Financial Institutions (Reform) Bill – FAQ

PRELIMINARIES

What are the principal objectives of the Bill?

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

Or put another way, the main purpose of this Bill is to minimise moral hazards within banking, by making those who make or preside over risk-taking liable for the consequences of that risk-taking - allowing no more lame excuses - and to implement procedures to hold them accountable.

Bottom line: we need to provide senior bankers with the strongest possible incentive to ensure the long-term survival of the banks they lead - and this is exactly what the Bill does.

What would be the likely outcomes of the Bill if implemented?

It would resolve the problems of the UK banking system and put it back on its feet. In the longer term, it would also make London a more attractive place to do business because risks would be more predictable.

The Bill would also lead to a fall in risk-taking activity – or more precisely, to the elimination of those risks involving moral hazard, i.e., where the profits of risk-taking are privatised but the potential losses passed off to others (e.g., via bailouts). Such risk-taking is both excessive and undesirable. Banks would still be free to take risks, but bankers would bear the direct consequences of the risks they would take and risk-taking would as a result become more moderate and considered.

What would be the impact on the City?

The main effect would be to make London a safer place to do business.

The Bill creates the best possible circumstances for the future of London as a financial centre. The City grew to prominence based on the integrity of its institutions ("my word is my bond", etc.), and this must be restored.

The examples of Switzerland and more recently, Singapore, also attest to the importance of institutional trust to a financial centre's long-term prosperity.

Conversely, the examples of Dublin and Iceland attest to the dangers of a short-term race-to-the-bottom approach to 'increasing market share' in the financial centre 'space'.

Wouldn't this lead to a loss of business overseas?

It would certainly lead to the loss of dangerously risky business and this would be a good thing: not all business is desirable. "Bad" business would doubtless go abroad where it would be more welcome.

On the other hand, one could also expect high-quality productive businesses to migrate to London when it became clear that London had sorted its problems out.

London's problems are deep and structural, and the Government should not be concerned about short term loss of business to overseas 'competitors', but rather about re-establishing the foundations of London's and the UK's prosperity, which is what ultimately matters. This Bill will help to do that.

We should also consider the alternative. If nothing is done to restore London's integrity as a financial centre, then we will see more bank failures and more public bailouts, all to no effect – and London will continue to lose business to overseas competitors.

What would be the likely impact on reported bank profits and losses?

Reported bank profits are likely to be lower but more stable. However, one should bear in mind that many of the 'profits' reported in recent decades were merely returns to excess risk-taking, which were then more than offset by subsequent losses when those risks turned sour.

Under this Bill, banks would likely report lower average profits but far fewer subsequent losses.

What would be the likely impact on bank remuneration levels?

Lower reported bank profits are likely to lead to lower remuneration levels in banking.

LIABILITY OF BANKERS

Why the provision for unlimited personal liability?

The risk of losing one's own personal wealth provides the strongest possible incentive for wise stewardship of other people's money.

Put bluntly, if I am looking after your money, you would want me to look after it as carefully as if it were my own money. But human nature being what it is, I will only do that if I am risking my own money when making decisions with yours. For me to care about your money as if it was my own, my own money must be at risk. It's as simple as that.

The Bill therefore reverses the contemporary 'something for nothing' culture that rewards decision-makers without also holding them to account for their mistakes. This 'something for nothing' culture implies no responsibility – as if bank losses come out of thin air and have nothing to do with the decisions that individuals had previously made. The Bill restores the notion that managing other people's money is a serious business and that those who do so must be held individually and jointly accountable.

The idea that directors should have unlimited personal liability for bank losses is also an old and historically tested one. For example, the two greatest bankers of the nineteenth century, Nathan Mayer Rothschild (1777-1836) and John Pierpont Morgan (1837-1913), both operated highly successfully under unlimited liability. Unlimited liability meant that they could lose all their personal wealth: this made them conservative in their risk-taking and reassured counterparties who appreciated what they stood to lose if a deal went wrong. It also gave them a strong personal incentive in the long-term survival of their banks and made for a banking system that was safer and more stable than the modern banking system.

