Cobden Partners
Helping Nations Solve Banking Crises

Cobden Partners Paper

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Position Paper of Cobden Partners on the inefficacy of the EFSF Bailout Mechanism

The EFSF mechanism should be abandoned for the following reasons:

The crisis in the Eurozone is a banking crisis. The 2008 solution – bailing out insolvent banks - has not worked because most of them have loss making business models and engage in wrong accounting to mask this. The crisis can be solved, but only after an accurate diagnosis of the problems.

Whilst no serious commentators believe that the problems of overindebted countries can be solved with more debt, our political leaders endorse just this medicine in the hope that it will enable the patient to "buy time".

Sadly, the time so bought will achieve the opposite of the desired result – it will worsen the problems for the indebted countries, ie their indebtedness will simply spiral further out of control. If the EFSF bailout is implemented in its present format, debt will simply be spread among the Eurozone countries. After an initial boost to markets the crisis will return, only far worse, when it is revealed that the EFSF, like the ECB, is deeply insolvent itself. The Japanese system has still not recovered from the 1990s adoption of precisely this type of wrong accounting – recording on the books purchases of bonds at par value which are worth only a fraction of said value.

This is a serious problem for Germany. As the charts in the attached presentation show[1], Germany's fiscal statistics - Government net borrowing and gross debt as a % of GDP - are particularly robust. Its total government expenditure is relatively high but so is its tax revenue income. Germany risks serious damage to its national health if the EFSF, EFSM and ESM (collectively the "EFSF") fail, which we are certain in their present format they will.

Our analysis of the certainty of this failure breaks into three sections:

a) The ECB's own published views on the crisis and the EFSF solution;

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[1] Appendix A - Investec analysis of International Government Spending, charts pp 28 - 31

b) The Financial Alchemy of the EFSF structure;

c) Failure to analyse the causes of the 2008 crisis – a banking crisis fuelled by bankers' desire for compensation leading to wrong accounting and inept regulation of banks. All of the measures enacted since the crisis have operated in a "world of opposites" in which measure after measure has worsened, rather than eased, the crisis.

a) ECB analysis.

In its July 2011 Monthly Bulletin, the ECB acknowledges that the "smooth functioning of Economic and Monetary Union (EMU)" requires national governments to balance their books and ensure the competitiveness of national economies.

The text is replete with statements that the solution cannot be one that creates "moral hazard".

At page 71 the ECB sets out the two cornerstones of EMU aimed at curbing excessive sovereign indebtedness:

- the "no bailout" clause (Article 125 of the Treaty)
- the monetary financing prohibition (meaning no Eurozone wide monetisation of individual nation's debt) – Article 123.

Yet on page 72 the ECB notes:

"The fiscal rules (laid down in the Stability and Growth Pact SGP) have…not been implemented. This weakness is to be addressed by a new enforcement regime, but confidence is low among markets that such a regime could be effective since no attempt was ever made by the old regime to enforce any of the provisions of the SGP."

The EFSF structure is described as "bridge" financing, allowing countries to buy time. But no country in recent times has avoided default on its national debt when its level has reached 90% of GDP, and of the 17 Eurozone countries Spain is at about 90%, and each of Portugal, Ireland, Italy and Greece are in excess of 100%. Bear in mind that the 17 countries include states with very small economies such as Malta, Luxembourg, Slovenia and Slovakia. Of the major countries, only Germany is still fiscally sound, and only just.

As part of the moral hazard argument, the ECB confirms at page 73 that *"financial assistance must be granted on non-concessional (i.e. sufficiently unattractive) terms to increase the incentive for the country to return to the market as soon as possible."*

Yet even though the 2010 rate struck most market commentators as small enough, 5.5%, the EFSF 2011 interest rate has been set to 3.5%. This is substantially below the market rate for any of these countries as a brief review of present credit default swap rates reveals.

On the same page the ECB notes that in 2008 *"sovereign bond spreads were clustered in close proximity to each other".* The ECB then blames inefficient markets for allowing this clustering and argues that the perceived mutual strength of EMU led to the underpricing of certain sovereign states' debt thus encouraging overborrowing and contributing to the present crisis.

At this point the ECB appears to be contradicting itself. Just as it is arguing for a massive fund to be used to boost the credibility of the overindebted nations, so tending to recluster sovereign bond spreads, it also argues that such reclustering is an undesirable objective.

