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TO:

Mr. Sajid Javid, MP
Economic Secretary to the Treasury
1 Horse Guards Road
London SW1A 2HQ
United Kingdom

WITH A COPY FOR:

Prof. Mervyn A. King
Governor of the Bank of England
Threadneedle Street
London EC2R 8AH
United Kingdom

Dear Mr. Javid:

Re: Banking Reform

I thank you for your letter of 5 October 2012 and wish to extend my congratulations to your appointment as Minister responsible for Banking.

We are both bankers with a distinction. You are an economist by training; I'm a grass roots banker with an apprenticeship, and public accountant.

The root cause of the banks' failures during the Global Financial Crisis, that started as a "liquidity crunch" before being called a "credit crunch," were foretold by Thomas Jefferson, Irving Fisher, John Maynard Keynes, and John Kenneth Galbraith in their various publications, and also by myself starting in 1992, "Money in Crisis."

The root cause of the GFC lies not, as you say, in the abundance of cheap money during the bubble — that was only the symptom — but in the perversion of GAAP's and the IFRS's accounting principles, standards and rules, namely, to record and report loans receivable as assets and their corresponding liabilities as demand deposits under Luca Pacioli's (1494) device of double-entry bookkeeping for a commercial enterprise, and the banks do so without a cost basis, by self-dealing and such other violations as outlined in by publication (2012), "Accounting Perversion in Bank Financial Statements — Root Cause of the Ongoing Global Financial Crisis." (www.iicpa.com "Publications")

Thanks to the insights of Prof. Mervyn A. King, Governor of the Bank of England, and his colleague, and the UK government's appointent of Sir John Vickers to chairman of the Independent Commission on Banking, HM Treasury is now following the ICB's recommendation by introducing a banking reform bill for the "ring fencing" of core bankings services.

However, with respect, I submit that the said draft banking reform bill is at best only a half-measure:

- While the banking reform bill will separate deposit taking from investment banking, the bill does not separate deposit taking from lending, effectively allowing the continued mixing customer's cash deposits with the bank's much larger inherently **illiquid** quasi money created by double-entry bookkeeping through 'lending,' and not cured by the capital adequacy which cannot safeguard customers' deposits. I will discuss this in detail below.
- The banking reform bill still permits private commercial banks to create money out of nothing through what the banks call 'lending,' instead of requiring pre-existing liquid money (legal tender being cash or funds at the central bank) to be in the bank's possession before the bank makes the loan. This bank-Achilles-heel had been cured by the 1844 Bank Act under Prime Minister Robert Peel, but was circumvented by the development of the check book system by which customers can draw on their accounts at the banks, which the banks would settle against incoming checks for deposit by way of offset, rather than the bank giving the customer cash or deposits backed 100% by cash or central bank balances.[1] The present banking reform bill's "loss absorption ability" of the commercial banks cites the definition in the Basel Committee on Banking Supervision's (BCBS) model Basel III, which is based on the misconception that a deposit institution's equity capital is a protector of its deposits — which flies in the face of simple accounting principles and standards, capital being on the wrong side of the balance sheet (liability side) when liquidity (assets) are required.

In my long years of practice as a banker and public accountant, and lately a professor, I stand at an insurmountable wall of ignorance on the part of learned economists who maintain that "capital" is a thing that can do everything from providing a buffer for banks' losses, a safeguard against bankruptcy, and — worst of all — a protector of bank deposits. In truth, capital is an abstract, not even an account that can be drawn upon because it is a "plug" being the difference in value of assets less liabilities. To payout depositors, liquid assets are needed, not an item on the liability side of the balance sheet. This very simple point is not seen by regulators who hide behind a vail of self-created complexity, and Economics 101 as taught at B-Schools is of no help.

