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Mr. Darryl Chambers

**What Works Best for Banking Regulation: Market Discipline or  
“Hard-Wired” Rules  
Bankers or Regulators? Or “Never the twain shall meet”**

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Contact Darryl Chambers via email: [darrylchambers352@hotmail.com](mailto:darrylchambers352@hotmail.com)

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## **What works best for banking regulation?.....**

### **Abstract – Essay Title:**

#### **Bankers or regulators?, or “Never the twain shall meet”.**

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Bank failures have had catastrophic effects on world economies. By concerted supranational regulation, bankers must be weaned off their errors and averted from future errors we cannot yet conceive of.

The sub-prime mortgage problem stemmed from reckless credit granting. Bankers responsible for credit approval had conflicts of interest: more mortgage approvals brought bigger bonuses. Credit must be micro-managed by central banks, with concerted processes to prevent the bar being set too low. The failure of mortgage-backed securitised debt arose through defaults on underlying mortgages; these instruments will fare better if their underlying assets are more secure.

The U.K.’s Northern Rock mismatched assets and liabilities in retail and wholesale markets. Banks must be categorised into either Commercial or Investment, and authorised to carry on one - or the other - business only.

Fair value accounting stoked bankers’ greed in boom years; traders’ soaring optimism in rising markets was booked into IFRS financial statements without regard to accruals and prudence - principles typical of national accounting bodies, but not of the IASB. The E.U. and the national bodies must champion their reinstatement into IFRS, and persuade the IASB to recognise that market prices, which are forward-looking and include future, unearned profits, are for markets and not for financial statements. Fair value accounting, disclosable only in the Notes, must be banned from Accounts, along with models used to compute fair value, as it is open to manipulation and subjectivity.

How can a bank have more derivative assets than customer loans? Derivatives should return off-balance sheet, only cash movements booked. Most derivatives would go into the Investment bank category, ring-fencing them from Commercial banks ... and national economies.

## **What works best for banking regulation?.....**

### **Essay title:**

### **Bankers or regulators?, or “Never the twain shall meet”.**

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#### **Introduction**

At a moment when the international community is providing responses<sup>1</sup> towards preventing future financial crises this paper points to the main banking roots of the recent crisis and proposes concerted regulatory solutions. “Free market” liberty enjoyed by bankers must be rolled back - for the common good - if states are to reduce chances of their economies being affected by future bank crises.

The crisis had its roots in the mortgage lending business and how this business was – and largely still is – carried out. U.S. mortgage credit was granted too easily by state-authorized bodies chasing mortgage growth targets: and when this and securitised mortgage debt defaulted, losses, in uncertainty, spiralled and capitalisation and liquidity dried up. In the 2006/07 U.S. Illinois experiment Agarwal comments that the vast majority of subprime mortgage lending was actually done by authorised lenders<sup>2</sup>, and the stricter regulation imposed made a difference to the activities of these lenders: they rejected more applicants under tightening screening, or withdrew from business<sup>3</sup>.

Mortgage lending must have minimum supranational guidelines, agreed amongst central banks. This paper proposes new Credit Granting Rules<sup>4</sup>, with regulatory onus on the professionals rather than customers<sup>5</sup>. This will entail fewer mortgages being granted, but to applicants who can afford to repay them. Down payments such as those commonly required in Canada should be necessary.

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<sup>1</sup> e.g. British Prime Minister Brown’s tax on bankers’ bonuses of 9/12/2009, ECB President Trichet’s warnings about bonuses on 11/12/2009 and U.S. President Obama’s decision on 21/1/2010 to curb the activities of the biggest U.S. banks (the ‘Volcker Rule’).

<sup>2</sup> Agarwal (2009), p. 18.

<sup>3</sup> Op. cit., p. 29.

<sup>4</sup> To be formulated by central banks in forum.

<sup>5</sup> As indicated under Note 3 above, the main improvements came from Illinois lenders, rather than from actions on the part of applicants.

