating the interest of banking requirements to its perception of what public markets wanted, but neither objective was in fact met.

From early 2008 markets were quite rightly walking away from rights issues so unreliable was the reporting regime in place. But, as a result of misdiagnosis of the problem, the time scale of the rights issue regime was blamed. The fact is the markets were inevitably more perceptive than banking regulators, and even the directors of banks themselves.

IN SHORT, THE FSA:

- had a conflict of interest in having the Listing Authority within the same organisation as banking (and insurance) regulation,
- accepted an accounting framework that did not support capital maintenance (despite the law being unchanged which requires that it does),
- missed the dynamic of going concern being a matter of economics and incentives rather than regulation and process,
- had not got the correct objectives even for market confidence, having subordinated banking regulatory objectives to its – misplaced – view on what instils market confidence.
- had absolutely misunderstood the difference between “market confidence” (which may be a low turnover of stock) with market volume interest, i.e. trading shares. Markets are markets. The essence of company law objectives for banks in particular is not concerned with information that is about trading volumes, but information and assurance that better governs the company itself. For parties in markets interested in trading shares, uncertainty is good news. It boosts volume. There is actually an inverse relationship between the quality of financial information and assurance required for shareholders as a class (with the interest of the company at heart) with the more commoditized and inherently uncertain information for parties trading shares that benefit from price volatility.
There are broadly six areas where IFRS obscures the true capital condition, i.e. whether capital is being created, destroyed or whether it has been pledged to another party.

These are the areas of defectiveness.

- by allowing to be presented as “equity” things that do not represent ordinary shareholders’ funds, and by including the equity of entirely separate legal entities, e.g. such things as Master Trusts as if they were part of the capital of the company),
- the risk to capital – i.e. the risk that assets supporting the capital will not recover their stated amount,
  - this also has the impact of overpaying staff as profits are not sustainable
  - it also incentivises poor lending, as it produces strong short run profits.
- obscuring gearing against illiquid assets that have been marked up by analogy, but not actually sold (by allowing mark to market or mark to model illiquid positions, for which the process of realisation would reduce the price),
- the capital consuming impact of contingent liabilities (by leaving them out)
- by creating a process based test for accruals, rather than an economic one
- not being clear on what the purpose of consolidated accounts are. IFRS is the accounting equivalent of a Christmas Tree, sticking presents on it here and there. This masks the fact that a company prepares consolidated accounts as its capital will comprise what it has paid for subsidiaries and any loans made to them. Preparing consolidated accounts is a route to demonstrating what is behind that capital. Particularly relevant if a subsidiary has made a loss.

Each and all of the above are critical to whether a company is a going concern. Being a going concern requires a stable balance sheet and clear profit/loss trend. Reaching a rigorous going concern conclusion requires reliable audited information in order to reach that conclusion. If IFRS information is being fed up the reporting chain to boards, and auditors, and also via other audited subsidiaries’ accounts, it is difficult to see how the directors and auditors can form a robust opinion on the going concern status of the company or the group.

If the auditors are receiving from other auditors (of subsidiaries) audited information in IFRS only form, there is no information passing up the chain about the losses that IFRS is leaving out, or overvaluations that IFRS is leaving in. The law articulates corporate stability in terms of whether the accounts are reliable enough for a distribution to be made without being out of capital. The fundamental (common law) accounting principles relevant for determining that are:

- prudence,
- no unrealised profits,
- matching all costs relating to the period,
- no netting of asset and liabilities or profits and losses,
- being a going concern

Whilst the matters are worded in law, the objectives are economic. If the company is about to fall over, one factor of which may be collapsing asset values, then one should not be making distributions from it. Similarly it would be imprudent to make a distribution from a company that is not a going concern (i.e. there may be closure costs that will eat into reserves and capital). It is logical therefore to have developed an accounting model that is indicative of whether a company is in fact capable of being a going concern linked to its capacity to distribute its profits. Given that:

- profits are paid out as cash, creditors and shareholders are left with the residual assets, hence the accounts have to get the recoverable amounts of the residual assets right, else, creditors and shareholders are left with something inherently less stable.
- new capital is subscribed from time to time, then new shareholders are protected, from not putting money into a company where asset values are about to collapse, or have already collapsed.

Clearly to the extent that going concern is dependent on new customers crossing the threshold, that is an inherent uncertainty. However, to the extent that a company is harbouiring losses, in the case of a bank where its assets are largely financial assets, hidden losses may be obscuring whether a bank is even capable of being a going concern or not.

What is therefore remarkable is that accounting standards have been set that make it impossible to conclude whether a company is even capable of being a going concern. The next chapter looks at how this might have arisen.
THE LEGITIMACY OF IFRS

The IASB which sets IFRS is an unaccountable Delaware registered body. Its standards sit outside any legal authority. For that reason, the EU in adopting IFRS has set an endorsement process by which IFRS become instruments of EU law, replacing the existing EU accounting laws. The authority for bringing IFRS into EU law is the IAS Regulation of the Council and Parliament 2002. That sets out criteria for the Commission to follow before an IFRS can be endorsed.

