

J.F.C. van Velsen

Governed by Lies

Report of an effort to understand society and history, and learn from it.
Observations, analysis and corrective measures.

For the victims.

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By way of a preface.

William Shakespeare (1564-1616)

Hamlet

To be or not to be, that is the question:
whether 'tis nobler in the mind to suffer
the slings and arrows of outrageous fortune,
or to take up arms against a sea of troubles,
and by opposing, end them.¹

¹ Hamlet, III, i, 55-59.

Mark Knopfler (1949-)

Private investigations

It's a mystery to me,
the game commences,
for the usual fee, plus expenses;
confidential information,
it's in a diary;
this is my investigation:
it's not a public enquiry.

I go checking out the reports,
digging up the dirt;
you get to meet all sorts in this line of work.

Treachery and treason,
there's always an excuse for it;
and when I find the reason
I still can't get used to it.

And what have you got at the end of the day?
what have you got to take away?
a bottle of whisky and a new set of lies,
blinds on the windows
and a pain behind the eyes.

Scarred for life, no compensation:
private investigations.²

² From *Love over gold*, 1982.

Louis de Rouvroy, duc et pair de Saint Simon (1675-1755)

**To know
whether it is permitted to write and read history,
in particular that of one's own time.**

From the preface of his memoirs, written in 1743.

Do these scrupulous people want us to believe that God demands of us what is opposed to himself? For he is light and truth. Would he ask of us that we blind ourselves in favor of the lie, out of fear to see the truth? Do they want us to believe that he has given us eyes to keep them fully closed to all events and people, that he has given us mind and reason to be used only to dull them and to make us completely coarse, stupid, and ridiculous, and perfectly incapable of being tolerated among even the most tolerant people?

Let us worship the Creator more reasonably, and let us not reciprocate the salvation which the Savior acquired for us with total dulling and the perfectly impossible. He is too good to want the one, and too just to require the other. Let us flee the extremes which only lead to the abyss, and, with Saint Paul, let us be more afraid of pushing our wisdom beyond its just limits than to measure it by sobriety. So let us use the faculties which it pleased God to give us, and let us not believe that charity forbids us to see all kinds of truths, and to judge the events and all that goes together with them. We must love ourselves at least as much as others. We owe ourselves at least as much charity as others: we must thus instruct ourselves, to avoid being dumb and stupid, and to be duped continually.

We should not fear, but endeavor to understand good and bad people, in order not to be cheated, and, on the basis of wise discernment, determine our conduct; for both are necessary, and depend on one another. Let's make a mirror of this knowledge, to form and determine our manners; flee, avoid, and detest what must be; like, esteem, and serve what merits it, and to approximate the ideal by imitation and noble or holy emulation.

So let us know, as good as possible, the merits of people and the price of things: the great difficulty is not to make mistakes in a world which for the major part is carefully concealed, and let us understand that knowledge is always good, but that good and bad depend on the use that is made of them. That is where scruples need to be applied, and where Christian morality and the extent of charity, in short the new law, must incessantly enlighten and contain our steps; and they should not be let loose on knowledge of which we cannot acquire enough.

The bad people who, in this world, already have so many advantages over good people, would have another rather strange advantage against them [= the good people], if it were not permitted good people to discern them, to know them, and consequently to avoid them, to inquire who they are, what they have done with respect to the events of life, and, if they played a small or important role, to show them to posterity as they are, and what they have been, when telling the history of their time. And on the other hand, as regards this world, the good people would be rather maltreated if they were to remain, like wild animals, exposed to the bad ones uninformed, and consequently without defense, and their virtue buried together with them. In this way, all truth would become extinct, all examples useless, all instruction impossible, and all providence restricted to the domain of faith, but destroyed in the eyes of men.

Let us therefore distinguish between what charity asks of us and what it does not ask, and what it does not want to ask because it does not want to ask anything harmful, and that its light becomes the mother of blindness. Charity, which asks us to love our neighbor like ourselves, by this command alone decides the question. By this command she forbids quarrels, harm, hate, insults, slander, piquant mockery, and scorn. All this concerns the interior emotions which one must repress in oneself, and the exterior effects of these things which are forbidden in social intercourse. It forbids to harm, and even wish to harm, anyone in any way; but, however absolute and comprehensive this command may seem to be, one has to acknowledge that it has its limits and exceptions. The same charity which imposes all these obligations does not forbid seeing things and people as they are; she does not demand, on the pretext that one should love people because they are our brothers, to love their faults, their vices, their bad designs, and their crimes; she does not ask us to expose us to them; she does not forbid, but even requires one to warn those whom they threaten, even those whom they regard; so that they can protect

themselves against them; and she does not forbid one to take all legitimate measures to safeguard oneself.

In the lives of the most venerated and illustrious saints everything is full of this practice. They did not hold back the discovery of the ugliest facts, nor the bitterest invectives against the malicious persons against whom they had to defend themselves or whom they believed they should discredit; and when I say malicious persons, this expression only means to exclude vague generality, and to show that they addressed persons of their own time, and sometimes with the highest positions in the Church or the world. The reason for this conduct is evident: it is that charity is only meant for the good, and, under this condition, for people; but, as soon as it detracts from the good and only concerns people, it is clear that charity is due to the good at the cost of the bad, whom it is not permitted to allow free scope to oppression nor to harm the good people, without warning and defending them, and making known as much as possible the tricks, bad intentions, dangerous conduct, and even the crimes of the bad, who, given free rein, become the masters of all their undertakings, and will surely always succeed against the good, and who, notwithstanding these aids, overpower them so often.³

From this explanation follows another: namely that the Christian, whom charity forbids to speak badly of, and to harm his fellow-creature, and to the full extent indicated above, is for the same reason obliged to do the opposite in certain cases, different again from those which were noted earlier. Those who have the confidence of the generals and ministers, and even more those who have the confidence of princes, may not leave them ignorant of the manners, conduct, and activities of men. They should let them know people as they are, to safeguard them against traps, surprises, and most of all against bad choices. This is a form of charity due to those who govern, and which in the first and most important place regards the public, which should always be preferred to the individual. The leaders of the public interest, as a whole or for a part, are too busy with public affairs, too circumvented, too flattered, too easily abused and cheated by the great interest to do so, to be able to properly disentangle and discern. They are wise if they let themselves be enlightened about the persons, and happy when they find true and faithful friends who prevent them from being seduced; and the public, or the part of the public which is governed, is much obliged to those enlightened advisers who protect it against many kinds of administrations from which it always has to suffer so much when they fall in bad hands. And it does not suffice for those who have the ear of the masters of the era to wait until they are consulted about certain bad people: they must know their master's tastes, their weaknesses, and the ambushes laid for them, and prevent them from falling into them. They must consider themselves placed for that purpose in the confidence of these masters of the era; and especially those who have the confidence of those favorites who can say everything should not neglect to inform them, and make themselves useful for society in this way. It is the same towards the close relations and the friends.

If it is obvious, as shown above, that charity allows self-defense, and even to attack malicious people; if it wants good people to be warned and supported; if it requires that those who have positions in public administrations are informed openly about people and affairs, although all these steps cannot be made without harming in a very direct and very radical way reputations and fortunes, then with more reason charity does not forbid to write, and consequently read, the general and particular histories.

³ The present author is not sure that he understood the original of this sentence correctly. The original may be linguistically and/or grammatically incorrect. The difficulty can be traced to the “de[s] personnes et de personnes”, and the “à qui”. Where the [s] indicates a difference between the editions of Boislisle (with the s) and Coirault (Pléiade).

William Lawrence Shirer (1904-1993)

The rise and fall of the Third Reich A history of Nazi Germany

From the preface.

Some may think that it is much too early to try to write a history of the Third Reich, that such a task should be left to a later generation of writers to whom time has given perspective. I found this view especially prevalent in France when I went to do some research there. Nothing more recent than the Napoleonic era, I was told, should be tackled by writers of history.

There is much merit in this view. Most historians have waited fifty years or a hundred, or more, before attempting to write an account of a country, an empire, an era. But was this not principally because it took that long for the pertinent documents to come to light and furnish them with the authentic material they needed? And though perspective was gained, was not something lost because the authors necessarily lacked a personal acquaintance with the life and the atmosphere of the times and with the historical figures about which they wrote?

In the case of the Third Reich, and it is a unique case, almost all of the documentary material became available at its fall, and it has been enriched by the testimony of all the surviving leaders, military and civilian, in some instances before their death by execution. With such incomparable sources so soon available and with the memory of life in Nazi Germany and of the appearance and behavior and nature of the men who ruled it, Adolf Hitler above all, still fresh in my mind and bones, I decided, at any rate, to make an attempt to set down the history of the rise and fall of the Third Reich.

"I lived through the whole war," Thucydides remarks in his *History of the Peloponnesian War*, one of the greatest works of history ever written, "being of an age to comprehend events and giving my attention to them in order to know the exact truth about them."

John Locke (1632-1704)

An Essay Concerning Human Understanding

Of the abuse of words

[...] language is often abused by figurative speech. Since wit and fancy find easier entertainment in the world than dry truth and real knowledge, figurative speeches and allusion in language will hardly be admitted as an imperfection or abuse of it. I confess, in discourses where we seek rather pleasure and delight than information and improvement, such ornaments as are borrowed from them can scarce pass for faults. But yet if we would speak of things as they are, we must allow that all the art of rhetoric, besides order and clearness, all the artificial and figurative application of words eloquence hath invented, are for nothing else but to insinuate wrong ideas, move the passions, and thereby mislead the judgment; and so indeed are perfect cheats: and therefore, however laudable or allowable oratory may render them in harangues and popular addresses, they are certainly, in all discourses that pretend to inform or instruct, wholly to be avoided; and where truth and knowledge are concerned, cannot but be thought a great fault, either of the language or person that makes use of them. What and how various they are, will be superfluous here to take notice; the books of rhetoric which abound in the world, will instruct those who want to be informed: only I cannot but observe how little the preservation and improvement of truth and knowledge is the care and concern of mankind; since the arts of fallacy are endowed and preferred. It is evident how much men love to deceive and be deceived, since rhetoric, that powerful instrument of error and deceit, has its established professors, is publicly taught, and has always been had in great reputation: and I doubt not but it will be thought great boldness, if not brutality, in me to have said thus much against it. Eloquence, like the fair sex, has too prevailing beauties in it to suffer itself ever to be spoken against. And 'tis in vain to find fault with those arts of deceiving, wherein men find pleasure to be deceived.⁴

⁴ III, X, 34 on p. 508 of the edition edited with an introduction by Peter H. Nidditch, Clarendon Press, Oxford, 1979.

Alexander I. Solzhenitsyn (1918-2008)

The Gulag Archipelago, Volume 2⁵

To taste the sea all one needs is one gulp.⁶

In the army even a fool and a nonentity can command, and, in fact, the higher the post he occupies, the greater will be his success. While a squad commander has to have a quick grasp of things, inexhaustible energy and courage, and understanding of the soldier's heart- it is quite enough for one marshal or another to be peevish, to curse, and to be able to sign his name. Everything else will be done for him, and the plan of operations will be brought him by the operations section of his staff, some bright officer with an unknown name. The soldiers will execute the orders not because they are convinced of their correctness (for often it is precisely the reverse), but because orders come from top to bottom through the hierarchy, and they are the orders of a machine, and whoever does not carry them out will have his head cut off.⁷

Out of one hundred natives [of the Gulag camps]- five are thieves, and their transgressions are no reproach in their own eyes, but a mark of valor. They dream of carrying out such feats in the future even more brazenly and cleverly. They have nothing to repent.⁸

⁵ Translated from Russian by Thomas P. Whitney.

⁶ P. 7. The page numbering is from the first edition by Harper and Row, New York, 1975.

⁷ P. 176.

⁸ P. 598.

Erasmus of Rotterdam (ca. 1467-1536)

To the illustrious prince Ernst, duke of Bavaria, 1517.

I admire the Alexander of the Greek history writers just as little as the Achilles of Homer; both are the worst example of a good prince, even though we could possibly find some good qualities between all their vices. Was it really worth while to make a carnage of Africa, Europe and Asia, only to indulge the wishes of a senseless young man, whose ambition could not be satisfied with the whole earth? It is quite good that fortune, otherwise not so compliant, denied these scourges a long life.⁹

⁹ Translated from the Dutch text on pp. 139-140 of *De correspondentie van Desiderius Erasmus (The correspondence of Desiderius Erasmus*, volume 5, Ad. Donker, Rotterdam, 2008), which was translated from latin by M. J. Steens. (This series does not present the correspondence, but only the letters sent by Erasmus).

Lev Nikolayevich Tolstoy (1828-1910)

War and Peace

Not only on that day, when he rode over the battlefield [of Borodino] strewn with men killed and maimed- by his will as he believed- did he, looking at them, calculate how many Russians had fallen for each Frenchman, and did he deceive himself into finding reason to rejoice about the conclusion that five Russians had fallen for every Frenchman. Not only on that day did he write in a letter to Paris that the battlefield was *superb*, because it was littered with 50,000 corpses; but even on the island of St. Helena, in peaceful solitude, where he had said that he wanted to devote his leisure to writing an account of his great deeds, he wrote:

«The Russian war should have been the most popular war of modern times: it was a war of good sense, for real interests: the tranquility and security of all; it was purely pacific and conservative. It was a war for a great cause, the end of uncertainties and the beginning of security. A new horizon and new labors would open out, full of well-being and prosperity for all. The European system was founded; all that remained was to organize it.

Satisfied about these great points and with tranquility everywhere, I too should have had my *congress* and my *holy alliance*. Those ideas were stolen from me. In that association of great sovereigns we would have discussed our interests as in a family, and rendered account to the peoples as clerk to master. In this way Europe would soon have become truly one single nation, and anyone traveling anywhere would have found himself always in the common fatherland. I would have asked freedom of navigation of all rivers, that the seas should be free for all, and that the great standing armies would be reduced to mere guards of the sovereigns.

Back in France, in the bosom of the great, strong, magnificent, quiet, and glorious fatherland, I would have proclaimed her frontiers immutable; all future wars purely *defensive*, and all new aggrandizement *anti national*. I would have associated my son in the Empire; my *dictatorship* would have ended, and his constitutional reign would have begun.

Paris would have been the capital of the world, and the French the envy of the nations!

My leisure then, and my old age, would have been devoted, in the company of the Empress and during the royal apprenticeship of my son, to visiting quietly and like a true country couple, with our own horses, all corners of the Empire, listening to complaints, redressing wrongs, and scattering monuments and benefactions everywhere.»

Napoleon, predestined by Providence for the gloomy role of executioner of the peoples, deluded himself into believing that his actions were aimed at the peoples' welfare, and that he controlled the fate of millions, and would use his power for the benefit of all!

«Of the 400,000 who crossed the Vistula», he later wrote about the Russian campaign, «half were Austrians, Prussians, Saxons, Poles, Bavarians, Wurttembergers, Mecklenburgers, Spaniards, Italians, and Neapolitans. Of the Imperial army in the strict sense, one third was composed of Dutch and Belgians living on the borders of the Rhine, Piedmontese, Swiss, Genevese, Tuscans, Romans, inhabitants of the 32nd military division, of Bremen, Hamburg, and so on; it included scarcely 140,000 men speaking French. The Russian expedition actually cost France less than 50,000 men; in the retreat from Vilna to Moscow and the various battles the Russian army lost four times as many men as the French army; the burning of Moscow cost the lives of 100,000 Russians, who died of cold and want in the forests; finally, in its march from Moscow to the Oder, the Russian army too suffered from the severity of the season; when it reached Vilna it numbered only 50,000 men, and at Kalisch less than 18,000.»