Fair value accounting has received significant criticism for its share of the crisis, and continues to do so<sup>6</sup>. European Banks had been using International Financial Reporting Standards (“IFRS”) and U.S. banks those issued by FASB, both of which required, and still largely require, financial instruments to be valued at “fair value”. In effect this is a market price for quoted, and model valuation for unquoted assets. Quoted prices are derived from traders’ price-quoting in stock markets, and unquoted prices from model results from in-house trading departments. These operators, unlicensed in terms of prudence, impartiality or objectivity, were driving large and fast-growing chunks of banks’ balance sheets, which remain large to this day. By 2008 derivatives alone in Royal Bank of Scotland<sup>7</sup> and Barclays Group<sup>8</sup>, valued at fair value - a large slice of which by models – were still 119% and 213% respectively of customer loans. Derivatives became as or more important than core banking.

Moved on-balance sheet under fair value accounting, derivatives had an inflationary effect on bank profits that influenced management<sup>9</sup>. The European Central Bank’s 2004 study, prior to implementation of IFRS in 2005, forecast<sup>10</sup>, amongst other fair value accounting drawbacks, that “The upward revaluation of assets would be reflected in bank profits and bank management could face pressure from shareholders to distribute dividends, including unrealised gains on assets...”. Fair value accounting has overseen large increases in balance sheets: in relation to Barclays and ING the ECB states<sup>11</sup> that if they had adopted fair value accounting in 2002, revaluation of their derivative position would have generated profits of around 18% of capital and reserves (by 2008 Barclays’ derivatives were over 700% of their 2005 values).

The valuation of financial instruments by models reflects the knowledge, expertise and creativity of their users. Yet such ‘mark-to-model’ fair valuation

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<sup>6</sup> See the comments of the Chairman of the U.K.’s Financial Services Authority, Lord Turner on 21/1/2010, blaming accounting fair value for inflating bankers’ bonuses.

<sup>7</sup> Royal Bank of Scotland 2008, p. 68: derivatives - £993 billion, loans to customers - £835 billion.

<sup>8</sup> Barclays 2008, p. 34: derivatives - £985 billion, loans to customers - £462 billion.

<sup>9</sup> See Note 6 above.

<sup>10</sup> ECB (2004), p. 8.

<sup>11</sup> Op.cit., p. 27.

must be banned, on the basis that it is subjective (i.e. results can be various), and can easily be manipulated by users (management can direct<sup>12</sup> results).

With asset values and market optimism rising, banking profits ballooned. However, when mortgage and securitisation problems surfaced, losses reversed earlier profits, and the resulting swing<sup>13</sup> caused even greater pessimism and ultimately the financial crisis and recession we have witnessed. Reporting volatility was exacerbated by fair value accounting. Valuation problems are by no means over: Barclays Bank still has total assets of £1,546 billion, 108% of the GDP of the U.K., over one third of which is derivatives<sup>14</sup>.

National accounting bodies (e.g. the U.K.'s ASB) must co-operate<sup>15</sup> to pressurise the IASB for a return to historical cost accounting - for all its criticisms<sup>16</sup>, the convention that best objectivises stewardship and - prudently - incorporates the concept of earned/incurred accruals that market-orientated IFRS do not. Derivatives must be moved back off-balance sheet (i.e. disclosure only). It is time to cut the Gordian Knot of the IFRS problem.

To ring-fence commercial banking from the vagaries of markets, 'Commercial' banks must close their proprietary desks and be split off<sup>17</sup> from 'Investment' banks. Market practice was and is insufficient to prevent the risk of such crises re-occurring, and this paper recommends regulation to firewall the activities of financial institutions and bankers. Bankers should be subject to new Banking Bonus Rules: it is human nature to try to benefit from short term agendas; but for the sake of the many, the few, in positions of responsibility in the banks of tomorrow, must be guided to avoid the errors of the past, and brought to meet regulators half way.

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<sup>12</sup> See Byrne (2008) (p. 4) for management appearing to choose assumptions that maximise UK pension scheme fair valuation income.

<sup>13</sup> See Laux (2009), pp. 10 & foll., for a discussion of contagion and procyclicality effects under fair value.

<sup>14</sup> Barclays 2009, p. 25: derivatives - £556 billion, loans to customers - £412 billion.

<sup>15</sup> For example by the formation of an International Accounting Committee, with members from relevant national accountancy bodies.

<sup>16</sup> For example see Laux (2009) for a discussion of the problems of historical cost's 'hidden reserves' (p.9) and 'gains trading' (p.11). However, the former can create a providential 'cushion' against downturns (a topical advantage), and the latter, constitute legitimate management strategy.

<sup>17</sup> See the declaration by U.S. President Obama under his 'Volcker Rule' (Note 1 above), made public after this paper was drafted.

