PRESS RELEASE – 15 May 2011 19:00 – Steve Baker MP

Released by: Steve Baker MP, 15 May 2011

Contact: steve.baker.mp@parliament.uk, 07850 005331

A Bill to expose banks' false profits, overstated capital and hidden losses

Today, Steve Baker MP (Wycombe, Con) claims that EU-mandated International Financial Reporting Standards (IFRS) are forcing UK and Irish banks to deceive themselves and all their stakeholders about their true financial positions.

Joining a growing body of opinion amongst accountants, investors and Parliamentarians, Baker says that auditing banks under IFRS means that their true solvency is not accounted for and that banks which look profitable under IFRS may in fact be unprofitable and destroying their capital.

Commenting on his *Financial Services (Regulation of Derivatives) Bill*, which would require financial institutions to prepare prudent parallel accounts in line with UK company law, Baker said,

> "When I introduced my Bill on 15 March, I explained how the accounting rules for banks incentivize trading in derivatives by enabling unrealized profits to be booked up-front, leading to large but unjustified bonuses and dividends.
>
> "On 30th March, the House of Lords Economic Affairs Committee published a report recommending that the Government reassert prudence as a guiding principle. That is what my Bill does and I hope the Government will adopt it.
>
> "While complying with the rules, banks are producing accounts that grossly inflate their profits and capital in three ways. First, using IFRS mark-to-market and mark-to-model accounting, banks record unrealized gains in investments as profits. Second, IFRS prevents banks from making prudent provision for expected loan losses by allowing recognition only of incurred losses. Third, IFRS encourages banks not to deduct staff compensation from profits. Taken together, these flaws mean that banks' accounts under IFRS are at once rule-compliant and dangerously misleading.
>
> "By way of example, we have deduced from the accounts of the UK Asset Protection Scheme that RBS may be overstating capital by as much as £25bn.
>
> "Boards take decisions based on their accounts. If the accounts are misleading, is it any wonder that boards and regulators are failing shareholders and taxpayers? The public are furious about the injustices manufactured by the banking system, and they are right to be, but how much greater is the injustice if grotesque bonuses are based on false profits?
>
> "Banks are living in a fools' paradise in which their boards cannot get a firm grip on vital measures like capital and profit. That is plain wrong.
>
> "Thanks to the European Union, the UK cannot simply mandate prudent accounting in compliance with UK Companies Law but we can require parallel accounting to British standards while international negotiations proceed. That is why I am calling on the Government to adopt my Bill."

The *Financial Services (Regulation of Derivatives) Bill* is scheduled for second reading with other private members' bills on 10 June 2011.

ENDS

Notes to editors

About Steve

Steve Baker is Conservative MP for Wycombe following his election in May 2010. He is a director and co-founder of The Cobden Centre (www.cobdencentre.org), an educational charity for social progress through honest money, free trade and peace. He is Chairman of the All-Party Parliamentary Group on Economics, Money and Banking.

Previously, Steve served in the Royal Air Force as a fast-jet engineer officer before reading for an MSc in Computer Science and becoming a consulting software engineer. Steve has worked with banks and their regulators in the UK, USA and Europe. His last contract was as Chief Architect of two global programmes at Lehman Brothers in the months and years leading up to its failure.

He says it wasn't his fault.

Steve's website is www.stevebaker.info.

About the Bill

The Financial Services (Regulation of Derivatives) Bill:

- Requires preparation of "prudent accounts of true capital and true profits",
- Provides a right to return to preparing Companies Act individual accounts,
- Ceases to have effect if EU-IFRS provides for prudent accounts.

Further details of the Bill and its text may be found here:

http://services.parliament.uk/bills/2010-11/financialservicesregulationofderivatives.html

or http://bit.ly/k9VSvw

Timothy Bush, Gordon Kerr and Kevin Dowd of Cobden Partners prepared the Bill and advised Steve. Cobden Partners is a new sovereign advisory business which emerged from amongst The Cobden Centre team.