He imagined that the war in Russia was ruled by his will; and the horrors that it caused did not stagger his soul. He boldly took full responsibility for what had happened, and his blind mind found justification in the fact that among the hundreds of thousands who perished, there were fewer Frenchmen than Hessians and Bavarians.¹⁰

¹⁰ The quote is from chapter 38 of part 2 of book 3. The translation is based on pp. 2602-2607 of the edition of the Nalanda Digital Library of the Regional Engineering College (Calicut, Kerala State, India), and pp. 279-281 of volume 4 of the collected works of L. N. Tolstoy (G. A. van Oorschot, Amsterdam, 1966). The last translation is by H. R. de Vries.

Émile Zola (1840-1902)

Open letter to prime minister Henri Brisson, published in L'Aurore, 16 July 1898¹¹

Every morning, since six months, I feel my surprise and sorrow grow. I don't want to name persons, but I see them with my mind's eyes, everyone I once loved, admired, in whom I had vested my hope for the greatness of France. They can be found in your cabinet, mr. Brisson, they can be found in parliament, in the world of literature and the arts, in all social conditions. And it is my continuous wail: how can he, how can she, how can that one, how can they not be with us, for mankind, for truth, for justice? They seemed to be quite intelligent, and I believed them to be good-hearted. It confounds reason. The more so, since when one wants to explain their behavior to me by the need of certain political craftiness, I understand even less. Because it is quite certain, for everyone of common sense reflecting coolly, that these crafty people are running of their own accord to their nearby, inevitable, and irreparable ruin.

[...]

I believed you to be too well informed, mr. Brisson, not to be convinced, like me, that no cabinet can live, as long as the Dreyfus affair is not lawfully liquidated. There is something rotten in France; normal life will only return after medical intervention. And I add that the cabinet which will make the revision will be the great cabinet, the savior-cabinet, the one that will impose itself, and live.

You committed suicide therefore, as from day one, by believing you might base your power solidly and for a long time. And the worst is that, shortly, when you fall, you will have lost your political honor in the adventure; for I only think of you, I don't consider your subordinates, the minister of War and the minister of Justice, of whom you are the responsible chief.

A lamentable spectacle, the end of a virtue, this failure of a man in whom the Republic had vested its dream, convinced that this man would never betray the cause of justice, and who, as soon as he is boss, lets justice be murdered before his eyes! You just killed the ideal. That's a crime. Everything has a price; you will be punished.

Shall we take a look at the ridiculous comedy of an investigation you have permitted, mr. Brisson? We could have believed that the famous dossier would be put on the agenda of a cabinet meeting, and that all of you would examine it, joining your mental abilities, enlightening each other, discussing the files as they should be, scientifically. But no, not at all, the result unambiguously shows that no check or serious discussion has taken place, that the meeting has done no more than feverishly look not for the truth, but for those files which could best battle the truth, by impressing the simple of mind. It is well-known, this manner of studying a dossier in order to extract what can best serve a conviction obstinately established in advance. It is not a certainty that was discussed and proven, but only the hardheadedness of a man, placed in such personal mental and environmental circumstances, that his testimony has no historical value.

And see also what a pitiful result! What! You only found this? And, if you have nothing more to show, ardently desiring to vanquish us, must that not be due to the fact that you were unable to find anything better at the bottom of your bag? But we knew them, your three files; we especially knew the one that was so violently presented in the law court; the one that is the most unashamed and crude falsification that may fool the naïve. When I reflect that a general has come to seriously read this monumental mystification to a jury, that there was a minister of War who reread it to parliament, and that there was a parliament that let the piece be billboarded in all municipalities of France, I remain dumbfounded. I don't believe that something more stupid will ever leave its trace in history. And I really wonder to what state of mental aberration passion may reduce certain people, not more stupid than others undoubtedly, for them to attach the least credibility to a piece that seems to be the gamble of a falsifier trying to make fun of the people.

You probably realize that I am not going to discuss the two other files. One is tired of doing so, and of showing that they cannot apply to Dreyfus. And moreover, the necessity of revision remains

¹¹ Pp. 201-204, L'Affaire Dreyfus- «J'Accuse» et autres textes, composed and edited by Henri Mitterand, Livre de poche, 2010, ISBN 978-2-253-08872-1.

absolute, as soon as they have not been communicated with neither accused nor defense. The illegality is formal anyway; the Cassation Court has to annul the verdict of the military court. But you know these things just as well as I do, mr. Brisson, and that is precisely what stupefies me. Knowing this, how could you listen without shivering to the passionate assertions of your minister of War? What drama took place, in those minutes, in your conscience? Is it that you believe that politics is more important than everything else, that you are allowed to lie, to assure the country the welfare that your cabinet, according to you, brings to it? To believe that you are so unintelligent as to retain a shadow of doubt about the innocence of Dreyfus, is difficult for me; but on the other hand, to admit for a second that you sacrifice the truth, with the idea that the lie is necessary for the welfare of France, seems even more insulting. Ah! How I would like to read your mind, and how interesting it must be for a psychologist to see what happens in there!

[...]

And to conclude, let me amaze myself about the smallness of all of you [politicians]. If need be, I will assume that among you, there is no haughty and passionate lover of the idea, giving his life and fortune for the only joy of being just, and ready to withdraw when the truth has won. But you do have ambitions; in fact all of you are nothing but ambition. How then is it possible, that in your crowd, not at least one ambitious person steps forward, who has a vivid intelligence, audacity, and force, one of those ambitious persons with a wide and clear view, able to see the true role to play, and to play it courageously?¹²

¹² Because the present author did not know how to translate it in the given context, and because it did not seem to have significant added value, “à la main prompte” has been left out of the list of qualifications. The original has: «au coup d’œil clair, à la main prompte, capable de voir où est la vraie partie à jouer”».

Motörhead

Orgasmatron

I am the one, Orgasmatron, the outstretched grasping hand;
My image is of agony, my servants rape the land;
Obsequious and arrogant, clandestine and vain;
Two thousand years of misery, of torture in my name;
Hypocrisy made paramount, paranoia law;
My name is called religion, sadistic, sacred whore.

I twist the truth, I rule the world, my crown is called deceit;
I am the emperor of lies, you grovel at my feet;
I rob you and I slaughter you, your downfall is my gain;
And still you play the sycophant and revel in your pain;
And all my promises are lies, all my love is hate:
I am the politician, and I decide your fate.

I march before a martyred world, an army for the fight;
I speak of great heroic days, of victory and might;
I hold a banner drenched in blood, I urge you to be brave;
I lead you to your destiny, I lead you to your grave;
Your bones will build my palaces, your eyes will stud my crown;
For I am Mars, the god of war, and I will bring you down.¹³

¹³ This is a track from the CD *Orgasmatron* of 1986.

John Lennon (1940-1980)

gimme some truth

i'm sick and tired of hearing things
from uptight-short-sighted narrow minded hypocrites
 all i want is the truth
 just gimme some truth

i've had enough of reading things
by neurotic-psychotic pig headed politicians
 all i want is the truth
 just gimme some truth

no short haired yellow-bellied son of tricky dicky
 is gonna mother hubbard soft soap me
 with just a pocketful of hope
 money for dope
 money for rope
 i'm sick to death of seeing things
 from tight-lipped condescending-mommies
 little chauvinists
 all i want is the truth
 just gimme some truth

i've had enough of watching scenes
of schizophrenic ego-centric-paranoic-prima-donnas
 all i want is the truth
 just gimme some truth

Governed by Lies

Book 1

Inside a ministry

Chapter 1.

Introduction and preview.

Table of contents of this chapter.

1. The genesis of this report.
2. Goals and methodological remarks.
3. Preview of the chapters 2-9.

1. The genesis of this report.

This is the report of a study of the operation of governments and the functioning of people in organizations. It is the result of an effort to understand and explain them. At the same time it is the report of a series of unexpected discoveries.

In a certain sense the study started with questions which arose while listening to daily news broadcasts and reading history books.¹ These often gave a feeling of incomprehensibility and inexplicableness. Explanations were either absent or unsatisfactory. History books and books about specific events describe (selectively). They rarely if ever analyze openly,² or try to explain.³ They don't try to draw conclusions. Maybe there were methodological problems. Anyway, for a long time the present author did not know how to go about finding answers.

The mystery was an important reason for accepting a job at the Dutch ministry of education in 1985.⁴ In the course of time the job provided valuable direct observational information. But for twenty years important questions remained unanswered. An encompassing framework for explanation remained elusive.

The crucial opening came in the second half of 2005, when the author was asked to replace a colleague in a project intended to provide the education directories of the ministry with a new and better computer based information system. The colleague was moving to another department. Already by the end of the year it had become clear that very much was very wrong with this project. From that moment on, the author tried to play two mutually supporting roles: that of representative of his directory (= of his most direct colleagues), and that of a researcher trying to get as clear a picture of the phenomena as possible. Trying to understand them, and where this seemed impossible, to find additional information.

In June 2007 the efforts at improvement of the project had not produced any results. There even seemed to be a serious risk of worsening. According to the present author the worst thing about the project was the systematic deceitful behavior of the people building the system towards his colleagues and himself. In his opinion their behavior was simply unacceptable. It was in flagrant contradiction with the code of conduct of the ministry. He saw this contradiction as a good reason to appeal to the secretary general. An appeal would have the additional benefit of showing what the secretary general would do.

To inform the secretary general he wrote a history of the project until that moment. This was the first version of the first half of chapter 2. It was the beginning of this report. A history of the project

¹ Two memorable early ones were J.H. Breasted, *A History of Egypt*, and W. L. Shirer, *The Rise and Fall of the Third Reich. A History of Nazi Germany*.

² Analyze openly means among other things: honestly and clearly, independent of those who have an interest in what is written. For example, “less than frank” is vague and ambiguous. It covers all shades between white and black, and may be hardly objectionable. Using “less than frank” as a euphemism for “telling lies” is misleading and collaborative politics, not science. According to Merriam-Webster 2002: **Lie vb lied; lying [...] 1: to make an untrue statement with intent to deceive 2: to create a false or misleading impression ~ vt: to bring about by telling lies <i>**lied**</i> his way out of trouble>**

³ In a responsible way that is, to be distinguished from uncritical, dogmatic or authoritarian assertions. Where uncritical means: without appropriate reflection, asking oneself questions like: can this really be true, does it explain everything we see, are there counterexamples, does it explain other, similar phenomena as well?

⁴ “Ministry of education” is used as shorthand for: “Ministry of education, culture and science”. Where science is to be understood in the broad sense, including for example economics, law, and philosophy.

might serve another purpose as well. It was hoped that a chronicle of the events would show more than individual events, and help getting a better understanding. In the end it failed to elicit improvements in the project. But it greatly helped understanding. In the first place by showing the structural character of the misconduct.

From a logical point of view, and considering the character of the various forms of misconduct visible in the project, the misconduct could not be exceptional. But even the most logical reasonings can better be checked. For that reason several other projects and activities were studied as well. This gave rise to the chapters 3-5.

The chapters 2-5 describe the reality of what can be considered as some arbitrarily selected projects in government and its agencies.⁵ It is obvious that the observed misconduct is incompatible with adequate supervision of government. How can this be? Why don't we hear about the misconduct from the Dutch General Accounting Office (DGAO)? Why the need of whistleblowers? To shed some light on questions like these, chapter 3 considers the way in which the DGAO evaluated the effectiveness of its reports about the management of ICT-projects⁶.

The observed phenomena are incompatible with all known codes of conduct, and with the assertions of ministers about the integrity of the government. The Dutch government has created an Office especially for the purpose of promoting integrity in government. Some of the activities of this Office are studied. It is found that both Offices, DGAO and this integrity office, do as if there is no serious problem at all.

The chapters 2-5 about the cases in the education ministry are followed by an analysis (chapter 6). This analysis was made at a time when the official reports about the financial crisis were still unpublished. The author's plan was to first analyze and formulate (hypothetical) conclusions on the basis of the preceding chapters alone, and then to study a number of other cases. The new cases could be used to check the conclusions of the analysis of the earlier chapters. The reasons for presenting an analysis immediately following the chapters 2-5 are:

1. It is an analysis of these chapters only;
2. It was actually made immediately following the completion of the first drafts of these chapters;
3. It shows the reader that, and how much, can already be inferred from a few cases.

To have significant added value, and to be useful as a check on hypotheses, the chapters 7 and 8 should overlap at most a little.

Chapter 9 provides complementary analyses, conclusions and measures. The analysis of chapter 6 has been kept separate because it concerns little more than the preceding chapters about the *internal* operation of organizations. Chapter 6 does not refer to the chapters 7 and 8. The analysis of chapter 6 has significantly influenced the work on the chapters 7 and 8, but not vice versa.

The chapters 2-5 show the internal operation of government, including the functioning of top managers. The influence of the political top remains implicit.⁷ This can be seen as a notable fact in itself. It makes one curious as to what political administrators do, and how they work.

In September 2008 the financial system collapsed worldwide. In the following years and in many countries, governments or parliaments installed inquiry commissions, ostensibly to find the causes. By the end of 2010 the author happened to see the report of the hearings which had been held by the Dutch inquiry commission. The commission had questioned everyone who had been head of an organization with a role in the Dutch financial system, and some selected experts. (It questioned almost no one else). The commission asked these people questions about their functioning in the years before the crisis.⁸ The hearings report therefore looked like a perfect complement to the chapters 2-5.

⁵ Arbitrarily selected relative to the reader. Assuming the position of the author to be randomly selected. The projects were all projects he could see sufficiently clearly.

⁶ ICT= information and communication technology.

⁷ With the exception of minister Hermans in the renewal project of IAG. See Chapter 5.

⁸ For simplicity the introduction uses the singular "crisis" instead of the plural "crises", and ignores the debt crisis. Actually there were two crises: the subprime crisis and the crisis of the government debts. Although they have similar causes (irresponsible, dysfunctional governments), they are very different in character. The debt

As further study showed, this was indeed the case.

It turned out that US Congress had installed a similar commission, the FCIC⁹. This commission too had held hearings. It had published the transcripts. Both commissions also published very informative reports with descriptions and (hypothetical) explanations of the crucial events.

In order to properly evaluate the hearings it is necessary to know the history of the crisis and to understand the essential processes and events. Thanks to the reports of the commissions and the internet, most of the necessary information can be found easily.¹⁰ Fortunately the relevant processes and events are less complicated and far less difficult to understand than many of the heads suggested. As a consequence it is rather easy to explain the crisis, to find its causes, and to formulate measures which may be expected to prevent repetition. It turned out that many (kinds of) failings contributed to the disastrous course of financial history, and that many of them have a rather general significance. This explains why the chapter about the financial crisis is longer than the chapters 2-5 taken together. One of the conclusions is, that the findings of this chapter are compatible with, and help explain, those of the chapters 2-5. The chapters 2-5 very much help to understand the causes of the financial crisis, but they do not (and cannot) explain the crisis.

One of the aims of this report is to bring related phenomena together in a single (explanatory) framework. The report wants to explain what the cases show, assume and imply. It tries to find out whether the cases agree or differ as to what they show, assume and imply. It wants to find out whether the common denominator helps explain these and other cases and phenomena, or is incompatible with one or more of them. At the same time, having written the chapters 2-7, the question arose of checking compatibility of the conclusions with other cases. In addition there were cases which seemed to deserve serious study in their own right. Such as some well-known whistleblower cases. The more so since without an appropriate study one cannot know whether cases hide something new and unexpected. These were the reasons for studying the set of cases of chapter 8. Of course, after the chapters 2-7 and as long as no contradiction is found, their treatment can be less extensive; and priority can be given to discovering the similarities and differences, and to aspects which are peculiar to a specific case.

The main conclusion is that the fundamental aspects of the phenomena observed in the chapters 2-7 are all-pervasive. It must be inferred that they dominate the development of society. They guarantee the worst possible disasters.

The conclusions of the chapters 2-8 were unexpected and far reaching. Still, to infer them required no more than easily accessible public sources. It was more a matter of adding one to one than something difficult.¹¹ The same conclusions could have been drawn from numerous other cases, including the run up to the second world war.¹² The question therefore arises: why didn't numerous other people, especially historians, draw these or similar conclusions? Why aren't they common knowledge? These and similar questions are addressed in the chapters 6 and 9. They give at least partial answers. They go a long way towards explanation.

