Stress Test Show UK Banks Have Been Subsidized But Remain Unreformed

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June 2016

Executive Summary

Britain's banking system is unsound despite assertions that it is by the Bank of England on 1st December 2015, when it declared that all 7 major banks examined had passed their "stress tests."

Leaving aside the flaws in the stress testing process itself, the weakness of our largest 7 banks – the extent of their leverage - is actually revealed by the source data that accompanied the Bank of England's stress test results. These 7 banks have similar levels of leverage today as in 2007, shortly before the collapse began with the failure of Northern Rock that September.

The Bank of England reached the opposite conclusion from the same source data. Why? We cannot claim to be inside their minds, but we cannot escape the conclusion that regulators have become conflicted, or "captured" when it comes to systemic solvency, and that stress tests are simply a waste of time and money. This is merely the latest in a series of stress test exercises that have taken place throughout Europe, all of which have grossly exaggerated the health of all large banks. All have in turn been followed by collapses of major banks (Dexia 2011), Cypriot banking system 2013, Portugal's Banco Espirito Santo (2014). The Bank of England should quickly retract its message that the December stress tests demonstrate that UK banks are sound.

The measures we set out in the section "Solutions" would address the problem and help defuse these risks. We set out a range of practical and implementable solutions. None will result in chaos, but perhaps they would reveal some unpalatable truths. But surely that would be very much in the public interest and lead to systemic reforms that would help the UK's economy to recover and grow.

1. Introduction; Bank Leverage is the only indicator of Solvency

The rarely expressed reason for the enormous resources invested by regulators in stress testing banks is the universal acceptance of the unreliability of accounts; it is impossible to form a view as to the health of a bank or lack of it from its published accounts. Further, regulators receive far more information than is available to investors, stakeholders and the public. Rather than scrutinise the basis of the numbers, regulators prefer to dream up mildly adverse economic scenarios, construct detailed computer models, enter terabytes of data into these models and after a few months express a verdict as to whether banks are "holding" enough capital to withstand the hypothetical adverse scenario modelled. (We will return to the language of banks "holding" capital later.)

Eight years ago UK banks failed because over-borrowing and low levels of capital exposed them. When various markets fell the banks failed. Nobody should have been surprised; many ordinary businesses fail when they assume too much debt as compared with the amount of their savings reserves or capital. The December stress tests confirmed that our banks are in as poor shape today as they were in 2007.

The most worrying point we took away from the 2007-09 meltdown was that the insolvent condition of banks was denied by the authorities at the time. Regulators such as the Bank of England defended banks as fundamentally solvent from 2007 for four years. Only in June 2011 did Bank of England admit that banks had become insolvent.

At first the Bank of England claimed that the crisis was only one of "liquidity" – meaning that the mechanism by which money flowed from bank to bank had seized up merely because a small US investment bank – Lehman Brothers – had failed. Banks were too interdependent and had to be rescued. Of course banks had become interdependent – they had taken too much risk on each other. When enough banks failed chain reactions were set off. But the decisions to become interdependent were taken at the level of each individual bank. Making mistakes of this nature led to many other banks becoming insolvent. But for the injections of public money as bailouts, the entire system would have failed. That would have been bad news for the UK economy, but at least that would have led to speedy reforms and the elimination of some of the least acceptable features of banking outlined in this paper. It would also have negated the rationale for setting interest rates to near zero. This is turn has immiserated prudent savers, disincentivised younger generations from saving for pensions, triggered bubbles in house prices and stock markets, and emboldened speculators to assume even greater levels of cheap debt to jump on these bandwagons and inflate further various bubbles. (These points are not considered further in this paper.)

The liquidity excuse was rather like putting an old clapped out banger of a car fit only for the scrapheap in the middle of a motorway traffic jam and asserting that the only reason it is not moving at 70 miles per hour is that traffic is not "flowing". Unfortunately we are today more or less in the same position as we were mid 2007. This, as set out below, is confirmed by the information on the degree of bank leverage published alongside the stress test results.

2. The Bank of England Says Banks Passed Stress Tests. Why Should Readers Reach the Opposite Conclusion?[1]

The stress tests covered six major banks and one building society – Barclays, HSBC, Lloyds Banking Group, the Nationwide Building Society, The Royal Bank of Scotland Group, Santander UK and Standard Chartered. Between them these institutions account for over 80% of lending to the UK economy.

