Financial Institutions (Reform) Bill – Definitive Statement of Provisions

The purpose of the 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 liable for their own actions, so reining-in rampant moral hazards and excessive risk-taking. These measures would remove the most flagrant abuses and 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.

Put simply, the main purpose of the Bill is to minimise moral hazards within banking, by making those who make or preside over risk-taking as liable as possible for the consequences of that risk-taking. Since rules are usually gameable, a secondary principle underlying the Bill is systems redundancy, i.e., mutually reinforcing measures that minimise scope for evasion.

1. Liability of bankers

1.1 Board members of financial institutions would be strictly liable for any losses reported by their institutions.

[Note: strict liability means that they are held to be liable without the need to prove fault on their part, i.e., "it wasn't my fault" excuses don't mitigate liability.]

1.2 Board members of financial institutions would to be subject to unlimited personal liability for any such losses.

[Note: This means that their own personal wealth - all assets, houses, pensions, etc. - is to be at risk if their banks make losses.]

1.3 Board members of financial institutions would be required to post personal bonds that would be potentially forfeit in the event that their banks report losses.

[Note: This measure ensures that board members provide a form of additional core capital of known value that would be easily seizeable to cover bank losses.]

1.4 The value of the bonds posted for each person concerned should be the higher of £2m adjusted for future RPI or 50% of the person's net wealth.

[There needs to be a simple formula to determine an effective bond requirement and RPI is a better choice than CPI for adjusting the £2m for future inflation.]

1.5 Any board members who resign would still be subject to unlimited personal liability and the requirement to post bonds for a period of 2 years following their resignation.

[Note: This is to prevent directors running away from recently incurred but not reported losses by resigning before the losses are reported: hence this requirement means that if the roof should just happen to fall in any time within 2 years of their leaving, they are still liable, no excuses. This should take care of the common problem of soon-to-retire execs deferring problems until they themselves had just got out of the door. The 2-year expiration period would also counteract short-termism by giving board members an incentive to ensure that they are replaced by responsible successors].

1.6 Why a 2-year period and not longer? A long expiration period would impair the market for board members (making skills and experience less easily transferable, also leading to loss of skills whilst former board members sat out their 'waiting periods' before moving on). Hence the period should be long enough but not excessively long, and 2 years seems reasonable

2. Bonus payments to be deferred and liable

2.1 The payments of any bonuses that are awarded in any given year would be deferred for a period of 5 years.

2.2 The amounts involved ('bonus pool') would be invested on beneficiaries' behalf in an escrow account. Where the bonus takes the form of stocks, these would typically accumulate dividend payments over time. Where they include stock options, such options would be exercised on maturity if they expired in-the-money and so then convert to underlying stock positions, and if they expired out-of-the-money they would become worthless. Where the bonus takes the form of cash, these cash amounts would be invested in an independent money market mutual fund with a horizon period equal to the period when the original 5-year deferment has lapsed and payments can then be made to beneficiaries.

2.3 The reason for this requirement is that bankers and traders are good at creating personally lucrative time bombs that blow up years later when the individuals responsible have long since departed with their bonuses etc., and under current rules past remuneration cannot be retrieved by the bank when the damage is eventually revealed. The deferment period therefore needs to be a fairly long one.

[Notes: (1)These provisions would ensure that the control of the bonus pool is outside the hands of either the beneficiaries or the bank that paid the bonuses. This helps prevent either party 'gaming' the bonus pool for their own ends.
(2) The provisions for stewardship of the bonus pool should be uncontroversial: those who hold stock are entitled to receive dividend payments on their stock holdings, and those who hold options would wish them exercised on maturity if they expired in the money. The proposed provisions for the stewardship of cash bonuses are conservative and reasonable.
(3)The provisions regarding stock options also have important additional benefits by stopping well-known stock-option abuses by banks. (i) Banks are often evasive about the details of stock options, and this allows them to hide their true value and hence cost. (ii) Such evasiveness has often enabled them to tinker with stock options after they have been awarded (e.g., quietly replacing underwater options with above-water ones to transfer stock option losses to other bank stakeholders). However, such shenanigans are only possible while the bank itself 'holds' the stock options. The escrow requirement will stop such abuses because it would require the actual options to be handed over to the party that manages the bonus pool and this party would be independent of the bank: this would make stock option positions more transparent and put an end to expost 'tinkering' in favour of stock-option beneficiaries.
(4) So for example, bonuses awarded at the end of 2013 would be eligible for distribution to beneficiaries at the end of 2018, etc.
(5) The total current value of the bonus pool at any given time will be equal to the sum of the current values of the invested bonuses for each of the last five years. The total current value of the bonus pool at any time is also easily ascertainable, and the pool itself can be easily and rapidly liquidated at low cost.
(6) To avoid a potential source of confusion: once a bonus is awarded the awardee has a claim on it independent of subsequent employment status i.e. whether he/she continues to work for the bank.]