As part of the search for answers, the author reread some of his old history books. That is to say: he reread them with the above questions in mind. The first book chosen was *The Proud Tower* by Barbara Tuchman.¹³ Apart from being useful in the search for an answer to the question about the failure to

crisis is very simple to understand and explain, and therefore needs only little space in this report. To avoid misunderstanding it is noted that the relative amount of space is not meant to express a value judgment: the debt crisis may be just as important as the subprime crisis, or even more important.

⁹ FCIC= Financial Crisis Inquiry Commission.

¹⁰ An important exception is the legal framework, especially applicable liability law. Another is the duties and authority of supervisors. The practical meaning of formal (legal) descriptions may be puzzling, especially as compared with claims of supervisors in their (annual) reports, and as compared with the duties and authority of other supervisors.

¹¹ The point being that the addition has to be made.

¹² This follows from analysis of Shirer's *The collapse of the third republic*, and some of its sources, or similar works.

¹³ About the years before World War 1 in various European countries and the USA.

learn lessons,¹⁴ *The Proud Tower* proved useful in another way too. Namely as a reminder of the Dreyfus Affair. The Dreyfus affair was socially traumatizing France around 1900. Closer study of the affair (= case) revealed important similarities with cases studied earlier. Since it seemed very valuable to extend the historical basis of the study, the Dreyfus case was studied in some detail. The findings were added to chapter 8. Comparison with one of the most important Dutch whistleblower cases shows that in the 20th century important social and political customs have remained the same, or became worse. And whatever improved had no significant effect on the main evils.

So the drafts of the chapters 2-9 were written in the order presented. And without the policy portal project of chapter 2, the study would not have been made, and the report would not have been written.

2. Goals and methodological remarks.

Ultimately this report has a practical end. It wants to prevent innocent people from being harmed by avoidable behavior of other people which they never approved of. The other goals are subordinate to this ultimate goal. They are means to help realize this end.

The methodological sections account for some peculiarities of this report.

The report wants to inform.

As noted above, this report was written to support the efforts to stop the revolting and mystifying phenomena observed in the policy portal project. As time went by, and the efforts at correction were systematically obstructed by the management, a report about the reality shown in this project and in many other cases seemed useful if not necessary as information of the public. The author had never seen a publication showing anything similar.¹⁵ Scientific publications not excepted. Scientific publications don't even notice a possibly important hiatus in the knowledge of reality. They manifest a complete absence of interest in the internal operation of public administration. This fact alone suffices to explain the absence of understanding in the sciences. A clear indicator of the state of affairs in the sciences is the fact that Weber (1864-1920) is still presented as being relevant.¹⁶ While Weber never saw the inside of government bureaucracies of his own time, let alone those of the years after 2000, which are about 100 times bigger.

There should be publications showing voters how a ministry really works,¹⁷ and to warn them against illusions and misleading tattle and lies. The publications should elicit and support a discussion aimed at correction. Now as in the beginning of the inquiry, the author thinks that knowledge of the reality of government and politicians is a requisite for being able to vote responsibly. It is a requisite for the correction of government, and possibly even for the survival of mankind.

Reality does not agree with what most people imagine or what they consider necessary or desirable. Publications and the media betray no understanding.¹⁸ This lack of knowledge and understanding motivates the emphasis on descriptions of empirical reality in this report. The descriptions are little more than selections and summaries of documents in the archive, and the reader is urgently recommended to check everything for him or herself.

Against the background of the contents of education and what one sees in the media, the facts are surprising. Without study and reflection it may be hard to accept that they are not incidental but structural. And that no effective supervision and correction take place. The analyses are meant to find explanations, and to find measures to eliminate the causes.

¹⁴ The book is not interested in learning lessons. As a consequence, much of the information needed to draw conclusions and learn lessons is missing. History writing requires selection, and selection requires criteria.

¹⁵ The books of Van Buitenen's were studied as part of the inquiry. Although they give much helpful information about the internal operation of the European Union bureaucracy it is difficult to call them similar to the present report. Nijeboer's book about whistleblower Spijkers gives much helpful information about the misconduct of the defense ministry, but does not show (or discuss) its internal operation.

¹⁶ In the index of Braud *Sociologie politique* (2008) only Pierre Bourdieu is referred to more often. Weber is referred to twice as often as the next author. To mention just one example.

¹⁷ To be distinguished from theoretical-idealistic: how they should work or are supposed to.

¹⁸ Van Buitenen and Nijeboer are no exceptions.

The report wants to warn.

The expanded study showed much more than the cases in the education ministry, and much more than expected. Both quantitatively and qualitatively. Information may remain the most important goal of the report. But much more than thought initially, the report is also meant as a warning. It shows that the cases cannot be interpreted as incidents. They can only be understood as manifestations of structural, harmful and dangerous defects in present social and political systems. The report and its analyses can help protect against the eternal tattle of politicians and their clients. Against the kind of tattle seen in all of the cases. The report and its analyses show that it is indeed no more than tattle, meant to mislead, of incompetent and unreliable people. The report and its analyses show that the combination of (ab)use of power with slippery tattle makes them very dangerous. The report shows that far-reaching measures are absolutely necessary to avoid greater catastrophes than mankind has ever seen. It shows the causes of the status quo and of its stability. The causes explain the status quo and the absence of improvement. They also explain why certain (half-) measures are equivalent to doing nothing or worse, and to letting dangerous people continue making the world ever more dangerous.

The report wants to show how to make an inquiry like the one underlying this report.

In addition, the content and structure of this report have a methodological-didactic goal. The report tries to show the power of the method of “search, reflect, combine and analyze”. It shows that and how readily available information can be analyzed to show, or rather imply, very much more than one sees on the surface. “On the surface” (“superficially”) meaning: without appropriate reflection and comparison. Numerous (“sub”)methods used to find or induce explanatory information or hypotheses are implicit in the analyses.

The report would like to show how one can find and infer useful or necessary information, meaningful knowledge, or understanding, implied by (“concealed in”) available information. So that more people can do this kind of analysis, and, among other things, correct and improve this report, and contribute to the realization of its aims.

The set of cases provides plenty of opportunities to compare people, phenomena, etcetera, with one another, to check for similarities, differences, consistency or contradictions. The report (together with its appendices and archive) includes more than enough material to check its reliability.

The role of the archive and appendices. The report as a guide to the archive.

The report is intended to be checkable and reproducible. It wants to show how the reader can find his way independently. It wants to enable the reader to reproduce it, or, preferably, improve it. For this reason the report and the archive on which it is based should be seen as an indissoluble whole. The report should be seen as “summary and conclusions” of, and guide to, the archive. The report does not replace the archive.¹⁹

The appendices form an intermediate stage between the archive and the report. Especially the chapter about the financial crisis began with what have become appendices. Most of the appendices began as preliminary studies. Some of them have been changed in the course of the writing of the chronicle or analysis, for example when something required clarification. The appendices may also contain material (tell-tale quotes and analytical remarks) which was found in efforts to check hypotheses. They form an archive with a higher concentration of relevant information, and more easily accessible than the underlying documents. For example if one wants to check something, or get the flavor of a publication or series of publications, hearing(s) or whatever.

In principle, chronicle and analysis are kept separate; but they are not independent.

Where feasible, the observations are presented in the form of chronicles. From the very beginning

¹⁹ No history can replace its sources. Even less when the selection has not been specified and accounted for.

the chronicles were meant to orderly present the most important facts. The facts being selected so as to be as self-explanatory as possible.

Facts are facts, and differ in nature from analyses. For that reason the facts have been kept separate from the analyses.²⁰ This also helps to keep the history as accessible as possible during further work, and to avoid mixing up facts and analysis as much as possible.

The analyses try to explain what the descriptions do not, or insufficiently. They may also note gaps in the chronicle: things that did not happen but should have happened. This is rather crucial. Much misleading is accomplished by leaving unmentioned that duties required actions or a different actions. In particular by not noting inaction where action was required to prevent immeasurable harm.

The analyses reflect on what the description shows, on what it assumes and what it implies. They make comparisons with similar or seemingly incompatible phenomena. The results are presented in the form of summaries and conclusions. As regards the conclusions: it has been tried to find and formulate conclusions which enable one to present a set of measures of which it is clear that they are necessary and sufficient to prevent the undesired phenomena listed in the chronicle.

When one analyses and tries to explain phenomena described in a chronicle, one may notice both redundant information and gaps (with respect to the analysis, summaries and conclusions that is). This suggests an iterative approach, wherein the chronicle is more or less adapted to the analysis, and, of course, the analysis to the chronicle. In other words: the facts presented in the chronicle are selected on the basis of their importance for peoples lives and all kinds of developments which affect peoples lives, and on the basis of the needs of explanation, conclusions and measures. Taken together, chronicle and analysis should explain the chronicle (the observed facts), and show the reader that denial of the conclusions is incompatible with the facts or makes them unexplainable, and that non-implementation of measures will keep matters as they are.²¹

Keeping the chronicle separate makes it relatively easy to test intermediate results in the course of the analysis and the iterative process. Apparent contradictions have to be explained or solved. Of course, the final explanation should be free of contradictions.

Separation of chronicle and analysis is feasible or relatively easy when a case is defined by unambiguously identifiable processes, and these processes have run their course. It can be different when a process has not been completed. Then responsible selection is more difficult, or impossible. Chapter 2 is devoted to a project wherein the author participated. It was written in the course of the project, as a parallel activity. Additional events and information required reflection and possibly action. This is how in chapter 2 process (history) and analysis got interwoven. It did not seem useful or necessary to disentangle them.

Most of the other analyses are explicit efforts to understand and explain, and to find out what has to be done to set matters straight.

The (sub)sections “Summary and conclusions”.

All chapters and several sections are provided with a (sub)section titled “Summary and conclusions”. These (sub)sections are meant to present the important results; to provide easily accessible overviews; to stimulate reflection about the observations and analyses; and to distinguish more and less important aspects. They represent an essential, though not necessarily final, stage in the analysis.

They are placed at the beginning of chapters and sections, and not at the end. This is done for convenience, to make them easier to find when using a table of contents. It is not done because they

²⁰ To a certain extent, description is impossible without analysis. In order to keep the length of a description within bounds, a writer has to decide what to include and what to leave out. In the case of this study the ultimate goal is prevention, to be accomplished via understanding and explanation. The descriptions should be sufficient as a basis for understanding and explanation, and possibly, for the refutation of incompatible alternative “explanations”. It need not contain information that does not serve these goals.

²¹ Note that “explainable” is supposed to mean explainable in a deductive sense. Explainable therefore is a form of consistency. There should be no inconsistency between various pieces of information. (Assuming information to mean reliable information). Trying to understand is trying to deduce; and if understanding proves possible one has also shown consistency.

have to be read before reading the text which they summarize. Rather the contrary: they can better be skipped at first reading. They are at least one analytical step removed from the observations. Reading them before reading the analysis on which they are based may introduce bias. They may moreover be hard to understand without having read the main text.

Note about the country of origin and relevance of the cases.

Everyone is born somewhere, and the author was born in the Netherlands. It was in the Netherlands that he spent most of his life. From 1985 to 2011 he worked at the (Dutch) ministry of education. Combined with a desire to understand the operation of government, it were his experiences with a project in this ministry from 2005-2010 that gave rise to the inquiry which resulted in this report. Already in the course of the project, the inquiry was expanded to other processes about which the author had sufficient information.

Analysis of the observations led to the conclusion that the observed misconduct and failure are structural, and have causes of a general nature. That is: they are not due to specific characteristics of the activity or organization which shows the misconduct and failure. They can be observed almost everywhere. They are not caused by “human error” or unavoidable circumstances, but consciously, by man made, avoidable conditions, such as laws, procedures, and ways of selecting people. It followed that similar phenomena should be visible elsewhere. Although there is good reason to expect them to be hidden as good as possible by those responsible, as in the ministry of education. This is why as a rule cases only get known if they are impossible to keep hidden, either by the size of the damage caused externally, or because someone blows a whistle (or both).

To test the hypothesis about the general nature of the causes, a number of cases outside the ministry and the Netherlands were studied. Mainly because the author was best informed about Dutch cases, these form the majority of the test- or comparison- cases. However, cases concerning the European Union, the United Nations, and even a (French) case of around the year 1900 could also be studied. They show nothing substantially different.

From the point of view of this inquiry, the subprime crisis came as if sent for. Especially because it heavily involves the USA. An equally important reason being that it enables evaluation of the persons in the highest responsible positions, and to see how they account for their behavior. The crisis supports the hypothetical conclusions drawn from the Dutch cases, and provides important additional insight. Analysis shows that as regards the deeper causes, there is no significant difference between the USA and the Netherlands, or other countries for that matter.

Summarizing: By their nature the causes found are general. They are independent of specific characteristics of the case or the organization or country of origin. In number, most cases are from the Netherlands. In size and weight, the case-studies mostly concern the Netherlands and the USA approximately equally. Still, cases from other countries and international organizations are also studied, and important. Everything seen in the cases, in history, and in the present, supports the hypothesis of the general nature of the causes discovered.

The norms and values used in the evaluations.

The present report tries to distinguish facts and evaluations as much as feasible. By definition, evaluations include judgments.²² Judgments are made with the help of a set of norms and values. In the present report, “a set norms and values” indicates the measuring stick for judgments, including judgments made in evaluations.²³ The following introduces, outlines, and accounts for the set of norms and values used in the present report.

²² Merriam-Webster 2002: «evaluate [...] 1: to determine or fix the value of 2: to determine the significance, worth, or condition of usu. by careful appraisal and study»

²³ For consistency (required at least for communicative purposes) a set of norms and values has to be consistent. It should distinguish violable and inviolable norms and values. The violable norms and values should be provided with relative weights. Enabling consistent application. Without weights, a given situation may allow for different decisions. This note is meant to indicate that the present text is incomplete. It presumes acquaintance with the principal parts of the publications mentioned later in this subsection.

An action or omission may be in agreement with one or more specific norms. It may serve one or more values. It may do so to a greater or lesser extent. It may comply with certain norms or values, while falling short of others. It may violate one or more of them. A lie violates the norm of truthfulness. Dumping waste in the environment harms, and/or creates risks for, the welfare of people, and for life in general. Welfare is a value. Values such as welfare may be used as a norm.²⁴ A set of norms and values determines in what respects something is good or bad, laudable or objectionable, and to what extent it is good or bad. Deceit undermines communication and cooperation. In other words: deceit is incompatible with the value of cooperation. Even if deceit is not intentional, it still means a lack of reliability, and reduces the score on the norm of reliability.

As far as known, objective norms or values do not exist. No norm or value has ever been proven to be objective in the sense of being independent of any human opinion. Norms and values therefore must be assumed to be subjective. A matter of opinion. This means that at least in principle, everyone is free to accept or reject any norm or value. This freedom is two-sided however. A person may be free to do what he or she likes. But everyone else enjoys, or can claim, the same freedom. People may react the way they like upon the use a given person makes of his or her freedom. For this reason, restraint is a wise and safe strategy.

In fact, as soon as one wants something of somebody, and doesn't want to use force or threaten with the use of force, then one has to respect certain norms and values. One of the most basic things people want of one another is communication. This means that one has to reach agreement about the meaning of signs. This turns out to be equivalent with acceptance of a small but important set of norms and values. Which includes a (possibly minimal) dictionary, some grammar, and the promise to mean what one says or writes. Henceforth this set is called the basic set. Specifics depend on the nature of the communication. Apart from the definition of the signs, the set of norms and values required for communication is limited and conceptually simple.²⁵ To put it in a nutshell: communication requires truthfulness and reliability.

Communication can only be called meaningful if the people who communicate mean what they say. Without that, utterances are undefined and without a reliable meaning. Hence in this report, communication is always supposed to mean meaningful communication. Meaningful communication is necessarily voluntary. If communication is not voluntary, there is no binding reason for compliance with the basic set of norms and values. Without for example truthfulness, communication is, or rather: utterances are, meaningless or worse: misleading.

