Flaws in variable interest clauses

Cormac Butler

Hedging Contract

Rate Agreement Date	07 September 2007
Start Date of Interest Fixing	25 September 2007
Maturity Date of Interest Fixing	25 September 2010
Fixed Rate Period	3 years starting on the Start Date and ending on the Maturity Date
Rate	5.8200% **The fixed rate is equal to the aggregate of:-** **4.5700%** **representing the Bank's cost of funding the Facility; and** **1.2500%** **representing the Bank's margin.**
Convention	Act / 360 interest for the purposes of this loan is calculated on a Act / 360 day basis
Currency	EUR
Amount	2,000,000.00
Comments	Bullet

Extract from Ulster bank reply letter

Furthermore in relation to the above claim, I note that the report from Blackhawk Banking Advisors has calculated the total interest rate as being a varying Euribor rate together with the Bank's margin of 1.5%. Accordingly the rates used in the calculations within the report are incorrect for two reasons, namely:

(a) The rate on your loan facility was based on the Bank's Cost of Funds and not a Euribor rate (per the enclosures mentioned above)

(b) Notwithstanding the fact that the incorrect rate was used, in fact the Euribor rate used in these calculations is varying which would indicate a variable rate loan , when in fact the subject of your complaint & the nature of the product taken out, was a fixed rate loan ie one where the underlying interest rate does not change over the course of the fixed term period- in your case 5 years

Unfortunately, given your confirmation and agreement to the rate both verbally by way of the telephone conversation with you on 12 March 2007 & in writing on the Fixed Rate Loan Advisory Note and Repayment Schedule dated 14 March 2007, I cannot uphold this element of your complaint.

Foundation Stone of Company law

- Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such **that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses**, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

IASB public statement on Prudence

balance between the three, but absolutely critical. Quality is of course something we can never walk away from, but there comes a point where there are diminishing returns. Convergence is also important. It is something we remain very much committed to finishing. But maybe the time for timeliness is now upon us."

We can't help thinking that he has a point. The G20 set the IASB and Financial Accounting Standards Board (FASB) a deadline of June 2011 to complete their remaining convergence projects. But almost a year later, major projects on financial instruments, leasing, revenue recognition and insurance contracts remain stubbornly on the IASB's agenda. Important amendments that would

"IFRSs did not cause the crisis... They do not remove judgement or override prudence"

IASB Agenda ref	10D

STAFF PAPER

May 2016

IASB Meeting

Project	**Conceptual Framework**		
Paper topic	Prudence		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board® ("the Board") and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB *Update*.

Removal of Prudence

The IASB attempted to remove Prudence in 2010 without approval from the European Union legislators.

"In developing the existing version of Chapter 3—*Qualitative characteristics of useful financial information*, (corresponding to Chapter 2 of the Exposure Draft), issued in 2010, the Board removed the reference to prudence, because it was concerned that the term could be interpreted to be inconsistent with neutrality."

Extract from Staff Paper

"(c) explaining in the Basis for Conclusions on the revised *Conceptual Framework* that the notion of prudence cannot be used by preparers to override the requirements in IFRS Standards"

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European Financial Reporting Advisory Group

- In the revised Conceptual Framework, prudence is used in the meaning of caution under conditions of uncertainty. It has been the view of EFRAG that prudence in some circumstances requires asymmetry in Standards in recognition such that assets or income are not overstated and liabilities or expenses are not understated. As prudence in this case is considered for the cases where it is not reflected in requirements in Standards, the two meanings may be similar.

Honohan – Anglo Tapes could lead to criminal prosecutions

* DPP to rule in Drumm case

Regulator concerns on Criminality

NEW evidence from Anglo Tapes could lead to fresh criminal investigations, the Governor of the Central Bank has said.

The development comes as the Irish Independent has learned the Director of Public Prosecutions is close to determining whether disgraced Anglo Irish Bank chief executive David Drumm will face criminal charges here, it is understood.

In his first reaction to the publication of the tapes by the Irish Independent, Central Bank Governor Patrick Honohan said the regulator was examining whether Anglo Irish Bank "deliberately misrepresented" the position of the bank when it sought taxpayer support in 2008.

"There is one element in what has been disclosed in these tapes which alerts us at the Central Bank to the dimension which we had not been aware of and which we think needs further scrutiny," he said.

