Crash Bank Wallop: The Memories of the HBOS Whistleblower
Book by Mike Haworth

Paul Moore was Head of Regulatory Risk at
Halifax Bank of Scotland (HBOS) until he was fired
by the CEO for blowing the whistle on top management's dangerous sales tactics. ..

From: Paul Moore [mailto:Paul.Moore@moorecarter.co.uk]
Sent: 01 March 2011 13:16
To: Phil Hodkinson
Subject: Article [Scanned]

Phil,
Hope all goes well with you and yours; all is well with the North York Moores...although Emily is now in London doing midwifery and Daniel is in NZ on his gap year.
I am interested in picking your brain on this whole accounting standards in banks (and elsewhere) thing we have discussed before. You remember you said that one of the causes of the banking crisis was "accounting standards designed for a different purpose".
You will be aware that there has been a lot of talk about the position in the Economic Affairs Committee of the House of Lords in the last month or so which supports exactly what you say.
Do you know anyone who is good at this stuff who might be prepared to work with a journalist and me on the topic in the background as an expert. If you were prepared to get involved that would be even better. The journalist, Ian Fraser, (who is well respected) would guarantee your confidentiality....but I guess this may be beyond your risk appetite?
Also, what is your view as an expert on all these comments about the accounting at Lloyds? See articles at web links copied below?
http://ftalphaville.ft.com/blog/2011/02/25/498226/lloyds-first-8bn-htm-accounting-switch/
http://www.economist.com/blogs/newsbook/2011/02/british_banks

It's about time for another curry? Or perhaps a walk in the bluebells of the North York Moors?

Cheers
Paul Moore

From: Phil Hodkinson [mailto:phil@hodkinson.com]
Sent: 03 March 2011 18:37
To: Paul Moore
Subject: RE: Article [Scanned]

Hi Paul
Thanks for your note.

I’ll have a think about who might be able to advise you on accounting standards ... certainly not me, not least because I’m not an accountant and I’d prefer to keep my thoughts private.

The points I recall making when we met were:

1. There was widely discussed desire around the world (certainly in Europe) including regulators to use the published accounts of financial services companies as the basis for regulation and taxation as well as markets, rather than maintain the three parallel accounting bases for each with the inherent confusion that caused.

2. The IASB (via the introduction of IFRS) were, however, determined that the accounts should represent the most likely outcome of a company’s performance today, not a conservative view of the performance over time, which arguably had been the norm before. I’m not sure they were really bought into the desire for an unified approach ... their actions certainly doesn’t suggest so.
   So, for example, banks weren’t permitted to provide for future bad debts in their published accounts. They could only provide for loans that were delinquent today. Despite knowing that a percentage of today’s customers would default at some time in the future, they could not put any money aside today in their accounts to provide for this. The purist IFRS approach said that the provision for those bad debts should be made when they happened, not in advance.
   IFRS was not, however, consistent! Thankfully the IASB did not suggest to insurance companies that they shouldn’t put aside money today in their accounts to pay for future claims (e.g. when people die!). I could not get a clear answer from the technical accountants as to why there was not symmetry between the two ... the only logical difference between them is that the insurance contract is a liability (i.e. money to be paid out in the future) whereas the bank loan is an asset (i.e. money to be received in the future). I think it was more likely that the accounting standards for banks and insurance companies were produced in different parts of the IASB by different people, and no one was smart enough or influential enough to address the inconsistency!

   There was also the issue of the greater volatility of results that IFRS introduced ... in other words the desire to value everything on the basis of mark-to-market or what others would pay for your assets today ... when most banks had no need or intention of disposing of their assets (mostly loans of course) until the customer repaid them.

3. So, in short, at the same time as companies and regulators (and tax authorities) wanted to move to one version of the truth (one set of accounts) from which to base their financial assessments, the IASB were, in my view, taking the published accounting basis (IFSR) in the direction of a more volatile, less intuitive version of the truth.

4. Whilst banks and regulators probably realised what was happening (i.e. that profits were flattered by IFRS whilst market confidence was high, and were shattered when market confidence was low ... neither being an accurate reflection in my view), the markets were less clear and one can argue that the pressure from shareholders for dividends share buybacks in the good times was in part due to this. Shareholders could not see why banks wanted to hold onto their cash. They were concerned that it was because they wanted to acquire other businesses rather than because it might be needed to support existing businesses.

