

Strategic Disinformation

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Famous Last Words ?

- This company is well capitalised
- This company is well capitalised
- This company is adequately capitalised
- This company is healthy
- This company is in no imminent danger
- This company is & always has been solvent
- This bank is solvent, exceeds its regulatory capital requirement & has a good quality loan book
- There is no reason for people to withdraw their funds.
- Indymac
- Bear Stearns
- Fannie Mae
- Merrill Lynch
- Executive Life
- The Equitable
- Northern Rock
- Pyramid

Questions

- Case Studies of Historical Events (old and new)
- 1. How often do regulators provide misleading information about financial institutions which are in trouble?
- 2. What were they thinking?
- 3. How do regulators mislead the public?
- 4. How well did it work?
- 5. Independent Review

The Benefits of Disclosure

By General Agreement:

Financial Institutions should disclose their financial status and the risks underlying their business.

- Market Integrity
- Market Efficiency
- Market Discipline
 - The Third Pillar of Prudential Regulation
 - Provides an incentive for better risk management
 - The ally of prudential regulators

The Downside of Disclosure

- Analogy: Discipline for a badly behaved child.
 - Gentle smack ?
 - Homicidal maniac ?
- BIS: Markets may “react harshly” to bad news
 - (and why not?)
- -> FI has a natural incentive to hide bad news
- -> And in many cases, so does the regulator...
 - (For many reasons – often very good reasons)

Two Questions

- *1. Should there be disclosure of any intervention by the regulator?*
- *2. When there is **already** widespread public concern about one or more financial institutions, what (if anything) should the regulator say?*

Disclosure and the Regulators

- Confidentiality is essential / obligatory
- Normally, problems are resolved quietly
 - By recovery or orderly exit
 - APRA seems to be pretty good at this ⁽⁰⁾
 - “Mandated Improvement” = operating in an unsustainable way
 - “Restructure” = in serious danger of failing

APRA Statistics ⁽¹⁾

Entities in Mandated Improvement (2003 - 08)

<u>Current stance</u>	<u>Total</u>
Normal	17
Oversight	32
Mandated Improvement	15
Restructure	0
Exit	80
Failure	0
Total	144

Entities in Restructure (2003 - 08)

<u>Current stance</u>	<u>Total</u>
Normal	4
Oversight	1
Mandated Improvement	0
Restructure	5
Exit	29
Failure	0
Total	39

Some Nostalgia

- UK Secondary Banking Crisis in 1973-4 (Never heard of it?)
- **The Lifeboat Plan**
 - Bank of England “persuaded” other banks to provide liquidity
 - Bank of England put in 10% as well
 - 26 banks, more than £1.2 billion
 - *“One of the most striking aspects of the crisis was that many people were unaware that there was a crisis at all.”(4)*
 - *(Losses were estimated at about £100 million)*

Some More Nostalgia

- BCCI crisis in 1991 (UK)
 - *“a secret rescue operation for several Britishto try to head off a systemic collapse which threatened to wreak havoc in the financial markets”*
 - *[Lord Spens] believed the Bank may have had to deal with up to 60 problems in the banking system since 1991.*
 - *The Bank declined last night to name the banks and financial institutions in which it had intervened, on the grounds of banking confidentiality. ”(5)*

These Days it's Harder....

- Northern Rock 2007
- Bank of England Governor:
 - *The (way) the Bank would have preferred to do it in years gone by,*
 - *and did do it in the 1990s,*
 - *and the way that I would have wanted to do it on this occasion,*
 - *is to have acted covertly as lender of last resort, to have lent to Northern Rock without immediately publishing that fact.⁽³⁾*

But sadly legal advisors said NO.

Reassuring Press Release - Friday September 14

*“The Chancellor of the Exchequer has today authorised the Bank of England to provide a liquidity support facility to Northern Rock against appropriate collateral and at an interest rate premium. This liquidity facility will be available to help Northern Rock to fund its operations during the current period of turbulence in financial markets while Northern Rock works to secure an orderly resolution to its current liquidity problems ... **The FSA judges that Northern Rock is solvent, exceeds its regulatory capital requirement and has a good quality loan book.**” (4, p65)*

The Run Begins September 14 (Leak)

- *Q. Would you leave your money in a bank that needs help?*
- A. Most people decided “NO”.
- They took out about £1 billion that same day. (5% of deposits)
- And then another £1 billion ...
- On Sept 17, a full govt guarantee was announced.
- The run stopped.

