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MONETARY POLICIES IN THE BALKAN REGION.
THE FUTURE OF THE EURO AND EUROZONE IN THE BALKANS.

Gordon Kerr

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ABSTRACT

Europe's policymakers and crisis stewards persistently refuse to recognise the kernel of the persistent, anaemic European financial crisis; the unacceptable business practices of bailed out but insolvent banks. One example of how post crisis accounting rule changes have facilitated, rather than addressed, the falsification of profits and capital is set out. Bankers' lust for personal earnings based on loss-hiding transactions and a host of other rapacious practices will ensure that QE funds are misappropriated until radical reform is effected. Sadly, almost all mainstream media believe the story that banks have been reformed, have emerged from a routine cyclical recession, and are on the road to recovery. This belief has led to the re-emergence of support for Milton Friedman's quantitative theory of money, justifying QE. This thinking merely reinforces the circularity of QE funds flowing to bankers. Policymakers refuse to countenance radical reform and are only interested in "nudges and tweaks", hence the present stagnation. But this will lead to continued pressure on the existence of the euro itself. What does this mean for Balkan countries? They should recognise the need for a Currency Plan B. The least indebted countries have the most to lose from the mounting problems afflicting the euro.

Key Words: Unreformed banking, stress tests, credit derivatives, euro, monetary policy Balkans

Introduction

This paper is in four sections. It starts by summarising a presentation to an accounting conference in 2013. The topic was the manipulation of mark-to-market accounting rules enabling banks to hide true losses and inflate reported capital and profits based on post crisis rule changes. This explains how the true condition of banking is far worse than suggested by official central bank stress testing. Section 2 explains how banking has managed to stave off calls for radical reform. Section 3; given the gravity of these points and the relative unique position being explained by Cobden Partners and a tiny group of other commentators, I set out my credentials. The inescapable conclusion (Section 4) is policy stagnation, leading to the necessity for every country, particularly those in the Balkans, to prepare a Currency Plan B. This coincides with revived support for Friedman's monetarist theories, justifying now unlimited European QE, which will fix nothing in banking but lead to continuing debasement of the euro.