I have passed all parts of the rigorous uniform US Certified Public Accountant's Examination in November 1976 (during the week of the presidential elections; Jimmy Carter won), have maintained a CPA practice license in the State of Washington since 1977 (including a license to practice in the UK in the '70s). I have been a corporate credit analyst at the Bank of Nova Scotia in Toronto and had three Canadian provinces under my supervision. And still, my argument falls on the bankers' and banking supervisors' deaf ears. I wish to say with force, "What is wrong with you all?" The Basel Committee on Banking Supervision is run by economists, has put Basel I, II and now III in place since 1988, and still we have these catastrophic bank failues so that, as you write, "whole economies suffered, tens of thousands of jobs were lost and many billions of taxpayers' money was put at risk" and you urge "wide-ranging regulatory reform." I ask, based on what? More misconceptions?

[1] Writes JM Keynes (1913:27): "The sound principle for regulating the issue of a Paper Circulation," wrote the Secretary of State, "is that which was enforced on the Bank of England by the Act of 1844." In England, of course, bankers immediately set themselves to recover the economy and elasticity, which the Act of 1844 banished from the English system, by other means; and with the development of the cheque system to its present state of perfection they have magnificently succeeded. (JM Keynes. 1913. "Indian Currency and Finance." Reprinted 2011 by IICPA Publications.)

Letter to Mr. Sajid Javid, MP
HM Treasury, London
2012-11-16

Your kind lettter (received six weeks after dispatch) makes me think for the need of another publication: “The Misconception of Capital Adequacy in Banking”.

JK Galbraith observed, that “there are no propositions in economics that can't be stated in clear, plain language. There just aren't.”[2] I am citing Galbraith in my publication (2012), “Liquid Money — The Final Thing. Federal Reserve and Central Bank Accounts for Everyone,” of which I enclose a courtesy copy for your reading enjoyment.

Permit me to give a simple example to demonstrate my point that capital adequacy for depository institutions, including those that are also lending, is a misconception because it cannot protect customers’ deposits in ANY way, unless you as Head of Global Credit Trading at Deutsche Bank’s Asian desk in Singapore in 2006, at the hight of the financial bubble (with lots of cheap money around, as you said in one of your interviews)[3] had the unforgiveable lack of foresight to lend to a correspondent bank in need of liquidity on the strength and quality of its loan portfolio… but you are no longer there.

Example:

A bank has been created in a city, say Bremesgraf or Bremesburh (which are the ancient names for your constituency currently known as Bromsgrove). The founding shareholder and promoter has put up his ancestrial estate woth £10 million and taken back capital stock. You are a director. Based on your good name and international banking experience, the people of Bremesburh line up at Barclay’s, HSBC, Lloyd’s and BlueSky, take out their deposits and redeposit their cash or bank drafts at the The New Bank of Bromsgrove. The drafts clear in two days. No loans have been made as yet. The unpublished in-house statement of financial position (balance sheet) of NBB would be as follows:

The New Bank of Bromsgrove
“Balance Sheet”
December 31, 201X

Assets		**Liabilities and Shareholder’s Equity**	
Vault cash	20,000,000	Demand deposits	5,000,000
Balances at the BofE	70,000,000	Savings deposits	85,000,000
Bank premises	10,000,000	Equity capital	10,000,000
Total assets	**100,000,000**	Total assets & Shh. Equity	**100,000,000**

[2] “The final thing, in economics, is to have one great truth always in mind. That is, that there are no propositions in economics that can't be stated in clear, plain language. There just aren't.” (John Kenneth Galbraith, Interview with Harry Kreisler. Conversations with History: Institute of International Studies, UC Berkeley, March 27, 1986.)

[3] The Village, April 22, 2010:
Mark France: “Deregulation of our financial services caused greed and it infected our MPs.”
Mr France backed the so-called “Robin Hood Tax” on banks, which he said is estimated to raise £100bn for the UK economy in a year, with no cuts in services or any rises in personal taxation.
“It means that the people who caused this crisis will pay for us to get out of it.
“I’m sure Sajid is certainly experienced as an international banker, but I don’t think Bromsgrove needs a banker as its next MP.”
Sajid Javid: ”Of course banks had a role to play in the crisis, but this crisis was also caused by cheap money flowing around the global system.