The overarching criteria set by the IAS Regulation is that an IFRS cannot be adopted by the Commission if it is contrary to the accounts giving “a true and fair view”.

THE TRUE AND FAIR VIEW UNDERPINS THE LAW

The structure of accounting in the EU has been legally harmonised for a number of years. This was achieved by taking the formats, and valuation methods from UK Company Law, and creating two EU Directives to roll that model across the EU, these are the:


Both Directives require that accounts ultimately give a “true and fair view”.

In the UK, true and fair view is defined in case law and statute such that it is inclusive of a capital maintenance objective. This means that it sits within a model that is intended as a bare minimum to show whether a company has the capital and reserves, i.e. it is concerned with the appraisal of assets and liabilities from a capital solvency perspective.

The practical implications are that the accounts are not masking that capital has been destroyed – by for example hidden losses (whether these are obligations to pay, or the overstatement of assets above their recoverable amounts). This ensures that the shareholders are fully aware of the directors’ stewardship of their capital, and it ensures that dividends cannot be paid out without leaving a loss for the creditors to bear.

UK statute is clear in respect of the primacy of capital maintenance in statutory accounts such that there is a derogation from the full extent of the true and fair view, some things can be left out from disclosure, subject to not excluding that which is material for capital maintenance. This has been confirmed by legal counsel for the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland.

It is quite clear too that now in EU law, as decided by the European Court of Justice, that the true and fair view relates to a capital maintenance objective.

THE EU ENDORSEMENT OF IFRS HAS BEEN FLAWED – IT FAILS TO ADDRESS THE MAINTENANCE OF CAPITAL – INHERENT IN A TRUE AND FAIR VIEW

However, what is now clear is that the Commission has endorsed several IFRS that fail the true and fair objective, with respect to capital maintenance, by leaving out capital relevant losses and including unrealised (uncontracted) profits. IFRS accounts therefore no not merely not direct things towards giving a true and fair view, they positively contradict it.

This is because the EU Commission has, remarkably, had no proper yardstick with which to assess a “true and fair view” for the capital maintenance objective as required in law.

The Commission has failed to regard true and fair view as an objective test, set out in law, to which particular functions apply on purpose, and financial governance relies. The Commission has instead regarded things as a subjective test that could be met by discussion, compromise and a plurality of views.

Were that defective process not enough, there is a further problem. IFRS have not been properly assessed by any process by the EU Commission for use in company (“company only”) as distinct from group accounts. The consequences of this are covered below.

THE PROBLEM OF NOT ASSESSING IFRS FOR USE IN COMPANY ACCOUNTS

Companies as incorporated entities either have capital, or they do not. In the normal course of things shareholders are not obliged to subscribe more capital, this means that for accounts to be true and fair on a going concern basis, the company must be able to stand on its own feet. Put more generally, it has capital and it is generating profits, thus maintaining and growing the capital. The more that there is shrinkage of capital, the less likely the company will be a going concern.

Capital maintenance in accounts operates at two levels:

– Company accounts (4th Directive), and
– Group accounts (7th Directive)

2 FRC - Martin Moore QC, legal opinion, citing ECJ cases.
A company preparing true and fair accounts, is demonstrating whether that company has capital, and whether that company can lawfully make a dividend distribution without disadvantaging creditors. If the company has subsidiaries, its principal assets (which represent its capital) will be investments in subsidiaries and intercompany advances it has made. Both of these assets will be in peril if the subsidiary is in fact loss making.

Group accounts are merely another way of preparing a company’s accounts, but, as the assets and liabilities of the subsidiaries are those of the company. This has the accounting impact of replacing investments in subsidiaries and intercompany advances with the underlying assets of the subsidiaries. The benefit of this is that it reveals whether a holding company is investing in subsidiaries which are themselves capital depleted, thus having a potential impact on the capital position of the holding company. This is relevant as a subsidiary with losses may be unable to repay intercompany loans to the parent company, or the parent company may have obligations to make good losses in subsidiaries, such as bank guarantees.

Further, subsidiaries may already have had an asset shortfall compared to what the holding company has paid for it, this is goodwill. Consolidated accounts, post acquisition, should bring out any additional losses in addition to that which existed as goodwill upon acquisition. New losses in any subsidiary for which goodwill has arisen are themselves indicative that the goodwill – and hence the holding value of investments and intercompany loans to subsidiaries – requires writing down. Put another way, if a company has invested its capital in acquiring another company, any diminution in value of the goodwill, or the assets of the subsidiary, is indicative of a diminution of the capital of the acquiring company.

FAILURE TO HAVE A PROCESS AT ALL FOR THE EU ENDORSEMENT OF IFRS FOR COMPANY ONLY ACCOUNTS

In addition to the EU IFRS endorsement process, not actually assessing IFRS properly for group accounts for the true and fair view objective incorporating capital maintenance the EU has had no process at all for assessing company accounts.