Judge slams False Accounting

Lisa O'Carroll *and* **Nick Fletcher**

Wed 20 Jun 2018 16.23 BST

The former chief executive of a bank that played a pivotal role in Ireland's financial crash almost a decade ago has been jailed for six years.

David Drumm, 51, the former chief of Anglo Irish Bank, was sentenced to six years in prison after the judge took into account mitigating factors, including five months he spent in a US jail awaiting extradition.

Drumm was found guilty earlier this month of conspiracy to defraud and false accounting for his part in a €7.2bn (£6.3bn) fraud conspiracy.

IBRC Commission

- In subsequently identifying transactions that fall within paragraph 1(a) of the Terms of Reference, the Special Liquidators have made reference to a number of detailed assumptions that they have made. Certain of the features of the transactions included in, and excluded from, the Schedule provided by the Special Liquidators give rise to questions as to the meaning of the term "*capital loss*", and its application. By way of example, the Special Liquidators have excluded from the Schedule loans where, although the loan was fully provisioned and the underlying security sold, the loan had not been formally written off during the Relevant Period.

Lloyds' loophole

Court papers released in 2019 (Sharp v Blank) showed that Lloyds:

- knew HBOS was concealing losses and admitted in 2019 that it used the same loophole to hide its own losses (**overvaluation of assets loophole**)
- removed certain liabilities from the HBOS balance sheet to make HBOS look profitable and healthy (**concealment of liabilities loophole**)

EU Regulations

- Prior to Brexit EU Regulations were binding on UK and Irish companies. For technical reasons, Brexit did not have an impact on UK law.
- The relevant legislation for our purposes is EU Regulation 1725 of 2003.
- Statute of Limitations will expire at the end of 2023.

Consequences of using loopholes

- It is illegal for banks to misrepresent deliberately their financial position and it is a criminal offence to borrow money using accounts that portray a misleading financial position.
- Banks cannot pass on the cost of these illegal borrowings to their customers. Therefore, in addition to the flaws pointed out on derivative contracts by Steve Middleton there is an extra flaw. Any swap or loan contract that references 'cost of funds' are potentially illegal.
- If a bank chooses to misrepresent its financial position and attempts to borrow funds, interest costs will normally be higher. The bank cannot pass on the costs of its crimes to customers.

FT article

Opinion **City Insider**

Black is white for Anglo Irish Bank's long-suffering shareholders

PwC's finest scientific minds attempt to prove banks can exist in two states at once

MATTHEW VINCENT + Add to myFT

PwC's David Tynan was appointed by the republic's government to assess the claim. And he has now concluded that no payments are due because, in the depths of the financial crisis**, Anglo was "both cash flow and balance sheet insolvent".** That's a blow for shareholders. It's even worse for the European and Irish central banks — which lent billions to Anglo during the crisis, even though they are not meant to lend to insolvent institutions. So why did they? Accounting expert Cormac Butler points City Insider to a 2015 inquiry in which former Irish Central Bank governor **John Hurley said Anglo could not have been insolvent at the time because a big accountancy firm had "examined the books of Anglo some months later and didn't come to that view".** That firm? The mercurial PwC. Butler claims: "PwC knew in 2008 that Anglo Irish Bank was insolvent yet advised the ECB and the government otherwise." PwC Ireland declined to comment. To City Insider, though, it looks black and white. Or, rather, black is white.

Evidence of Loophole 1 RBS (2018 accounts)

Impairment, provisioning and write-offs (audited)
In the overall assessment of credit risk, impairment, provisioning and write-offs are used as key indicators of credit quality.

The new IFRS 9 impairment provisions accounting standard was implemented with effect from 1 January 2018. Set out below is further detail regarding the impact of the transition from IAS 39 to IFRS 9 impairment provisioning, how key credit risk management activities link to IFRS 9 impairment provisioning and the key policy and modelling decisions that have been made in implementing IFRS 9 (refer also to Accounting policy 14 and Note 14 on the consolidated accounts).