### **Problem No. 1 - Sub-prime mortgage lending**

The sub-prime mortgage element of the crisis is recognised as one, if not the, principal and initial trigger. It was sparked by unregulated mortgage lending, sometimes at reckless levels, to U.S. borrowers who could not afford repayments. When these mortgages began to fail, institutions which had granted these mortgages, or purchased securitised mortgage instruments, began to panic at the scale of losses.

It is well known some mortgage approval staff approved mortgages they knew were beyond the means of applicants to keep up with: in effect, applicants were shown where to sign on the dotted line and were then given the mortgage. While it may be difficult to accept that a regulator should micro-manage banks' credit-issuing policy, this is the area that needs to be improved. Market discipline has not sufficed.

Of average 2006 Citibank<sup>18</sup> North America net consumer banking loans of \$255 billion \$2.6 billion were 'non-accrual' loans, that is about 1%, an industry-typical figure. The figure for 2008, that is, \$9.9 billion out of loans of \$298 billion, had tripled to a massive 3.3%.

Italian bank Intesa Sanpaolo had net non-performing Italy loans to customers ("doubtful loans") as at 31<sup>st</sup> December 2008<sup>19</sup> of €3.7 billion, 1.1% of total Italy loans of €344 billion. The figure for 2006<sup>20</sup> was 0.9% for Banca Intesa pre-merger with Sanpaolo IMI, at €1.6 billion over total customer loans of €177 billion.

For Royal Bank of Scotland 2008<sup>21</sup> net total 'impaired' loans and advances to customers were £10.4 billion (2006<sup>22</sup> - £2.9 billion), representing 1.1% (2006 - 0.6%) of total loans of £875 billion (2006 - £467 billion).

### **The solution – State regulation of banks' mortgage approval process**

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<sup>18</sup> Citigroup 2008, pp. 39 & 55.

<sup>19</sup> Intesa Sanpaolo 2008, p. 303.

<sup>20</sup> Banca Intesa 2006, p. 217.

<sup>21</sup> Royal Bank of Scotland 2008, pp. 175 & 213.

<sup>22</sup> Royal Bank of Scotland 2006, pp. 140 & 155.

Firstly, the difficulty in comparison of international data, as shown by the above section, needs to be addressed. Classes of impairment (doubtful, non-accrual, non-performing, etc.) must be defined under agreed parameters - and given the same names: once the problem can be seen more clearly this is a start to sorting it out.

Regulators must ensure that bankers grant credit to suitable borrowers. No individual can guarantee that he will always have a job, that his employer will always be in business, or never dismiss him: a bank can never have a cast-iron guarantee. However, a full and valid customer analysis must be made, and this process must be enshrined in detailed legislation at national level.

There will always be different internal controls drawn up and operated by individual banks<sup>23</sup>. But quality must be uniform and minimum, and enforcement must be by penalties that affect management. If left to individual banks there will always be some in which rules are either bypassed or omitted, in order to increase bonuses and volumes.

Size of loan is generally a multiple of salary. However, U.S. mortgage staff are known to have dispensed with this, or connived at falsifying the salary of the applicant. Evidence of most recent salary details must be reviewed. In the U.K. applicants could borrow at 100% of the property value, or more. Loan to value has been more conservative in Italy: 80% is still common. Common U.S. practice did not encompass a down payment on loans, in contrast to 20% that can be required in Canada.

New Credit Granting Rules should be devised<sup>24</sup>. Compliance should then be supervised and enforced by separate national authorities: in the U.K. this would be the Financial Services Authority (FSA). The Bank and FSA would have separate and clearly defined roles without overlap<sup>25</sup>.

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<sup>23</sup> In Italy the problem of sub-prime mortgages in banks is relatively unevidenced. In 1999 one important regional Italian bank was requiring mortgage loans to employees of the bank to be approved by its General Manager, and this practice may be indicative of approvals policy in the country's banks that lasts up to the present time.

<sup>24</sup> Formulated as per Note 4 above.