Trust Issues?

- **Northern Rock Chairman:**

- *“I think it is worth reflecting that all of us, (were) surprised by the degree to which the announcement of a facility from the Bank of England—not the use of it but the existence of a facility—and the reassurances that went with it about us being a solvent and profitable business did not have a sufficiently reassuring effect on customers.” (2)*

Trust Issues?

“There is probably no better and simultaneously more self-defeating indication that a bank is in trouble than an advertisement indicating everything is fine.” (8)
(William Seidman, Former Chairman of the FDIC)

Q. Would a bit less transparency be desirable ?

- White Paper: Bank of England should be able to give Emergency Liquidity Assistance in secret; banks should not have to reveal any such assistance. (6)
- Consultation Comments:
 - - Contrary to all avowed principles of disclosure (Charles Goodhart)
 - - Unfair to other creditors
 - - Not desirable to allow govt to pay out money secretly
 - - It wouldn't work anyway (can't keep this kind of thing secret)

BIS Committee : discussions about problem of “*stigmatisation*”

The American Solution to Stigmatisation

- GFC October 2008.
- Bear Stearns, Indymac, Fannie and Freddie, WaMu, Lehman, AIG
- Next in line: Merrill Lynch, Citibank, and then.....???

- Solution: Camouflage
- Paulson summoned the 9 most systemically important Fis
- *“Here is \$125 billion dollars from the govt. Just take it.”*

Camouflage

- All 9 were more or less required to take the money
 - (whether they wanted it or not).
- *“Federal Reserve officials later explained that **acting as a group would help to avoid any stigma that might have been associated with accepting capital from the government.** If some of the institutions had accepted capital and others had not, the markets may have viewed the decision to accept capital as a sign that the institution was experiencing financial problems. Such an assessment by investors could have led to a further destabilisation of financial institutions and markets.” (3)*
 - (seems a bit expensive?)

Reassurance

- Press Releases : Treasury, FDIC, and Federal Reserve
 - *“These are healthy institutions, and they have taken this step for the good of the US economy. As these healthy institutions increase their capital base, they will be able to increase their funding to US consumers and business.”* SIGTARP page 31
- Really ??? Is this some new definition of “healthy”?
 - Healthy = “on the verge of collapse” ?

Special Inspector General-TARP Comments

- Subsequent events demonstrated that Citicorp and Bank of America were not, in fact, “healthy”.
 - Citi -> another \$20 billion plus guarantees of \$300+ billion
 - BoA -> another \$20 billion plus guarantees of \$100+ billion
- Q. for Paulson: Did you *really* think they were all healthy?
 - A. “... *some of the nine were healthier than others*”

He admitted he was concerned that one was in danger of failing.

SIG-TARP Comments

It is not our intent to suggest that Government officials should make public their concerns over the financial health of individual institutions, but rather that government officials should be particularly careful, even in times of crisis, of describing their actions (and the rationales for such actions) in an accurate manner.

(Otherwise no one will trust us in the next crisis)

(Treasury did not really agree with this critique)

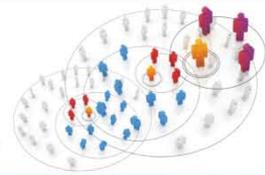
Sideline : Merrill Lynch Controversy

The Merrill Lynch problem was solve by arranging a takeover by BoA.

The BoA shareholders had to agree to this takeover.

There were allegations (investigated by SIGTARP) that Paulson encouraged the CEO of Bank of America to refrain from disclosing information about the parlous state of Merrill Lynch.

(Ask me later)



- Q2. What should the regulator do when the general public **already suspects** that one or more FIs is in trouble?