Wouldn't these liability provisions discourage people from becoming bank directors?

There would still be a market for bank directors, and remuneration practices would adjust to compensate directors for the additional liabilities they would take on, i.e., directors would be compensated.

As with other forms of professional liability, directors would also be free to take out indemnity insurance. However, any sensible insurer would insist on some element of co-insurance from the insured in order to control the insurer's moral hazard vis a vis the latter.

Why the provision for personal bonds on the part of board members?

Two reasons:

1. Unlimited liability in itself is of no value unless the bank's creditors can get at directors' assets in the event they need to, and the personal bond provision helps to do that. Even if a bank exec manages to squirrel away most of his wealth in some place where it can't be touched, he/she still stands to lose their personal bond. So this gives them some serious incentive to behave responsibly.
2. The personal bond provision provides an additional source of capital to cover bank losses. So if the bank reports losses, then the personal bonds are used to meet those losses before the ordinary shareholder is expected to. This helps to protect the ordinary shareholder and, more importantly, the financial health of the bank itself.

Why should the size of the personal bond be set in legislation?

The precise formula is less important than the basic principle that the bonds must be sufficiently high in value (a) to provide some protection for other stakeholders and (b) for the risk of their loss to impact significantly on board members' behaviour.

Why not leave the size of the personal bond to the Chancellor's discretion?

Any Chancellor would be deluged by banking lobbyists pressuring him or her to water down the personal bond provision. Chancellors should be protected by the will of Parliament in legislation.

Wouldn't the formula for personal bonds exclude poorer people from becoming board members?

It would certainly make it very difficult for them to become board members. However, this concern is largely academic because there are no poor senior bankers - at least, not yet.

It would be wrong to see this as some sort of equal opportunities issue: the key concern is to make sure that board members have a sufficient amount of their own money at risk, i.e., that they have enough of their own 'skin in the game'.

Why would board members be liable for two years after they have stepped down?

To give the bankers a stake in the survival of their own banks after they leave. We need to put an end to the common practice of execs putting off problems till just after they leave or retire, and then later denying any responsibility with the lame excuse that "It was all OK on my watch even if the roof did just happen to fall in shortly afterwards."

BONUS PAYMENTS TO BE DEFERRED AND LIABLE

Is the Bill anti-bonus?

No. The Bill is not anti-bonus. The Bill promotes just bonuses.

It is important to address the weaknesses of the current system, which encourages the payment of bonuses on short-term and often non-existent profits. Any distributions - dividends or bonuses - must be based on real and not fake profits. This is what the Bill seeks to achieve.

Would bank bonuses disappear?

No. Bonuses would still be useful for performance-related pay. Bank boards would also have an incentive to maintain a healthy bonus pool to provide some protection against the prospect of their personal bonds being called in.

The Bill addresses bonuses related to risk-taking activities, but why should bonuses for other activities - such as marketing - also be deferred?

Two reasons:

(1) Any attempt to draw a line between these different types of bonus-generating activities would invite gaming by the banks. For example, if we imposed deferments for risk-taking bonuses but not for marketing ones, we would start to see bonuses for risk-taking reclassified as bonuses for marketing, and so forth. The banks are very good at this type of thing.
(2) Marketing is not a good example of non-risk-taking activity anyway. Look at all the recent scandals involving mis-sales - PPI, etc. in which the people involved earned commissions and hence bonuses for mis-selling financial products, thus dumping losses on their employers.

In any case, if a bank had a particular employee it wanted to reward, or it wanted to give a special present to all its employees, etc, it also has the option of pushing them up the salary pay scale, increasing everyone's salary etc. – or it could just award them a bonus.

Why are bonuses to be deferred?

To discourage bonus-oriented, short-term risk-taking at the expense of the bank's longer-term interest.

Bankers have been good at extracting bonuses based on short-term results whilst leaving time bombs for their banks that blow up later. We must put a stop to this. Deferring bonus payments for five years will help.

Why are bonuses first in line to cover reported losses by the bank?

