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# Treasury - Written Evidence

## Banking Crisis

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## Memorandum from Carmel Butler

CONSUMER AND TAX PAYER

> "|Let us be clear that the reason for today's injection is the lack of openness and honesty by the banks on the amount of bad debts that they have on their books|"
> JOHN McFall MP[105]

1. The banks have stated their case. They say: the banking crisis ensued from bad borrowers to bad debts to toxic assets to taxpayer support. The banks with their powerful lobby, powerful public relations and easy access to the media have framed the public debate. Consumers on the other hand do not have such powerful infrastructure to effectively rebut the bankers' defamatory accusations. This written evidence challenges the bankers' version and endeavours to dispel the bankers' myths. The chain of events is rooted in lenders' abuse of unfettered power to impose unsustainable interest and charges on consumers combined with their determination to avoid contributing to the public purse.

2. The evidence contained in this memorandum is focused on two fundamental issues. Firstly, the consumer issues that arise in the context of Special Purpose Vehicles ("SPVs") that are incorporated as securitisation companies who issued the infamous "toxic-assets"; and secondly, the taxpayer heist at the hand of the SPV securitisations companies. The evidence will illuminate the hitherto hidden

truth that the tax payer is supporting the profits of foreign owned companies incorporated in tax havens and their private investors.

## BRIEF INTRODUCTION

3. I am British Citizen resident in the UK and a qualified lawyer admitted to practice in New York, U.S.A. I have an LLB Laws from the London School of Economics and a JD (Juris Doctor) from Columbia University, New York. I practiced securities law at Sidley Austin LLP New York office from September 2006 to December 2007. Whilst at Sidley Austin I worked on various Structured Finance transactions such as mortgage securitisations, CDOs and various derivatives. I am also a consumer of a mortgage product that has been securitised. Consequently, as both an ex-practitioner of securitisations and a consumer subjected to a securitisation, the intention is to focus on consumer issues that arise from mortgage securitisations, its central causal role in the banking crisis and its detrimental effect on the economy and public purse.

## SUMMARY OVERVIEW

4. Six key submissions are evidenced in this memorandum:

   — Passing on the Interest Rate Cuts (see paras. 5 to 13). Banks do not pass on the interest rate cuts to borrowers because they do not have that power. That power is vested in the SPV securitisation companies.
   — Openness and Honesty (see paras. 14 to 37). The Government has saved banks from the allegedly bad debts on their books. But banks are unable to say the extent of the bad debt problem. This is because, in truth, there are no bad debts of any significance. Two sleights-of-hand are discussed under the headings "the legal ruse" and "the auditor ruse". Enlightenment of the combined effect of these manoeuvres explains how the allegedly bad debts appear on the banker's books.
   — The FSA Regulatory Role (paras. 38 to 43). The Practitioners Panel have called for rigorous enforcement of the FSA's MCOB rules. Consumers would concur with this principle.
   — The Fallacy of Financial Advice (see paras. 44 to 52). The source of this issue is the mortgage originators' failure to disclose material facts on the products sold to consumers. The lenders' concealments render independent financial advice a nullity and an academic exercise.
   — The Rule of Law—Repossession or Dispossession? (paras. 53 to 78). The Financial Services Practitioner Panel calls for the faithful application of the rule of law with respect to the performance of contractual obligations. There is no difficulty in concurrence with this principle. Accordingly, the Treasury Committee are invited to consider the SPV securitisation companies' performance of its contractual obligations and the effect of their abrogation from such obligations on the functioning of the mortgage market.
   — The Perfect Storm (paras. 79 to 88). The cause of the banking crisis is widely mooted as the abrupt closure of the wholesale money markets in August 2007 but the public debate on why the market seized is conspicuously absent. It is submitted that new tax laws were the catalyst instilling fear which caused the flight. The money-men fled from securitisation companies on the real prospect of their being called upon to contribute to the Treasury. The liquidity had to be filled. The tax-paying public was rallied to fill the gap and to suffer the economic fall-out. Paragraphs 83 to 86 recommends: a potentially effective solution in which

the Government can revive the housing market and economy without the need for the banker's acquiescence to the hitherto unheeded pleas for the bankers to commence lending.