<sup>25</sup> It is by no means clear that overlap does not currently exist between the Bank of England and the FSA - as evidenced by criticism in the recent crisis, and see 'Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority', section 2 - the Bank's Responsibilities, where it is left to the FSA to supervise

These Rules, constantly reviewed in line with market experience and conditions, should specify the lowest level of detail:

- ✓ Salary slips, originals;
- ✓ Multiples of salary: depending on mortgage term, for example twice salary for 20 years;
- ✓ Loan to value: this could initially be 75%, but should incorporate possible property devaluation: developments in speculative areas, such as converted dockland, include a discount to reflect price volatility. Established residential areas of Southern England might merit a premium, owing to the stable values they command even in difficult times;
- ✓ Financial information about the employer;
- ✓ Identity information in original, ideally passport or identity card, if available; otherwise birth certificate and proofs of residence are indispensable;
- ✓ Career prospects;
- ✓ Credit approval should be above branch manager level, to prevent a conflict of interest for the manager.

### **Problem no. 2 – Bankers’ bonuses subject to conflict of interest**

Current concerns about this topic have been well aired<sup>26</sup>. Credit managers were subject to conflicts of interest, that is, the greater their volumes the more bonuses they earned. Bankers earned bonuses from rising, unrealised asset values. Another criticism concerned the element of speculation that banks were seen to have dealt in. Banks have systems of internal controls which govern how bank staff perform their business; yet these are not drawn up to prevent normal commercial banks from what can be described as potentially dangerous speculation, that is, legal gambling.

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the implementation of the rules; devising of the rules is not mentioned. Under sections 6 and 7 both institutions are to liaise to avoid gathering the same information, which would not occur under this proposal.

<sup>26</sup> See the statements of U.K. Prime Minister Brown on the U.K.’s 50% bonus tax (Note 1 above), and Lord Turner’s comments (Note 6 above) - made public after this paper was drafted.

### The solution – Bonuses to be earned over the longer term

Central Banks must formulate<sup>27</sup> Banking Bonus Rules which reward bankers not for immediate profits, but over the longer term. In other words, bonuses on business that matures over the long term should be calculated after an agreed amount of time has passed.

Variable compensation should be broken down into its contributory business elements, each analytically categorised by duration for bonus formulation. For example, bonuses relating to mortgage business: five years, to allow time for defaults to transpire; trading on banking book: three years, for market volatilities to feed through to profit and loss. Bonuses, therefore, take account of losses as well as profits.

### **Problem No. 3 – Mismatch of business**

With the widespread writedowns made on mortgage and securitisation portfolios in banks affected by sub-prime problems, the capitalisation of such institutions was severely reduced, and affected banks sought funding to shore up their balance sheets. A bank that could not match funding source maturities to assets was in difficulty: the U.K.'s Northern Rock bank collapsed when its mortgage portfolio had to be written down, as it had relied heavily on wholesale markets for funding, not customer deposits, and institutions proved reluctant to lend to a counterparty in these financial difficulties. A mismatch problem, therefore, became a liquidity and then a wider problem.

Currently we have institutions with a dual personality: in the networks there are branch staff engaged in the typical lending and deposits business, while in head office there are operators performing large and incentivised trading operations, with the bank's own money.

### The solution – Bank categorisation

Banks must be split into two<sup>28</sup>: 'Commercial' – retail business (from sole trader customers though SME's and up to large corporate); and 'Investment' – including

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<sup>27</sup> E.g. in the same forum as suggested for the Credit Granting Rules above.

<sup>28</sup> And see U.S. President Obama's 'Volcker Rule' (Note 1 above) – made public after this paper was drafted.

proprietary desks. A bank should be authorised to carry on either commercial or investment business, but not both.

Regulation must be co-ordinated at international level to ensure an international level playing field. It should focus on the source of liabilities and destination of assets as it does the existing matching of asset and liability currencies and maturities. Retail deposits from customers, such as current and deposit accounts, should fund retail loans to customers such as residential mortgages. Wholesale funding would be matched for purchasing wholesale investment assets.

Where a Commercial bank has an excess of cash from deposits this should only be used to acquire highly liquid, secure assets such as its national government's bills, and not for higher earning but riskier assets such as securitised or corporate debt. Derivatives can only be entered into for hedging purposes or on customer instructions. Speculative shorting is not permitted.

The proprietary book is that subject to most risk, including fair value valuation volatility, and if an Investment bank experiences difficulties it should not affect commercial banks and the general public. It is, therefore, not liable to spark a bank run. Commercial banks can be ring-fenced from 'Investment' proprietary trading departments; they must be the financial strongholds of economies, rock-solid and, in market stress, insulated from unrelated contagion.