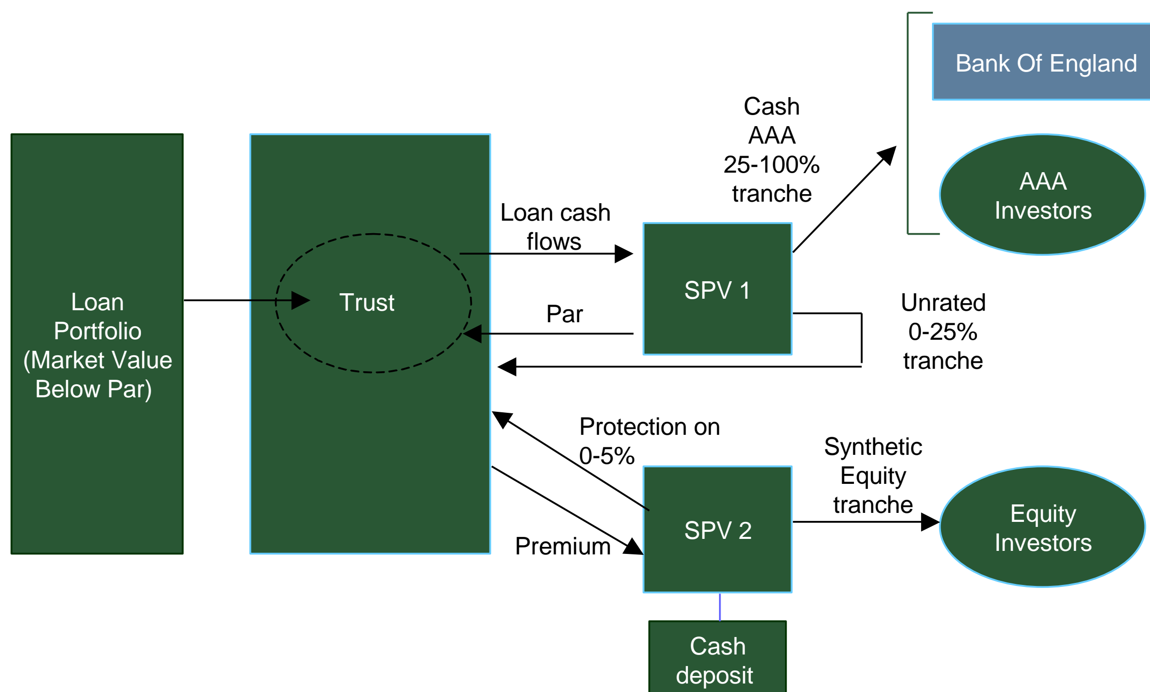
Section 1

Reluctance to Understand Banking.

The silence that greeted my May 2013 exposure, at the European Parliament, of the latest twist in profit falsification was deafening. To an audience comprising 140 of Europe's most senior accountants, and using only two simple slides (see Diagram) I set out the nuts and bolts of a transaction designed in 2010 to enable a large British bailed out bank to falsify £1 billion of profits and invent £340 million of equity capital. Causing £1bn of mark-to-market losses to disappear created the profits. New post crisis central bank repo rules were easily gamed to achieve this. These rules govern central bank lending to banks against supposedly high quality collateral. I further explained how a little booster was added to the structure to produce an additional sweetener. New Core Equity Tier 1 (CET1) appeared, as if by magic, from

nowhere[1]. Since equity capital is always in short supply in the European banking industry in general, let alone among overtly insolvent banks, this feature was rather appealing to the managers of this particular bank. It was also simple. An economically pointless SPV was introduced to the structure purely to 'write protection' in the form of a credit default swap (CDS) on the most risky, 'first loss' 5% slice of the bank's underwater £10 bn loan portfolio[2].

UK Bailed Bank Social Housing Portfolio



Notes:

•2 Separate transactions

•AAA tranche pledged to central bank to fund 75% of portfolio

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[1] This technique for creating fake Basel capital was hardly innovative, merely an updated variant of the structure I co-designed when at Abbey National in 1999, see Kerr, "How to Destroy the British Banking System; Regulatory Arbitrage via 'Pig on Pork' Derivatives. http://www.cobdencentre.org/2010/01/how-to-destroy-the-british-banking-system/

[2] "Underwater" is a term for assets that have lost value. In this case, if marked to market, these assets would have been accounted for as worth only 90% of historic, par value.

•Credit Derivative hedge of 0 – 5% via the second transaction reduces capital consumption (Basel 2 or 3) from 4% to about 0.5%, creating the false impression of £340mm of new bank capital on this £10bn portfolio

•Banks try hard not to sell below par loans, or losses will have to be booked, even under IFRS and Basel

The consequent risk weighting to be applied to these assets, under the Basel rules, was adjusted downwards automatically creating £340 million of CET1 for the bank. Forgive the repetition; the transaction was almost entirely circular and the economic exposure of the bank to the assets was virtually unchanged. Thus an additional benefit was created by manipulating accounting and Basel capital rules which the bank had not even dreamed of requesting. The bank had only wished to hide the portfolio's mark-to-market losses.

The primary purpose of the structure was to exploit the Basel rules. The trick was to transact protection within the structure; save for an optional arrangement with an external hedge fund set up to assist an array of banks with these types of structure, and which would take very little risk, no protection existed for the sorts of ordinary mark-to-market losses which were in this way being masked. No third party would offer protection on such losses at anywhere near the transacted price, but accountants and regulators appear either incapable, or unwilling to figure this out.

This second SPV was initially a vacant shell, but ordinary loan portfolio cashflows would be directed for a period of time until its obligations were fully cash collateralised, such that its obligations would then achieve AAA ratings. At this point the CET1 would be triggered. But the structure was circular and could not properly be described as insurance. The cash collateral was being provided by funds that would otherwise just have flowed straight into the bank itself.

The audience was smart enough to realise that I had just demonstrated that the accounting and regulatory capital rules, all of which had been supposedly tightened up since the 2008 systemic collapse, were achieving the opposite of their stated objective. Managers of insolvent banks now found it easier to arrange loss hiding transactions that in turn artificially boost profits and reserves of their banks. In any

legal system with which I am acquainted, such conduct is classified as fraud. But not in the parallel legal universe of banking.