In the absence of proof of the opposite, it must be assumed that people are free to communicate with a given person, or to forgo communication. In general, people will be willing to communicate with a given person only under certain conditions. Which means that voluntary communication may require acceptance of more norms and values than those of the basic set. That is: the promise to comply with a given dictionary and grammar.

The basic set premises a form of mutual respect. The reason being that voluntary communication implicitly recognizes the right to abstain from communication. In other words: voluntary communication assumes a right to choose. Which is a form of respect.

The most important elements of the above can be summarized as follows. One is free to communicate or not. One may set additional conditions for the willingness to communicate. But once one has chosen to communicate, one is obliged to accept the set of norms and values which is necessary for communication to be meaningful. In other words: there is no proof of the existence of any objective ("naturally binding") norms or values. But a communicative society by definition has a basic set of norms and values; applicability of the adjective "communicative" requiring compliance with this set.

The set may be simple, but its implications are far reaching. The set implies much more than one might possibly think. For example, meaningful communication requires consistency, honesty and reliability. A speaker or writer should mean what he or she says or writes.²⁶ He/she should not lie, and

²⁴ This is why norms and values can best be kept together and treated as a whole, as a set.

²⁵ It is limited in this sense, that it is necessary and sufficient for communication, but not suitable to evaluate everything. Such as food or music, or brands of phones. It is necessary to evaluate a constitution, but not sufficient to evaluate every stipulation in a constitution.

²⁶ In many circumstances, public officers should moreover say and/or write what they mean.

should therefore (!) keep promises. A speaker or writer should not contradict him- or herself knowingly, because contradictory statements cannot all be true.

The fundamental concept of “respect” is subjective. Everyone is free to decide for him- or herself whether he or she is or feels respected. It is therefore not the actor who can decide whether another person is respected (sufficiently), but only the person who wants to be respected. Unless a speaker is assumed to be honest, it is useless, misleading and/or harmful to listen to him or her. Last but not least, respecting a person may require care for that person’s welfare, and may require safeguarding that person from the undesired consequences of one’s avoidable activities and/or omissions.²⁷

Integrity can be seen as a condition for respect and reliability. For the purposes of the present report, the concept of integrity is specified in section 4.3. It is specified by a list of conditions. The conditions are meant to be satisfied by an accountable representative. Such as a public official. The list begins with: truthfulness, openness, self-knowledge (including knowledge of limitations of abilities), consistency, and absence of false pretensions. All of them are derived from, or forms of, respect and reliability. They express generally, publicly, accepted norms and values.

It will be clear that respect and reliability require a lot. Respect and reliability require for example that one only accepts a job which one can fulfill without causing harm or risk for anyone. One should be able to account openly about the fulfillment of the job. Not only about successes, but also about mistakes and failures. Respect and reliability forbid the assumption of tacit agreement with the given regulation of the state. And so on.

The set of norms and values necessary for communication includes those “universal” human rights which do not infringe upon the right to be respected or safeguarded. The set does not include obligations other than the obligation to communicate reliably. It does not admit unequal treatment of people in a communicative society. Unequal treatment being incompatible with (equal) respect.²⁸ The set includes only those norms and values which are necessary for meaningful communication, and which can be accepted voluntarily. The fundamental reasons being 1) that there are no objective norms or values, rights or obligations whatsoever; 2) that meaningful communication requires acceptance of some basic norms: especially respect, safeguarding and reliability; and 3) that- consequently- all other norms and values, rights or obligations are binding only when voluntarily accepted. Acceptance by a (political) majority, or the threat or use of force, do not make norms or laws logically or ethically legitimate or binding.

The norms and values associated with communication may seem natural or self-evident. In the following sense they are. Communication is the basis of every human society. The fact that meaningful communication requires acceptance of a specific set of norms and values, explains that these norms and values are shared by almost all peoples and religions. Irrespective of their specific language and customs. At the same time however, the set is not compatible with the present laws of any country. In terms of the norms and values of communication, present laws respect the people in power much more than everyone else. Even if the law would require those in power to communicate reliably and respectfully with the powerless (it doesn’t), it certainly allows those in power to violate these norms and values with impunity. Moreover, as a matter of principle, it is noted that there are no known grounds for assuming the present laws to be logically or ethically binding. This report does not make that assumption either. Instead, laws and their makers are part of the subject matter of the report. They are going to be evaluated.

People who want to communicate should accept the norms and values which are premised and required by communication. But what if they don’t? What if they only pretend to communicate, but do not really respect the people they speak to? If they withhold important information, lie, or use other tricks to make people believe what they themselves do not believe? In this connection it is essential to repeat that there is no ground for assuming the existence of objective norms and values which bind everyone or anyone. One is under no obligation to communicate and accept the norms and values of

²⁷ Again: undesired according to the person possibly being affected by consequences.

²⁸ Respect meaning complete respect. Equality is therefore implied.

communication. (Of course, people should only be admitted to public positions if they accept these obligations). But if one doesn't accept this obligation, other people have no obligations either. The other people are free to give rights (that is: to create obligations for themselves), or withhold them. Someone who does not want to communicate in accordance with the appropriate norms and values has no grounds for claiming any rights or obligations from anyone. A communicative society is free to do with non-communicants or violators as it deems fit. Of course, using this freedom may have consequences. To minimize harm, it is wise to use this freedom with restraint.

To summarize this section in a simple fashion, it can be said that the present report tries to establish to what extent conduct, activities, etcetera seen in the various cases comply with the norms of respect and reliability. The report assumes no rights and obligations other than those required for voluntarily and meaningful communication. As regards human conduct, it only accepts explanations which are compatible with the norms of respect and reliability. Neither constitutions, treaties, laws, nor political theories are assigned normative significance. Their legitimacy and quality are to be proven. As will be amply shown in the following chapters, none of them can pass the muster of the norms of respect and reliability.

For more explanation and elaboration of the norms and values related to communication, the reader is referred to the book *Het recht van de logica* (*The law of logic*, in Dutch²⁹) and the paper *Communication and norms*. The paper can be found on the internet.

Why the writing of history should begin as soon as possible.

If history is to be reliable and useful, the contemporary information required for the writing of history should be collected as soon as possible. It bears no delay. The reason being that those in power want people to have a positive image of their persons and performance. Both during their lifetime and in history. For that reason they have an interest in hiding a lack of integrity and/or competence. They don't want to leave traces proving misconduct or failure. They have an interest in selectively hiding or destroying evidence. They have the power to do so. And they actually use that power.³⁰

It is an empirical fact, observable every day in the news, that people in power, and people aspiring to positions of power, do all they can to create a positive image of themselves. It is untrue that they are open, and encourage open discussion.³¹ They are not interested in all relevant information, arguments and the full truth. They are only interested in information which supports their preoccupied viewpoints. They abuse their power to select information and manipulate discussions. They do not refute counterarguments. They ignore, deny or downplay them. Open discussion requires a questioning and listening attitude. Instead, they almost always assume a defensive and repressive attitude. They defend their own proposals. They ignore alternatives, or try to show that they are bad, useless, impossible, etcetera. They defend whatever they did or did not. They try to make believe that they did and do whatever was possible and needed. They try to make believe that they make and made no errors. They do not tolerate true opposition, even when they say they do.³²

These remarks are supported by an overwhelming amount of evidence from all ages. Including the evidence contained in the present report. It clearly shows that writing reliable history is no easy task.

It is interested politicians who decide if minutes are to be made of internal meetings, who can modify and have to approve them, and make the rules for archiving. It is these people who determine the length of time documents are kept in archives, and when they are to be destroyed.

They abuse their position and power to influence the media and public opinion. The media have allowed themselves to be maneuvered in a dependent position. A position in which compliance with their own codes of conduct is suicidal.³³

²⁹ I am sorry for that, but the book contains substantial specifically Dutch sections. These require more than translation to become understandable and useful for people outside the Netherlands.

³⁰ See the case Spijkers, sections 4.7 and 8.3, and the reports of various inquiry commissions. Such as those of the subprime crisis.

³¹ Think of interviews!

³² Corollary: they are not leaders at all.

³³ Supposing they have (relevant) codes of conduct.

This is corroborated by all relevant contemporary evidence, and by the absence of contrary evidence. Not only by the media, but also by history books. The fact that many heads of state, from Alexander “the great” to Mao, are still held in high regard by very many people, is incompatible with truthful history writing and social education. Quite generally, history books tend to continue the propaganda of the governments whose activities they describe. There are exceptions, as when a thoroughly vanquished criminal ruler is condemned by the victors. Hitler is the main example. (There are not many examples). This exception cannot be seen as a sign of integrity of politicians and historiographers however. The point being that the condemnation of Hitler, the trials of Nuremberg, and the excessive attention to the war itself, greatly help obscuring the responsibility of the allies for the war. Many of them could and should have prevented it. Few people understand that Hitler could only wreck havoc because the governments of the other main western states did not do their duty.³⁴ If they had done their duty, there would have been no major war.

These remarks are consistent with the observation, that government organizations are kept hermetically closed, and that the information flow out of these organizations is strictly controlled by their political heads. It is obvious that rigorous control of information is only necessary if transparency and freedom of information would undermine efforts to create and uphold a positive image of politicians and governments.

Someone who really wants to understand political and related events, and the course of history, does not assume what has to be proven. Let alone assume what is known to be untrue. Such as the integrity of politicians. Someone who really wants to understand sociopolitical developments must try to obtain not only official publications, which are censored by definition,³⁵ but as much relevant evidence as possible. Because of archival rules, the possibility of accidents, “accidents”, and other causes of disappearance, he should do so as soon as possible. Only in this way can the possibilities for crucial information getting lost be minimized, and can one reasonably hope to get the information needed.

Prompt action is necessary but not sufficient. As the present report shows, the writing of reliable and useful history is not only hampered by insufficient information about the internal operation of government organizations. It is also hampered by a- possibly unconscious- subservience of journalists and historians to those in power, and by complacency and lack of integrity and competence. As shown for example by the general lack of interest in the internal operation of government organizations, and the tacit acceptance of their closed character. In theory, knowledge of the internal operation of government organizations might be irrelevant. But a priori the irrelevance is only a hypothesis. The truth or untruth of which can only be determined on the basis of relevant information. In fact, this report proves that such information and knowledge is necessary for the proper evaluation of the given political system. It is true that much can be learned and guessed without it.³⁶ But knowledge and understanding of the people involved (directly and indirectly), and of the structural character of the phenomena, are impossible without it. The state of mankind, and the fact that no fundamental improvement takes place, are the best proofs of this.

Maybe, theoretically, the collection of information and the writing of history need not go together. But if the writing of understandable and explanatory history is the goal of the information collection, then the collection can best be guided by questions arising in the process of writing. Specific questions arise especially when one tries to understand events. One should avoid collecting a terrible amount of similar information and missing the one crucial report. Which due to general biases and illusions can easily happen.³⁷ The passage of time need not help. “Distance” cannot fill gaps in information. Time

³⁴ Something similar applies to the financial crises of 2007-2013, and climate change. Neither would have taken place if governments had done their duty.

³⁵ By the definition of “official”. Don’t forget in this connection, that assertions such as that governments serve the country, or serve the population as a whole, are to be proven too, and not assumed beforehand.

³⁶ Logically speaking, and according to the present author, it is even sufficient. But no publication whatsoever betrays any understanding at all. Almost all media and historical publications show many kinds of illusions. (Some of which are discussed in chapter 9). So from a practical point of view, more information is necessary.

³⁷ The subprime crisis is a case in point. The reports of the US General Accounting Office (GAO), and to a lesser extent some of the reports of the Committee on the Global Financial System (CGFS) of the Bank for International Settlements (BIS), can easily be overlooked, being from relative outsiders, and for bad reasons only

can only bring better understanding and judgment if the relevant information is available and taken into account. If part of the information is unknown, time is apt to mislead. The observations made above show why misleading is more probable than objectivity or wisdom. It is certain that time elapsed after the events can only cause loss of information. Therefore the writing of history can best begin as soon as possible. Even if the process of writing history is understood to be never ending.

The above should be kept in mind when reading the following section. And the whole report, for that matter.

Falsifiable history requires true names.

Much of this report is devoted to descriptions of events. It is a kind of history. Nothing is fictional. The descriptions are no goal in themselves however. They serve as a basis for analyses which are aimed at improving understanding and explanation, and at finding measures which can prevent man-made disasters. The descriptions should therefore be as reliable and verifiable as possible. For that reason only well-documented cases have been studied. But not everything can be shown and proven with documents. And the descriptions should be open to public scrutiny anyway. The possibilities for checks, correction, and improvement should be maximized. This especially regards the people who figure in the events described. They should be enabled and encouraged to correct descriptions, and give their personal explanation and motivation. An important additional reason for inviting them to provide this information being that the present study does not result in understanding of the actors.³⁸

The report mentions many names, and all of them are true. No distinction is made between people of different hierarchical or political positions. It is assumed that a difference in position is no ground for discrimination. In some cases the names of several of the top officers are already known.³⁹ The chapters 7 and 8 concern widely publicized events. They are based on public information. The names of many of the top officers responsible for these events are well-known. The chapters 2-5 are of a somewhat different nature. They mainly concern the internal operation of a ministry. A few of the participants are known by name outside the ministry, but most of them are not.

From a logical point of view, a distinction on the basis of rank or another characteristic would be arbitrary. Replacing the names of participants lower in hierarchies by fictional names, or leaving them unmentioned, gives descriptions the character of fiction. It precludes correction and explanation by the people who are in the best or only position to provide them. As will be shown, understanding their conduct is of crucial importance for the prevention of misconduct. Fictionalization removes essential actors from the learning process. Since empirical studies of the internal operation of hierarchical organizations in general, and of government organizations in particular, are non-existent or extremely rare, and since the conduct of the actors seems to be the least explicable and most important phenomenon encountered in this report, it is of the utmost importance to get the relevant facts right.⁴⁰

Quite generally, knowledge can only be called reliable if it does not depend on specific characteristics of the observer or author. Therefore it should always be possible to check the sources. Which implies, among other things, that the persons who played a role in an event, or have direct knowledge about it, should be known by name. Prohibiting actors to comment, precludes correction of the description of the facts. It thereby precludes the improvement of the analyses and inferences which are based on them. It obstructs the acquisition of knowledge and understanding of the past, and the correction of public administration and political systems. As a consequence it blocks the search for effective means to prevent man-made disasters like financial crises, climate change and wars.

The report shows that voters do not know and understand the reality of the operation of government. It shows that it is of vital importance that they do. Without this knowledge voters cannot

touched upon by inquiry commissions (if at all). The adjective “relative” should be stressed: institutions like the GAO are principal agencies of the state.

³⁸ Apart from concluding that people differ far more, and more fundamentally, than commonly thought, and that differences in behavior can often better be ascribed to specific personal characteristics than “explained” by for example different circumstances and personal histories.

³⁹ Even of civil servants of lower rank. See for example Alexander Nijeboer *Een man tegen de staat (A man against the state)*, Papieren Tijger, Breda, 2006. See the chapters 4 and 8 of the present report.

⁴⁰ In fact, the misconduct is easily explained, but not in terms of defensible motives or norms.

know and understand what boundary conditions have to change, and how public administration can be enabled to do its job properly: for the public benefit. Without such knowledge and understanding voters cannot make responsible choices in public affairs.

It is furthermore highly desirable to end the dangerous custom of letting only top managers and heads of organizations (or their professional spokespeople) provide information about “their” organizations. It is dangerous because it goes entirely unchecked. It facilitates misleading and lies. It allows a hierarchical organization to operate as a dictatorship. It means acceptance of repression.