Scenario

- The financial system is in a fragile state.
- Financial Institution XYZ is in an unsatisfactory financial condition.
- The regulator is unable or unwilling to resolve the situation very quickly. (e.g. Large FI)
- It is considered desirable to allow XYZ to continue operating in the meantime.

Problem

- At least some members of the public are aware of problems at XYZ.
 - There is a danger that a run will occur
 - (or perhaps it has already started).
 - The run will have disastrous consequences.
 - -> A failure of prudential regulation.
- Unless the run can somehow be stopped.....?

Theoretically Correct Response?

- *“The regulator does not comment on the financial status of individual financial institutions.”*

In Practice? Strategic disinformation

- Strategic Misinformation
 - *“Misleading information supplied intentionally”*

Case studies

- *Regulators allowed the FI to provide misleading information,*
- *Or regulators provided misleading information themselves*
 - *Or both.*

Less Transparency, Please

- *Overstated Asset Values*
- *Failure to write down asset values after a crash*
- *Insufficient bad debt provisions*
- *Intangible Assets counted as assets*
- *Slightly higher interest rate (discount) assumptions*
- *Contingent Liabilities remain unacknowledged*
- *Mis-classify A or L into lower risk-weight category*
- *Financial Reinsurance*
- *Backdate post-balance-date transactions*

Example: LDC Debt Crisis 1980s

- US banks lent way too much money to Central and South American countries
- Encouraged to do so by US govt (foreign policy)
- 1982 Mexico defaults
- -> Big Bad Debt problem
- Solution: Lend them more money
 - Conflict : Foreign Policy vs FDIC
 - If their banks close on Monday, ours will close on Tuesday.

Conflicting Objectives

- RESULT: Even BIGGER bad debts
- Should the banks set aside realistic bad debt provisions?
 - > 7 or 8 of the top 10 US banks would be insolvent
- Conflicting objectives
 - FDIC: realistic reporting.
 - Federal Reserve : No, avoid financial meltdown.
 - *“The regulators looked over the abyss and decided to take a different path.” (8)*

Example: Savings and Loan Crisis

- Early 1980s: Roughly 90% of S&Ls were insolvent
- Deposit Guarantee Fund did not have enough money
- President Reagan
 - “No bailouts” philosophy
 - No budget deficits (don’t ask us for money)
- Let them trade their way out of trouble
 - They should be more entrepreneurial
- Regulatory Forbearance
 - Realistically, what other choice was there for the regulators?

(C) RAP

- *“Regulatory Accounting Principles (were) designed to accomplish an accounting miracle. Insolvent S&Ls were turned into solvent ones by a number of accounting tricks...”*
 - [e.g. counting thin air as an asset]
- *The government examiners who had to apply these principles did not like them at all; they started called them Creative Regulatory Accounting Principles (CRAP).”* ⁽⁸⁾
 - [NB This did not turn out well]

Misleading statements by regulators

- Not exactly a lie
- (which would clearly be wrong and likely to have unpleasant consequences for the liar)
 - Lying is not necessary...
- A carefully worded half-truth can be sufficiently misleading.
- Note: Some “discrepancies” between public and private statements.

My Favorite Example

- Public Statement
 - *“Executive Life is in no imminent danger”*
- Private Statement
 - *“Executive Life is hanging on by its fingernails”.*
- In receivership 4 months later: deficit \$4.5 billion
- [Read Congressional Testimony where regulator explains why he made this statement.]

Case Study: Fannie and Freddie

- Publicly: *“The regulator has confirmed that both GSEs remain adequately capitalized”*
 - *(Henry Paulson to Senate Banking Committee, July 2008)*
 - Privately: *“This is bullshit capital.”*
 - *(Henry Paulson to Treasury Colleagues).*
- Outcome: *Fannie and Freddie are taken into conservatorship 7 weeks later. All shareholders’ capital is wiped out by losses. Govt provides a capital infusion of \$150 billion.*

Paulson's explanation

- *Q. How could you say that Fannie and Freddie were adequately capitalised?*
- *“I never said that they were adequately capitalised.”*
 - *“I said that the regulator said that they were adequately capitalised.”*

Regulator's explanation

- *Q. How could the regulator claim that Fannie was adequately capitalised when it was on the verge of collapse?*
 - A common misunderstanding...
 - Some people foolishly assume that
 - *“Adequately Capitalised”*
 - means
 - *“Has enough capital to cover business risks”*

“Correct” Meaning of “Adequately Capitalised”

- This company (*which has an established record of accounting fraud*)
 - has reported that it has surplus assets (*which are largely composed of intangible items such as future tax benefits for past losses which will probably never be claimed*)
 - which are sufficient to meet the regulatory solvency requirements (*which are ridiculously inadequate relative to risks, due to many years of aggressive lobbying*).