Bonuses are earned by traders as well as bank directors, but only the latter would be subject to strict and unlimited liability and the obligation to post personal bonds. Since traders would not be subject to these requirements, making the bonus pool first in line to cover reported losses would maximise the personal incentives for traders also to take responsible risks.

How would traders respond to the bonus pool being first in line to cover any bank losses?

They would take risks much more responsibly, and therefore take far fewer of them: remember that a trader stands to lose up to five years' worth of accumulated bonuses.

They would also monitor each other, and be much more enthusiastic about cooperating with the bank's risk managers. This, in turn, will make risk management much more effective.

Wouldn't deferred bonuses prevent beneficiaries of those bonuses from being able to 'spend' them before the 5 year deferment period expired?

No. They can present their bonus statements to their local bank manager and ask for loans against them. The loan rates they would obtain would presumably reflect the 'default risk', i.e., the risk that the bonus payments awarded might not actually materialise 5 years later.

This is a straightforward business risk for the bank manager and the terms of any such loan are of no concern for anyone else.

Wouldn't bonus beneficiaries lose their entitlements if they subsequently moved or lost jobs?

No. Once the bonus is awarded the bank that awarded the bonus would have no further say in the matter and no control over how the bonus pool is managed, and the beneficiary would keep their bonus entitlement regardless of whether they subsequently move on.

BEHAVIOUR OF DIRECTORS

How would bank directors respond to the new regime?

Their main objective will be to make a steady profit whilst trying to minimise the chances of having their personal bonds called in. They can do this by a combination of:

- Taking fewer and smaller risks – and this is exactly what is needed.
- Shifting their own remuneration more towards salary, whilst ensuring that the overall bonus pool is large enough to provide a healthy cushion to protect their personal bonds. At the same time, directors would not wish to push this too far because of their own self-interest in performance-related bonuses, etc.
- To the extent that the accounting rules enable them, they would probably wish to under-report profits and build up 'hidden reserves' that can then allow profits to be 'smoothed' to cover the occasional loss without that being reported as such. Such loss smoothing has been a common practice historically, and is of no great concern as it means that banks would typically be stronger than their accounts at face value suggest and also, moreover, because there is a natural limit to such smoothing, not least because too much smoothing undermines directors' own performance metrics, leads to lower dividends, etc.

Note that although every system is gameable to some extent, directors' room to game the new system would be severely constrained not just by their unlimited and strict liability and their personal bond requirements, but also by the obligation on their part to use the older pre-IFRS accounting standards, which will put a stop to fake profits and other egregious IFRS scams.

BANK INSOLVENCY

Why should a bank be put into receivership if its core capital/assets ratio falls below 3%?

A 3% ratio of suitably defined core capital to assets is widely accepted as a minimum standard, even by the Basel Committee, which nonetheless would inconsistently allow some such banks to continue in operation. Given the inadequacies of any metrics, a 3% core capital ratio means that the bank can give its creditors next to no protection against possible losses - a loss of only 3% on its assets would wipe out its whole paper net worth - and this means it can no longer credibly claim to be a going concern. Hence it should be put into receivership.

OTHER PROVISIONS

Why the provision for a new FCIU and criminal investigations into all major recent bank failures?

There is a prime facie case that, at the minimum, many bank execs have failed to exercise their obligations under Companies Act and other legislation, and few if any bank execs have yet been held to account.

In this context it is important to note that when banks failed historically, it was relatively unusual to subsequently discover that there was no malfeasance involved.

Note that the Bill does not call for retroactive legislation in this regard, but instead provides for measures to ensure the enforcement of existing law.

Why should this be carried out by the FCIU and not by the FSA?

The FSA has proven itself useless and it needs to be held accountable. The FSA tends to focus on compliance with box-ticking exercises and its record of identifying wrong-doers post-2007 is lamentable.

But doesn't this mean that we would be better off abolishing the FSA and its likely successors?

Yes.

Why are all the provisions of the Bill mandatory and subject to criminal penalties?

These are serious issues and all parties concerned need to appreciate that compliance should not be an option, but a binding requirement. We must also get away from the culture that it is OK to comply with just some requirements, or that the parties concerned can escape accountability through excuses.

24 February 2012