How funny numbers drive dangerous behaviour

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What gets measured gets managed

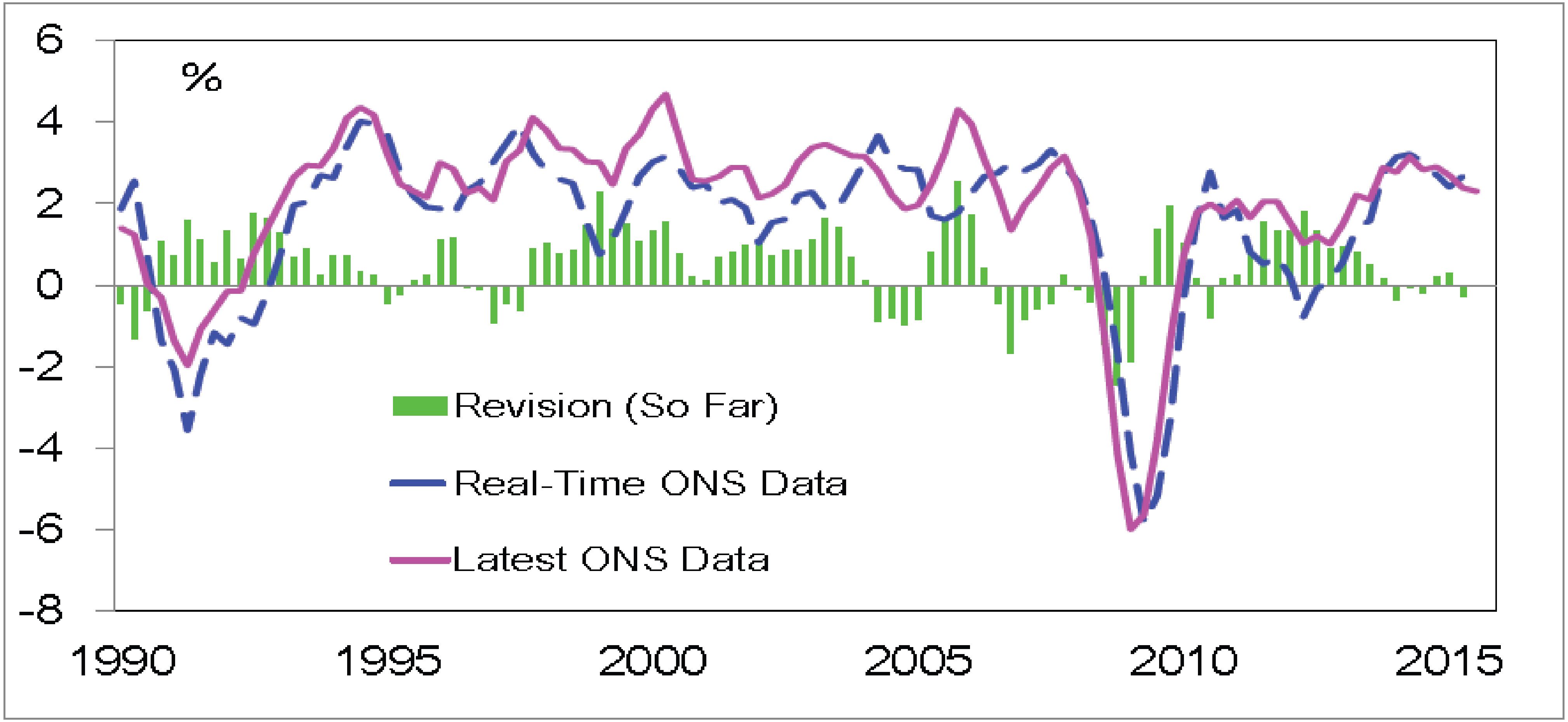
Lord Kelvin, a Scottish physicist commented in 1883:

"I often say that when you can measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot express it in numbers, your knowledge is of a meagre and unsatisfactory kind; it may be the beginning of knowledge, but you have scarcely, in your thoughts, advanced to the stage of science, whatever the matter may be."

The idea that anything important can be measured is deeply engrained in our economic system: numbers are critical inputs into decision-making at all levels in society

Numbers that matter to policy-makers

UK real-time and revised data for YoY Growth in real GDP 1990-2015



Sources: ONS and Citi Research

Numbers that matter to investors: Accounts

Is my capital being deployed in a way which creates enduring value?