We therefore reach the conclusion that the ECB is living in a "world of opposites":

- it insists that bailouts must respect moral hazard, but it endorses the EFSF structure which is riddled with moral hazard;
- it claims that the emergency funding must be on "sufficiently unattractive terms" to encourage nations to return to the markets on their own standing as soon as possible, yet the terms on offer are the most attractive ever offered by the ECB or EFSF, and are a fraction of the levels at which the overindebted countries could borrow on their own;
- it blames low spreads emanating from the perceived strength of EMU for the crisis yet imposes one low spread for the worst credit risks in the Eurozone.

b) EFSF Solution – Further Financial Alchemy

Please see attached presentation[2] and analysis therein contained.

C) The True cause of the 2008 Crisis.

By the mid 2000s it was obvious from the absurd regulatory and accounting rule framework that the banking system would crash. It will fail again unless its true cause is immediately addressed, since subsequent rules have made the position, and the economic incentives for bankers, even worse for the taxpayer.

Economics is all about incentives and human behaviour. Banker compensation is linked to accounting profit. If rules are created by incompetent regulators and accounting bodies that enable bankers legitimately to account for the vast bulk of cash under their stewardship as profit, banks will fail tomorrow.

http://www.cobdencentre.org/2011/03/the-banking-crisis-has-been-exacerbated-by-new-rules-and-regulations/

Contrary to what many bankers claim, CDOs do not represent an evolved modern form of traditional lending activity.

At the consumer level CDOs worked so well for banker compensation that they incentivised the creation of loans to very weak borrowers purely to drive the CDO engine (sub-prime).

At the corporate level they encouraged loan recycling, not new loans. By 2006 a great percentage of newly issued Eurobonds were not being purchased by capital markets investors. They were bought by the investment banks that had brought them to market. They were then packaged together and reissued. Rating Agencies wrongly concluded that default risks were lowered (ratings raised) if chunks of bonds from different industries were bundled on the ground that default probabilities of different industries were not "correlated".

The bank systemic failure exposed the emptiness of this non-correlation theory. The agencies have, post-crash, downgraded by 5 notches (from AAA to say B) up to 4500 CDO transactions. In our view, Eurozone leaders are wrong to continue to take these American agencies seriously with their reputations so damaged.

The only motive for the rise of the credit default swap market and its spawn, synthetic CDOs, was banker compensation. Swaps enable profits to be recognised

[2] Appendix B

in banks' accounts up front. By turning loans into swaps banks can artificially boost today's profits. The counter argument was that these instruments were needed in order to facilitate transfers of loan risk from banks to insurers and other banks. This is a false statement. For 20 years prior to the advent of CDS, banks were engaging in loan transfers via sales, novations and sub-participations of loan books.

Securitisation has been targeted by the rulemakers. Yet securitisation is a perfectly healthy activity when used properly. The capital markets help to curb the cartel-forming tendencies of bankers. One such cartel was formed in the mid 90's by UK banks lending to the rapidly growing Housing Association movement. After the first securitisation of Housing Association receivables, loan spreads halved overnight. This securitisation of future tenant rentals facilitated direct access for these providers of social housing to the capital markets.

By 2000 the non-correlation theory was gaining prominence. Securitisers loved rating agency naivete and designed CDOs and their exponents to exploit the rating and accounting rules by incessantly repackaging debt. At this point scrutineers should have worked out that the rules needed tightening to curb bankers' zeal for compensation. By then it was driving the issuance of virtually worthless, but AAA rated bonds.

When synthetic structuring was overlaid onto this form of securitisation the result was a rapid inflation of asset price bubbles before the inevitable burstings.

Far from addressing its true cause, regulators and politicians simply froze at the point of the crash and capitulated to demands from bankers for even greater compensation. One example. When its credit default swap liabilities had brought AIG into trouble, AIG was negotiating with its CDS counterparties to accept 60 cents on the dollar. Amazingly, the failed creditor banks were better poker players than the guardians of US taxpayer funds and the banks won a 100% TARP bailout, or $62billion in respect of these AIG swaps. (See Johnson and Kwak "Thirteen Bankers" pp 169, 170).

Another example is the near zero interest rate policy which is artificially keeping asset prices high. Good for bankers once again. By propping up bank collateral values, bank balance sheets appear healthier than otherwise. Bad for ordinary citizens as inflation kicks in causing food, utility and transport prices steadily to rise.