Steve Baker's speech seeking leave to introduce the Bill may be found here:

http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm110315/debtext/110315-0001.htm#11031569000001

or http://bit.ly/k1N50a

Support for the Bill

Steve Baker, Douglas Carswell, Andrea Leadsom and Chris Heaton-Harris introduced the Bill to Parliament on 15 March 2011. Further Parliamentary support is expected from within both Houses.

Lord Flight stated his unhappiness with IFRS in a letter to the House of Lords Economic Affairs Committee on 22 February 2011, which may be found here:

http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/11917.htm#note214

The second of three conclusions of the 30th March 2011 Report of the House of Lords Economic Affairs Committee, *Auditors: Market concentration and their role*, was:

> *"that prudence should be reasserted as the guiding principle of audit" (page 6).*

The document may be found here:

> http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf
>
> or http://bit.ly/jMaZ5g

Relevant paragraphs are as follows:

> 193. We accept that standards for use in many countries need clear rules which all can apply. It follows that IFRS is more rules-based than UK GAAP. **But we are concerned by evidence that, by limiting auditors' scope to exercise prudent judgment, IFRS is an inferior system which offers less assurance.** IFRS also has specific defects, such as its inability to account for expected losses. The **weaknesses of IFRS are especially serious in relation to bank audits**. (para 130)
>
> 194. We recommend that the profession, regulators and the Government should all seek ways to defend and promote the exercise of auditors' traditional, prudent scepticism. **The Government should reassert the vital role of prudence in audit in the UK, whatever the accounting standard**, and emphasise the importance of the going concern statement. (para 131)
>
> 195. Achieving general agreement on IFRS could be a long and uncertain process. In the meantime, **we recommend that the Government and regulators should not extend application of IFRS beyond** the larger, listed companies where it is already mandatory. **Continued use of UK GAAP should be permitted elsewhere, so that the basis of a functioning, alternative system remains in place** in case IFRS do not meet their aims. (para 132)
>
> 196. As it revises banking regulation, we recommend that the Government should have the importance of accounting standards at the forefront of its mind. **It should promote a prudent interpretation of IFRS as applied to banks. This would include sober valuation of complex financial instruments.** At present IFRS permits recognition only of incurred losses, not expected losses. So it is essential that banks put aside reserves in good times to provide against downturns. This would have the incidental advantage of reducing the scope for banks to pay bonuses on the basis of profits struck without taking account of possible losses. We recognise that a fully satisfactory outcome depends on international negotiation and believe that the Government should give a lead.

And

> 124. Mr Peter Wyman, formerly of PwC, [former global head of public policy and former President if the Institute of Chartered Accountants in England & Wales] recently said: "The rules allowed banks to pay dividends and bonuses out of unrealised profits—from profits that were anything but certain. The system is still in place now—we can't tell if similar problems are building up because there is no requirement to separate realised from unrealised profits."

Related stories

Telegraph, 26 Aug 2010, "UK bank accounting rules 'fatally flawed', warns influential watchdog":

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7964816/UK-bank-accounting-rules-fatally-flawed-warns-influential-watchdog.html

Telegraph, 27 Aug 2010, "Coalition admits concerns over 'flawed' IFRS":

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7966680/Coalition-admits-concerns-over-flawed-IFRS.html

QFinance, 6 September 2010, "Thanks to IFRS, Irish and UK banks have lived in a fool's paradise for years ... and they're still residing there":

http://www.qfinance.com/blogs/ian-fraser/2010/09/06/thanks-to-ifrs-irish-and-uk-banks-have-lived-in-a-fools-paradise-for-years-ifrs-analysis

Telegraph, 28 October 2010, "Lord Lawson calls for review of IFRS accounting 'fiasco'":

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8091057/Lord-Lawson-calls-for-review-of-IFRS-accounting-fiasco.html

Telegraph, 13 January 2011, "Bankers' bumper bonuses are the 'mistake' of flawed accounting rules":

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8255590/Bankers-bumper-bonuses-are-the-mistake-of-flawed-accounting-rules.html

QFinance, 14 January 2011, "Scrap mark-to-market accounting or face further crisis, warn investors":

http://www.qfinance.com/blogs/ian-fraser/2011/01/14/scrap-mark-to-market-accounting-or-face-further-crisis-warn-investors