#### **Problem No. 4 – IFRS fair value valuation**

Much has been written about the effects of the fair value problem on the crisis. The adoption of International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB), used for accounts of European banks from 2005 onwards, brought a significant use of fair values in the valuation of banks' assets and liabilities, including derivatives, which were brought on-balance sheet for the first time. U.S. banks were using the Financial Accounting Standards (FAS) of the FASB, with similar fair value elements.

An example can serve to demonstrate the unsuitability of fair value valuation for accounting purposes. Essentially, the IFRS ‘fair value’ of a company’s quoted share is its quoted market price. Leaving aside the price nuances of bid, ask, closing, average, etc., the quoted price is set by market makers and is based on the company’s current performance and assessments of its future performance.

In other words the price is largely based on traders’ views of the company’s earnings, as these are evidenced by forecasts issued by the company, non-published company information, and economic sector information considered to impact the company. Where the company is expected to increase earnings its share price will rise. Where earnings are forecast to fall, *mutatis mutandis*, its share price will fall. The resulting price is booked by accountants to value that share in banks’ balance sheets.

A golden rule of accounting is that profits must be earned before they can be booked<sup>29</sup>. Yet IFRS require the booking of *forecasts of future* company earnings in balance sheets before they are earned. Assuming a rising market, optimism fuels share prices, which are then incorporated into financial instruments’ values, which then rise on further market optimism, and so forth. In times of crisis, negative sentiment will, *vice versa*, exacerbate share price plunges<sup>30</sup>.

These forecasts are unrealised. They are paper valuations; they might never be cashed. At the balance sheet date they are also unearned profits: they might never be realised.

#### The solution – IASB discontinuance, or E.U. opt-out, of fair value accounting

The fundamental accounting concept the accrual requires that all gains and losses relating to a period be accounted for, or ‘accrued’, in that period, even where these gains or losses have not yet been cashed. In this respect a fair value valuation appears similar to an accrual, being a value accounted for as a gain or loss even though not yet cashed. However, the basis of an accrual is that it

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<sup>29</sup> See the ASB’s FRS 18, paragraph 28: “In preparing financial statements, an entity will have regard to requirements in companies legislation that only profits realised at the balance sheet date should be included in the profit and loss account.”

<sup>30</sup> See the vivid imagery of market volatility in the ‘Millenium Bridge’ in Plantin (2008), pp. 3 & foll..

removes the pure time-delay element of a known amount that will ultimately be cashed. Interest accruals are time-driven, and at any point it is possible to calculate exactly how much interest is earned or incurred at that moment.

IFRS fair value valuation, answering “No” to the following questions, does not pass the test of accrual accounting:

1. Is this valuation evidence of an increase/decrease in value that relates to the period in question (and not to any future period/s)?
2. Does this increase/decrease in value constitute pure time-delay of value that will be cashed after a known lapse of time?

Fair value also has problems for market revaluation of a building. A property can be revalued to reflect its reference date market value. However, it is difficult to be certain that no future element of earnings potential are included; the valuer may consider the future movements of rents in that particular area, to increase or reduce the current earning power of the building. To avoid booking revaluation that includes any future earnings, we should rely on another fundamental accounting concept.

This concept, part of national accounting principles, but formally removed from IFRS, is prudence. Prudence requires a valuation not certain to constitute an accrual not to be booked. It has long been an integral part of national accounting concepts, and should be reinstated<sup>31</sup> by IFRS.

“Prudence requires that accounting policies take account of ... uncertainty in recognising and measuring ... assets, liabilities, gains, losses and changes to shareholders’ funds<sup>32</sup>”. Prudence is necessary in uncertainty. The French Plan Comptable Général specifies “the accounts are drawn up on the basis of prudent valuations, to avoid the risk of transfer, to future periods, of present uncertainties<sup>33</sup>”. The Italian Civil Code (‘Codice Civile’) specifies that “the

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<sup>31</sup> IFRS Impairment rules are, however, exercises of Prudence: p. 13, Whittington (2007).

<sup>32</sup> ASB’s FRS 18, paragraph 37.

<sup>33</sup> Titre I, Chapitre II, article 120-3 – the author’s translation.

valuation of items (in the financial statements) must be in accordance with prudence<sup>34</sup>”.