The EU endorsement process has overlooked the relevance of group accounts to determining the capital of a company, by not having a proper definition of true and fair view, and making matters worse, for company only accounts, has had no process at all. This is not a minor matter, some things, such as intercompany balances, only appear in company only accounts.

THE DIFFERENT APPLICATION OF IFRS

This table shows how IFRS is applied by the EU IAS Regulation.

<table>
<thead>
<tr>
<th>Compulsory?</th>
<th>Group accounts - listed companies</th>
<th>Company only accounts - listed and non listed companies</th>
<th>Group accounts – listed companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS compulsory or not?</td>
<td>Optional</td>
<td>Optional</td>
<td>Optional</td>
</tr>
<tr>
<td>True and fair view inclusive of capital maintenance?</td>
<td>EU has had no objective yardstick to reflect the law.</td>
<td>EU has had no objective yardstick to reflect the law in addition to having no objective yardstick to reflect the law.</td>
<td>EU has had no objective yardstick to reflect the law.</td>
</tr>
</tbody>
</table>

As covered in Chapter 7, the UK and Ireland took the option to allow IFRS for use in company only accounts. The FSA then permitted IFRS for banking companies. IFRS because it does not fit with capital maintenance, does not work either for measuring banking capital for regulatory oversight.

As also discussed in Chapter 7, the EU Commission and the FSA made the same mistake. They both overlooked the essential element of capital maintenance, inherent in the pre-IFRS accounting framework, which is particularly critical if EU member states opted to use IFRS for companies, including banking companies. If the accounts fail, which IFRS does, then the whole basis of banking capital adequacy fail. Perhaps equally remarkably, that part of the Commission responsible for accounting standards was also responsible for banking capital adequacy rules (Basel II).

WHERE IFRS HAS GONE WRONG FROM THE OUTSET

Many of the concepts in IFRS have come from the USA. The standards sit in a framework based on the following objectives:

- that accounts are executed by following standards, with an apparent proviso that standards can be overridden (the “true and fair override”), however that then comes up against the circularity that doing that must be in accordance with “The Framework”, an document that links with an assertion called “The Objective of Financial Reporting”, however, at the root of that document is the assertion that,
- accounts to be “useful for users” in capital markets, that is a non-objective. Firstly, it is disconnected from the statutory purpose for the shareholders to see that the directors have discharged their duties to the company (including trading solvently, i.e. with capital as stated). Secondly, the objective is vague as to be meaningless, further,
- there is then another assertion, that a company is “worth the net present value of its [projected] cash flows”, and IFRS assists in that. The assertion is arithmetically flawed to the extent it is avoiding the question of whether a company currently has capital or not, which is the prerequisite to it actually existing to earn future cash flows.

These flawed objectives therefore contrast with those required in company law, that the accounts give a true and fair view in order to:

- discharge the directors’ obligations to report on the capital position of the company,
- to enlighten the shareholders as a body for a proper holding to account at the AGM.
MORE ON WHERE THE IASB IS ARITHMETICALLY WRONG
As referred to above, central to the focus of IFRS is the assertion that accounting standards are to be "useful for predicting future cash flows". This assertion, in which current capital does not feature as it is not a "future cash flow" is in fact wrong. It betrays a lack of understanding of the key drivers of corporate finance.

For any business its future expected cash flows can be separated between "new" cash flows (those not contracted and from new capital) and "old" cash flows (those contracted as part of the current business and existing capital).

To appraise a business properly, it is essential to distinguish between existing and future capital. In a free market, new business will achieve a similar competitive return amongst competitors, and a threshold return is demanded on new capital.

A threshold return is hurdle not a target, it is all or nothing, if the market demand is for a 9% return on new capital, then any new raising based on an 8.5% return expected to be achieved would fail.

Similarly, if the market demand is for a 9% return and new capital will achieve that return, but, the current business has subnormal returns or losses, then the weaker old business dilutes the new. In short, if there is "negative equity" in the existing business this is an impediment to attracting new investment for new business.

YOU GET WHAT YOU MEASURE?
With IFRS not focussing on the current capital it is creating a situation for not identifying negative equity. That means that IFRS vindicates poor, capital consumptive, business models which ultimately reveal weakness that through sudden collapse.

The conceptual flaws in IFRS were introduced into US GAAP earlier before the adoption with IFRS. The list of apparently profitable companies suddenly collapsing now includes:

- Enron
- Royal Bank of Scotland
- Ulster Bank
- HBOS
- Bank of Scotland
- Northern Rock
- Bradford and Bingley
- Anglo Irish Bank
- Allied Irish Banks
- Bank of Ireland

All appeared to have plentiful capital, but in the end the markets came to the conclusion and refused to fund them (debt or new equity) on the intelligent presumption that they did not have capital.

