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3 May 2012

The Rt. Hon. George Osborne
Chancellor of the Exchequer
11 Downing Street
London SW1A 2
England

Dear Mr. Osborne,

Capital requirements are the misconception of the Basel Capital Accord in its vain attempt to keep internationally active banks solvent.

And I disagree that you may "look like an idiot" if you fail, as you said on May 2, 2012 ("Britain's Osborne hits out as EU bank capital talks stall" – Reuters). I wished you had been my student in international accounting, finance and banking, because it pains me to see so many politicians of equal rank embracing these very same misconception outlined below, not you alone.

For your information, accounting principles and techniques do not treat capital as an account to draw on in order to pay depositors if there is a run on the bank. Capital is only a 'measure', namely the difference between the total value of assets and total liabilities; an 'abstract' so to speak. Liquidity — to be precise, legal tender being central bank money — is the ONLY thing to pay off depositors and creditors; the private banks' self-created surrogate 'money' does not suffice.

Why is surrogate 'money' sufficient in good times? The answer is that surrogate 'money' can clear in the daily payment clearing by way of offset with receipts (also of surrogate money) so that nothing changes hand, is only 'booked', so long as there is no run on the bank. During a run, receipts stop, no money is coming into the bank to be offset against outgoing payments. During a run, only outgoing payments are made and those are, of course, limited to the very low amount of legal tender or central bank balances held by the private banks.

The Bank of England and the European Central Bank have provided their high-powered central bank money to the private banks by way of loans in great measure (many trillions of dollars, pounds, and euros), to keep the payment system from collapsing (not so much to 'stimulate' the economy, because banks are not lending). I believe that your Governor of the Bank of England, Prof. Mervyn A. King, would be well to consult on this point.

To be clear on the inadequacy of 'capital' to secure depositors' deposits, capital is completely irrelevant except for the 'reputation' factor, maybe. Even a private bank with a capital ratio of say 50% of total assets, but has no liquid assets in the form of central bank money, is ILLIQUID, unless it can quickly sell its assets for liquidity. A commercial bank should not have to sell its assets to become liquid — impossible during times when ‘financial markets’ are frozen; the commercial banks should be liquid at all times.

The European Banking Authority’s stress testing based on capital ratios is therefore a hoax I call ‘stress teasing’. (See my publication (2011) “European Banking Authority's *Stress Teasing*. The fallacy of capital adequacy requirements for commercial banks.” (http://www.iicpa.com/publications/publications.HTML)

A good step forward in UK banking reform will be the separation of banks into (1) deposit taking and (2) lending operations. The Sir John Vickers’ IBC Independent Banking Commission in its September 2011 Final Report has recommended the separation of deposit-taking from lending by what the IBC calls ‘retail ring-fencing’.[1]

The demand for the separation of banks’ deposit-taking from the banks’ lending operations has been on the table for over seventy years, at least since Irving Fisher’s (1935) “100% Money,” and one wonders why it has taken so long to sink in.

Accounting principles are compromised if not perverted and corrupted all the time, and financial history is not well taught. Too many politicians are not financial men and women at all.

I explained the problem concerning the creation of surrogate ‘money’ by the private banks in my publication (2012) “Accounting Perversion in Bank Financial Statements. Root Cause of the Ongoing Global Financial Crisis”, available at Amazon.com, both as paperback and eBook (Kindle).

Another publication of mine (2011), “The Euro is Still the Strongest Currency Around,” is worth reading to explain the so called Euro-crisis which is actually a non-event played up by the ignorant press and ‘promoted’ by equally misconceived politicians. What does the bankruptcy of the State of Greece have to do with the convention underlying the Eurosystem? The money created and lent to the sovereign is still good money but in other people’s accounts and will not be returned to the investors, that’s all — investors including the private commercial banks that created these euros as surrogate ‘money’. Let them learn to stop creating money and giving it to sovereigns. In the meantime central bank money is lent to the private money creating banks to keep them ‘liquid’ until the debt is repaid, repudiated, or written off.

With all my best wishes,

Michael Schemmann
Director

Cc: Prof. Mervyn A. King
Governor of the Bank of England
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[1] “The purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank’s customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank’s failure without government solvency support.” (IBC, Financial Report, September 2011. Recommendations, Chapter 9.2 on page 233.)