IFRS have focused accounting on markets, and removed the more traditional governance and stewardship concerns of national accounting bodies. It is time for these national bodies (e.g. the ASB in the U.K.) to liaise<sup>35</sup> to persuade the IASB to return accounting to its more conservative role and roots: bankers’ and markets’ interests cannot be preferred to national economies’. Analyst-aided disclosure of fair values can be viewed in in the Notes to the accounts.

The use of fair value, revisited by the IASB in Exposure Draft No. 5/2009, risks, however, becoming more widespread. The E.U. must pressurise the IASB to remove fair value, or reject it in a similar way to its ‘carve-outs’ of parts of IFRS 39 at adoption for 2005 accounts. It makes accounts needlessly volatile and complex, subjective, and counters the concepts of accruals and prudence. But what takes its place?

Before the advent of IFRS/FAS fair value, the accounting cornerstone historical cost convention accounted for assets and liabilities at the value at which they were purchased or sold. A share purchased in, for example, July for £5, at year end under historical cost (and unimpaired) would still be valued at £5. Under fair value it might rise to £6 if the company has prospects of increased future earnings, or fall to £4 if the company’s prospects worsen. Fair value produces a subjective view of future prospects, changeable at any moment, but historical cost documents an objective cash amount (here, purchase), and thus complies with the realisation principle above. It also complies with prudence, being a certain amount. In these two fundamental areas it is superior<sup>36</sup> to fair value. What is more, any ‘accrual’ of value is not possible, given the lack of certainty in the valuation relevance and of strict connection to the passing of time.

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<sup>34</sup> Clause 2423-bis – the author’s translation.

<sup>35</sup> See Note 15 above.

<sup>36</sup> It is unlikely that any accounting principles or ‘standards’ will be able to ‘achieve all things for all men’. However, the stewardship objectives of accounting favour historical cost.

Published accounts bring a duty of care towards the economies in which entities are based. This duty of care consists in producing accounts that contain prudent accounting information, i.e. that does not needlessly cause problems. Accounting must return to its stewardship role<sup>37</sup>, and abandon its IFRS(/FAS) orientation towards markets, a detour misguided, outdated and manifestly dangerous.

A definition<sup>38</sup> of accruals and prudence to be inserted in the IFRS Framework document might be as follows:

*“Accounts shall be drawn up according to the Accounting Principles as hereby defined. [Going Concern, the assumption that the reporting entity will stay in business, is a sine qua non]:*

*Accruals requires the accounting for both gains (and any other term for income) and losses (and any other term for charges):*

- ✓ *Only that relate to the period in question, and not to any future period(s);*
- ✓ *Whose calculation can be precisely performed, given that it is a function only of the passage of time.*

*Prudence requires the accounting for both gains and losses:*

- ✓ *Only that are certain in amount, and thus can be quantified.”*

### **Problem No. 5 – Derivative valuation by models**

In years leading up to the crisis derivatives use in banking increased many fold. Certain banks, in the U.S., the U.K. and certain areas of Europe, held asset trading derivative volumes larger than their lending activities<sup>39</sup>. This contrasted with banks of other countries, where trading derivatives volumes were of lesser dimensions<sup>40</sup>: in 2008 the ratio between derivative assets and customer loans rose to 213% in Barclays Bank<sup>41</sup> (from 51% in 2005<sup>42</sup>), whereas the same ratio for

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<sup>37</sup> See Watts (2006) (pp.9 & foll.), showing historical U.S. attitudes to the importance of stewardship and informational needs of accounting.

<sup>38</sup> drawn up by the above proposed International Accounting Committee.

<sup>39</sup> For example: Barclays 2008, p. 34: derivatives of £985 billion, customer loans of £462 billion; and Citigroup 2008, pp. 91 & 121: derivatives of \$1,173 billion (before netting), customer loans of \$555 billion.

<sup>40</sup> For example: Unicredit Group 2008, pp. 210 & 138: derivatives of €121 billion; customer loans of €612 billion; Société Générale 2008, pp. 1 & 70: derivatives of €12 billion; customer loans of €355 billion.

<sup>41</sup> Op.cit. in Note 39.

<sup>42</sup> Barclays 2006, p. 27: derivatives of £137 billion, customer loans of £269 billion.

2008 was only 10% in Intesa Sanpaolo<sup>43</sup> and 20% in Unicredit<sup>44</sup> (the latter with 17% in 2005<sup>45</sup>).