The fundamental flaw is that IFRS is predicted on giving information that is useful to markets for pricing shares, but in leaving out information critical to whether a company in fact has any value and is a going concern, the defect effectively leaves it up to the market to deduce the correct answer despite the accounts showing a positive and apparently healthy position.
In view of the recent statements by the Bank of England, a re-read of the Walker Review of July 2009 is interesting. Walker focuses on liquidity, which we now know not to be the primary cause of the crisis, and governance.

The terms of reference of the Walker Review said:

- the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively;
- the balance of skills, experience and independence required on the boards of UK banking institutions;
- the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees;
- the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and
- whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

Whilst these may be aspirationally admirable objectives, none of these provide any reason as to why a banking sector in the UK and Ireland might collapse so systematically. It takes some explaining as to how so many boards of banks could become so bad all at the same time, i.e. it would be logical that a poor board would lead to a poor bank. However, imputing the converse, that in this crisis all failed banks had had poor boards all at the same time is quite a different proposition.

One needs to look no further than the board of Alliance & Leicester. Indeed, the assumption of a systemic governance problem (the people on the boards) may have been challenged by Sir Derek Higgs, Chairman of Alliance & Leicester from 2005, himself the chairman of the main corporate governance review prior to the Walker Report, “the Higgs Review” of 2003. Unfortunately, Sir Derek died in post in April 2008, unable to challenge whether it was in fact the structural governance of Alliance & Leicester that was at fault.

Further, if the problem was the people on the boards of banks which failed (or nearly failed) the case of Alliance & Leicester is even more interesting.

The Chief Executive of Alliance & Leicester, (at the bank since 1992), became the chairman of (nationalised mortgage book) Bradford & Bingley in November 2008, and Northern Rock Asset Management (nationalised) in January 2010, and since July 2010 has been the Chairman of UK Asset Resolution Ltd (a new nationalised holding company bringing together both the books of Bradford & Bingley and Northern Rock). Furthermore, the Chief Executive of UK Asset Resolution Ltd, (who joined the board of nationalised Bradford & Bingley in May 2009), was a main board director of Alliance & Leicester as Group Risk Director.

If the conclusion of the Walker Review that people were running banks who should not have been running them, or there was insufficient attention to “risk” in particular, then the position of Alliance & Leicester is quite difficult to explain, in terms of the undisputed quality and experience of the person chairing it, Sir Derek Higgs, but given also where other senior executives have since ended up.

The position of the Walker Review, on shareholder engagement is also illogical as an instrument of public policy to protecting the banking system. By definition those institutional investors in banks who stayed in, or increased stakes, would have been very happy with what they could see. Given the gearing model of a bank, if any shareholders suspected a problem to the extent that there was laying latent a problem sufficient to cause a collapse, their best route in a bank would not be to engage, once bad loans have already been made, but to sell and get out.

On the basis that shareholders were relying on the same faulty public information as the FSA, it is difficult to see how shareholders could positively engage. Indeed a logical conclusion from looking at Northern Rock’s accounts would be for shareholders to engage to have excess capital returned. Something that the FSA authorised in July 2007, a month before it collapsed.
What has been absolutely lacking from analysis in the Walker Review, is why did bank share prices fall very accurately in those banks which collapsed, or had rights issues which failed? The collapse in the share prices in 2008 did not put loans onto the book that had originated in 2007, 2006 and earlier.

The Walker Review also concludes that risk committees are essential. However, what the Walker Review does not address is that Northern Rock had a risk committee, and collapsed. HSBC which did not have a risk committee did not collapse.

Indeed this statement from HSBC in 2010 is positively worrying.

"The Group Risk Committee, whose members are all independent non-executive Directors, is responsible for advising the Board on material risk matters and providing non-executive oversight of risk. The Committee was established in February 2010 following publication of the final recommendations of Sir David Walker’s Review of Corporate Governance in UK Banks and other Financial Industry Entities, to focus on risk governance and to provide an increasingly forward looking view of risks and their mitigation."

"Historically the Group Audit Committee has provided non-executive oversight of risk as well as financial reporting. As noted in the section headed 'Group Audit Committee' above there is currently a degree of overlap between responsibilities of the Group Audit Committee and the Group Risk Committee in relation to risk governance and oversight matters and internal controls. Each committee is reviewing its terms of reference with the aim of minimising the overlap."

Not only is overlap a risk, but presumptions about overlap, can in fact create another hazard, underlap.

Put another way, one of the central tenets of the Walker Review does not stand up to the position of the bank that survived and represented 40% of the entire UK market capitalisation of banks.

That is in addition to the fact that the chairman of a bank that on the above criteria did lose most of its capital was chaired by Sir Derek Higgs.

However, the new acceptance that the banking crisis was always a capital problem rather than a liquidity crisis puts the Walker Review in a somewhat different light.

The extent of failure in the UK and Ireland of 2007-2010, is so systemic, even by the standards of the EU, that the most reduced explanation is that there was not a problem of words and process, but something systematically wrong with the numbers in the majority of banks.