Section 2.

How has the Banking Industry Avoided Radical Reform?

Why is there so little enthusiasm among highly qualified professionals working very closely with banks to accept that flaws in the way IFRS standards are interpreted and applied are so pervasive that the numbers produced are essentially meaningless? The answer is the self-interest of all the actors whose primary aim has always been to protect their positions and reputations.

Culture and governance are regularly mentioned as matters that need to be addressed in banking. I disagree. Such statements are a regulatory cop-out. All that needs to be addressed in banking is the absence of any simple framework of rules ensuring probity, integrity and accountability. Cultures will change very quickly after the introduction of such rules.

Culture and governance are merely polite excuses for banker fraud and regulatory incompetence. The focus on culture and governance should target not banking but the businesses of regulators and other banking scrutineers – accountants, ratings agencies and lawyers. As integrity in banking has declined this triumvirate of professional service industries have played their role as willing accomplices.

Incomes of all have rocketed. All three have exploited the crisis to ensconce their positions in the architecture of bank supervision even more firmly. They receive further fee earning supervisory mandates under every fresh iteration of global banking rules.

Taxpayers and ordinary folks uneducated in the black arts of banking forlornly hope that new rules and regulations such as the 2013 "Leverage Ratio" and "Volcker

Rule"[3], will stem the flow of taxpayer bailout funds. Neither will have any such effect. I urge nobody to hope that the global rulemaker, the Financial Stability Board (FSB), will enact any rule that will provide effective scrutiny. To do so is like hoping that foxes will care for, feed and nurture chickens. The FSB is comprised of representatives from national central banks. The Bank of England (B of E), as one example, only seeks "nudges and tweaks", not radical reform.[4] In fact it appears to be so concerned as to the true weak financial condition of British banks that it gamed the FSB's rules when it stress tested our banks in December 2014. It gamed the rules by setting a pass mark, a level of minimum CET1 to be demonstrated by each bank under its economic stress scenario, way below the pass mark the rules required the B of E to apply. It further gamed its own regulatory timetable by rushing out the results before its planned February 2015 announcement of the additional capital requirements to be demonstrated by the 4 British banks that it would designate as "systemically important financial institutions (SIFI)". It is not credible to assert that the B of E's thinking about a) which banks to designate as SIFIs, and b) how much extra CET1 for Basel purposes should be added to each bank's core minimum, only germinated in January 2015. Invaluable research to this effect has recently been published by Cobden Partners' Kevin Dowd.[5]

How can banking be in truth in such poor shape, and yet have succeeded in bluffing everyone with the recovery story? The media seem very naive. Naturally politicians regulators and of course bank CEOs have embraced the recovery narrative with glee, and the nagging but accurate scrutiny of the few astute academics is sidelined.[6]

Those whose reputations are tied to the decisions to bail out failed banks in the past have little interest in seeking to understand this poor condition of banking. Official enquiries seem pointless (such as the UK's *Vickers Commission* which reported December 2013). Politicians prefer to upbraid the banks for not lending enough to their chosen targets, ignoring the obvious explanation that the continued production of solvent looking accounts under IFRS accounting and Basel capital rules merely

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[3] See IREF Newsletter February 2015, reproduced here: http://cobdenpartners.co.uk/news (scroll to 16 February entry).
[4] Personal meetings with a senior BofE official.
[5] See Dowd, June 2015. *"No Stress"* Adam Smith Institute, London. http://www.adamsmith.org/wp-content/uploads/2015/06/No-Stress-ONLINE1.pdf
[6] See Anat Admati & Martin Hellwig 2013 "*The Bankers' New Clothes*", Princeton University Press.

encourages loss making banks, short of CET1 to carefully manage cash positions and, in particular, avoid making loans to small and medium sized businesses[7]. Such loans entail the highest level of regulatory capital, consuming disproportionately the benefits of the £340 million which magically appeared on the balance sheet of the UK bank in the example above.