The stress tests were billed as severe and the press would commonly label the stress scenario as a 'doomsday' one. Here are some of the headlines:

"Bank of England stress tests to include feared global crash"

"Bank of England puts global recession at heart of doomsday scenario"

[1] This section is a summary of Kevin Dowd's research, published as *No Stress;* Adam Smith Institute 2016 [Ref?]

All this is pretty scary, but fortunately there was a happy ending: there are one or two small problems but on the whole, the banks come out smelling of roses:

“UK banks pass stress tests as Britain's "post-crisis period" ends”

“Bank shares rise after Bank of England stress tests”

“Bank of England’s Carney says UK banks’ job almost done on capital”

Phew! The Bank of England put the UK banks through a daunting stress test but the banks came out in good shape and we can sleep safely in our beds.

Going further, at the press conference announcing the stress test results Bank of England Governor Mark Carney couldn’t have been more reassuring:

“UK banks are now significantly more resilient than before the global financial crisis. …This year’s test complements last year’s effort. It is focused on an emerging market stress that prompts reassessments of global prospects and asset prices; considers the implications of deflation not inflation; and places greater emphasis on exposures to corporates rather than households. It also includes an unrelated but important stress of costs for known misconduct risks. “

The stress test results, taken together with banks’ capital plans, indicate that the UK banking system would have the capacity to continue to lend to the real economy even under such a severe scenario.

They testify to the value of the reforms that have rebuilt capital and confidence in the UK banking system.2

The key point to take is that this [UK banking] system has built capital steadily since the crisis. It's within sight of [its] resting point, of what the judgement of the FPC is, how much capital the system needs. And that resting point - we're on a transition path

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[2] Financial Stability Report Press Conference, 1st December 2015, ”Opening remarks by the Governor,” p. 1.

to 2019, and we would really like to underscore the point that a lot has been done, this is a resilient system, you see it through the stress tests.3

The message was that there would be no more major increases in capital requirements and we were now at the end of the post-financial crisis era.

This interpretation of the stress test results is unjustified on the following three counts.

2 a). The Test was not particularly Stressful.

The theoretical stress scenario hitting the UK economy against which banks were tested can be summarised as follows:

- Bank Rate is projected to fall from 0.5% at the end of 2014 to 0% in 2015Q3 and then stay there.
- CPI inflation is projected to fall from 0.1% at the end of 2014 to bottom out at -0.9% in 2015Q1 and then recover to 0.5% by end-2019.
- Real GDP growth rate falls from 0.6% at the end of 2014 to bottom out at -1% in 205Q4 and recover to 0.5% by end-2019.
- Unemployment falls from 5.7% at the end of 2014 to peak at 9.2% in mid-2017 and then fall back to 7.2% by end-2019.
- UK residential and commercial property prices fall by 20% and 35% respectively.
- Bank lending expands by 9%: this looks very odd for an adverse scenario, especially given the long contraction in bank lending post-2007.
- Impairments on lending to UK businesses remain modest.
- Bank pre-tax losses of £37 billion: this compares to UK bank losses of at least £98.4 billion over 2007-2010, and which wiped out at 185% of banks' capital.4

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[3] Bank of England Financial Stability Report Q&A, 1st December 2015, p. 11.
[4] Local Authority Pension Fund Forum, "UK and Irish banks capital losses – post mortem," September 2011, p. 3.

- The Vix financial market volatility index[5] – often called the 'fear index' – is projected to rise from just over 20% at the end of 2014 to peak at 46% in 2015 before falling back. This compares to its 2008 peak of just short of 70%.[6]
- World GDP growth dips to -0.7% before recovering, compared to its fall to -2% in the Global Financial Crisis.

The rise in the unemployment rate and the falls in UK property prices are on the moderately severely side but are still lower than what we have witnessed in other countries in the EU since the onset of the Global Financial Crisis. For their part, the other projections in the Bank's adverse scenario range from mildly adverse to highly optimistic.

The banks' projected reaction to this scenario is also on the mild side. The capital ratio that the Bank prefers to cite when discussing the stress tests, the CET1 ratio, falls on average by 3.6 percentage points from 11.2% at end-2014 to 7.6% by end-2016; its secondary stress test capital ratio, known as the leverage ratio, falls on average from 4.4% to 3.5% over the same period; and the CET1 capital measure falls by £55.5 billion from £298.1 billion to £242.6 billion.

In short, the Bank's stress scenario is not particularly stressful.