Their capital was unreliable and transient, as they were overvaluing assets. The price setting part of the market that identified that was picking up precisely what the accounts of the banks were not showing, their assets were systematically overvalued.

Also unaddressed by the Walker Review, despite its focus on remuneration, is the obvious conclusion that the best form of alignment of the public and shareholder interest in remuneration and risk would be to not pay management until the last penny of each loan was collected, or more practically, that profit is only stated after an independently audited and disclosed, prudent assessment of how much money lent will not in fact be coming back, (i.e. adequate bad debt provisions).
CHAPTER ELEVEN

THE FRC AND STANDARD SETTING IN THE UK AND IRELAND

The politics and jurisdictional coverage of accounting standard setting is strange, as is revealed on the Financial Reporting Council (“FRC”) website in August 2011. The FRC Chair and then Board is appointed by the UK Secretary of State.

Chapter 9 also covers whether the EU Commission has in fact endorsed IFRS in accordance with the law set out by the IAS Regulation of the Council and the Parliament. Whether it has is not an inconsequential matter, as the same part of the Commission (Single Market) that was responsible for accounting standard setting was also responsible for capital adequacy regulation.

However, what is clear from the FRC structure (in place since 2005), is that there has been a most peculiar form of nationalisation of the structure of that body too. Not merely in whether its standard setting arm has been implementing standards according to the law, but, why is the UK Secretary of State the person responsible for appointing the people responsible for setting auditing standards for the Government of the Republic of Ireland?

THE PRE-2005 FRC STRUCTURE

The FRC was owned by the accounting institutes of the UK and Ireland, which as private sector bodies operated cross border. The three main institutes relevant for auditing purposes being:

– ICAEW (England and Wales – United Kingdom)
  Additionally, ICAEW covers the non-EU crown dependencies of Jersey, Isle of Man and Guernsey).

– ICAS (Scotland, United Kingdom)

– ICAI (All Ireland, Republic of Ireland and Northern Ireland (United Kingdom).

The Accounting Standards Board and the Auditing Practices Board were underneath a wholly owned subsidiary of the accounting institutes. In no respect was the ASB or the APB under the accountability of a UK government department or Secretary of State.

However, with the post 2005 structure, the FRC has a clearer linkage with the UK government. The FRC has owned the standard setters, even to the extent of absorbing the boards of the ASB and the APB by winding them up as separate legal entities under the FRC board. The FRC is clearly accountable to the UK Department of Business.

The relevance of all of this is that with the passing of control of standard setting from overtly private sector public interest institutes, to the quasi nationalised FRC (which rather than being the subsidiary of the institutes is now their regulator), the thorny question of negligence is raised. In a private contract the only source of negligence can be the private sector parties.
However, in nationalising the process, the issue of blame and negligence somewhat shifts. The following chapters address the law and the constitutional issues around accounting standards and the law.

It is quite clear, that within the UK and Ireland there is a most peculiar model of authority and accountability to the extent that 89 years after Ireland’s independence, but only since 2005, the Auditing Practices Board of the FRC Limited (whose chairman is appointed by the UK Secretary of State) is now setting auditing standards for the government of the Republic of Ireland. This was further embedded in 2009 by winding up the Auditing Practices Board Limited and absorbing that function into the FRC Limited itself.

Prior to 2005, the Auditing Practices Board Limited was a subsidiary of the CCAB Ltd itself a subsidiary of a consortium which included the Institute of Chartered Accountants of Ireland, with no consortium member being owned or “under the government”.

## APPENDIX

### UK AND IRISH BANKS CAPITAL LOSSES – POST MORTEM

<table>
<thead>
<tr>
<th>Bank</th>
<th>Shareholder capital per accounts 31 December 2007</th>
<th>Losses 2007-2010</th>
<th>% Loss by reference to capital</th>
<th>Rescue required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Rock</td>
<td>£1,778.3</td>
<td>£3,500.3</td>
<td>196.8%</td>
<td>Nationalised as a whole</td>
</tr>
<tr>
<td>Dividend paid, bank insolvent (liquidity) August 2007, clear capital problems by end of 2007 (overvalued, poor assets), then nationalised.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bradford &amp; Bingley</td>
<td>£1,710.8</td>
<td>£1,710.0</td>
<td>113.7%</td>
<td>Nationalised mortgage book</td>
</tr>
<tr>
<td>Dividend paid, two failed rights issues, then nationalised September 2008: clear capital problems (overvalued, poor assets), nationalised and part sold.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HBOS</td>
<td>£21,849</td>
<td>£40,838</td>
<td>204.5%</td>
<td>£23,189 (2)</td>
</tr>
<tr>
<td>Dividend declared, then cancelled, bank insolvent September 2008, part nationalised via Lloyds, clear capital problems (overvalued, poor assets).</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alliance &amp; Leicester</td>
<td>£1,715</td>
<td>£1,533</td>
<td>89.2%</td>
<td>N/A</td>
</tr>
<tr>
<td>Dividend declared, then paid. Bank is sold to Santander in deal announced July 2008 via Lloyds acquisition.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RBS</td>
<td>£37,445</td>
<td>£25,801</td>
<td>68.9%</td>
<td>£12,000</td>
</tr>
<tr>
<td>Dividend paid, bank insolvent (liquidity) September 2008, clear capital problems (overvalued, poor assets): 80% nationalised.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Note

* Dates for Northern Rock are a year earlier: capital 31 December 2006, losses 2007-2010.