— Conclusion (paras. 89 to 91). Confusion through concealment creates complexity. Transparency is the antidote. Once illuminate, securitisation is simple. Follow the asset and follow the cash which reveals that the supreme beneficiaries of the crisis are the banks, the SPVs and their investors.

— Recommendations: The Committee is invited to consider the recommendations at paragraphs: 37, 43, 52, 79 and especially the recommendation at paragraphs. 85 to 88.

PASSING ON THE INTEREST RATE CUTS

5. The Committee has rightly been concerned to elicit a reason for banks failure to pass on the Bank of England interest rate cuts to borrowers and yet, do pass on the interest rate cuts to the savers[106]. The answer to the question is simple. The banks have passed the interest rate cuts to the savers because the banks have the power to set the interest rate for the savers. Conversely, the banks do not have the power to pass the interest rate cuts to the borrower.

6. This is because, the banks have sold the mortgage contracts to the SPVs and it is the SPVs alone, that have the contractual power to determine the borrowers interest rates. Consequently, it is the SPVs that decide whether or not to pass on the interest rate cuts. It is the SPVs that have decided not to pass on the interest rate cuts.

7. This fact is evidenced by the various and respective Prospectuses that the SPVs file at the UK Listing Authority. In general, the bank that originates the loans will make a True Sale[107] of the mortgages to the SPV which means the contractual power to set the borrower's interest rate is vested in the SPV.

8. Following the bank's True Sale of the mortgages, the bank's contractual relationship with the borrower is extinguished. The SPV, as assignee, becomes the party that is in privity of contract with the borrower. However, neither the bank nor the SPV inform the borrower of the SPV's ownership of the mortgage contract.[108] The SPV will remain concealed. The borrower is unlikely to discover the SPV's ownership of their mortgage contract because, following the sale to the SPV, the bank and the SPV enter into a contract wherein, the bank agrees to administrate the mortgages on behalf of the SPV and in return, the SPV remunerates the bank for its administrative services. Consequently, whilst the bank has extinguished all its right and title to the consumer's mortgage contract, the bank's connection to the consumer's mortgage is through its administration agreement with the SPV only. Following these legal manoeuvres: (i) the consumer and the SPV are in privity of contract under the mortgages; (ii) the bank and the SPV are in privity of contract through their administration agreement; and (iii) the world will remain ignorant of these events because, the bank continues to service the loans as if nothing has happened.

9. Therefore, the bank's only interest in the loans following its True Sale of the mortgages is that of a mere administrator and servicer of the loans. It is the SPV that is the bank's client from whom the bank earns its servicing fees and from whom it receives its instructions. Consequently, the bank's loyalty is to SPV client only. The power to set the borrowers interest rates is a contractual power contained in the mortgage contract: a fortiori when the contract is sold to the SPV, the contractual power to set the borrowers interest rates is vested in the

SPV and not the bank. Therein is the reason why the banks have not passed-on the interest rates cuts. It is simply because: they cannot. They must, in accordance with their administration agreement with the SPV, implement the interest rate policy of their client, the SPV.

10. Evidence of these submissions is best demonstrated by example. In the case of Northern Rock, the SPV has given Northern Rock the authority to set the interest rates. However, Northern Rock has undertaken to set the interest rate at a level that not only covers Northern Rock's administration costs, it is contractually obliged to set the rate at a level sufficient to support the entirety of all the administration costs, expenses and profits of each of the numerous entities involved in the securitisation structure[109]. This means that Northern Rock must set the interest rate at a level that will ensure the SPV suffers no revenue shortfall. In the event that Northern Rock fails to set the rate at a level sufficient to satisfy the SPVs required revenue, then the mortgage trustee may "notify the administrator that the standard variable rate and the other discretionary rates or margins for the mortgage loans should be increased the administrator will take all steps which are necessary to effect such increases in those rates or margins."[110] Consequently, Northern Rock may only exercise the interest rate pursuant to the SPV's authority to do so under the terms of its administration agreement, and in any event must set the rate at levels to the satisfaction of its SPV client. In other words, Northern Rock does not have the autonomous power to set the rates independent of its SPV client. Accordingly, it is the SPV that controls the interest rate setting power.