2 b). The Bank of England Relies on the Discredited "Risk Weighted Assets" metric.

The good news is that by the capital-adequacy measure that the Bank cites most - the ratio of Tier 1 capital to Risk-Weighted Assets (RWAs) – the banks are getting stronger. By end-September 2015, the average value of this ratio across the UK banking system had risen to 13%.[7] An alternative capital ratio, the ratio of Common

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[5] Vix is the ticker symbol for the Chicago Board Option Exchange Volatility Index, a popular measure of the implied volatility of S&P 500 index options, which in turn is a measure of the market's expectation of the stock market volatility over the next 30 days.
[6] https://uk.finance.yahoo.com/q/bc?s=%5EVIX&t=my. Accessed December 20 2015.

[7] Bank of England, "Financial Stability Report," December 2015, Issue No. 38, p. 7.

Equity Tier 1 capital to RWAs, had risen to 12% by the same date.8 Back in 2007, the average ratio of Tier 1 capital to RWAs across the big UK banks was little more than 6%.9 By this comparison, the Bank of England is entitled to claim that the UK banking system has undergone a major recapitalization.

Moreover, given its view that the optimal Tier 1/RWA ratio is about 13.5% - and about 11% if certain risk measurement improvements are made - then the Bank could also rightly say that the job of recapitalizing the banking system is nearly done: only another 50 basis points to go.

But before getting the champagne out, we should pause to note that there are several rather big 'ifs' in there.

One of them relates to the Bank's confidence that the optimal Tier 1/RWA ratio is about 11% post the risk measurement improvements they have called for. A few years ago the experts – the Basel Committee (including Bank of Canada Governor Mark Carney) and the Vickers Committee – were telling us that the optimal ratio was 18%. Now the experts – including Bank of England Governor Mark Carney – are telling us that the optimal ratio has gone all the way down to 11%.

We do not concern ourselves with whether 18% or 11% is "correct", we simply have no confidence whatsoever in the RWA measure on which these recommendations are based.

Why the Bank of England relies on this measure we don't know. Analysis by its own (now) chief economist in 2013 elegantly destroyed whatever credibility the RWA measure might once have had. Comparing the average leverage and average RWAs of the big global banks in the run-up to the crisis, Andy Haldane sardonically observed that as the crisis approached," the risk traffic lights were flashing bright red for leverage [whilst] for [average] risk weights they were signaling ever deeper green."

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[8] Bank of England, "Financial Stability Report," December 2015, Issue No. 38, chart B.1.
[9] Bank of England, "Financial Stability Report," December 2015, Issue No. 38, chart B.1.

So the bad news is the capital ratios based on an RWA denominator tell us nothing useful about the banks' real capital strength – except, perhaps, to signal that a higher ratio of capital to RWAs might perversely indicate a weaker bank.

2 c). The more reliable Leverage Ratio indicates banks are in trouble.

Back in 2007, UK banks' average ratios of capital to assets were just a little bit below 4%, according to a well-known study by the Bank of England's own chief economist.[10] At the end of September 2015, according to the data in the Bank's own 2015 stress test report, they were 4.17%.[11] This is a low number, and is unlikely to meet minimum required standards under the Basel III capital regime when that is fully implemented by 2019, and which are themselves undemanding.[12]

3. Structural Flaws in Stress Testing.

The reason for introducing the UK stress testing regime was set out by the Financial Policy Committee in March 2013. 13 "main purpose of the stress-testing framework is to provide a quantitative, forward-looking assessment of the capital adequacy of the UK banking system and [of] individual institutions within it" (p. 7).

But, in his introduction to a recent paper14 Dowd summarised the weaknesses in the UK's stress testing programme.

"To start, it violates some of the principles of good stress testing methodology, including most basically the need to consider a range of alternative scenarios and not

[10] See A. G. Haldane, "Banking on the state," p. 14, chart 2.
[11] See Bank of England, "Stress testing the UK banking system: 2015 results," Annex 1, and note we refer to the leverage ratio calculated using the Common Equity Tier 1 capital in the numerator. CET1 is a more reliable (because more conservative) core capital measure than Tier 1 capital, but even if we use the latter, the average leverage ratio would still be only 4.61%.
[12] In April 2014, the US bank regulators finalized an "enhanced" Supplementary Leverage Ratio (SLR) on the 8 U.S. global systemically important banks (G-SIBs) and their insured depository institutions. As part of the "enhanced" SLR, the 8 US G-SIBs must meet a 5% SLR at the holding company level and a 6% SLR at the level of their banks benefiting from federal deposit insurance. These requirements will become effective on January 1, 2018.
[13] http://www.bankofengland.co.uk/financialstability/fsc/Documents/discussionpaper101