Even though some people may not like to be reminded of events in which they played a role, nothing is reported that is secret. Unless everything that is illegal and goes wrong in public administration is secret, and for that reason.⁴¹ Indeed, given the findings of the present work, the omnipresence of phenomena that cannot bear the light of day may very well be the one and only true reason for keeping organizations opaque. In any case, the secrecy cannot be justified by defensible interests of the people involved. Obviously, some of these people may not like the reported conduct to become public. But as the descriptions clearly show, they had a choice. They could have acted differently. Even though all of them are subordinates. They did not simply and only do what they were asked to do. They may have done what they thought was expected of them, or what they thought would further their career. But both before and during the described events they could have made other choices. They could have made a defensible choice. But they didn’t.⁴²

The people at the top are more or less public figures. They cannot be kept anonymous anyway. Their functions directly lead to their names. If “ordinary” employees are kept hidden behind a veil of anonymity, and if the top is left unmolested for reasons like the impossibility of knowing and controlling everything, then nobody is responsible in a way that is meaningful in any corrective and preventive sense. If secrecy would be meant to preclude their being held to account for the cases discussed, that would simply mean placing most of public administration outside the scope of any form of control. When public administration operates properly, there is no reason for secrecy.⁴³ It seems probable therefore, that those objecting to the use of true names do not do so to protect the people concerned or to defend a legitimate interest,^{44,45} but because true names must correspond to true reports, as fictional names suggest fiction. True names require reliability. Protection of employees is just a pretext. What those responsible want to suppress is not so much the names of employees, as the truth of what is happening. They want opacity because the internal operation of many of the organizations of public administration is indefensible. Public knowledge of what is really going on would require a very different kind of organization of public administration. It would mean the end of politics as we know it. This must be the ultimate reason for keeping organizations opaque. The present work clearly shows what this opaqueness leads to.

When public administration does not operate as it should, and represses internal efforts at correction, when supervision fails completely, and when this harms or endangers outside citizens, then every employee and citizen has a social obligation to inform his or her fellow citizens. This is the reason for writing and publishing the present report. It is published to contribute to more responsible public administration.

⁴¹ Much of what is shown in the chapters 2-5 is indeed illegal. At least in this sense, that the Dutch code of conduct and the general regulation for civil servants (“ARAR”) require civil servants to act as a good housefather should. Which many people obviously didn’t.

⁴² In the course of the events described, all actors mentioned have had plenty opportunities to give explanations. In the cases in which the present author participated he has always asked everyone why. He really wanted to understand. He did not get any sensible answer. Never. Most of the time problems were simply denied.

⁴³ Except for really exceptional cases.

⁴⁴ In the course of this report it will become obvious that secrecy is very harmful for public administration and society, and that it is incompatible with democracy. Reliable information about the performance of elected officials requires reliable information about the performance of the organizations of public administration for which the officials are responsible. Without this information, officials cannot be reliably evaluated.

⁴⁵ This would moreover mean an inconsequence of the law, since in general harm has to be proven (and to exceed the benefits of openness). The requirement would seem to be necessary to safeguard a meaningful freedom of publication.

Matters would be different if much was already known about the internal operation of hierarchical organizations. Or if the subject was given due attention by the media or the scientific disciplines concerned. Or if it had been given due attention in inquiries into the causes of the subprime crisis. Matters would be different too if the public prosecutor had investigated the criminal misconduct of employees of the ministry of defense with respect to whistleblower Spijkers. If parliaments had abandoned the fiction of the exclusive responsibility of the person “politically responsible” for these organizations. Or if they had treated such people as any other person having caused great harm. Or if the present work had shown that the internal operation of these organizations is of no importance in the cases where failings or misconduct of organizations played a vital role.

If there were open and reliable studies of the internal operation of the organizations of public administration, or if honest efforts were being made to correct these organizations,⁴⁶ then the need for verifiable case studies, complying with the customary scientific norms, would not be stressed so strongly. Regrettably there is no scientific monograph or textbook describing, analyzing and explaining the internal operation of hierarchical organizations as it really is. Including their operation in cases like those treated in the present report. The subject seems to be completely ignored by scientists, even though a majority of the working people in the present world works in hierarchical organizations, and even though it is obvious that the responsible operation of these organizations is of the utmost importance for these people and for the development and fate of human society.

In March 2018, an appeal to the Dutch Academy of Sciences to fill the gap remained unanswered. All of the many parliamentary commissions studied in the present report treated the organizations involved in failure or misconduct as an amorphous whole. They implicitly assumed organizations to be indistinguishable from its top. They ignored the distinction even when the organizations had hundreds or thousands of employees, and even when many employees must have been more knowledgeable (and honorable) than their management. In general, they seemed to be unaware of the employees outside the top.

The above is amplified by the observation that publication of the reports of the chapters 2-5 is essential for the understanding of people and events in general. It is moreover a matter of now or never. The net results of the processes described in these chapters may be inferred from the archives. Probably not.⁴⁷ Drawing the correct conclusions from official archives would at least require a very honorable and fearless, and very experienced researcher. He or she would certainly not be able to explain the net results. Most of the evidence necessary for explanation has never been archived, or only for a few years. While disinformation in the form of silences and lies abound.⁴⁸ More or less detailed descriptions are essential not only for understanding the net results, but also for understanding the conduct of the people involved. In particular the management by the top officers and the submissiveness of nearly all of their subordinates. The descriptions are essential to show the irrelevance of the code of conduct and the complete failure of any form of supervision. Either by a parliament or a specially instituted supervisor or inquiry commission. As explained later on, all of this is essential for understanding what governments do and fail to do. Leaving reports like these unpublished makes history unexplainable. It would leave a biased, far to rosy picture of those responsible uncorrected. It precludes properly informed participation in democratic processes.

The present report shows that most of the very great harm caused in the cases studied was due to the failure of people and organizations which are part of public administration. The harm was either due to their actions, such as irresponsible policies or laws, or to their omissions, such as failures in supervision, or to both. Sometimes they themselves cause harm, sometimes they are responsible for harm by having omitted to do their duty. In the more important cases the harm is immeasurable and irreparable. Indeed, the present work suggests, and for the financial crises proves, that the largest man made disasters were caused, or could and should have been prevented, by one or more governments or

⁴⁶ In fact, no efforts are made at all. The problem is not even recognized or identified.

⁴⁷ If only because they have been destroyed in accordance with applicable law.

⁴⁸ As shown in the chapters 2-5.

government organizations. The disasters include wars like World War 2.⁴⁹ If one wants to reduce the probability of man made disasters, then one has to find the causes of the failure of these organizations. It is simply illogical and irresponsible to exclude the internal operation of these organizations and the conduct of their employees from an inquiry into these causes.⁵⁰

In other words: the present work always uses the true names because:

1. It is meant to be truthful. It wants to avoid every suggestion of fiction;
2. Every person is treated equally;
3. There is a total or almost total lack of scientific, empirically based, knowledge of the internal operation of hierarchical organizations in public administration;
4. Important parts of public administration are found to dysfunction seriously, and their dysfunctioning caused and causes immeasurable harm;⁵¹
5. Lack of knowledge of the situation precludes correction;
6. Reliable knowledge requires verifiability (falsifiability), and therefore the names of the relevant actors;
7. As regards the cases studied, there is no defensible reason for secrecy. Neither is there reason for making exceptions;
8. Publication is a matter of now or never;
9. It facilitates correction and improvement of the case histories. Actors should comment on the reports and explain their conduct.⁵²

Publicizing supposedly appropriate or successful actions while concealing misconduct and failures facilitates or even promotes misconduct. Not only by preventing correction, but first of all by producing a biased, incorrect picture of the responsible officials, procedures and laws. In a democracy voters should be able to judge candidates and government officials as they really are. Voters should have unbiased and full information. People should be provided with the information which enables them to understand. Selectively incomplete and biased information is incorrect information. It results in erroneous (mistaken) choices. At present, voters do not have the information they need to get the people, laws, and policies they want.

As will be shown, the operation of government differs greatly from its words. In general the words are nice, inspiring confidence or at least indulgence, and belief in best intentions. For example, the headline of an interview in the Yearbook Integrity 2010 of the Dutch Office for the promotion of integrity in public administration, quotes Andrée van Es, the director-general responsible for integrity policy of government at the Dutch ministry of Internal affairs, as having said:

«Everything you do should be able to bear the light of day»

This is addressed to government employees.

Somewhat farther on in the interview she notes:

«Integrity requires transparency and openness».

This leaves nothing to be desired, and nothing to be added.

⁴⁹ And obviously the Great Chinese Famine (with 40 million deaths) and the so called Cultural Revolution. The Cultural Revolution was a kind of civil war initiated by Mao to regain lost power. It destroyed innumerable lives and a large part of the material Chinese cultural heritage. The name “Great Proletarian Cultural Revolution” was used to hide the true purpose.

⁵⁰ Because of its illogical nature, the assertion that there is no need to study the internal operation needs proof. The above shows that this proof is nonexistent. The present work shows that understanding the internal operation of hierarchical organizations is essential for the explanation of the cases mentioned.

⁵¹ And will cause, unless fundamentally corrected.

⁵² Their views and motivation may be important for the solution of the problems. “Enabling them” to comment would therefore be too weak a formulation.

The report does not claim perfection; it marks a phase in an ongoing endeavor.

Although much has been done to ensure reliability of this report, it has not been tried to make it perfect in any sense, except perhaps with regard to reliability. The main reasons for accepting imperfection being that perfection is beyond the reach of any being, and useless. “Perfection” is anyway subjective, undefined, and possibly indefinable. The suggestion of believing it to be realizable shows a lack of understanding of the relativity of all human work and understanding, and of language. The idea that a report can give final answers or solutions is a chimera and a false pretension. If only because it is far from certain that even all practically important implications of the presented observations and analyses have been seen. Implications may be logically deductible, and nothing “really” new. This does not mean however that anyone sees them, or even the most important ones. Indeed, a large majority of people sees at best only a few of the implications of what everyone knows or can see.

Moreover, in the eyes of the present author, literary goals and requirements of conformity to what is customary, harm the more important goals, and easily hamper or inhibit thinking effectively and efficiently. An important example is the rejection of enumerations and the point-wise listing of items. Let alone the requirement to force all information into running text.

The relinquishment of the idea of perfection is related to the idea that this report is part of an ongoing collective endeavor, and to the wish of the author to be or make himself superfluous. Which is not to say that the report only wants to be helpful: it definitely tries to give reliable answers and solutions to questions and problems which it finds in urgent need of answer and solution. But at the same time it does not pretend infallibility, and is not intended as the last word on the subjects it discusses.

The report aims at overkill.

If one doesn’t know what is and what isn’t relevant for a convincing explanation of historical events or developments, one can only try to be as complete as possible. At least as regards everything that is not self-evident, generally known, or obviously irrelevant for understanding. This is the reason for the length of the original (Dutch) descriptions of the policy portal project and, to a lesser extent, the first financial crisis (the subprime crisis), and, with the opposite effect, for the brevity of the description (and analysis) of the second financial crisis (the government debt crisis) and the cases of chapter 8. The Dreyfus affair has been chronicled relatively extensively both to get a consistent picture of the most important facts and to spare the reader time and puzzles.⁵³

Initially, the author only wanted to understand the unbelievable things he saw in the policy portal project. In the first place to get an answer to the question: is this true or imagination? He had not the slightest inkling that this project could become a key to the understanding of government in general. But it did.

The case studies of other projects and events were meant as checks, and as efforts to try and answer questions which had arisen in earlier work. They were meant to help understanding, and/or help to convince the author of the fact that his eyes did not deceive him, and that shocking inferences are inescapable. Especially those about the structural character of the causes. It is difficult to believe ones eyes and conclusions if most people act and talk as if the world were entirely different. Indeed, the practical insufficiency of logic and the difficulty of conviction remain the most important reasons for the length of the study. From a strictly logical point of view, and as regards the facts needed to infer and support the conclusions, the chapters 2 and 7 contain all you need, probably excepting the terroristic behavior of politicians as displayed only in the whistleblower cases of chapter 8. What the chapters 2 and 7 show is fully 100% incompatible with the hypothesis of honorable and competent government. The chapters 2 and 7 disqualify every politician with any responsibility for either specific or general government or political affair(s). To be clear: this includes all members of parliament, government, and all party bosses (if not all members of political parties). It is because of the fundamental and far reaching character of the conclusions and measures that logical redundancy has

⁵³ Several easily accessible sources leave important factual questions unanswered, and/or are inconsistent

been deemed necessary.

The destruction of dangerous ingrained illusions, and conviction of the inescapability of the presented conclusions and measures seem to require logical overkill. In addition, overkill seems the least that can be done in view of the political resistance that is to be expected against acceptance of the conclusions and measures.

3. Preview of the chapters 2-9.

A story is often easier to follow if it is already vaguely known, or if it is known where it leads. This applies especially strongly when the story is unconventional, and hard or impossible to fit into an existing mental framework. The present section is meant to enable the reader to make a first acquaintance, and to introduce the principal ideas, in the hope of making the chapters 2-9 easier to digest.

Together with the detailed tables of contents of the chapters, the following may furthermore help the reader to select the parts to read. For though nothing in the report should lack added value, or tell something that is already told in, or implied by, other parts, not everything has equal importance as regards the final conclusions and the measures. As regards the empirical evidence, the chapters 2 and 7A, the sections on supervision in chapter 7B, and the whistleblower sections in chapter 8 are the most important. The evidence they provide may be sufficient. Chapter 7B assumes acquaintance with chapter 2; chapter 9 with (at least) chapters 2 and 7. The chapters 3-5 and 8 provide additional material, which is especially important in showing the structural- which also means international- character of the causes discovered in the chapters 2 and 7. Even though the events related in the chapters 2 and 7 are unthinkable if the causes were incidental instead of structural. Chapter 8 moreover provides indisputable additional support for the conclusions about structural repression and lack of respect for people by members of governments and others.

To resume: this report was not written to be read from beginning to end. The chapters 2, 7 and 9 are essential reading. As for the other chapters: browse and read what you want.

Chapter 2. The policy-portal project.

Chapter 2 is the report of the execution of a project in the Dutch ministry of education: the policy portal project. It describes the project as observed by the author. Who was a low-level participant. In the course of the project he tried to find out everything that could be useful for his own role, and for understanding the course of the project.

The main conclusions of the evaluation of this project are:

- There was no useful result. The available budget of over 4 M€ was completely wasted;⁵⁴
- The project was intended to improve the information of the commissioning departments (= directorates). It actually made their information worse;
- IFC, the Institutional Finance Center, the organization executing the project, had a history of failed projects. There was no reason to assume that sufficient improvements had been made to justify confidence in success;
- All representatives of IFC lied systematically about the progress of the project. The situation was always presented far too rose-colored;
- Pressure was put on the representatives of the commissioning departments to acknowledge that the result complied with the specifications. That is: the representatives were expected to lie about the state of affairs;
- The management of the commissioning ministry did not show any real interest in the project. It could see and test the results on its own PC's, but never did. The management did not support its representatives at their request. It did nothing constructive at all;
- It (mis)treated the representatives of the commissioning departments as if they were the cause of the failure;

⁵⁴ All amounts mentioned in the present report are contemporary. (They are not adjusted for inflation in the years between then and now).

- An appeal to the code of conduct and the secretary-general of the ministry had no (positive) effect;
- An “independent” research bureau and the auditors of the ministry colluded with the deceivers. The auditors violated their professional code of conduct;
- After the formal end of the project, new projects were started with the same goal;
- Failure was explicitly denied, but, by the commissioning of these new projects, implicitly recognized. As a consequence of the denial no lessons were learned;
- All efforts at improvement during the course of the project were in vain. Neither ministry nor IFC has effective mechanisms for self-correction;
- Even though the project cost over 4 M€, nothing about the project was reported to parliament. Everything in the project was done as if no control had to be feared. No external organization, such as parliament or the (Dutch) General Accounting Office, ever noticed anything of the above;
- The facts of the project make it impossible to believe that the observed phenomena are the exception and not the “norm”.

Chapter 3. Project- and agency management in a ministry.