The problem with derivatives is that the large majority, neither exchange traded nor quoted, depend on model valuation to formulate fair value. These models, at times producing significant trading profits or losses, depend heavily on the inputs selected<sup>46</sup> and operated by operators that can differ widely between individuals and institutions, and produce widely different results that users of accounts should consider accurate and objective accounting data. The following list of variables used to calculate fair value of an option derivative, a put option on an equity investment, provides some idea of the scope of choices available to individual operators, even with observable market data:

- ✓ Discount interest rate, parametered to the period of the option. Choice of rate will be exercised for option period not matching the rate period.
- ✓ Cost of capital of the investing group, differing from group to group.
- ✓ Beta of the market in which the entity operates. The beta encompasses a varying number of similar entities, and can be adjusted to include more or fewer 'similar' counterparties.
- ✓ Forecast future growth rate, including inflation.
- ✓ Budget of the entity subject of the option, preferably multi-year and showing cash flows. This should be the approved budget of the entity. Budgets range from prudent to aggressive, with great variety of range.
- ✓ Future dividend payout ratio of the entity, estimated by the operator if the entity's budget does not specify this.
- ✓ Multiple cash flow projections: the operator may perform a number of models and choose either highest, lowest, average, etc.. He may formulate a model with dividend discount, or risk-weighted target equity that adjusts the budget of the entity to calculate how much solvency capital to retain and distribute.

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<sup>43</sup> Intesa Sanpaolo 2008, pp. 114 & 164: derivatives of €42 billion, customer loans of €395 billion.

<sup>44</sup> Op.cit. in Note 40.

<sup>45</sup> Unicredit Group 2006, pp. 183 & 120: derivatives of €73 billion; customer loans of €427 billion.

<sup>46</sup> a single derivative model-valued at €3.5 million in the 2005 annual report of an Italian bank-holding company had potential fair value movement of +27% (+€0.9 million profit) under the modelling of a long term interest rate 1% lower.

There is much room for manoeuvre in the above areas. The formulation and choice of results cannot be left to bankers: it is simply too subjective and potentially open to manipulation. Who, when faced with meeting a bonus requirement in good times, or avoiding losses in bad times, will not be tempted to use inputs and model parameters that best suit the situation to hand? It can be imagined how much results can rise and fall both outside and in boom or recessionary periods.

#### The solution – Banning of fair value models

The use of IFRS fair value models depends on the IASB, and this body must be persuaded to drop fair value accounting for derivatives based on models. The IASB should re-formulate its Framework<sup>47</sup> document, and reinstate accruals and prudence as explained above. Derivatives would be accounted for on a cash accrual basis, as before the fair value rules were introduced. Banning of these models can be introduced by relying on the definition of prudence as outlined above: “Only [gains/losses] that are certain in amount, and thus can be quantified.” Where an item is not certain in amount no accrual can be justified.

Derivatives would therefore revert to their pre-IFRS status of off-balance sheet disclosure only, which still provides users of accounts with important information. (Internal ‘management accounts’ can continue with fair values.) Crucially, however, highly subjective valuation results are removed from profit & loss accounts, and bankers are weaned off an area of volume chasing for the sake of bonuses.

The European Commission, as lobbied by European banks which are more supportive of a reduction in fair value use, should combine with national accountancy bodies to apply pressure on the IASB, or refuse to accept its fair value principle. Regulators are realising that market orientation is not a suitable accounting objective, creating instability, volatility and subjective inputs that are forward-looking rather than earned or incurred at the reporting date. Accounting, particularly in banks, needs to be shepherded back to its stewardship role;

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<sup>47</sup> See the IASB Framework, *passim*.

market discipline alone does not ensure that bankers act in the interests of communities.

## **Conclusions**

Doubtless the next financial crisis will combine another unexpected set of events that states will struggle to overcome, as happened this time. It is recognised that the solutions proposed herein require considerable national government co-operation to be launched. However, if national bodies co-ordinate responses, the scourges of lax lending, managers' conflicts of interest, mismatch of business, fair value accounting and derivatives should have a much smaller role, if not altogether disappear. What is more, it is to be hoped that regulators, while going about their daily business, manage to foresee, and forestall, other possible contributory factors in the making. For, let us remember, it is the goal of bankers to make money, and regulators to regulate, and "never the twain shall meet".

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