[14] Link to "No Stress"

just the one scenario considered by the Bank [of England]. Bank [of England] control over the banks' modelling has the capacity to create systemic instability by forcing the banks to use risk models that incorporate the weaknesses of the Bank's own models, and the Bank's modelling is compromised by political factors that undermine any credibility that the exercise might have had. The exercise relies on flawed data and flawed capital-ratio metrics – most notably, an insufficiently conservative capital measure in the numerator and the use of an unreliable (because easily gameable) 'risk-weighted' asset measure in the denominator. The Bank also uses an insufficiently high hurdle ratio – the specified minimum post-stress capital ratio – and the same exercise based on higher hurdle ratios in line with the minimum requirements under Basel III would have suggested that the UK banking system was actually in poor shape. So would an analysis based on the use of a minimum leverage ratio capital requirement, which is also to be implemented under Basel III and is already mandatory in the UK. The single scenario considered is also highly questionable and the Bank's credibility to carry out such exercises is undermined further by its own dismal forecasting record since the onset of the Global Financial Crisis (GFC). Finally, concerns about the reliability of regulatory stress tests are confirmed by the very poor track records of similar exercises overseas. The Bank's stress tests are therefore highly unreliable and the UK banking system is much weaker and more vulnerable than the Bank of England would have us believe."

4. Banks cannot "hold" too much capital

By employing the term "holding capital" regulators fall into the trap set by the PR agencies and departments of banks. The term implies that capital is money that banks hold in reserve for a future rainy day. But, as Anat Admati and Martin Hellwig explain[15]:

"This statement is plainly false…Capital in banking is a source of funding that can be used to make loans and other investments. This source of funding, elsewhere called equity, must be distinguished from debt, i.e., funds obtained by borrowing. Whereas

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[15] The Parade of the Bankers'New Clothes Continues: 28 Flawed Claims Debunked Anat Admati and Martin Hellwig. Revised July 6, 2014 bankersnewclothes.com/wp-content/uploads/2014/07/Parade...….

banks typically fund less than 10% of their investments by equity, it is rare for any healthy non-financial company to have less than 25% in equity, and many successful companies borrow little or nothing, although there is no regulation that prevents them from borrowing as much as they would like (if they can find lenders).”

The language of “holding” capital has been carefully crafted by the banking industry to create the impression that capital is some kind of drag on banks’ abilities to fuel the wider economy. And the Bank of England has swallowed the argument hook, line and sinker. On December 1st 2015 when hailing the stress test “passes” of all UK banks, Governor Carney delivered a speech. In it he said:

“While the benefits of increased resilience are clear, higher capital costs are ultimately passed on to borrowers.”

Incorrect. Admati and Hellwig again16

“it is fallacious to suggest that using more equity in the funding mix is more costly on the basis of the mere observation that the required return on equity is higher than the required return on debt. The required return on equity, debt, or any other security depends on the entire funding mix, and the required return on equity (as well as generally on other securities, including debt) will go down if the bank has more equity.”

So the Bank of England’s fears of the consequences of more robustly capitalised banks are false. The opposite would occur – well capitalised banks would still be leveraged, but the leverage part of their funding base would cost much less to fund than that of weaker banks, enabling them to win business by offering customers lower borrowing rates because their own base costs would be lower. This effect would encourage weaker banks either to raise capital, merge with stronger banks or wind themselves up.

[16] Ibid, claim 7

Of course it is reasonable for banks to assume prudent levels of borrowing. Without borrowing, shareholders of successful banks would lose by having to split profits among too large an equity base. But slightly less than optimal shareholder returns is not a matter about which regulators should be concerned.

5. Meaningless Bank Accounts

But why should we be relying on central banks' opinions as to the resilience of our banks? Is that not the purpose of accounting rules? Yet it is hard to find a serious person who believes that the health of a bank can be determined from a detailed scrutiny of its published accounts. Of the multiple standard ways in which accounting standards have emerged that enable banks to record loss making exposures as profitable, consider two; i) gaming the mark-to-market rules on vast portfolios of barely traded assets whose true values are much lower, and ii) efforts of the UK's own regulator, the Financial Reporting Council, to hide problems in accounting standards by misquoting the legislation with which such standards are supposed to be compliant.

i) Falsifying Profits by Gaming the Mark-to-Market rules[17].