Key differences in moving from IAS 39 to IFRS 9 on impairment loss (audited)	Total £m
31 December 2017 - IAS 39 impairment provision (1)	3,832
Removal of IAS 39 latent provision	(390)
IFRS 9 12 month ECL on Stage 1 and Stage 2	513
Increase in Stage 2 ECL to lifetime (discounted)	356
Stage 3 loss estimation (EAD and LGD)	73
Impact of MES	64
1 January 2018 - IFRS 9 ECL	4,448

Note:

Evidence of Loophole Overvaluation of Assets (Lloyds)

"The implementation of IFRS 9 on 1 January 2018 resulted in an initial reduction in CET1 capital of 0.30 per cent which, following the application of transitional relief, reduced to 0.01 per cent. No additional relief has been recognised at 31 December 2018 as Stage 1 and Stage 2 expected credit losses (ECLs), net of regulatory expected losses, have not increased beyond the position at 1 January 2018."

Evidence of Loophole 1 Overvaluation of Assets

Table 1.28: **Movements in capital resources**

	Common Equity tier 1 £m
At 31 December 2017	29,647
Banking profit attributable to ordinary shareholders[1]	**3,759**
Movement in foreseeable dividends[2]	**(48)**
Dividends paid out on ordinary shares during the year	**(2,240)**
Dividends received from the Insurance business[1]	**750**
Share buyback completed	**(1,005)**
Restatement of retained earnings on adoption of IFRS 9	**(929)**
IFRS 9 transitional adjustment to retained earnings	**478**

Evidence of Loophole 2

- "An extensive exercise has been undertaken to determine the fair value of the assets, liabilities and contingent liabilities of HBOS…. This exercise has concluded that the fair value of the acquired net assets and contingent liabilities of HBOS was £1.2bn greater than their carrying value at 16 January 2009. This seems counterintuitive given the credit risk concerns surrounding the HBOS loan book. However, a £15bn fair value reduction in HBOS's loan books was more than offset by the reduced value of HBOS's own debt in issue (c.£16bn) reflecting increased credit spreads. "

Evidence of accounting loophole Lloyds' Bank

- It should, however, be observed, that this "fair value" adjustment was not permanent and would "unwind" over time because (unless the debt was bought in at a discount, as about £11bn of "own debt" was) the Enlarged Group would have to pay the debt back *at face value* at maturity.

Legal Requirement

- All UK and European banks are required to state the following in their annual report
- We report to you our opinion as to whether the consolidated financial statements give a true and fair view and whether the consolidated financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.
- Article 4 of the IAS Regulation requires entities to comply with the detailed accounting standards contained in EU Regulation 1725 of 2003 and any relevant updates.

EU Regulation 1725/2003

IAS 1.13

"Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the* Framework*. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation."

The 'Framework' is a reference to the Framework in existence in 2002 which was formally approved by the EU.

Framework

- Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such **that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses**, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Framework

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Framework

- Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

Private Eye

THE BIG FOUR

Refried beancounters

AS interest rates soar and debt defaults loom while Liz Truss's government deregulates the City regardless, the forgotten discipline of accounting remains dangerously unreformed since the last financial crisis and could well make the same inglorious contribution to the next one that it did in 2008.

In the run-up to that financial crash, banks such as Northern Rock, RBS and HBOS hid billions of pounds in losses on loans until it was too late to do anything about them. Since then, internationally agreed accounting rules – heavily influenced by the Big Four accountancy firms that draw so much of their income from the financial sector – have barely changed. Currently, banks have to estimate what their losses on loans such as mortgages will be over the following 12 months, rather than what the total they won't get back really is. As it's easy to put on the

and bankers' bonuses under similarly forgiving accounting rules, suggests otherwise.

The leader of British beancounting regulation might not, however, be the most independent judge of such matters. Du Plessis was on the board of Lloyds TSB in the run-up to its disastrous 2009 acquisition of HBOS. As *Eye* 1567 reported on his appointment at the FRC earlier this year, he admitted "clearly a big mistake" but said in mitigation that "many others involved in the industry at that time were appropriately humbled afterwards by incredibly bad judgements made during that time". Not sufficiently humbled, it seems, to do everything to prevent similar disasters.

Split decision

MEANWHILE, as the Noughties boom-time showed, there's nothing like big paydays to turn beancounters' heads.

For decades the Big Four firms have resisted separating the auditing and consulting arms that feed off each other while creating conflicts of interest and shifting focus from the core job of checking companies' accounts. According to their bosses, such as EY's then UK head Steve Varley two years ago, splitting them "could negatively impact audit quality".