Despite increasing evidence of the collapse of banking integrity, the 'misselling' of consumer 'insurance' products, collusive manipulation of global pricing benchmarks such as Libor and FX fixes, and even the plundering of dormant accounts[8], official scrutineers show little interest in understanding the true, dystopian condition of banking. Moreover, bankers have succeeded even in downgrading their culpability for fraud. The term "fraud" is never now used. Fraud has been retermed as "misselling"[9].

Such is the scale of the problem, so powerful and successful has the cartelised banking industry lobby become, that very few policymakers who understand the veracity of the points herein are willing to confront the industry.[10] Unless banking is radically reformed soon, it will surely at some point lead to social unrest.

Section 3.

Author's Credentials.

I am not a professional economist, but a banker with about 30 years experience in debt capital markets and derivatives.

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[7] The effect of this is being felt throughout Europe, hampering economic growth in particular in former soviet protectorate countries in the Balkans.

[8] http://www.thisismoney.co.uk/money/experts/article-1707782/Has-RBS-pinched-my-dormant-cash.html

[9] see Kerr 2014 *"The Case for Systemic Bank Reform"* Institute for Research in Economic and Fiscal Issues, Paris. http://de.irefeurope.org/article963,a0963

[10] One notable exception is UK Member of Parliament Steve Baker, who presented two legislative proposals for banking reform in the British Parliament 2010-15. See http://www.stevebaker.info/campaigns/the-financial-system/ and http://www.cobdencentre.org/author/sjbaker/

Having attempted in 2003 to explain to the Bank of England[11] that certain transactions which I had co-designed and executed, combining credit default swaps with bulk portfolios of AAA rated securitised loans, were likely to destabilise banking, I wrongly assumed in 2008 that public anger at the recapitalisation costs would lead to decent analysis of the true condition of banking. This would in turn lead to radical reform. I felt uncomfortable, as a British citizen, at the 2.5% increase in the regressive UK VAT (tax), specifically to fund part of the £800 bn cost[12] of the bailouts. In 2009 I resolved to do something, and as a typical lazy banker I was perfectly happy to respond to an invitation to join a small, Mayfair based capital markets brokerage business with a specific brief of pitching banking crisis solutions to sovereign governments.

But no sooner had I achieved some positive response from the Icelandic government to my June 2010 pitch that radical banking reforms were required than I was asked to resign from the firm. They were enjoying decent profits from selling variants of the capital falsification structures I have described above, and to continue to employ me as a seller of banking solutions to governments would, they argued, undermine their credentials in the business of accounting and regulatory capital "optimisation".

In 2010 I founded Cobden Partners, a small and fiercely independent consultancy offering professional advice to nations seeking to reform their banking systems, recognise unrepayable levels of sovereign debt, and / or prepare an alternative currency – a "Plan B". Working with currency experts such as Professor Kevin Dowd, banking and asset management experts such as John Butler, we are finally gaining some traction and receiving more attention from countries recognising the intractability of some of the points set out above. We are prophets of hope.

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[11] At the time this particular limb was technically separate from the BofE but has now been merged. In reality it was soft reporting to the BofE.
[12] UK Exchequer figures

Section 4.

Conclusion. Consequences of The Chain of Events; Changes in Macroeconomic Thinking, Debasement of Euro. Advantages of Balkan Countries preparing own Currency Plan B.

The summer of 2015 is experiencing a Milton Friedman mini- revival. Friedman, (1912 – 2006) is a leading light in the economic school who emphasise the importance of money supply. This "Quantitative Theory" school have observed a strong correlation between the supply of broad money and recorded GDP growth numbers. In other words, pushing narrow money, M0, will not drive growth. This line of thinking rather naturally leads to the endorsement of quantitative easing.

The counter argument is that this 2015 re-emergence to prominence of Quantitative Theory is blind to the true condition, as set out above, of banking. Proponents of money supply remedies[13] believe that banking is simply undergoing a routine cyclical recession and recovery. Most believe that banking is very much today in the recovery phase.

It therefore follows that, if radical reform of banking is ruled out as unnecessary, the policy response is to boost the supply of broad money in order to drive economic growth. But this is the wrong response. The supply of broad money is not an exogenous driver of growth. Central banks cannot effectively influence, let alone control, broad money. Their toolkit consists only of a small set of levers, the primary tool being interest rate setting. This only influences base money, not broad money.