1. Normal underwriting failed. £400m was picked up by 4 institutional investors. This was after 2 failed rights issues.
2. 8% take up of rights.
4. Additional losses to align RBS losses with the losses per the accounts of the Asset Protection Scheme (i.e. RBS still has not booked all of its losses).

# Additional losses to align RBS losses with the accounts of the Asset Protection Scheme (i.e. RBS still has not booked all of its losses)
NORTHERN ROCK PLC — POST MORTEM SUMMARY

1. 31 December 2006 year end accounts, signed by PWC, Newcastle, 27th February 2007. Accounts showed shareholder funds (capital) of £1,778.3m.
2. 24th April 2007, AGM.
3. Final dividend declared, 25.3p (up 20.3%) 32.3p to be paid 25th May 2007.
4. 29th June 2007, FSA grants waiver to increase dividend and reduce capital.
5. 14th September 2007, run on Northern Rock following revelation in press that Bank of England was providing emergency support.

Analysis “liquidity” crisis

16th Feb 2008. Northern Rock is “temporarily” nationalised.
21st February 2008. Northern Rock ceases to offer 125% mortgages.
20th November 2008. “Non-asset trigger event” (contractual) in Northern Rock in favour of Granite. £3bn of funding required from Northern Rock plc to Granite Master Issuer which Northern Rock will bear first loss. All Northern Rock mortgage repayments are also diverted to the buffer for protection of Granite.

Accounts – demonstrate Northern Rock plc was always a capital crisis, with contingent calls on the capital

31 December 2007 accounts, 29th March 2008, bad debt provisions charged of £471.9m (26.5% of 2006 y/e shareholders’ funds).
31 December 2008 accounts, 2nd March 2009, further bad debt provisions charged of £1,162m (65.3%, of 2006 y/e shareholders’ funds, total 91.8%).
31 December 2009 accounts, 23rd March 2010, (now called NRAM plc) further bad debt provisions charged of £1,038.6m (58.5% of 2006 y/e shareholder funds, total 150.3%).
31 December 2010 accounts, 23rd March 2011, (now called NRAM plc) further bad debt provisions charged of £827.8m (46.5% of 2006 y/e shareholder funds, total losses £3,500.3m 196.8% of the £1,778.2m 2006 shareholder’s funds).

Structural deficiencies in the accounts of Northern Rock plc (the bank)

The accounts failed to show:

i) the exposure to losses in Northern Rock plc from Northern Rock mortgages (direct exposure),
ii) the first loss exposure to Northern Rock plc’s capital for support for Granite mortgages from “trigger events”.

It took 15 months from Bank of England support for there to be wide public recognition of the implications of the commitments that were already present in the relationship with Granite.

The “non-asset trigger event” of 20th October 2008, was the lack of issuance of new mortgage loans by Northern Rock plc, due to its slowing down its rate of growth. Northern Rock was not selling enough new mortgages under government ownership. Essentially Northern Rock plc’s covenants with Granite were tying it into perpetual growth. The higher the growth the higher the ultimate liability and loss of capital of Northern Rock plc when growth stopped. Under the covenant (and the “laws” of economics) Northern Rock plc (the bank) was bound to have a crash landing.

All of the accounting deficiencies missing from the accounts of Northern Rock are covered by Companies Act accounts. However the IFRS accounts fail to show the stress and risks to the capital of Northern Rock plc. The failings are structurally embedded in the IFRS philosophy.

Companies Act accounts, the philosophy is the capital (capital maintenance)

a) the structure of Companies Act accounts, disclosure by legal entity, enable a view, first disclosure by legal entity, hence enabling a view to be taken on the capital of (and claims between) each legal entity,
b) the risk, provisioning and contingent liability disclosure regime of Company Law, explicitly, prudent net realisable value (banking companies individual accounts). These clauses are explicitly linked to capital maintenance (Part 16 and 23).

IFRS accounts are structurally defective by core concepts

Despite being permitted (as an option) under the Companies Act IFRS is:

c) neutral between parties - a euphemism for not being focussed on capital and the specific risks on it. It claims to be capital/creditor interest “neutral”. That is lethal if there are covenants between the capital and creditors which impact on the capital. (this defect is known as the “reporting entity concept of IFRS”),
d) neutral in “measurement” - a euphemism for not looking out for losses, again lethal given that losses are borne by the capital of a banking company.

The IFRS and Companies Act treatment can be compared diagrammatically in the case of Northern Rock as set out below.