Attempts to Change the Framework

- *George Bompas legal opinion 24th June 2013*
- *7. A difficulty with Mr Moore's Opinion is that since 2008 "the Framework" referred to in IAS 1 (that is, the Framework for the Preparation of Financial Statements adopted by the International Accounting Standards Board in 2001) has been replaced with a new "Conceptual Framework for Financial Reporting" ("the Conceptual Framework"). A passage in the Framework referred to and relied upon by Mr Moore in his Opinion, namely paragraph 46 quoted in paragraph 28 of the Opinion, is not to be found set out in the Conceptual Framework.[11] Further, while IAS 1 does permit a degree of departure, as mentioned in the passage from the Opinion quoted at the end of paragraph above, where it does so (notably paras 15, 19, 23 and 24 of IAS 1) it is by reference to matters in the Framework which are not stated, or stated in the same way, in the Conceptual Framework. In this respect the landscape appears to have changed since the Opinion was given.*

Martin Moore KC response

- It is important to note that the European Union has not adopted the version of IAS 1 which refers to the Conceptual Framework. Consequently, it is the Framework to which reference should be made when interpreting IAS 1, paragraphs 15 et seq. - not the Conceptual Framework. Accordingly, unless and until the European Court of Justice rules that accounting standards adopted by the EU pursuant to the IAS Regulation do not permit a true and fair override, there is no necessary tension between Section 393 and Section 397.

Six-year Statute of Limitations

The 6 Year Rule

But many of the swaps that may have been mis-sold were sold some years ago. And so the 6 year rule may appear to apply to prevent potential plaintiffs from launching actions. But a defendant is estopped from relying the 6 year rule in cases here there has been misrepresentation or deception. For there to be mis-selling there must usually either have been a fraudulent or negligent misrepresentation by the bank. In that case the borrower may be entitled to rescind the contract and recover any losses in the form of repayments made. In conjunction with a claim for misrepresentation plaintiffs may be entitled to claim, as the Cosgraves have, deception. Deception is a tort arising from a false statement of fact made knowingly so that it would be acted on by another who suffers damage as a result. If that claim is successful it may also entitle the plaintiff to recover damages.

Repeated denials

- Admission of ICAEW
- IASB assurances
- FRC claims that banks continue to comply with company law
- Failure to disclose accounting policies prevents court action.

Regulation 1725 Disclosure Requirements

108. ***An entity shall disclose in the summary of significant accounting***

policies:

(a) ***the measurement basis (or bases) used in preparing the financial***

statements;

and

(b) ***the other accounting policies used that are relevant to an understanding***

of the financial statements.

UK Parliament Future of Audit Inquiry

- A 2005 paper by the Institute of Chartered Accountants in England and Wales (ICAEW, the body responsible for producing the Guidance referred to by Sarasin above) outlined how IFRS is not aligned with the law. It explained that the transition to IFRS was creating "serious concerns" and "many issues" about the lawful payment of dividends under the capital maintenance regime. And yet, ICAEW did not side with the law, arguing instead that the rules were flawed and needed to be adapted to IFRS:

Neutrality v Prudence

- In a 2016 staff paper (Neutrality v Prudence) the IASB encouraged "the notion of prudence cannot be used by preparers to override the requirements in IFRS Standards."
- This advice is contrary EU Regulation 1725/2003 IAS 1.13 which
- "***requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions[including prudence] and recognition criteria for assets, liabilities, income and expenses set out in the*** **Framework**

IASB argument

- Companies often take action today that will improve its reputation amongst customers, creating profits in the future. The IASB disagrees with the conservative accounting approach of waiting until 'objective evidence' emerges ie profits can be independently verified. It argues that conservative accounting is 'asymmetric' which can be corrected by permitting the delayed recognition of losses.

Legislators counter argument

- Legislators argue that recognising estimated profits encourages Ponzi schemes
- They further argue that delaying the recognition of losses is a fraud, even if the intention is to remove asymmetry.
- While Prudence is conservative it is still the most optimum form of neutral accounting. Without it companies can over value assets (the incurred loss model) and under-declare liabilities (the liability recognition model). Both forms of accounting are clearly asymmetric.

Neutrality

- The IASB has nevertheless redefined neutrality by claiming that asymmetrical accounting is a form of non-neutrality and on that basis has argued that there is a clash between Neutrality and prudence. However, the IASB's revised definition of Neutrality was not endorsed by the EU. Therefore IASB advice remains illegal in Europe.

- END