The author did not really understand what he saw in the policy portal project. That is: he could not reconcile what he saw with what he thought he should expect. One key-question seemed to be: is this an exception, or the rule? Could there be something in between? Chapter 3 is the report of an effort to try and find the answer to this question. The chapter was made possible by one of the frequent reorganizations of the ministry. It gave the author an opportunity to move into a position that enabled him to follow the developments of all the projects being executed by the agency doing the policy-portal project, IFC.

The main conclusions of this part of the inquiry are the following:

- Of the 9 projects evaluated, the best performing had only a delay; of 2 years. All other projects had either a larger delay, considerable budget excess and/or considerable underperformance;
- For none of the projects an evaluation had been made of costs and benefits. At most there were papers with a one-sided argumentation concluding that the project was necessary;
- The projects seem to have been commissioned on the basis of imaginary castles in the air;
- Possible difficulties (and costs) were systematically neglected, underestimated or talked away. It was assumed (at least said) that whatever could be imagined could be done (and profitably);
- The rules for professional project management were systematically neglected;
- Where provided, progress-reports were concealing, untruthful, and inconsistent;
- Efforts at improvement, also through the highest responsible official, were in vain;
- Serious evaluation did not take place. Neither during the project nor afterwards. Lessons were not learned. (With an unlimited supply of money there is no need);
- The higher management knew, took no corrective action, and sidetracked critical people;
- The commissioning departments of the ministry have very low expectations of the execution and results of projects of IFC. Delays, budget excess and underperformance are accepted as a matter of course. Efforts at correction are considered useless (or madness), a waste of time, and are therefore exceptional;
- Auditors, parliament, and General Accounting Office seem nonexistent;
- The inquiry confirms the systematic character of the phenomena observed here and in the course of the policy portal project.

Chapter 4. Integrity in the Dutch ministry of education and government.

In the policy portal project the author represented his department of higher education. The departments of primary, secondary and vocational education had similar interests, both in the policy portal project and the operation of IFC in general. Each of the departments had its own representative. The representatives were to make sure that their departments got what they paid for, or at least something useful. This would have been difficult enough with decent people in the project organization, and with a realistic plan. But none of these conditions was fulfilled. However, what

shocked the representatives most was the universality of the misconduct of the IFC-spokespeople, including the “managers”⁵⁵ and that of their own “management”, and the quality of the playacting of these people. Obviously, the job of the representatives was extremely unpleasant and stressful. Both IFC and their own management tried to make them believe that they were entirely wrong, and nothing but obstructive fools. Tricks were played behind their backs. Their superiors were lied to without their knowledge, and pressure was exerted to make them accept unacceptable results.

The ministry has a code of conduct. Of course, it prescribes what outsiders expect and consider normal: “good practice”. It was obvious that the code was violated on a regular basis. The author did not understand why his colleagues and he had to fight continually in order to get the project executed properly. In a way everybody would consider normal.⁵⁶ The more so in a ministry with a code of conduct. The code was signed by the highest official in the ministry, the secretary-general, “SG”. In speeches, weblogs and other statements the SG regularly made claims about the integrity of “his” ministry. Therefore, the author decided to appeal to him directly to set matters straight. In vain. The code of conduct turned out to be no more than a piece of paper. Events show that it can only be meant to deceive. To put this experience in perspective, a study was made of the way the code is supposed to function, and of the integrity policy of the Dutch government in general. Chapter 4 is the report of this study. Some of the conclusions are the following:

- The code of conduct of the ministry of education was signed by the SG. Publicly he actively propagated the code;
- The SG has been asked personally and explicitly to maintain the code of conduct. In vain. Initially, he ordered an inquiry; finally he denied any problem and sidetracked “difficult” people (and left everybody responsible for misconduct in his place, or had them promoted);
- No corrective action was ever taken;
- The SG and his deputy lie as a matter of course;
- In general, functionaries give priority to orders and perceived wishes of superiors, and ignore codes of conduct and generally recognized norms;
- The relevant publications of the General Accounting Office and of the Office for the promotion of integrity in public administration implicitly suggest that integrity violations in the public sector are exceptional and relatively unimportant;
- Nothing in these publications betrays any knowledge of the reality as described in this report. Neither do they show the least trace of an analysis of whistleblower cases such as that of Spijkers, or knowledge of the paper of Van der Vliet et al about this case;
- Neither the General Accounting Office nor the Office for the promotion of integrity in public administration warn the reader about limitations of their methodologically flawed inquiries and publications;
- Disintegrity dominates public administration.

Chapter 5. Chronicle of a Policy claim/ IAG2000!/ Renewal program.

The policy-portal project was a project of one of the two agencies followed by the author in the years 2005-2010 (approximately): IFC and IAG. IAG meaning Information Administration Group. Chapter 3 evaluates the management of projects of IFC. Before 2005 the author did not know or understand very much about IAG. He had been involved with it for more than 10 years, but almost as an outsider. In 2005 he took part in discussions about the definition of a new and big project of IAG. Contrary to the other participants he was critical and doubtful. The doubts were based on experience, inconsistencies in the project proposal, and lack of clarity of its goals. He got no answers to his questions, and left the project. By accident he got the opportunity to take part in discussions about the project at the end of the project, late 2009. It turned out that the project had failed completely. Curious as always, the author tried to find out what had happened. It was furthermore possible to observe the follow up. Which was just as amazing as the project itself, and fully consistent with its history and that of the other projects discussed..

⁵⁵ Manager is put between quotation marks because in general they do not and cannot manage. In other words: the quotation marks are meant to counterbalance the misleading suggestion of the word.

⁵⁶ Everybody outside the ministry and IFC that is to say.

Chapter 5 is a report and evaluation of this project and its management. Some of the conclusions are:

- The renewal project is an example of false pretensions, and of systematic efforts to keep them up by untruthful and otherwise inadequate reporting;
- The project followed a similar but failed project. It failed just as well. It was followed by a new (third) project with similar goals;
- In 2005 IAG claimed approximately 50 M€ without knowing whether it could spend this money in a useful and responsible way. In other words: the money came first, the “plan” afterwards (though IAG didn’t even know how to make a plan);
- The commissioning ministry never checked whether IAG had learnt the lessons from the failed earlier project, and whether it could be relied upon to execute the new project properly;
- A timely and well-reasoned warning mail of the author to the responsible undersecretary-general was ignored 100%;
- There was no sign of memory and of lessons learnt;
- The chronicle of the project provides several examples of external research organizations producing evaluations which fatally underestimate problems.⁵⁷ None of them expressed doubts about success;
- None of them enquired about lessons learnt from the earlier failure;
- As a rule, the research organizations make a potentially fatal methodological error. Most of what they say is based on interviews with interested participants;
- The commissioning ministry’s attitude towards IAG was ambiguous and misleading;
- The hypothesis that everybody tries to do things as good as possible is untenable. The behavior shown in the report is unthinkable if participants knew they would have to account for their behavior publicly;
- The report of the project shows selection phenomena that maximize the probability of failure. Thinking people are sidetracked, blind optimistic believers are given key functions;
- The ministry of education and IAG act like swindlers: they claim (more) taxpayer money with false promises;
- The start of the 50% more expensive follow-up project shows no improvement over the start of the failed project.

Chapter 6. Analysis of the chapters 2-5 regarding the internal operation of hierarchical organizations.

This first analytic chapter concerns the internal operation of government organizations, as seen in the chapters 2-5 and in a few sections of chapter 7. The “internal operation” includes the management. The following are some of the conclusions drawn from analyses of the chapters 2-5:

- The management of these organizations is characterized by false pretensions. It claims to be what it is not, and to be able to do what it cannot. There are false pretensions in almost every field: in technical fields like information technology, but also in integrity, inquiry and management. The false pretensions are very detrimental to the integrity, effectiveness, and efficiency of the organizations;
- The management does not take its own internal agreements and promises seriously. The agreements and promises sometimes seem to be made only for the record, to mislead future investigators who assume (without checking) that words reflect reality;
- The top management is characterized by irresponsible behavior. For example by approving something it doesn’t understand, or against better judgment;
- The top management dishonors people of whom it knows that they did their duty, and that they refused to collaborate with misconduct. It does so in an underhand way, without accounting;

⁵⁷ The adjective “fatal” and adverb “fatally” are used when serious harm is actually caused. An error need not cause harm; a fatal error does, or has already caused serious harm. “Evaluations which fatally underestimate problems” failed to prevent (costly or worse) failure. A reliable, open evaluation could have prevented failure.

- The top management (publicly) rewards people whom it knows did not and cannot do their duty; who failed grossly and avoidably; pretend that everything goes fine; and harm people who say otherwise in order to keep up appearances;
- When reporting, it is assumed that everything is permitted in order to be able to paint a positive picture. Lies included. Failure and its causes are not mentioned, or lied about, making correction difficult or impossible;
- This also applies to audit organizations like the (Dutch) General Accounting Office and the internal audit department of the (Dutch) education ministry;
- Managers violate the code of conduct of the organization at discretion;
- Employees of the audit department violate their professional norms, and commit forgery. Possibly at the request of the top management. But they may also have been selected for having a good intuition for what the top expects of them;
- The organizations operate (almost) as if there is no supervision, and no sanction for misconduct. In particular, the observations are consistent with absence of any form of parliamentary control;
- The organizations are essentially corrupt: they are characterized by socially harmful, improper conduct.

Chapter 7. The financial crises of 2007-2013.

Chapter 7 consists of two parts and a set of appendices. Part A is a chronicle of events directly related to the financial crises of 2007-2013. Part B gives an analysis of the events, of the behavior of responsible actors, and of concepts and phenomena which are crucial to understanding the events. The chapter is based on the work of the Dutch and US parliamentary inquiry commissions CDW and FCIC, on the appendices, and documents in the archive.⁵⁸ Most of the appendices are reports of studies of individual actors and organizations. For reasons of readability only part of the results of these studies has been integrated in parts A and B. Of course, restriction to summaries and conclusions has a price. There is quite a difference between the effect of reading that a supervisor has failed systematically, and seeing all kinds of nonsense mixed up in one annual or hearings report after another. In order to convince him or herself of the fundamental and systematic failure of the present political and supervisory system and of those occupying the key positions in this system, the reader is strongly recommended to study at least a few of the appendices and their sources.

Chapter 7 is a very welcome complement to the chapters 2-5. The chapters 2-5 mainly show phenomena inside a ministry. That is: inside a large government organization. Chapter 7 shows other kinds of phenomena. The most important phenomenon seems to be the (dys)functioning of organizations and people with key roles in the financial and political systems. Through annual reports and the hearings of CDW and FCIC, the financial crises show the lack of integrity and competence of all the (ir)responsible people, including the inquiry commissions. They show the extent of the failure of the system. Not just a few organizations or top people failed. All of them failed. Without exception. The system failed as a system, and not only in the financial sense. Last but not least the chapter shows a 100% absence of effective self correction.

As regards the causes of the subprime crisis and the government debt crisis, the following conclusions are drawn:

- The financial institutions in the restricted sense- such as banks- could have prevented the first crisis by applying stricter than legal norms at the cost of their position with respect to the competition;
- By its housing policy the US government actively stimulated people and financial institutions to accept unbearable risks. The housing policy significantly increased the relative number of high-risk mortgages. The housing policy is the best candidate for “cause” of the subprime crisis;
- Supervisors and governments could and should have prevented both crises by fulfilling their (legal) duties. This can be seen as the “cause by omission”;

⁵⁸ CDW= Commission De Wit, FCIC= Financial Crisis Inquiry Commission.

- The financial institutions in the restricted sense could not have prevented the second crisis;
- The supervisors could and should have prevented the second crisis. They could if at least a few of them had warned unanimously.

The financial crises are “large” cases. They show many different kinds of shortcomings and failures. The following are some of the more general conclusions:

- The members of the governments and parliaments of the OECD countries,⁵⁹ the heads of the various supervising organizations, and the heads of many financial organizations have demonstrated a fatal lack of integrity and competence;
- This was the cause of the crises. Not the unpredictability of fatal phenomena. An authoritative organization, the US General Accounting Office (GAO), had given well-reasoned unambiguous warnings about the processes which precipitated the subprime crisis. Every financial expert should have been able to reproduce its argumentation and conclusions;
- Even if they would be able to evaluate people correctly, untruthful and incompetent people will not appoint honorable competent people in positions of power. Such people would surely have them removed from any influential position;
- Due to the inadequate and unequal law, politicians and top “managers” who take unbearable risks need not fear negative consequences for themselves. In combination with other circumstances, this creates unlimited risks for human society and life on earth;
- Reminder: the law is made by governments and parliaments;
- The present social organization, as induced and controlled by present laws, precludes occupation of top functions by honorable and competent people;
- Both in organizations and the sociopolitical system, self-correction mechanisms are absent or insufficient;
- It is highly unlikely that nobody in the relevant ministries and supervising organizations knew about the GAO reports, and/or understood the processes and risks. Only dishonesty and incompetence of the “management”, in combination with repression made possible by the hierarchical (dictatorial) character of these organizations, can explain that nothing was done with their insight;
- Codes of conduct and whistleblower regulations had no observable effect. The facts explicitly and implicitly show that codes of conduct were violated regularly;
- The widespread failures can be partly ascribed to a variety of defects in education;
- Education (at all levels) fails to prepare for the real world. It does not teach a questioning attitude, to critically evaluate answers, and to reject nonsensical answers. It does not teach to fight the social pressure to tolerate harmful nonsense;
- As regards the financial-economic matters, education in the most relevant disciplines, such as law and economics, has potentially fatal defects;
- There is no sign of improvement of education and research. There is evidence of continuing if not increasing corruption;
- Governmental or parliamentary inquiry commissions lacked integrity and competence. Their reports do contain much useful information, but their analyses are fatally flawed;
- The inquiry commissions questioned top officials as if they were reliable experts: honorable and competent. From the facts and preliminary studies of the crises, the commissions could and should have known that this assumption is incorrect. The inquiry commissions could have obtained all necessary information from historical documents. Most of the hearings served no other purpose than offering culprits the opportunity to exculpate themselves;
- Although many of the relevant organizations have thousands of staff, the commissions as a rule questioned only top functionaries (“managers”), with only very few exceptions. The commissions showed no interest in their management or the functioning of their organization;
- In their hearings, the inquiry commissions did not ask questions of which the answer would reveal one or more of the conclusions of this study. They did not ask questions of which the answer would reveal that the responsible person was unfit for his job.

⁵⁹ OECD= Organization for Economic Cooperation and Development, an international organization of states.

Chapter 8. Other examples.

Chapter 8 gives concise descriptions and analyses of more than fifteen other cases. It mentions several more. The findings are consistent with the conclusions of the earlier chapters. They are incompatible with denial of these conclusions. The cases of chapter 8 support the hypothesis of the structural character of the phenomena described and analyzed in the earlier chapters. Wherever you look, you see the same kind of phenomena. Possibly more than other chapters, chapter 8 shows that politicians do not respect even the lives of other people.

The chapter starts with four whistleblower cases. When analyzed thoroughly, these cases reveal very much more than can be gathered from contemporary information by the media. Logically speaking even a single whistleblower case furnishes more than enough evidence of the lack of integrity and competence of the whole political world. The other cases, in this and other chapters, are not logically necessary to reach this conclusion. But they do show the extent and consequences of the corruption, and they do help with their explanation. They help to convince the reader of the inescapability of the problem. Like the financial crises, the whistleblower cases show a total absence of ability and/or willingness of the political world to correct itself. The given system evidently lacks effective mechanisms for (self) correction.