Why did they say this ?

- In 2007 - Subprime debt crisis had wiped out the private mortgage market.
- Fannie and Freddie had to make more loans, to fill the void left by the collapse of the subprime lenders'.
 - > Otherwise: the collapse of the US housing market

Conflicting objectives:

OFHEO – not enough capital, reduce risk

Treasury – public interest, take on more risk

“It was a tightrope with no safety net” ⁽⁷⁾

- *So...A very fragile economy*
- *A large systemically important (essential) FI*
 - *Which is grossly undercapitalised*
 - *Must make more loans*
 - *In order to save the housing industry*
- *And obviously needs to raise funds in order to do so.*
- *Probably not a good time to express any doubts about capital levels.*

Consequences?

- *Most sophisticated investors were skeptical.*
 - *Share price plummeted*
 - *Spread on debt securities widened*
 - *Debt not rolling over (silent run)*
- *Inevitably -> government takeover*

Collateral damage?

- Unsophisticated investors lost everything
 - (preferred stock wiped out as a result of takeover).
- *Q. Who were these investors ?*
- A. Small banks and S&Ls.
- Regulators had encouraged them to invest in Fannie/Freddie preferred shares. Low risk weights, no concentration limits.
 - “A nice safe investment”
 - (10 insolvent, 74 impaired ⁽⁷⁾)
 - Collateral damage.

Double Standards?

- Disgruntled investors
- *“The US government, with access to information no private investor could summon, had lured investors into a trap. Had the CEO of a private company gone about telling investors that his company had “more than adequate capital” and was in a “sound situation” knowing that the company might be in bankruptcy within weeks, he would have gone to jail for securities fraud.” (6)*

Case Study: Equitable

- The Equitable was in serious financial difficulty (1998 - 2003)
- Lots of negative publicity.
- Closed to new business in 2000.
- Policyholders very concerned.
- 2 Key messages from the Financial Services Authority:
 - 1. The Society was and always had been solvent
 - 2. The Society had always met and continued to meet all regulatory requirements (9 at 10.619)

Was the Equitable Solvent?

- *Q. Was this true?*
- A. Hmmmm.....
- Parliamentary Ombudsman ⁽¹⁰⁾:
 - *The information before them should have led the FSA to realise that the assurances that they were routinely providing were unsustainable on the facts and were misleading.*
 - (Equitable Life : A Decade of Regulatory Failure)

The Equitable

- One of the largest insurers in the UK (£33 billion)
- A Mutual with an unusual philosophy :
 - Minimal Reserves
 - Maximum Bonuses
- Sold deferred annuities.

Recurrent single premiums ---> account

Investment earnings credited to accounts (bonus)

Conversion to an annuity at retirement.

The Equitable

- In a mutual, future profits are generally used to provide future bonuses for policyholders.

1. Over crediting

- Recommended approach to smoothing
 - Hold back some profits now to supplement future bonuses
 - Not-recommended approach
 - Pay higher bonuses now and hope that this will be covered by future profits
 - Equitable's total policy values exceeded assets throughout 1990s (11, 6.54)
- > **Future profits would be needed to pay past bonuses**

1. Future Profits Implicit Item

1994 – Future profits implicit asset

£1000 (in 2000)

Future profits would be used to cover existing liabilities in the event of any adverse experience

-> Hence future profits might be needed to pay for existing liabilities

3. Subordinated Debt

1997 – Subordinated debt

£346 million

Future profits would be used to repay subordinated debt

(Hence some future profits would not be available to pay future bonuses)

4. Financial Reinsurance

- In 1998 the FSA realised that the Equitable had large contingent liabilities arising from guaranteed annuity rate
And they had not set aside any reserves to cover the guarantees
Setting aside the required amount would have made the Equitable insolvent

Solution - Financial reinsurance treaty **£800 million**

Future profits would pay for these claims

5. Expenses

2000 – Quasi Zilmer adjustment **£950 million**

New business expenses would be recouped from future premiums.