1a) Companies Act accounts – individual accounts (separate legal entities). Companies Act accounts show the capital and the risk as follows:

- **Northern Rock plc**: Loans (a)
- **Granite plc**: Loans (b)

**Contingent liability (c)**

*Schedule 2*

b) same criteria applies for exposure via the investment/loans made by Granite.

c) same criteria applies for contingent liabilities with Granite, e.g. recourse due to trigger events.

1b) Companies Act consolidates accounts should the capital and risk as follows:

- **Northern Rock plc**
- **Granite plc**
- **Northern Rock Mortgages**
- **Granite Mortgages**

( NB: Company law requires all subsidiaries of any regardless of jurisdiction to come up to accounting standard of the Act (Section 386 (5)), that way the parent company knows its risk exposure)

a) Companies Act, Section 396, all items to be prudently stated, loans and investments to be at net realisable value.

b) same criteria applies for exposure via the investment/loans made by Granite.

c) same criteria applies for contingent liabilities with Granite, e.g. recourse due to trigger events.

2a) IFRS – IFRS individual accounts for Northern Rock plc (Northern Rock took the option to apply IFRS for Northern Rock plc). IFRS accounts confuse the capital and the risk.

- **Northern Rock plc**
- **Granite plc**
- **Northern Rock Mortgages**
- **Granite Mortgages**

IFRS does not show Granite as a separate legal entity. This is a structural flaw in IFRS. It is treating Northern Rock and Granite as one entity. The contingent liability between Northern Rock plc and the separate legal entity is therefore not shown. And critically:

z) there is no provisioning to ensure that Granite’s and Northern Rock’s loans are at prudent net realisable value.

2b) IFRS – consolidated accounts (EU compulsory) also confuse the capital and the risk.

- **Northern Rock plc**
- **Granite plc**
- **Northern Rock Mortgages**
- **Granite Mortgages**

This is substantially the same as 2a) above, treating Northern Rock and Granite as one entity. The contingent liability between Northern Rock plc and the separate legal entity is therefore not shown. And critically:

z) there is no provisioning to ensure that loans are at prudent net realisable value.

As a result of this accounting Northern Rock/Granite was masking not only poor loans made by Northern Rock directly, but an enormous margin call of > £3bn to Granite, for which Northern Rock bore first loss. The confused status of Northern Rock/Granite permeates several parliamentary debates during 2007 and 2008.

**SUMMARY**

The IFRS accounts fail not only to show the risk of the loans of Northern Rock/Granite, they also fail to show the conflicts between Northern Rock plc’s capital and Granite’s bond holders, i.e. Granite had a large call on the capital of Northern Rock plc that was getting nearer and nearer to the tipping point. The confused status of Northern Rock/Granite permeates several parliamentary debates during 2007 and 2008.
BRADFORD AND BINGLEY – FAILED INSTITUTION – POST MORTEM

1. 31 December 2007 year end accounts. Accounts signed by KPMG Leeds, 12th February 2008. Shareholder’s funds (capital) of £1,210.8m.
3. 22nd March 2008, AGM
4. 14th April, Bradford and Bingley denied it needed a rights issue.

Rights issue fiasco
1. Rights issue announced, 14th May 2008, £300m, 16 for 25 at 82p per share. 48% discount to closing price of 158.74p. EGM planned for 16th June 2008. Rights issue then cancelled.
2. Restructured Rights issue announced, 2nd June 2008, £400m after TPG has been given preferential terms for 40% of the issue.
5. 11th July 2008, Prospectus for Enlarged Restructured Rights Issue.
6. 17th July 2008, EGM.

18th August 2008, 27.84% acceptances, remainder left with underwriters (4 investors, M&G, L&G, Standard Life and Insight Investment).

Nationalisation

Accounts
31 December 2008, bad debt provisions charged of £507.7m (41.9% of 2007 stated capital).
31 December 2009, bad debt provisions charged of £593.7m (49.0% of 2007 stated capital, 90.9% total).
31 December 2010, bad debt provisions charged of £276.6m (22.8% of 2007 stated capital, total £1,378m 113.7% of 2007 stated capital).

The Chairman of Bradford and Bingley was Rod Kent.

HOBOS – FAILED INSTITUTION – POST MORTEM

1. 31 December 2007 year end accounts. Accounts signed by KPMG Edinburgh, 26th February 2008. Accounts showed shareholder funds of £21,849m (Bank of Scotland, £19,971m).
2. Dividend declared, 32.3p to be paid 12th May 2008 £1,205m.
3. 29th April 2008, AGM.
4. 29th April proposed dividend cancelled.
5. 29th April rights issue announced, £4bn, price 275p, discount to market price of 500p.
8. 2nd May 2008, Rights issue 16 for 25 at 82p per share. 48% discount to closing price of 158.74p.
9. EGM planned for 16th June 2008. Rights issue then cancelled.