2.4 The bonus pool would provide an additional form of core capital that would be used to make good any reported losses.

[Note: The beneficiaries of the bonus pool include not just board members, but also, e.g., traders. Thus, the traders' bonuses are also at risk - and of course, the bigger the traders' bonuses, the more they have at-risk. This will help to discourage traders from excessive risk-taking, as their own accumulated bonuses would be in line to cover any losses.]

3. Use of personal bonds and bonus pool to make good bank losses

3.1 Should a bank report losses over any period, these losses would be made good in the first instance by drawing from the bonus pool.

[Note: This will further help to discourage traders from excessive risk-taking, as their own accumulated bonuses would be not just in line but first in line to cover any losses].

3.2 So if a bank reports a loss equal to 50% of the value of the bonus pool, then 50% of the bonus pool would be liquidated and transferred to the bank to cover those losses, and each beneficiary of the bonus pool would lose half his/her claims on it.

3.3 Should a bank report losses that exceed the value of the bonus pool, then the whole of the bonus pool would be forfeit to the bank to make good the losses. The difference remaining - the difference between the reported loss and the value of the bonus pool - would then be made good by drawing from the board members' personal bonds. Should their bonds prove insufficient to meet the whole of the remaining loss, then all their bonds would be liquidated to offset that loss, and any subsequently remaining losses would be passed to shareholders.

[Notes: (1) In short, any losses in the first instance are borne by beneficiaries of the bonus pool; further losses are borne by board members and made good from their posted bonds. Any further losses are then borne by shareholders in the usual way.
(2) This means that we would have three different types of bank core capital, with the bonus pool being the most junior, the personal bonds being the second most junior, and equity capital being senior. The most junior capital absorbs any initial losses until that level of capital is wiped out, the second most junior capital absorbs any further losses until it is wiped out, and so forth.
(3) The reason why the bonus pool is made most junior is to ensure that the traders bear the first losses, thus giving them the strongest incentives not to take excessive risks, bearing in mind that they would not be subject to the personal liabilities to which board members are subject].

3.4 In the event that board members' personal bonds are forfeit to the bank, board members would be required to replenish their personal bonds within a specified short period. Failure to meet this obligation would trigger personal bankruptcy.

4. Definition of core capital

The core capital of the bank would be the sum of the shareholder equity capital, the current value of the bonus pool and the current value of the personal bonds of the board members.

[Note: This is a robust measure of core capital, and is far better than the core capital definition of Basel II, which is open to widespread abuse. Note, too, that we need a clear definition of core capital when coming to the question of determining whether a bank is, or is not, solvent. See section 6 below.]

5. Accounting standards

5.1 For the purposes of the Bill, all relevant figures (measures of profit, loss, capital, bonuses, personal bonds posted, etc.) would be obtained using the parallel accounting rules (i.e. UK GAAP under Companies Act legislation).

[Note: This was proposed in Steve Baker's Ten Minute Rule Bill last year: The Financial Services (Regulation of Derivatives) Bill]

5.2 The values of board members' personal bonds and remuneration, all bonuses awarded and the current values of the bonus pool would to be reported in full.

[Note: This information obviously needs to be in the public domain.]

6. Bank insolvency

6.1 Should the ratio of a bank's core capital to its assets fall below 3%, then the bank would be deemed to be insolvent.