5. The assumption at the time from banks and regulators was, however, that this shift in accounting basis driven by IFRS which led to upward pressure on dividends and buybacks didn't matter at the end of the day because banks around the world had in any case just implemented a new, more rigorous and demanding capital regime i.e. Basel II which although taking the published accounts of banks as the starting point for the calculations largely assumed the worst case scenario in terms of bad debts, etc. when determining the capital they required.

6. The Basel II capital basis, signed off by regulators for the major banks 18 months or so before the crisis of October 2008, showed that they had adequate capital even after the dividends, share buybacks, etc of the past few years. The worst case scenario assumed in Basel II, however, was based on past experience which arguably missed the big difference between then and today ... namely the impact on liquidity of a crisis of market confidence which arose because of the much greater interdependency of the banking system that had developed in the meantime (especially in relation to instruments such as securitisations, hedging, shorting, etc. that were less common then).

7. In the event, and for whatever reason, Basel II capital requirements proved to be inadequate compared to the losses anticipated by the volatile IFRS basis, and hence more capital was eventually called for. We can only speculate as to whether a less volatile, more intuitive accounting basis would have helped maintain market confidence. We will never know.

Definitely time for a curry and/or walk. We're really busy this side of July with various triathlons and cycle ventures overseas, and a bit of work in between, but I'll go through the diary to find a long range forecast.

Best wishes to everyone

Phil

From: Paul Moore [mailto:Paul.Moore@moorecarter.co.uk]
Sent: 04 March 2011 12:53
To: Phil Hodkinson
Subject: RE: Article [Scanned]

Phil,

Many thanks for this; a very useful analysis. Of course, it raises questions including, why, if banks and regulators knew that the standards were flattering profits and allowing excessive dividend and bonus payments to be made, they didn't they do anything about it? I never remember it appearing in any of the risk assessments I saw at HBOS?
I also simply don't understand why executives in banks did not realise the liquidity risks in the market? Have you got any ideas why? Surely the liquidity "contagion risk" of a massive drop in confidence was obvious: or did people simply think it was so unlikely that it was not worth mitigating? And even if banks thought this, why didn't the regulators get it?

The whole subject warrants more discussion!

On curries, are you around night of 23rd March? If so I could come to you for a curry as I am on my way to Bristol from London that day.

Also, have a look at this early briefing paper on "Faithonomics" which I am setting up with Holly Ball, ex fund raising director of CAFOD...and tell me what you think.
I heard the Chair of Christian Aid on Desert Island Discs on Sunday...jolly good!

Best wishes
Paul Moore

From: Phil Hodkinson [mailto:phil@hodkinson.com]
Sent: 04 March 2011 16:23
To: Paul Moore
Subject: RE: Article [Scanned]

Hi Paul
23rd March is ideal for a curry. I'll be in London until about 17.30, so perhaps we could travel out to Holyport together?

The answer to your first question is that although banks and regulators might have known reported profits were being flattered, Basel II had just confirmed that even after dividends, etc. banks had more capital than they needed. So, neither the banks or regulators were worried or nor had any grounds on which to say "no" to shareholders even if they had wanted. In contrast, banks holding on to capital were generally de-rated by the market due to the fear that they were on the acquisition trail.
On the second question, individual banks (especially retail banks not operating in the investment banking market) were simply not in a position to judge that there was a heightened liquidity risk due to a crisis of confidence fuelled by the greater inter-connectedness of the market participants that had developed in the run up to the crunch. Not only was this inter-connectedness largely invisible to individual retail participants until it emerged, but also I would argue that, in the event, the confidence crisis was hugely exaggerated by the market, in part because many had a financial interest in shorting it. At some point I even suggested to the FSA that market participants should only be allowed to short stocks if they could show that they had a legitimate "insurable " interest given the moral hazard that existed otherwise. Needless to say, they didn't take up my idea!

Regulators, of course, were much better sighted on the issue of liquidity risk as they could see the whole picture in their jurisdiction but even they were not sufficiently joined up across the world or focused enough on the issue for it to worry them. Indeed they chose to de-prioritise new liquidity regulations in favour of capital regulations when deciding to proceed with Basel II.

By the way, liquidity was always in the HBOS business plan as the most significant risk facing the business.

See you 23rd?

Best wishes

Phil