Three fundamental weaknesses of the mark-to-market rules encourage gaming:

i) The last traded price is the correct market price for all assets;
ii) There are buyers for every asset at this price (infinite liquidity);
iii) The absence of fraud.

Imagine an ordinary "real economy" business and how it would change if it adopted accounting rules that determined profit by marking to market. Consider the economic incentives and likely behaviour of staff on a perfume counter at a department store.

Tabitha works on the shop floor of a Debenhams perfume counter. Her contract with Debenhams provides that she earns 10% of Debenhams' profit. So if the cost price of

[17] A version of this section was published 2011 in "The Law of Opposites…" ASI

the average bottle of perfume is £25 per bottle, it is sold for £75, and Tabitha sells 50 bottles each week, Debenhams would earn £2500 and pay Tabitha £250.

New mark-to-market accounting rules are explained to Tabitha. She understands that the new way of recording profits is no longer based on bottles sold, but on the market price of her stock of unsold perfume.

Being a bright woman, Tabitha realizes that this is an easier and more profitable way to make money. All she has to do is buy as many bottles as possible, refuse to sell any and engage with other market makers so as engineer price increases.

The next week, Tabitha buys 600 bottles from wholesalers and calls her competitors at Selfridges and other department stores in order to ensure that there is no perfume available for sale.

A young man comes to her counter desperate for a bottle for his girlfriend. Tabitha sends him to a small chemist whom she says is the only supplier in town. The chemist charges the young man not £75 but £115 and agrees to confirm to Debenhams's accountants that he sold a bottle for £115. £115 is therefore now the market price.

Under the new IFRS accounting rules Tabitha can mark to market her entire pool of unsold stock, 600 bottles. Debenhams today records a profit of £90 per bottle on 600 bottles = £56,000. The store's managers are delighted; they too earn large bonuses. Tabitha's 10% arrangement entitles her to a bonus of £5600 rather than £250.

ii) Regulatory Endorsement of Defective Accounting Standards

The UK's Local Authority Pension Fund Forum (LAPFF), a collective body of local government pension fund investors, is championing the cause of reining in defective accounting standards. Their work is of exceptional importance. In September 2015 they wrote to Lord Hill, the EU Commissioner for Financial Stability asking for action to stop if not reverse the implementation of accounting standards 'endorsed' as consistent with EU Treaty legislation by the specialist endorsement entity EFRAG[18] .

Specifically, LAPFF explained to Lord Hill that in endorsing new standards, EFRAG publish abbreviated versions of the legislative provisions with which the standards should comply. By not transcribing the actual legislation they are able to use a form of words which makes the standard appear to be compatible, when a reading of the actual legislation would reveal that the standard would not so comply.

One example is Article 4(3) of Council Directive 2013/34/EU, which contains the wording "The annual financial statements shall give a true and fair view of the undertakings, assets liabilities, financial position and profit and loss."

Another regulation called the "IAS" regulation supplements Article 4(3) …test with other tests. The IAS Regulation says:-

'..they are not contrary to the principle set out in Article 4(3) …and they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.'

However, EFRAG, in explaining why it endorses a recently submitted new accounting standard called "IFRS9", published its own interpretation of the way it should discharge its obligation to assess whether a submitted standard is consistent with the "true and fair view.." of Article 4(3) as follows[19]:

"EFRAG's assessment on whether IFRS 9 is not contrary to the true and fair view set out in Article 4(3)…is based on the assessment of whether it meets all other technical criteria and whether it leads to prudent accounting. Detailed assessments are included in this appendix in the following paragraphs:

- *a) relevance..*
- *b) reliability…*

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[18] spell out

[19] EFRAG, Draft Endorsement Advice, IFRS9, 2015 para…(Tim?)

c) *comparability...*
d) *understandability…*
e) *whether overall it leads to prudent accounting.*

EFRAG has misdirected itself. It is obliged to test a new standard both against Article 4(3) and apply the additional tests contained in the IAS regulation. LAPFF's letter to Lord Hill points this out. The criteria of" understandability, relevance, reliability and comparability" are further tests which a new standard should satisfy in addition to being demonstrably consistent with generating numbers which provide a "true and fair view" of the bank's "undertakings, assets and liabilities, financial position" etc. By conflating the IAS regulation with Article 4(3) EFRAG ends up by ignoring its obligation to assess whether the standard is consistent with the production of accounts providing a true and fair view of the bank's assets, liabilities, undertakings and financial position.