[Notes: (1)This sets a clear solvency standard: a 3% ratio of core capital to assets is an absolute minimum. (And it is to obtain a clear solvency standard that we need a definition of core capital hence section 4 above.) A bank with a core capital/assets ratio below 3% is essentially a zombie, i.e., not a going concern, and as such should not be allowed to continue in operation.
(2) Why 3% particularly? (i) 3% means that a loss equivalent to 3% of asset value means that the bank no longer has the assets to repay its creditors in full, even on paper: this is a very vulnerable bank. (ii) Even the Basel regime regards the 3% ratio as equivalent to a basket case, although it calls for intensive supervision, support, intervention, etc. instead of the more obvious bankruptcy. (iii) We should be more conservative than Basel].

6.2 The Secretary of State would be required to place any insolvent bank into receivership.

[Note: This deliberately leaves no room for discretionary judgment.]

6.3 In the event of insolvency, the bonus pool and the personal bonds of board members would immediately be forfeit to the creditors of the bank. Board members themselves would be deemed to be personally bankrupt and court proceedings would be instituted to recover their remaining personal property. This property would then be liquidated and the proceeds would belong to the bank creditors.

7. A New Fast-Track Receivership Regime for Banks

The Secretary of State would be required to propose a new fast-track receivership regime to handle insolvent financial institutions. The purpose of this regime would be to ensure that future bank insolvencies are handled expeditiously.

[Note: An insolvent financial institution would either be quickly broken up and marketable parts sold off, or else it will be quickly reorganised in receivership and put back out into normal operation. There have been calls for a fast-track bankruptcy regime for banks for years.]

8. End of State Support and Return of Financial institutions to Normal Operations

8.1 The Secretary of State would be required to present to Parliament a Bill outlining a programme (including a timetable) leading to the end of all state support for financial institutions.

[Note: This would lead to the liquidation or reorganization of any banks currently on state support and the return of any reorganized banks to normal activity.]

8.2 For the purposes of the Bill, state support would be deemed to include: all bailout support, all lender of last resort support, public shareholdings in banks, central bank holdings of any bank assets and any form of state-supported deposit insurance.

[Note: This might pave the way for a later reform of the Bank of England.]

8.3 Future state or central bank support for financial institutions would be prohibited.

[Note: Implicitly this also covers UK state support for overseas banks, so it would prohibit the Bank of England or HMG from supporting EU measures to prop up EU banks.]

9. Authorisation to Operate

9.1 Any banks that operate in the UK would be required to obtain UK authorisation. This means, in effect, that the UK would unilaterally withdraw from the EU 'passport' system under which financial institutions established in one member state can operate in other member states with no further authorisation requirements.

[Note: Consider the alternative. If the current passport system were to continue to operate, banks could evade all the provisions of this Bill simply by obtaining non-UK authorisation and then operating here under the passport scheme. Furthermore, UK-authorised banks would be at a competitive disadvantage relative to non-UK authorised banks, because the former would operate under the more onerous restrictions of this Bill and because the latter would be in receipt of state support that would be denied to the former.]

10. Criminal Investigations into Problem Banks

10.1 The Secretary of State would be required to set up a new Financial Crimes Investigation Unit to investigate financial crimes, and whose focus would be crimes committed by senior bankers and financiers.

10.2 The Secretary of State should direct the new FCIU to begin investigations into possible criminal offences committed in all financial institutions that have failed since 2007 and/or been in receipt of state support (e.g., bailouts).

[Note: This is not a call for retroactive legislation, only the establishment of criminal investigations into possible wrongdoing.]

10.3 Should a financial institution fail, the FCIU would be required to open an investigation into possible financial crimes committed by the senior management of that financial institution.

[Note: A serious financial crime investigation unit would make financial regulation, e.g., the FSA, obviously redundant: the FCIU would be looking for evidence (e.g., incriminating emails etc.) instead of the pointless box-ticking of the FSA].

11. Criminal liability of parties referred to in this Bill

Any failure on the part of any of the parties mentioned in the Bill to fulfil their obligations in full should be deemed to be a serious crime as defined in the Serious Crime Act 2007.

[Note: Serious crimes include, e.g., fraud, money laundering etc. so classifying these financial crimes as "serious" is not an exaggeration.]

12. Definition of Financial Institution

For the purposes of the Bill, a financial institution would be any company regulated under the Financial Services and Markets Act 2000.

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