Funding the Future

The UK's banks have massively overstated their profits

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The FT has noted this morning that:

New accounting rules could force Europe’s top banks to recognise an extra â‚¬61.5bn in loan losses, new analysis shows, as a major UK pensions group has warned that bank accounting is not fit for purpose.

Analysts at Barclays have calculated how 27 of Europe’s biggest banks would fare under new global rules governing how much lenders should set aside for potential bad loans.

In a report published on Tuesday, they found that the rules would trigger an increase of about 34 per cent in loan loss provisions across the group, as well as lower bank valuations and more volatile earnings.

This is deeply significant. The new rules are what are called International Financial Reporting Standard 9. What they demand is a change to the way that banks provide for bad debts in their accounts.

Until the adoption of IFRS in 2005 UK banks were required to anticipate the losses that they might incur on their loan books. That meant if they had a reason to think a loan might go bad they had to anticipate that and make a provision for the loss when it could be anticipated. The approach was prudent but wholly relevant: it meant that managers had to focus on the future consequences of current loans: that is exactly as it should be as all loans exist over time, and not in a moment.

IFRS changed that: what it said was that loan losses should only be booked as they were incurred. So, unless and until a loan actually went bad nothing should be done about it in accounting terms even if it was entirely anticipatable that it would, at least in part, fail. This measure also had the net impact of reducing general loan provisions that recognise that some loans will fail, but you just don't know which ones as yet.

The 2005 changes had a massive impact on bank profits: they rose enormously. This in turn had a massive impact on the economy. Bank loans could be offered to people who may not be able to repay without any impact on current reported profit: in fact, the upside of fees and charges could be taken immediately and the losses could be deferred. So, not only did profits increase, and with that bonuses, the share price, stock option valuations and so much more that all favoured bankers in the short term, but risk for everyone else rose at the same time. Banks did, effectively, dump their risk on the rest of us.

As a result people were recklessly offered loans.

The economy was over-geared.

Bank shares were over-priced.

Bank balance sheets were over-stated.

A myth that all was well when the opposite was true.

The 2008 crash followed.

That was not all down to bad accounting, but that accounting had a massive impact on it: the fact that the US did the bad accounting first did not help.

It will take until 2019 to put this right. Itself this is a scandal. Tim Bush at PIRC, a former chartered accountant who I have known for many years and have had the pleasure of co-operating with on a number of occasions, is the hero for exposing this risk. He did so most emphatically in 2010 in evidence to parliament. The case he made then was unambiguously right: bank accounts were not true and fair and the consequences for the UK had been catastrophic.

It is clear that they still are. If banks have â‚¬61.5 billion of excess assets on their balance sheets (not all in the UK, admittedly) three consequences follow.

First, bank shares, and so stock markets as a whole, are overpriced. There are losses to come.

Second, the banks face major crises in filling these holes in their balance sheets that will test their ability to perform in the economy in the next few years.

Third, there is considerably more stress in the economy than current forecasts suggest likely.

These facts (for that seems to be what they are) then suggest that George Osborne's expectation that he can rebalance the economy on the basis of increased lending to companies and consumers utterly implausible.

This is yet another case where an elite - the accounting and auditing profession acting on behalf of their banking clients - took control of a process that should have been subject to control by the state and abused the power they were given with disastrous consequences. The lessons need to be learned. As I argued yesterday the first lesson is that the state needs to take back control of accounting standard setting. The second is to realise that over0-geaing is not the solution to boosting private sector activity. The third is to anticipate this crisis with an alternative economic plan. You already know what I think that that is, and I am certain it will be needed.