Rescue
17th September 2008, Lloyds agrees to rescue HBOS.
13th October 2008, HMG to inject capital into HBOS, RBS and Lloyds TSB.
19th November 2008, Open Offer (Rights Issue underwritten by HMG), £8.5bn.
19th January 2009, Asset Protection Scheme announced, Lloyds to put £250bn of problem assets into scheme, Lloyds to take first £13bn of losses.

Accounts
31 December 2008, impairments on investment securities (i.e. CDO’s) £2,193m, loan provisions, £9,857m (49.4% of 2007 stated capital).
31 December 2009, £20,055m (100.4% of 2007 stated capital, total 149.8%).
31 December 2010, £20,055m (100.4% of 2007 stated capital, total losses £40,838m, 204.5%, of 2007 year end capital).

Accounting issues – HBOS had similar securitisation structures to Northern Rock (see Northern Rock post mortem for detail).

The Chairman of HBOS was Lord Dennis Stevenson.

UK AND IRISH BANKS CAPITAL LOSSES – POST MORTEM 37
ROYAL BANK OF SCOTLAND – FAILED INSTITUTION

1. 31 December 2007 year end accounts.
3. Accounts showed shareholder funds of £37,445m
4. Dividend declared, 23.1p to be paid 6th June 2008.
   22nd April 2008, AGM.

Rescue
13th October 2008, HMG to inject capital into HBOS, RBS and Lloyds TSB.
10th November 2008, Open Offer (Rights Issue underwritten by HMG), £14.7bn ordinary shares, £5bn prefs.
19th January 2009, Asset Protection Scheme announced, RBS £325bn to be covered by the scheme, RBS to take first £60bn hit.
Open offer £5.27bn, B shares, £25,101bn, £5bn preference shares cancelled.
Total capital raised £57,716m.

Accounts
31 December 2008, impairments on trading book £4,657m (i.e. CDO’s etc), £1.255m loan provisions, £5,912m (15.8% of 2007 stated capital)
31 December 2009, impairments on trading book £5.161m, £9.221m loan provisions, £14.382m (36.4% of 2007 stated capital, total 54.2%)
31 December 2010, impairments on trading book £31m, £5.476m loan provisions, £5,507m (14.7% of 2007 stated capital, total 68.9%, £25,801m)
NB: per asset protection scheme, expected loss £51bn, therefore further £25.2bn to come. Total losses 136.2% of 2007 capital.
NB: The Chairman of Royal Bank of Scotland was Sir Tom McKillop.

ALLIANCE & LEICESTER – POST MORTEM

1. 31 December 2007 year end accounts. Accounts signed 19th February 2008 Deloitte & Touche, London. Shareholder’s funds (capital) of £1,717m.

Acquisition
1. 14th July 2008, Alliance & Leicester announces it will be acquired by Santander, for 299p (plus interim dividend of 18p), £1.3bn in total.
2. 16th September 2008. EGM for approval of the acquisition, 84.18% in favour.
3. 10th October 2008 Alliance & Leicester acquired by Santander.
4. Santander injected new ordinary share capital of £701m on 17th September 2008. Acquisition has cost £2.0bn.

Accounts
31 December 2008, bad debt provisions charged of £1071m (62.3% of 2007 stated capital).
31 December 2009, bad debt provisions charged of £462m (26.9% of 2007 stated capital, 89.29% of total 2007 stated capital).
31 December 2010, business wholly transferred to other parts of Santander Group.
NB: The Chairman of Alliance & Leicester from October 2005 was Sir Derek Higgs. He died on 28th April 2008.
Company only accounts - those accounts that are not consolidating the accounts of subsidiaries

Consolidated Accounts - the same as group accounts, the accounts are consolidating the accounts of subsidiaries

EU Directive - a requirement from the EU (Council and Parliament) requiring member states to pass into national law, laws that conforms with the Directive

EU Regulation - a requirement from the EU (Council and Parliament) that is binding on the affected parties in member states and requires no national law to implement, it has "direct effect"

Fractional reserve banking - is the system whereby a bank borrows short-term (deposits) to finance long term lending. At any time the bank is relying on the fact that it will not be in the predicament of not being able to refund all deposits if all customers wish to withdraw their deposits at the same time. In the event that they do, the system is protected by the "lender of last resort" (see below) function of a Central Bank.

Going concern - the basis for preparing accounts on the basis that it will continue in existence.

Group accounts - the same as consolidated accounts (see above)

IAS Regulation - the legal instrument overriding existing EU accounting standards, thus introducing IFRS into the EU legal system

IASB - International Accounting Standards Board, sets IFRS, formerly known as the IASC (International Accounting Standards Committee)

IFRS - International Financial Reporting Standards, formerly known as IAS (International Accounting Standards). IFRS are set by the IASB

Lender of Last Resort - The function of a Central Bank to lend short-term to a bank temporarily unable to roll over its liabilities.

Regulatory capital - The minimum amount of capital a regulator permits to a bank that is temporarily unable to roll over or refinance its liabilities.