For these reasons the experiment into uncharted waters of QE will fail. It has to date merely masked the insolvent condition of Europe's largest banks. We at Cobden Partners have spent 5 years explaining these points to policymakers throughout Europe. None of them disagree, but all appear to be unable to articulate these points in public. I am therefore grateful to this conference for the opportunity to explain this fundamental message.

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[13] See Hanke, Globe Asia August 29015, reproduced by Cato Institute here: http://www.cato.org/publications/commentary/imf-experts-flunk-again

The problems are quietly but steadily affecting the suitability of the euro for Balkan countries, whether full euro users such as Croatia, hard linked such as Bulgaria, or loosely linked such as Macedonia. For each of these and the other major Balkan economies the question upon which they should be focussed now, in the Autumn of 2015, is whether it is in their best interests to remain linked to a currency which seems likely either to be substantially restructured or to suffer chronic debasement if the hard core force their political decisions (eg refugees) on the reluctant periphery. Further, there has been a silent sea change of thinking, with Germany clearly reluctant to countenance any further enlargement of the Eurozone.

Although it might sound a daunting prospect, introducing an alternative currency is not particularly difficult as long as the fundamentals of currency design are understood by its architects, and it is professionally planned in advance. The perennial observations about the euro's continuing effects of disincentivising structural reforms, inconsistency with the concept of national economic management, and the circuitous debates about eurobonds and fiscal transfers bear testimony to the euro architects' abject failure to satisfy either condition. The problem for Greece and other countries is that currency design is a skill which the troika are actively seeking to have every nation "unlearn", in Orwellian speak. The personal careers of too many senior individuals depend upon no one of the 19 nations breaking away and thriving, rather than collapsing.

Having spent four years pitching currency design alternatives to an array of governments, central banks, and leading opposition parties we are happy to set out the basic steps. The domestic banking and payments systems must be made sufficiently flexible to switch from one unit of account to another. Either physical cash, or some form of electronic cash, such as debit or credit cards, must be printed or produced in advance, with a robust distribution plan. These logistical considerations are no different in principle than a new product roll-out for a major corporation in a major industry.

What is different, and requires due consideration, is how a new national currency will be credible in the eyes of the public which will be expected to use it. Any currency

thought to be at risk of a major devaluation and inflation will struggle to gain sufficient credibility. However, if the currency is introduced at an already credibly devalued rate--one which would reset Greek unit labour costs to a level competitive with the euro-area average for example--and the national debt burden is also redenominated in a fait accompli vis-à-vis creditors, greatly reducing its value in real if not nominal terms, then the new currency's value will indeed be credible and will be able to support commerce and business as usual. Additional credibility-boosting actions could include the build-up of foreign reserves, say by selling off certain specified state assets.

Yes, this devauation implies a wave of inflation as the domestic price level adjusts to the new national unit of account, but this will also serve to devalue government pensions and other public obligations that, at present, are simply unserviceable in any case. Sudden, large devaluations are common in European history and, while there is no 'free lunch' in economics, they have, from time to time, facilitated major currency reforms and, subject to sufficient political will, led to major structural reforms helping to restore and sustain economic competitiveness longer-term. France is a textbook case of a country which, following a major devaluation in the early 1980s, set about this course, with some success, only to slip back into poor fiscal and regulatory habits again following the introduction of the euro in 1999. More recent examples are provided in Eastern Europe, when in 2008 multiple small regional economies suffered major devaluations but maintained fiscal discipline and, in a short time, enjoyed strong economic recoveries.

The lesson for a future Greek government, or any present or future euro-area government is clear: If you want to restructure your sovereign debt or restore sovereignty over fiscal policy, you simply cannot negotiate without a credible plan to re-introduce a national currency. Recent statements by the governments of Poland, Bulgaria and the Czech Republic that they are in no hurry to join the euro, if ever, indicate that this message is not lost on these increasingly successful, competitive economies. Present euro-area members take note: Failing to prepare an alternative currency Plan B is preparing to fail in future negotiations. The time to plan is now, before the probably inevitable arrival of the next euro sovereign debt crisis.