11. Whilst Northern Rock has been used as the example, the Treasury Committee is reminded that this circumstance is not unique to Northern Rock. It is standard to most SPVs. In conclusion, it is recommended that the Committee encompass within its inquiry consideration of the role of the SPV in the banking crisis and the relationship between the banks and the SPVs.

12. Finally, if the Government is determined that the interest rate cuts are passed on to the borrowers, it must ask the SPVs.

13. In conclusion, this means that the correct answer to the Committee's question No. 170[111]: ". . . Are the banks just pocketing a few bobs for themselves here?": the full and correct answer is—No, it is the SPVs that are pocketing a few bobs for themselves.

OPENESS AND HONESTY

14. There are no bad debts on the bank’s books. And if there is any bad debt, the amount is de minimis. A primary purpose of a securitisation is: to remove the credit risk from the bank's books. The bank, under a `true sale' will sell all its rights and title in the mortgages to the SPV and the SPV will in return pay the bank cash for the mortgage assets. This plain truth has remained elusive because under the terms of the true sale contract, **the bank and the SPVs have unlawfully agreed to keep the transaction concealed from the borrower and, from H.M. Land Registry**. Thus, giving the false appearance to the world that the banks still own the mortgages.

15. Two sleights-of hand are at play in this manoeuvre. One is the legal ruse, the other the auditor ruse. This is not to suggest that the professions have conspired, they are each compartmentalised and each are generally unaware of the combined effect.

THE LEGAL RUSE

16. First, the legal ruse. The law provides mortgagees with a statutory power to transfer a legal charge.[112] It is under these statutory provisions that the banks exercise their right to assign the mortgages to the SPVs. In a contract of sale that provides for a disposition[113] of an interest in land, the legal title will be conveyed immediately from the seller to the buyer[114] on the completion date. There can be no doubt that on completion, the buyer has acquired the legal title, but there will inevitably be a "registration gap" between the conveyance date on which the buyer acquired the legal title and the date on which his legal title is registered at H.M. Land Registry. During this registration gap, the law provides that the buyer's title: "does not operate at law until the relevant registration requirements are met".[115]

17. This is where the legal ruse comes into play. It is this "registration gap" that the SPV unlawfully exploits in order to conceal its ownership and control of the mortgages. Under the Land Registration Act 2002 ("LRA 2002"), the transferee[116] of a registered charge is required to register at H.M. Land Registry, its ownership of the mortgage that it purchased.[117] Therefore, it is a legal requirement that the SPV register its proprietorship of the mortgage at H.M. Land Registry. Whilst the law implicitly permits the registration gap as a matter of pragmatism, the law also implicitly mandates that the registration requirements are to be observed expeditiously. Nonetheless, in contumacious disregard for its legal duty to comply with the registration requirements of the LRA 2002, the contract of sale expressly provides that the SPV will not register the transfer at H.M. Land Registry indeed, the contract provides that notice of the transfer is to be concealed from the borrowers and H.M. Land Registry and a fortiori concealed from the world[118].

18. The suppression and concealment of this information from H.M. Land Registry is a criminal offence[119], and in furtherance of this offence[120], the SPV's legal title to the mortgages is also concealed from the county courts and the Government. The Banks remain registered as the proprietor of the mortgages and accordingly all interested parties are deceived by this concealment with one exception. The SPV does inform its investors that the bank sold its legal title to the SPV (to whom, the right to register the legal title to the mortgages is important). Consequently, the bank appears to be the legal owner, but it is not.

19. For example, in the case of Northern Rock as the seller of mortgages, the prospectus states: "under the mortgage sale agreement dated March 26, 2001 entered into between the seller, the mortgages trustee, the security trustee and Funding, the seller assigned the initial mortgage portfolio together with all related security to the mortgages trustee|"[121]. Additionally, under the terms of Northern Rock's mortgage sale agreement, it is, "entitled under the terms of the mortgage sale agreement to assign new mortgage loans and their related security to the mortgages trustee". [122] (bold emphasis added).

20. Northern Rock may remain falsely registered as the putative `legal owner' but in truth, Northern Rock is merely the administrator of the mortgage loans. Again the Prospectus states: "The seller acts as administrator of the mortgage portfolio under the terms of the administration agreement, pursuant to which it has agreed to continue to perform administrative functions in respect of the mortgage loans on behalf of the mortgages trustee and the beneficiaries, including collecting payments under the mortgage loans and taking steps to recover arrears."[123] (Bold emphasis added).