A brief history: Merchants to Companies Act 1947

Today accounts are at the heart of our system of corporate governance:

> *Given the separation of ownership from management, the directors are required to report on their stewardship by means of the annual report and financial statements sent to the shareholders. [Cadbury, 1992]*

A core accounting principle was established:
prudence to underpin capital protection

A brief history continued

The early accountants understood the importance of the numbers they presented:

- Investors allocate capital between companies based on accounts
- Executives allocate capital within companies (and their pay is often linked to accounts)

They understood the dangers of overstating profits or capital in an uncertain world: insolvency

Prudence was the bulwark against the impulsive executive:

- No early recognition of profits: only when an exchange had taken place (legally)
- Immediate recognition of foreseeable / likely losses

But as the world has sought an international set of accounting standards (IFRS), a new imperative came to the fore: a desire to support trading in capital markets

- Prudence was downgraded
- “Efficient Market Hypothesis” has become a predominant underpinning philosophy

Banks and the febezzle: a cautionary tale

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The ‘febezzle’ (Charlie Munger): *a “febezzler” benefits from legally appropriated money, but the victim does not yet know that he will have to pay for it.*

Profits recognised today, costs for shareholders (and society) paid later.

A story of how the banking crisis was facilitated by imprudent accounts:

- **Know-nothing shareholder provides equity capital to Best Bank** and is promised a steady flow of dividends and stock appreciation
- **KN watches contentedly** as BB reports rapid growth, substantial profits and a comfortable capital cushion.
- **KN doesn’t worry about reports of easing lending standards**. The share price is strong.
- **KN is happy to pay large increases in bonuses** as a price for stupendous performance.
- **KN cannot understand the change in mood**. Overnight the markets have gone into cardiac arrest. BB’s share price falls precipitously.
- **BB announces large write-downs.** Profits give way to enormous losses, and the capital buffer the bank reported just last quarter disappears.
- **The government has stepped in** with a multi-billion pound capital injection.

Banks and the febezzle: prudent accounts would have helped

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- **All-knowing shareholder demands prudent accounts** from Best Bank to ensure a reliable assessment of profits and capital
- **AK watches carefully** as BB builds its business through sensible lending policies and credit checks.
- **BB sets aside transparent reserves** to cover a prudent estimate of likely future losses in its loan book (and elsewhere).
- **On its trading book, BB ensures that real gains from sales are separated** from mark-to-market (MTM) gains that the bank could theoretically realise, but has not. Only realised gains are recorded in profits.
- **BB expands its business steadily and profits are reasonable**. Bonuses are also acceptable, and are paid for the delivery of performance over the business cycle.
- **The economy shows signs of stress**. A mild recession puts downward pressure on profits, but the bank continues to pay dividends as it has already provisioned for expected loan losses.

Local Authority Pension Fund Forum (2011): UK banks that failed between 2008 and 2010 lost virtually double their reported capital in 2007. In other words, shareholders' equity was wiped out almost twice over.

Sir Mervyn King, Govenor, BoE (2012): There are "good reasons" to think current capital ratios do not give an accurate picture of financial health. May require up to £35bn new capital.

Lessons for accounting

Prudence must be restored as a cornerstone accounting principle to underpin capital protection:

- Foreseeable losses must be accounted for – not ignored leading to the overstatement of lending profits
- MTM gains must be separated from realised gains – and only realised gains count towards profits

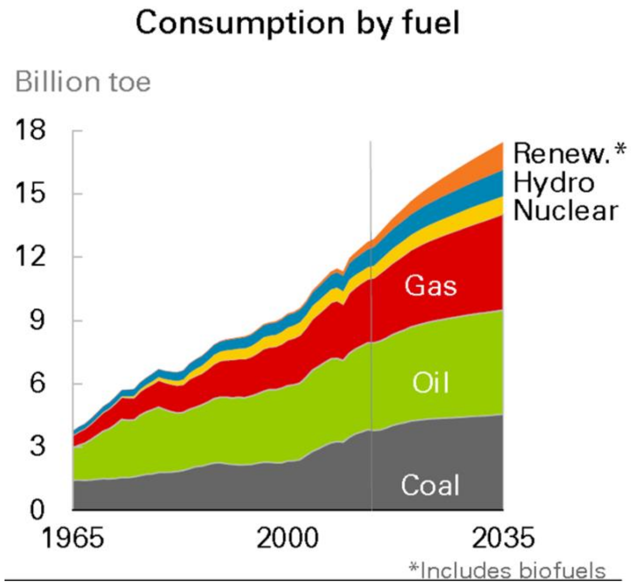
Judgment should be permitted to avoid perverse outcomes