Some of the case-unspecific conclusions of this chapter are the following:

- Many conclusions from the cases in this chapter coincide with conclusions from earlier chapters;
- No contradiction was found;
- In particular, the cases demonstrate the lack of integrity and competence of the responsible politicians. (Real) Openness could nowhere be observed;
- Most of the cases show inexcusable misconduct. By implication they show the lack of integrity of those who help to keep perpetrators and responsible people in power, and laws unchanged;
- None of the responsible persons has given an acceptable account of his or her (mis)conduct. They say that they have done what they could or should, or deny any wrongdoing. This was accepted by parliaments and inquiry commissions;
- The responsible people are characterized by (consequential)⁶⁰ false pretensions;
- Their interrogators did not pose questions of which the truthful answer would have been unacceptable to the public, and would have revealed one or more conclusions of this study;
- In many cases (much) avoidable damage was caused. Often it was irreparable. Where compensation was paid, costs were mostly covered by the taxpayer. Only a negligible part was recovered from the responsible actors;
- Which can be imputed to the law;
- Control and self-correction of organizations is insufficient or absent;
- External control and correction by parliament or supervisor is insufficient or absent;
- In most cases damage could and should have been prevented by the relevant supervisor;
- All observations support the hypothesis that repression almost completely prevents internal reporting of misconduct, and that chances of success of an internal report about misconduct are almost nil;
- The observations support the hypothesis that misconduct is made easy, or caused, by the legal regulation of the hierarchical organization. The head of a hierarchical organization is a virtual dictator. Repression is easy. Without external help, correction of a dysfunctional “management” is extremely difficult, and often impossible;
- Governmental or parliamentary inquiry commissions almost always lacked integrity and competence. Their reports may contain useful information, but their analyses are fatally flawed. They don’t see any weakness or error in the political or legal system;
- There is no sign of developments supporting belief in improvements which reduce the probability of occurrence of similar cases. No changes have been made which make misconduct by responsible politicians unattractive, or remove barriers for self-correction of organizations.

⁶⁰ In the sense of: “having significant consequences” (Merriam-Webster 2002).

Chapter 9. Final analysis, conclusions and measures.

Chapter 9 is devoted to general analyses and conclusions, and to measures which need to be taken if phenomena like those described in the earlier chapters are to be ended and prevented. Where the adjective “general” is used as the opposite and complement of case-specific.

The chapter begins with a review and analysis of the characteristics of the kind of people who are responsible for the phenomena and events described in the earlier chapters, including the lack of systemic improvement. Main characteristics are:

- Consequential false pretensions;
- Intelligent, but not enough for the job, and lacking the necessary integrity and competence;
- Born actors and swindlers. Integrity and competence are only pretended;
- Seem to think they know better what is good for us than anyone else, and that this gives them the right to dictate the law and to overrule everyone;
- Never acknowledge lack of integrity or competence, or falseness of pretensions;
- Try to keep up appearances at all costs;
- Always cover their colleagues, never criticize them;
- Have no real respect for people outside their own group;
- Don’t feel really responsible: are very good at story-telling, but don’t give an account that can pass muster;
- Are nearly never held liable or punished for harm caused;
- Are 100% successful in avoiding social improvements that endanger the position of their kind.

The chapter next tries to explain how a political elite consisting of dishonorable and incompetent people comes to dominate society, and how it can survive even its greatest failures, such as wars and crises, and how it can prevent fundamental improvement. Elements of the explanation are:

- Social organization characterized by top functions with impossible requirements;
- Meaning that top positions can only be occupied by people with false pretensions;
- With regard to both integrity and competence;
- There is no effective accountability for top functionaries. Due to an inadequate supervisory/-control system, and inadequate (unequal) liability, criminal and procedural law, top functionaries have nothing to fear from dysfunctioning;
- Hierarchical organization gives a tiny minority almost dictatorial powers. Hierarchical organization effectively makes the opinions of subordinates, that is: everyone below the top, irrelevant. Subordinates are made to understand that there is no crime worse than blowing the whistle on harmful misconduct;
- Hierarchical organizations are closed and opaque: outsiders are not allowed to see what happens inside. Outgoing information is censored. This hinders self-correction and causes a positively biased picture of organizations and their bosses;
- By forgetting and making forget, and because they depend on news providers, the media prevent learning, and actively help the establishment stay in power;
- Education is inadequate. Insufficient attention is paid to how things are, to understanding the relation between law and reality, and to preparation for the real world;
- Socially important sciences, such as law, economics, psychology, political and social science, lack integrity. Phenomena as described in this study are ignored instead of accepted as proof of the incorrectness of crucial theoretical assumptions;
- Mistaken illusions and faulty reasoning (wishful thinking without checking);
- Such as seeing only actions as a cause, and not failure to act when duty requires action;
- Interests having the same effects as censorship. The interests are partly created by the redistribution, by politicians, of taxpayers money. That is: the redistribution of about half the national income;
- In general, employees are subservient and taciturn. Except in very rare cases of whistle-blowing, violations of codes of conduct or failure to act as duty demands do not elicit noticeable reactions from employees. The terroristic attitude of the top towards whistleblowers can be seen as part of a culture of repression, and as the explanation of the silence of the

employees.

After the final analyses, and before the presentation of the measures, the general conclusions of the study are enumerated. Some of the more important are:

- Most cases would not have been cases if the responsible functionaries were competent and honorable, and therefore would have acted as they should have;
- In particular, the financial crises would not have taken place even if only part of the responsible government functionaries would have acted competently;
- All cases show a fatal lack of integrity and competence of all responsible functionaries;
- Responsible functionaries hardly if ever acknowledge failure or lack of integrity or competence;
- No failure to act as required had worse consequences for the responsible functionary than transfer to another well-paid position of power;
- Most of the victims of government failure (and harassment by government officers) have not been compensated;
- Codes of conduct have been violated systematically. The codes can only be meant to mislead outsiders;
- Governments, including parliaments, are characterized by false pretensions;
- There is no effective control of government. “Supervision” and “parliamentary control” are no more than examples of false pretensions;
- The present governments lack the competence to tackle the main actual problems. They lack the competence to avoid avoidable disasters. They do not understand the problems. They can choose nor understand their (independent?) advisors. There is nothing that resembles adequate risk management on a national or international level. Present governments must be expected to mislead and fail;
- Parliaments do not represent the people but their government and/or party;
- The (hypothetical) mechanisms for (self)correction are fatally inadequate;
- In order to avoid similar crises and far worse catastrophes relatively obvious but nevertheless far-reaching measures are necessary;
- History becomes much more understandable if thinking in terms of a single national culture is replaced by thinking in terms of several different cultures.⁶¹ Especially a culture of the top and a culture of the rest of society. Where the culture of the top is characterized by lack of respect.

The chapter is concluded with a section “Measures”. The principal purpose of the measures is to safeguard people from avoidable harm caused by others, especially governments. It is argued that the measures are both necessary and sufficient. To be clear: necessary and sufficient to avoid avoidable disasters. For this reason they are not “proposed” or “recommended”. They can be grouped under the following headings:

- Consequent liability and criminal law;
- Redefinition and redistribution of jobs and/or duties. All jobs and/or duties should be fulfillable by real people;
- Abolishment of (dictatorial) hierarchical organization. (This can be seen as consequence of the preceding);
- Education that prepares for participation in society as it is;
- Honorable science that gives the well-being of mankind a higher priority than the indiscriminate increase of knowledge in irresponsibly chosen fields;
- Parliament and representation;
- General standing⁶² for complaints about action and failure to act in public administration.

⁶¹ “Culture” refers to the set of norms and values. As manifest in people’s activities.

⁶² «Standing is the determination of whether a specific person is the proper party to bring a matter to the court for adjudication. The Supreme Court has declared that “[i]n essence the question of standing is whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues”» p. 60, *Constitutional Law*, 3rd edition, E. Chemerinsky, Aspen Publishers, ISBN 0 7355 5787 X. By “general standing” we mean standing for everyone. After all, everyone is affected by government, and government is responsible to everyone.

The report concludes with a warning. The conclusion about the lack of integrity and competence of the political elite is irrefutable: the phenomena described in this report could not be more inconsistent with integrity or competence of government. The present elite cannot cope. It lacks essential abilities and attitude. It will resist and fight the changes which are necessary for mankind's survival. The report shows that illusions are outright dangerous. Without the changes indicated, terrible disasters are not only possible or probable, but guaranteed.

Chapter 9 has an appendix. It gives an outline of a constitution of a communicative society. With the exception of the law of logic, and in order to comply with it, all (other) regulations of such a constitution are voluntarily. The appendix shows that and how a society can be organized on a voluntary basis. It shows that there can be law and order without a need to impose authorities, rules and institutions against the will of a part of the population.

The outline is meant to show that the existence of peaceful alternatives to the present political systems is not just empty talk. Alternatives are shown to be feasible. The appendix is meant to show that a respectful society can be organized, and that there is no need of dictatorship, either by majorities of "representatives" or otherwise, and to impose anything by force.

The report is concluded with a personal afterword, in which the author reflects on the understanding of the world of mankind as gained by the work on the report.

First of all it is noted, that the deficiencies and ensuing failures of human beings especially in responsible positions, can be explained by the impossibility of adaptation from life as an animal among animals to life in large human populations, in a time span that is very short in terms of biological evolution. Upon reflection, adequate adaptation must be considered impossible. An explanation is no excuse however. The explanation nevertheless shows that authority cannot have a solid foundation. The explanation strongly supports the need of modesty. And therefore of a fundamentally different social organization, which does not assume non-existent mental capabilities.

Secondly, it is noted that it is one thing to know that and how human affairs can be organized respectfully, and quite another to know how to realize a respectful system. Given the findings of the report and personal experience, the author sees no way. Informing the public about the findings of this report probably is a necessary condition. But it certainly is not sufficient.

Thirdly the author explains his thorough disappointment at the betrayal of their own norms and values by journalists and scientists, and to a slightly lesser extent (other) teachers. Their pretensions are false. Without their conscious or unconscious support, the given political systems could not and cannot survive. Journalists, scientists and teachers prevent improvement and correction, and facilitate repetition of crises and catastrophes. Conscious support means outright deceit. Unconscious support does not mean innocence: causing harm by pretending to be able and to do what one cannot and does not is criminal in the sense of the law of logic.

Some sections are not divided in subsections, but consist of two parts: a subsection "summary and conclusions" and the text proper. In such a section, the end of the subsection summary and conclusions is marked by a black square: ■.

Chapter 2.

The policy portal project.

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2.1. Chronicle of the policy portal project in a nutshell.

The policy portal project (PPP) was commissioned by and for the Dutch ministry of education, and executed by one of its agencies, IFC, the Institutional Finance Center.

- 2004: Preparatory discussions and planning.
- 2005: Promising & pretentious presentations by IFC of a hypothetical policy portal: an internal website with information about the education system.
Agreement about a *Global plan*, *Portal requirements*, and a budget of 4 M€ for release 1 of 3.
Contrary to the *Global plan*, release 1 of the policy portals for the departments higher education (HE) and professional and adult education (PAE) are not ready by the end of the year. Not by far. A “Première” is cancelled.
- 2006: The policy portals for the departments of primary and secondary education (PE and SE respectively) should be ready by April 1, but aren't. Not by far.
Mid-year a new steering committee is installed.
At the end of the year the lower part of the line management for the PPP in IFC is replaced.
- 2007: Vain effort to make a new beginning with the new IFC managers.
Grossly defective drafts of a *Discharge protocol* and *Service level agreement*.
Inquiry by external consultancy firm VKA of implications of governmental directives for websites.¹
Deliberations with the secretary-general of the ministry in pursuance of an appeal by the present author to enforce the code of conduct of the ministry.
A defective quick scan audit of PPP (audit 1) only leads to another audit.
- 2008: Two more audits of the PPP (audits 2 and 3). The report of the first is kept secret, the report of the last denies non-performance, and accuses departmental representatives of obstruction.
Top level deliberations about sequel. Main conclusion: new departmental representatives.
- 2009: A new beginning fails. The top management concludes that continuation of PPP is meaningless.
The datawarehouse, the foundation of the policy portal, turns out to be defective. M€ 2.3 is made available for repairs or new beginning.

¹ VKA= Verdonck, Klooster & Associates B.V.

2010: PPP is terminated formally. The project has produced nothing useful. The information of the education departments is worse than it was in 2005.

2.2. Summary and conclusions.

1. Up to and including 2005 the education departments themselves took care of the collection and management of the quantitative information they needed. In 2005, in order to make these activities more efficient, the four education departments accepted a *Global plan* of IFC for a policy portal. IFC was the agency responsible for the actual distribution of tax-money to educational institutions. It presented the policy portal project as an investment that would repay itself. The policy portals should eliminate the need of the education departments to collect and manage quantitative information by themselves.
2. Release 1 (of a total of 3 releases) of the PPP would cost 4 M€.
3. Notwithstanding the fact that IFC had a history of failed ICT-projects, its pretensions regarding the PP were fantastic.² It is not clear why the IFC management thought that it could bring this project to a good end (if it did). Neither is it clear why the responsible persons in the ministry thought IFC could (if they did).
4. The department of higher education fired the people who were responsible for the collection and management of quantitative information. At the moment it did so, there was good reason to doubt the success of the PPP.
5. Already in 2005 the time-table was exceeded without explanation. IFC said it had delivered what had been agreed upon. This was evident nonsense.
6. The representatives of IFC systematically failed their promises. They did not give acceptable explanations.
7. The progress reports of IFC were incomplete, misleading and sometimes contained important lies.
8. The representatives of the education departments always informed their superiors timely, fully and correctly. This never resulted in effective action with respect to IFC. The higher management never showed signs of sharing the concerns of its representatives. Instead it sometimes took action that frustrated the proper functioning of the representatives.
9. The periodic consultations of the top managers of ministry and IFC were systematically abused by the IFC management to give the top of the ministry a rosy or incorrect picture of the state of affairs, and to generate pressure on the education departments to accept a useless product.
10. The managements of ministry and IFC have shown competency only as regards misleading and repression. Their behavior is dishonorable with respect to all points of the definition of integrity of the secretary-general of the ministry: «[Our behavior with respect to each other and to the outside world should be open, service-oriented, respectful, impartial, and reliable. In a single word, honorable.](#)»³
11. The managements of ministry and IFC failed to do what was necessary to accomplish the goal of the PPP. Failure was never acknowledged. Until failure became too evident, they remained in a state of denial.

² ICT= information and communication technology.

³ P. 3, Code of conduct of the ministry of education. To be found in directory Integrity under 20050620. In the present report a person is called open, if he tells those concerned everything that is of interest to them, in their opinion. He doesn't wait till asked, and doesn't avoid answering.

12. The PPP is a complete failure. It produced nothing useful. M€ 4.5 was spent without any useful result. No (positive) lessons were learned.
13. The information of the department of higher education has become worse instead of better.
14. The PPP had no positive results, but it did have negative ones. In both the ministry and IFC the following notions are confirmed:
 - a. that the top managers lack integrity and competence,
 - b. that they cheat their own people,
 - c. that resistance against fraudulent behavior of IFC is punished, and
 - d. that IFC can cheat with impunity and is rewarded for failure with new contracts.
15. The pretensions of IFC, that is: its top management, regarding its abilities and promises were false.
16. IFC has tried to keep up its pretensions by all kinds of dishonest means, including lies and blackening representatives who only did their duty. It never acknowledged the falseness of its pretensions.
17. The PPP is an example of history repeating itself. The description in section 2.4 shows that this can be explained by false pretensions and money-hunting of dishonest and incompetent managers, and by the absence of any need for accounting.⁴ Staff who think independently and talk openly are shoved aside, and the positions of “optimistic” risk-takers and/or yes-people are improved.
18. Nobody in the higher levels of the relevant hierarchical lines of the ministry ever showed more than the most superficial interest in the useless product their staff would have to work with if IFC got its way. Even though it was simple to inspect the portal on their own PCs, they never did.
19. Instead, they blindly accepted IFC’s assertion that not their product but the representatives were the problem. They never took the departmental representatives and their complaints seriously. They never acknowledged the legitimacy of the complaints. They joined IFC in putting pressure on the representatives.
20. So that the departmental representatives had to fight on two fronts: against IFC and against their own management. (The representatives explained their behavior; the managements never did).
21. For years IFC and the top of the ministry treated the departmental representatives disrespectfully and unjustly. The representatives were cheated by their own management. The complete failure of the project proves that the representatives had been right in not accepting the “products”, and had done what behooves good civil-servants. This was never acknowledged.
22. On the other hand, no action was taken against the managers of IFC, notwithstanding their obvious mismanagement, false pretensions and outright lies.
23. The underhand instead of open behavior of the top of the ministry shows that there were no legitimate reasons for protecting the management of IFC.
24. The consultancy firm VKA and the audit department of the ministry turned out to be dishonest and incompetent.