Such a bank would be highly, yes, completely liquid. As of balance sheet date, it could redeem deposits in vault cash, or cash withdrawn without notice from the central bank. The equity capital would meet Basel III requirements, which would be, for example, Tier 1 capital ratio = Tier 1 capital / Risk-adjusted assets >=6%, if there were any risk-adjusted assets, but there are not as yet. Still, if on New Year's day the promoter's ancestrial estate vanishes and the bank needs to write them off (eg, insurance coverage is defective, not assigned, or some other reason), the bank has lost its capital and is technically bankrupt, although demonstrably 100% liquid and able to payout depositors fully.

If the bank had lent out, say, half of the initial deposits (not creating money by double entry bookkeeing, but lent out pre-existing money), and those loans would have been subject to write-off, the bank would also be bankrupt AND illiquid even if Basel III capital adequacy had been observed. The likelihood of other banks coming to NBB's rescue during a financial crisis is NIL.

In a paper entitled "Bank Failures in Mature Economies", the BCBS seems to admit that illiquidity rather than capital inadequacy causes bank failures. For example, Continental Illinois (1984) had $2 billion net worth when the FDIC closed it down ("the pitfalls of illiquidity" – BCBS). During the UK small banks crisis (early 1990s), the affected banks' capital positions were intact.[4]

I have written about the misconceptions of capital adequacy for commercial banks in my booklet "European Banking Authority's Stress Teasing. The fallacy of capital adequacy requirements ofr commercial banks," (January 2012) available online www.iicpa.com "Publications".

If my thoughts have any influence on yours, then the future of banking in the UK will be so much safer. If not, history will repeat itself as it has for 200 years since Thomas Jefferson, or shall we say since Robert Peel.

I will take the liberty of sending you a copy of my proposed publication on "The Misconception of Capital Adequacy in Banking". I have also just published a book entitled "Reflections on American Money, Private Wealth, the National Debt and Alternatives for Redemption" ISBN 978-1481017015, which should be available at Amazon online by the time you receive this letter.

With all best wishes,

Michael Schemmann
Director

Cc: Sir John Vickers

[4] "Indeed the small UK banks that would subsequently fair were well capitalized in June 1991, as most had risk-weighted capital ratios well above the 8% Basel minimum." Westernhagen, N. *et al*. 2004. "Bank Failures in Mature Economies." "The U.S. Experience." *BCSC Working Paper No. 13*. Basel: Bank for International Settlement, p. 68.

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HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Michael Schemmann
Director
International Institute of Certified Public Accounts
Box 9 Pak Thong Chai
Nakhon Ratchasima 30150
Thailand

5 October 2012

Dear Michael,

Thank you for your letter of 28 July to Mark Hoban about Banking. I am replying as Minister responsible for this policy area and I am sorry for the delay.

I welcome your view that the Government's implementation of the Independent Commission on Banking (ICB) 'ring-fence' recommendation is a "step in the right direction" for reforming the UK banking sector. The recent financial crisis in which the whole economy suffered, tens of thousands of jobs were lost and many billions of taxpayers' money was put at risk, makes the case clear for wide-ranging regulatory reform. The Government is determined to take action to deliver a stable, sustainable and competitive banking system so banks will be better placed to meet their core purpose of lending to the real economy and contributing to economic growth.

The Government outlined in detail its ring-fencing proposals in its white paper *'Banking reform: delivering stability and supporting a sustainable economy'*. The white paper can be found here:
http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm

The Government will implement the proposals according to the ICB's recommended timetable. Primary and secondary legislation to implement elements of the ICB recommendations will be completed by the end of this Parliament in May 2015. The final deadline for banks to be fully compliant with the proposals will be the start of 2019, as recommended by the ICB.

Your letter suggests that there is a misconception that equity capital protects deposits and that it is irrelevant for banking institutions. As the letter you received from the previous Financial Secretary of 29 June 2012 sets out, the Government considers the agreement reached by the Basel Committee on Basel 3 is one of the most important aspects of the international response to the financial crisis. In particular, the Government

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believes the Basel Committee's agreement to strengthen both the quality and quantity of capital that banks are required to hold at all times as a necessary step to ensure that banks can absorb losses, without jeopardising the solvency of the institution.

Thank you for taking the trouble to make us aware of these concerns.

Yours,

S.J.

SAJID JAVID