The consequences of these errors by Europe's main body responsible for bank accounting rules are grave. As LAPFF conclude in their September 2015 letter to Lord Hill:

"One consequence of the EFRAG position would be that auditors and directors (in signing off the numbers in accounts) aren't responsible for a proper opinion on whether the company is a going concern or not. "

In other words, auditors and directors may now be able to sign off accounts which falsely present an insolvent bank as sound, and be absolved of responsibility for this action because of the actions and endorsement advice of EFRAG.

<u>5. How to Start to Fix Banking.</u>

What should be done? There are a range of possible measures, but they depend on better oversight. Our scrutineers should be much more heavily focussed on excessive leverage than on assessing the supposed riskiness of bank exposures. Overleveraged banks should be told to strengthen their balance sheets by either or both reducing positions and / or increasing capital. Leverage is by a country mile the most important metric.

Regulators' present focus on assessing the riskiness of the plethora of banking exposures is pointless. Save for extreme examples (eg roulette style gambling positions), regulators are not able to opine that one risk is more or less risky than others. Were regulators refocused in this way, the system could be further fixed by other measures which the authors have over the past 5 years set out. Such solutions are implementable and practical. Two of them are legislative. In 2011 we proposed reasserting the primacy of UK Company law when preparing accounts20. A Bill was presented by Steve Baker MP, which would have required UK banks to prepare accounts that complied with UK law even if they still wished to produce accounts under European IFRS standards, which in many cases conflict with UK law.[21]

In 2013 we drafted another Bill, also presented by Steve Baker MP, proposing that senior bank executives have real 'skin in the game' by exposing their personal wealth to losses before future taxpayer funds are expended supporting depositors22.

As for misconduct, present laws are sufficient to deal with the flow of misconduct scandals that have hit the news in recent years. May we gently ask why existing UK laws are not invoked, especially when collusive criminal fraud is routinely uncovered such as the card protection plan fraud I explained in 2014[23]? Further, the procurement of debt by misrepresenting one's creditworthiness (such as lying on a mortgage application form about other indebtedness) has triggered fraud prosecutions and convictions. Why are we told that a bank's misrepresentations as to its market borrowing costs is not a crime?

Some of this misconduct could be nipped in the bud if European regulators were to emulate the US practice of installing bank monitors. Two years ago US regulatory

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[20] Parliamentary Bill 2011 co-drafted by Tim Bush
[21] See Bush T "Sorry, Wrong Number".
[22] Parliamentary Bill 2013
[23] The Case for Systemic Banking Reform, IREF 2014
http://en.irefeurope.org/SITES/en.irefeurope.org/IMG/pdf/wp-2004-01.pdf

concerns into the integrity of tax filings by Credit Suisse AG of Switzerland led to the installation of a former federal prosecutor, Neil Barofsky, as a 'bank monitor'. In January 2016 it was reported that his tenure is to be extended for another year. The UK could install bank monitors charged with obtaining the information corroborating reported accounting, capital and leverage numbers.

6. Conclusion

The 2007-09 meltdown was the predictable consequence of years of changes to accounting standards and practices which resulted in banks reporting truly lossmaking exposures as profitable. The moral hazard effect of the bailouts have exacerbated, rather than relaxed, the decline in integrity (popularly reported as "culture") in banking. Huge regulatory changes have been made, but none of them address the core problems of overleverage and accounting practices that enable years of hoped for income to be treated as profit today. The overriding reason for this dystopia is executive compensation. None of the bankers want this merry- go- round to stop. Reading the latest stress test results, we fear the regulators know this too, but – perhaps understandably – seek to suppress the truth by dressing up these naked banks in the finest of imaginary clothes.

And yet we remain optimistic that these problems can be fixed without undue difficulty. As a first step UK Company Law should be respected. The Baker Bill should be enacted. One surefire way to fix banking and eliminate moral hazard is to bail in bank directors and senior management. Regulators should bring in prosecutors where fraud and systemic misselling are uncovered. Accounting standards must be tightened. The Financial Reporting Council (FRC) is demonstrably not independent of the accountancy profession. It should be abolished and replaced with an accountancy regulator that is itself accountable to Parliament and the Treasury Select Committee.

5 June 2016