Regulatory, accounting and political responses continue to miss the cause of the crash by a country mile. RBS appears to be pushing the accounting rules beyond any measure of acceptability. UK taxpayers insure its junk portfolio and Her Majesty's Treasury valued (mid 2010) the expected losses at £25bn higher than RBS employees. We still await a reply to our May 31st letter as reported in the Daily Telegraph on June 2nd:

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8551272/Royal-Bank-of-Scotland-told-by-MPs-to-explain-25bn-accounting-distortion.html

Since the crisis there have been universal calls for better regulation of banks and an intense focus on Basel 2 and 3. In July the prestigious Washington based Cato Institute published a paper by Cobden Partners' Professor Kevin Dowd, compellingly arguing that the entire Basel regulatory capital regime is pointless:

http://www.cato.org/pubs/pas/pa681.pdf

Irrespective of the strength or otherwise of his arguments, what is remarkable is that there has been almost no attention post crash to poor accounting by banks in general and the IFRS regime in particular.

Yet Irish, UK banks and the ECB, have only implemented the EU-wide IFRS regime unconditionally at the banking company level. As Tim Bush has ably argued, and will shortly publish (3) a paper consolidating such arguments, IFRS requires wrong accounting. Even those European countries who do not allow IFRS for their actual banking companies (ie they employ IFRS only at the consolidated level where it can do far less harm) appear oblivious to a major root cause of the 2008 systemic banking failure, wrong accounting for credit default swaps and their derivative cousins.

As I explained a year ago (Appendix C), it is simply wrong from a common sense accounting perspective to allow banks to purchase long term default risk, lay it off with another financial counterparty, and treat the risk for accounting purposes as non-existent, as sold. This is so for two reasons, a) the counterparty may default and b) there may be a very high correlation between the risk of default of the underlying risk the subject matter of the cds and the risk of counterparty default. In the example of US sub-prime risk and AIG the correlation was a perfect 1.

[3] Tim Bush, UK Local Authority Pension Fund Forum

http://www.cobdencentre.org/2010/11/proof-that-the-banking-system-in-its-present-format-cannot-be-regulated/

Irrespective of your views of the merits of some form of parallel bank risk measure (which is in essence all that BASEL can ever claim to be), the formal accounts of any company, bank or not, are surely of vastly greater importance than a theoretical BASEL measure. Accounts should be the managers' and auditors' honest statement of the bank's financial position. Once they cease to be an honest reflection of the business' financial position chaos ensues. BASEL becomes ever more pointless since it in turn relies on published accounts.

At this critical juncture of Eurozone negotiations over the terms of another round of bank recapitalisations, Cobden Partners would advise an immediate reassessment and revision of the wrong accounting of the ECB. What is the point of throwing more good money after bad since the accounting regime upon which all stakeholders are relying masks wrong accounting?

Since the introduction of a Bill in the UK Parliament by Steve Baker MP to require financial institutions to produce parallel prudent accounts alongside their IFRS ones, it has emerged that the IMF and Irish Central Bank are exploring mitigating the problems of IFRS accounting.

The Bank of England is also sufficiently worried about the impact of IFRS on the overstatement of bad loans, that it is taking advice on moving loan loss provisioning off the IFRS system from July 2011. Sources: Daily Telegraph and Irish Independent articles:

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8555745/Irish-banks-may-have-to-declare-extra-losses-under-accounting-rules-change.html

http://www.independent.ie/business/irish/banks-may-be-forced-to-frontload-billions-in-losses-2665095.html

We have also learned that the IMF has expressed concern that UK banks are understating bad loans. This is because IFRS masks loans in forbearance situations from provisioning, irrespective of how likely losses are.

http://www.telegraph.co.uk/finance/economics/8560840/IMF-warns-on-UK-banks-masking-bad-debts.html

Steve Baker MP commented on IFRS in June, *"Accounting Standard setters have partly owned up to their standards being 'procyclical'. However procyclical is an inaccuracy. It implies that IFRS-using banks get back to where they started. A more accurate description is that IFRS creates a death spiral. Banks silently destroy their capital under the guise of profit, then they require taxpayer support, then the process starts again. The prolonged destruction of banking capital is disturbing normal credit intermediation and once again threatening the financial system."*

Conclusion

Implementing the EFSF in its present format will seriously impair Germany's wealth and economy, and will merely delay by a period of time possibly as short a year an inevitable and even worse Eurozone crisis.

Cobden Partners present ourselves as monetary and banking systems experts. We have no political agenda. There is every reason for many Eurozone nations to embrace a common currency. However as presently structured, operated and managed, the Euro itself is being undermined by proposed solutions to the sovereign debt crisis that are undermined by the banking system.

The first priority for the leaders of the Eurozone should be to ensure true, fair and honest accounting among all Eurozone banks for whom the passporting rules apply. As a second step, the Basel regime is ineffective as Kevin Dowd's recent Cato Paper demonstrates.

End. Oct 20 2011