21. The legal reality is that: (i) Northern Rock sold its legal title to the SPV, in this case, to Granite Finance Trustees Limited[124] and therefore, Granite is the legal owner; (ii) Northern Rock is the administrator of the mortgages and falsely holds itself out as the legal owner of the mortgages; (iii) Granite Finance Trustees Limited should be, but is not, registered as the owner of the mortgage; and (iv) all these facts remain concealed because Granite and Northern Rock have unlawfully contracted to suppress this information from H.M. Land Registry.

22. Notwithstanding that the SPV conceals its legal title from H.M. Land Registry, the SPV will, nonetheless, avail itself of, and exercise, all the statutory and contractual legal powers that the legal owner enjoys. For example, the SPV will exercise the legal owner's statutory power to create a legal charge [125] on the borrower's mortgages. The **SPV will file at Companies House a Form 395** "Particulars of a Mortgage or Charge" within the statutory 21 days, to register the Legal Charge that the SPV created against the mortgage loans in favour of the SPV's trustee, as security for the payment of money due to its investors and creditors.[126]

23. The SPV's exercise of the legal owner's contractual and statutory legal powers leaves no doubt that SPV is: the legal owner of the mortgages. Nonetheless, the banks and the SPV unlawfully exploit the "registration gap" in a smoke and mirrors tactic to cause confusion and conceal the SPV's legal title. The SPV is the legal owner. The banks are the administrators.

THE AUDITOR RUSE

24. The Treasury Committee has endeavoured to discover the amount of bad debts on the banks' books. An answer to that question has hitherto evaded an adequate response. As discussed above, the bank has sold the mortgages and thereby transferred the credit risk to the SPVs which means, that the banks do not have these (allegedly) "bad" debts on their books.[127] Therefore, to provide the Committee with the full answer, the question must be re-framed as: having sold legal title to the debts, how do these allegedly "bad" debts appear back on their balance sheets?

25. Likewise as discussed above, the SPVs legal title to the mortgages is also concealed from the auditors. The auditors know that the bank originated and owned the mortgage loans and therefore, the mortgage loans are initially and correctly `recognised' as an asset on the bank's books. However, when the bank securitises that asset, the bank has sold the asset to the SPV. This means that the SPV owns both the benefits and the credit risks of the assets. Accordingly, the bank's transfer and sale of legal title should result in the assets being `derecognised' as an asset on the banks' books. However, the auditors continue to recognise the assets on the bank's books. This is because of an inadvertent erroneous evaluation and application of the IAS39 accounting standard.

26. IAS39 sets out three main scenarios in which an asset will be derecognised and removed from the bank's books. Under any one of these three scenarios, the mortgage loan assets that have been securitised should be derecognised with the consequent effect that the assets are removed from the bank’s books.

27. The mis-application of the IAS39 derecognition policy is best illustrated by the following example. In the Northern Rock's Annual Report and Accounts 2007, the derecognition policy states:[128] "The Group also derecognises financial assets that it transfers to another party provided the transfer of the asset also transfers the right to receive the cash flows of the financial asset." In a

securitisation, that is exactly the legal effect. However, auditors are called upon to make an evaluation of the bank's legal rights in their analysis. The auditor must determine who has the legal right to the cash flows. Understandably, an auditor is not best qualified to make an accurate legal determination. Nonetheless, the auditors do see that: (i) the bank's legal title is still registered at the Land Registry (albeit falsely); (ii) the auditors see the bank's administration of the mortgage loans; and (iii) the auditors see the cash flows from the mortgage loans are paid to the bank. In contrast, the auditors do not see (iv) the contract of sale wherein the bank transferred to the SPV, all its title and rights to the asset; (v) do not see the bank's administration agreement with the SPV which evidences the bank's interest is merely authority to administrate the mortgage loan asset; and (vi) do not see that the bank has no right or title to the cash flows it receives from the mortgage loans. Consequently, the auditors understandably fail to accurately evaluate the legal rights and accordingly fail to derecognise the asset. As a result, the asset erroneously remains recognised as an asset on the bank's book.

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