Independent auditors ensure the accounts present a true and fair view

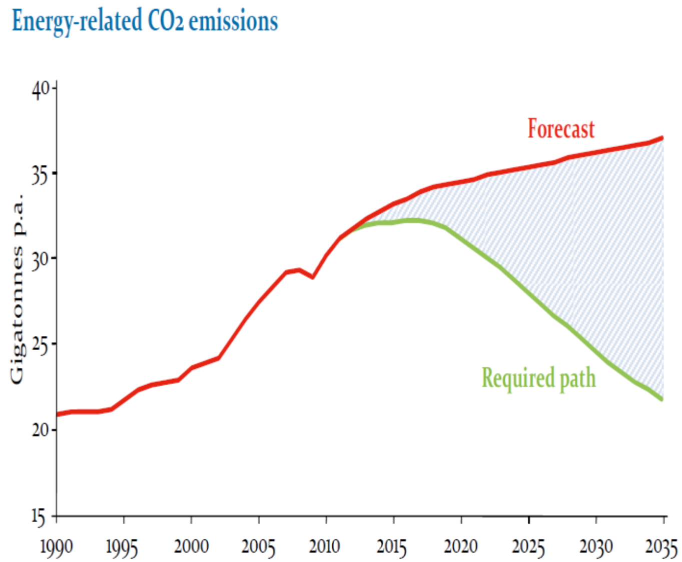
The next big febezzle in fossil fuel companies?

A "febezzle" occurs where the febbezler benefits from legally appropriated money, but the victim does not yet know that he will have to pay for it. ***Profits recognised today, climate costs externalised****.*

- Climate change is the greatest threat the world faces
- Scientists have determined a safe course for the world: GHG concentration capped at 450ppm
- 70-80% of proven fossil fuel reserves must stay in the ground & the world must decarbonise by 2100
- Governments are acting to reduce emissions
- Companies are in denial



Source: BP Energy Outlook 2035 [February 2015]



Source: A Global Apollo Programme to Combat Climate Change [2015]

A fossil fuel febezzel?

Coal, oil and gas companies must either:

1. Find a technological fix (affordable CCS),
2. Reinvent themselves as clean energy providers (renewables), or
3. Run themselves down

Threat is foreseeable and probable: it should be clearly articulated in annual reports as a risk

Accounting implications:

- Are profits today overstated?

They fail to take account of the future costs imposed on society, which could eventually be borne by the company: Carney's "liability risk" from compensation claims from victims

- Is capital overstated?

  In due course, assets will need to be impaired as prices for fossil fuels fall.

Funny numbers: what might be done?

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Recognise the underlying problem: Accounting for other people's money involves:

- Conflicts of interest
- The resistance to accountability / transparency

Recognise accounting is an <u>art not a science</u>: subject to manipulation whatever the rules:

- The system should be principles-based & supported by independent audit
- "The surest way to report stable profits is to make the numbers up" (Kay, May 2009)

Determine a clear objective

- To support responsible long-term stewardship through the prudent determination of profit and capital

Ensure the public interest is taken into account

- Do not leave the rules governing how numbers are reported to a vested interest group

Looking back to look ahead: preventing the next febezzle

"[This] is how we came to experience a decade of gross febezzlement. Bankers floated businesses that would never generate any cash, traders exchanged debt securities at inflated prices, consumers took out loans they couldn't afford… febezzlers borrow from the future with no intention to repay. When the future arrived in 2007, we learnt that others had febezzled from us on a massive scale. And that we had also febezzled from ourselves."

John Kay, May 2009

Perhaps we can learn from our mistakes:

"From a regulator's perspective the point is not that a reassessment of values is inherently unwelcome. It is not. Capital should be allocated to reflect fundamentals, including externalities…The more we invest with foresight; the less we will regret in hindsight."

Mark Carney, Speech to Lloyd's of London 29th September 2015

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