So that there would be less available to pay future bonuses.

Overloading ?

- As at 12/2000, future profits would be used for
 - - covering past overcrediting
 - - a reserve to cover adverse experience on liabilities
 - - paying back the subordinated debt
 - - paying the reinsurer under the Fin Re deal for GARs
 - - paying unrecouped expenses on existing policies
 - - and presumably (if anything was left) paying future bonuses
- The main problems being that the company was closed to new business in 12/2000 and then the sharemarket collapsed

Criticism of FSA

- Quasi Zilmer adjustment was contrary to regulations
- Use of Future Profits was inappropriate
- Approval of Financial Reinsurance was wrong
- Without these adjustments the Equitable would have been insolvent

Flexibility in the Use of Discretions

2000 – Hypothecation

£300 million

- This change to the Valuation method will increase assets by £300 million. Approval?
 - *Initial decision, No*
- “But we will be insolvent unless approval is given”.
 - *Final decision: Yes (clearly controversial)*

The Situation Deteriorates

2001 – Mis-selling Liability

£400 million ?

The Equitable was being sued for mis-selling

FSA estimated required reserve as £600 to £700 million

The Equitable set aside £220 million.

Note: Since the Equitable was a mutual, the only source of funds to pay compensation for mis-selling to some policyholders would be by paying less to other policyholders.

Bonuses slashed

New Board early 2001

-> Policy values slashed in July 2001 by 16%

-> And again in 2002, by 20%

This put policy values in line with actual assets

Policyholders not happy

Outcomes

- During the period 2000-2001 the FSA repeatedly assured policyholders that the Equitable was solvent
 - - Letters
 - - Website
- But internal memos reveal that the FSA staff had serious concerns about solvency throughout this period.
- -> Some memos say it is insolvent, others “its very tight”.

Parliamentary Ombudsman

- The PO said
 - - The FSA had no obligation to say anything
 - - but if they did say something, it should be complete, accurate, unbiased information
 - - especially in a country where legislation is based on “freedom with publicity”
- Recommended compensation to policyholders
- -> Govt agreed to 1.5 billion (much less than recommended)

Motivation

Why did the FSA keep saying the Equitable was solvent?

During this period

2000 – Open to new business

- trying to find a buyer
- no one interested
- value of company maximised if a going concern

Outcomes

Parliamentary Ombudsman

- *I am acutely aware that those exercising regulatory functions are often placed in very difficult situations in which they have to exercise judgement in relation to complex matters which require the balancing of a range of often competing pressures and interests.*
-

Outcomes

Parliamentary Ombudsman

- *This is especially the case where they are granted powers by Parliament to protect the interests of citizens but where the use of such powers, if exercised prematurely or without a sound basis, might bring about precisely the outcome – detriment to the interests of those citizens – which the system of regulation was designed to avert.*
-

Outcomes

Parliamentary Ombudsman

- *It is relatively easy for anyone to identify instances where the acts or omissions of others have turned out not to be the most optimal solution to a particular problem – but it is less easy to put oneself in the position of the person who had to take the relevant decision at the appropriate time. In this context, regulators are very often ‘damned if they do’ take action, while at the same time being ‘damned if they don’t’.*
-
- *When reviewing the acts and omissions of regulators, it seems*

Outcomes

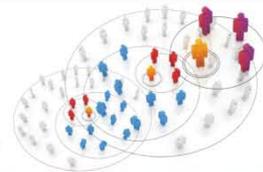
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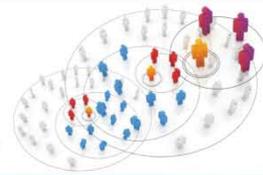
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