⁴ And by implication: far too easy (taxpayer’s) money.

25. The code of conduct of the ministry was trampled under foot by the top of the ministry, the management of IFC, and the audit department of the ministry. The author has personally asked the secretary general to maintain the code of conduct of the ministry. In vain.
26. The authors of the audits 1 and 3, members of the audit department of the ministry, have violated their professional code. Those of audit 3 are guilty of forgery.
27. The behavior of IFC can be explained by lack of integrity, competence, and an excess of pretensions. No manager ever acknowledged that IFC claimed too much. Instead, IFC always claimed to have produced what was agreed upon, and that the accusations of non-fulfillment were attempts at obstruction.
28. There doesn't seem to be an obvious and convincing explanation of the behavior of the top of the ministry. Some people believed in the existence of a hypothetical but unknown interest that justifies the expense. Since nobody was able to identify this interest, the hypothesis may be no more than an illusion, based on wishful belief in rational behavior on the basis of interests. The most plausible explanation seems to be: keeping up appearances: "we always take the right decisions, we make no mistakes, and never fail". On the other hand, the (immortal) costs of the misconduct are very high: demoralization of the organization due to behavior which is inconsistent with generally accepted norms and values, and the (relative) promotion of dishonest and incompetent staff. In other words: (increasing) the corruption of the ministry and its agency.
29. It is incorrect to think in terms of a culture of the ministry or agency.⁵ There is no single organizational culture. There is a culture of the top and its court, and quite another culture of the other part of the organizations.
30. Charging IFC with the development of ICT-products is irresponsible until substantial improvements have been proved, and, by implication, until the corrupt and incompetent management has been replaced by honorable and competent people.
31. The observed phenomena cannot be explained by specific properties of the PPP. They can all be traced to more general causes, in particular false pretensions. Which affect all projects, and many other activities in the ministry and IFC. The failure of the project was moreover complete. It follows that it is efficient to stop all similar projects, and not to start new ones.
32. The responsible dishonorable and incompetent managers are maintained. Some were promoted. They didn't learn anything from earlier failures. Therefore, no improvement may be expected. And indeed, no sign of improvement can be seen.
33. Neither ministry nor IFC has shown an ability to correct itself. Worse, their managements actively resist correction. Resistance by the majority of the employees is absent and useless.
34. From the characteristics of the very many unacceptable phenomena described in this chapter it follows that they are systemic, and dominate all activities of the organizations concerned. Most of the phenomena have nothing to do with ICT.

2.3. Introduction.

The very first version of this report was no more than a description of the policy portal project in the period August 2005- June 2007. The present chapter is the completed version of this report: a description of the project from beginning to end. The first version was written in the summer of 2007. It was meant to inform the secretary-general (SG, Koos van der Steenhoven) and the undersecretary-general (uSG, Simone Roos). It was meant to show that they should act in order to correct the

⁵ A culture is understood as a consistent set of norms and values.

misconduct of IFC-people. The remainder of this chapter, and the rest of this report, were written after it had become clear that SG and uSG not only did not act as requested, but even obstructed improvement. And after it had become clear that at least in the education ministry, the observed phenomena are not the exception but the rule.

The chapter is meant to show the functioning of people in a ministry. It is meant to be part of the empirical basis for efforts to explain the observed, similar and related phenomena, and for measures for improvement.

The chapter is a translation and abbreviation of the corresponding Dutch chapter. Abbreviation has been accomplished by summarizing, and by deleting what seems less relevant for the analyses and conclusions. For more context and details the reader is referred to the Dutch edition and the documents in the directory PPP of the archive. Obviously the original is closer to, and gives a better feel of reality. However, for the analyses, explanations, and measures, the translation and abbreviation would seem to be sufficient.

The PPP was developed by an agency of the ministry, the Institutional Finance Centre (IFC). The primary duty of this agency was the actual payment of the educational (and various scientific, and cultural) institutions according to budget laws and regulation. Formally, IFC was not independent, but part of the ministry. Its offices were in Zoetermeer (The Netherlands), which is about 12 km east of the ministry in the center of The Hague (on the North Sea).

The policy portal project was meant to reorganize the collection and management of the quantitative information used by the education departments of the ministry. Access to the information was to be modernized. In other words: the policy portal was to be an internal information website. Nothing else. By using web-based “portal technology” IFC meant to build a portal, a kind of website, for each of the four education departments. To wit: the departments of primary education (PE), secondary education (SE), professional and adult education (PAE), and higher education (HE). These departments were to pay the costs. The project was presented as an investment which in time would pay itself back. As regards HE, the project would result in the removal of 2,5 fte information-activities from HE to IFC.⁶

The content of the portals was specified by the education departments, and agreed by IFC. Each department appointed a representative for the project. The author represented HE. The representatives were the eyes and mouths (spokesperson) of their department. Their foremost duty was to ensure that their departments got what they needed and paid for. They took care of daily communication, and reported to the management of their department when necessary. In its turn, IFC had appointed a representative for the PPP for each of the education departments. Further details of the organization of the PPP in IFC can be found in the directory PPP.⁷

On the side of the ministry not the departments but a director-general (DG, DGPS Rob Kerstens) was formally responsible for the project. He was representative of, and responsible to, the uSG. The uSG was responsible for everything regarding IFC. Including its budget. She could overrule departmental decisions regarding IFC.

On both sides, ministry and IFC, about 10 people were involved in the PPP. External people hired by IFC not included. The project budget of 4 M€ only represents the costs on the side of IFC.

The author regrets that he cannot tell more about what happened inside IFC.

2.4. A history of the policy portal project (PPP).

2004 and 2005.

In April 2004 IFC distributed a “Plan for the repositioning of the information chain HE-IFC”.⁸ The purpose of the repositioning was the transfer of 2,5 fte information-activities from HE to IFC. The activities to be transferred were specified in an appendix. The specification was unambiguous and

⁶ Fte= full-time equivalent. Fte is a measure of the amount of manpower. Irrespective of the nature or quality of the work.

⁷ For example the files under 20050201 and 20050717.

⁸ In the PPP directory under 20040413.

covered all basic information. The repositioning should be completed by the end of 2005. But it was not to be a simple, passive transfer. The activities were to be reorganized and modernized as well. In particular, web-based “portal technology”, was to make information more accessible to more users. IFC meant to build a portal, that is: a kind of website, specifically for HE. For the other education departments there were similar plans.

By means of these plans, other documents and presentations, IFC raised great expectations.⁹ The plan of April 2004 promised that by the end of 2005 all HE-relevant information would be accessible through the HE-portal. A presentation of 28/4/05 stated that the numerical information should be checkable and reproducible. It stipulated that the quality standards were to be set by the education departments. In sum, realization of the plan would mean a major step forward in the information situation. No sensible person could oppose it.¹⁰

Up to and including July 2005, HE was represented in the PPP by Pieter Veen. On August 1, 2005 Veen moved from the information & analysis section of the department to its financial section. The head of the information & analysis section, Frans Dijkstra, asked Jan van Velsen, the present author, another member of his section, to succeed Veen. Dijkstra told Van Velsen that he was afraid that IFC would not build what it had promised and what had been agreed. Dijkstra expected IFC to try and dictate what HE needed. He asked Van Velsen to watch out, and try and get the best possible.

After having been informed by Veen and having studied the relevant documents, Van Velsen called upon the representatives of the other education departments to get acquainted and informed. In the course of the project he expanded his network of contacts as need arose. Among others with the departments of information policy (IP) and financial affairs (DFA), and with the assistants of the two education directors-general and of the uSG. With all of them he systematically discussed the situation, and proposals for what to do next. In general it was easy to reach agreement. The same approach was followed with respect to IFC. But there agreement was rarely possible, if useful. No one of IFC ever gave a reliable and useful picture of what was going on in IFC, of its problems or their causes. Last but not least, people from IFC almost never kept their promises.¹¹

The plan of April 2004 was written by IFC, and no more than a draft. The discussions about plans that were to be binding, one for each education department, were very wearisome. The plan for HE was signed 14/6/05. It wasn't signed because there was agreement, but because agreement seemed impossible, and because signing seemed less costly than waiting. In addition, IFC had recently told the ministry that it had already engaged (external) subcontractors. A prototype of the HE-portal had already been built, and looked promising. The HE-plan presented the prototype as representative for the portal. According to the plan, formal acceptance of the HE-portal by HE could take place 15/12/05 at the latest.

Beside the four department-specific plans there was a general plan for matters of common interest.

The plans distinguish three “releases” of the portals. The first release for HE and PAE was to be completed in 2005, that of PE and SE in March 2006. The total cost of release 1 was estimated at approximately 4 M€. Because most of this amount was needed to build a common datawarehouse, the education departments agreed to pay equal parts.¹²

The plans specify the information contents of the portals. But they do not specify the technical and quality requirements of the portals. For that purpose a document *Portal requirements* was adopted in August 2005.¹³ It is a rather remarkable document. For the following reasons:

- It explicitly accepts the governmental and ministerial directives for websites (which are mainly logical but not always simple to realize in practice);
- It explicitly gives the education departments a blank check for specifying requirements for

⁹ See in particular the presentation of 20050428, confirming completion of the HE-portal in 2005.

¹⁰ Unless because of the costs, or bad cost/benefit ratio.

¹¹ Regarding the PPP.

¹² HE had very much more content than the other three departments, probably more than the other three put together. Therefore the agreement about equal cost sharing shows that the representatives thought that building the datawarehouse was much more costly than building the web interface. See the memorandum of 20050905.

¹³ Programma van Eisen. In the PPP-directory under 20050816.

- accessibility and user friendliness;
- It allows response times of 5 seconds for simple tables, and 30 for multiple choice tables.

The first two points show that at the time of writing IFC did not understand that a portal is much more complicated than a collection of spreadsheets or a database, and that IFC very much underestimated the difficulty of building a user-friendly portal in accordance with applicable directives. The lack of understanding by IFC explains at least in part why IFC wanted HE to accept not the portal but separate tables. HE saw the portal as a whole. As much more than a set of tables. It should also be a properly working website. HE was afraid that acceptance of tables would be construed as acceptance of the portal, even if the portal didn't work as a portal at all. For this reason HE refused to accept separate tables. It wanted to test the portal as a portal. It would check the tables too, but only as a part of the portal.

In September 2005 IFC dropped the prototype, and switched to an “acceptance-portal”. It did so without prior discussion or explanation. Although the prototype was incomplete, it worked and looked credible. The acceptance-portal was very different. It was almost empty and hardly worked. It looked like a major step backwards. The plans suggested continuous development. The HE-plan saw the prototype as the norm. Nevertheless, and notwithstanding repeated requests, IFC never explained the switch. In its progress reports the switch isn't even mentioned.

In the beginning of October, Maurice Fransen, the IFC-representative for HE, told Van Velsen that the HE-portal was nearing completion. He asked Van Velsen to test the portal, in preparation of formal acceptance. HE tested the portal in the weeks around the first of November 2005. The test was performed by six members of the department (Van Velsen supervised, but didn't test). The conclusion was that the portal contained only a small part of what was agreed upon, and that the portal hardly worked as a portal.

The PAE-portal was just as useless.

In November the head of IFC, Ineke van Oldeniel, sent invitations for a festive “Première” of the policy portals to all concerned. The “Première” was to be held on 7/12/05.¹⁴ It was clearly meant to be a show-event. Van Velsen was afraid that attendance of the “Première” by the responsible managers of the ministry would dangerously weaken the negotiation position of the departmental representatives vis-à-vis IFC. He therefore wrote his head of department, Jo van Ham, a memorandum describing the state of affairs, including the test results. He advised him to stay away from the “Première”, and to ask IFC to postpone the “Première” until the portal was ready. Van Velsen requested permission to send a formal memorandum to the director-general informing him about the situation, and requesting him to abstain from attending the “Première”.¹⁵ This request had been discussed with the assistant of the DG and the financial assistant of the uSG. They had agreed with it.

Van Ham replied that he would phone the head of IFC about the situation.¹⁶ Van Oldeniel told him fairytales, which Van Ham believed. He accepted the “explanation” that the “Première” was not a première. It was only an “event”, a “preview”.¹⁷ He seems not to have asked why it wasn't called “Preview” if it was meant to be that, instead of “Première”. Van Oldeniel furthermore told him that PAE was satisfied with the results. This was simply untrue. But Van Ham believed it without checking. He concluded that he would attend the “Première”, and would not inform the DG.¹⁸

It follows that the head of IFC pretended to know enough about the project to be able to discuss it with Van Ham, and that she either was not informed correctly, or lied. Van Ham should have realized that Van Oldeniel was an interested party. She was not only responsible for the PPP, but also for the

¹⁴ The colorful invitation card can be found under 20051215 in the directory PPP.

¹⁵ One could only formally inform a DG, or anyone else outside his or her department, through the head of ones department. The head acknowledged his approval by a signature. Opportunities for informal information were rare.

¹⁶ His notes about the call are written on the memorandum under 20051118 in the PPP-directory.

¹⁷ She seems to have actually used these English words.

¹⁸ It was unwise of Van Ham to decide this of his own accord. He should have discussed it with Van Velsen and/or Dijkstra first. If only to be safe.

“Première”. Cancellation of the “Première” would mean loss of face. The memorandum of Van Velsen had shown Van Ham that the project ran out of its time-table, and that this was a result of other problems.

It was obvious that nobody would have reason to oppose a “Première” if the portals were reasonably useful. Like Van Velsen, Dijkstra didn’t like the idea of a “Première” if the portals were no more than empty shells, and if completion was a matter of believing against one’s better judgment. On the other hand, Dijkstra didn’t like to ask his head of department to go back on his decision to attend the “Première” either. Hoping that IFC had managed to substantially improve the portal since the test of (only) a fortnight ago, as it said it had, he asked some people of his section to do another test of the portal. If it was successful, he could tell his head of department that he could safely go to the “Première”.

The test was held in the afternoon of 30/11/05. IFC representative Fransen was present. The test was not only disappointing but shocking. For while everybody could see with his or her own eyes that the portal contained only very few of the promised tables, and frequently failed as a website, Fransen stubbornly maintained that this was what had been agreed upon.

The day after, Fransen sent Dijkstra a mail, concluding that apart from a few minor trifles, the portal was ready for acceptance. The mail made it seem as if the test had been very successful. Fransen asked Dijkstra to confirm that he agreed with his conclusions.¹⁹

Dijkstra asked Van Velsen to reply. The main points of the reply were the following:

- At present the portal contains only a small fraction of the data specified in the plans;
- The performance should be substantially improved. Basic information should be accessible to all users. The OLAP-technology²⁰ should therefore be the exception, not the rule;
- The required improvements are necessary to realize the goal of release 1, and should be realized within the agreed budget for release 1;
- A list of specified points for improvement will be sent shortly.

On 29/12/05 HE sent IFC a report of the test of October-November.²¹ IFC promised to solve some of the problems. Other problems were said to be unsolvable. IFC denied that it had been agreed that the portal should contain data per institution. HE considered these data of great importance. They were included in the prototype, and (implicitly) in the datasets listed in the appendices of the relevant plans. Because of the importance of these data, Van Velsen sent Fransen and the IFC project leader, Job van Weeren, a memorandum with a comprehensive justification of the assertion that the HE-portal should contain data per institution.²² They never replied.

In November it had become clear that the HE-portal was far from ready, and that IFC could not be trusted to fulfill its obligations of its own accord. Somehow pressure would have to be applied to IFC. That would be very difficult if the higher management of the ministry and IFC got the impression that the portals were virtually ready. Such an impression would make it difficult for the departments of HE and PAE to refuse acceptance of the portals, however useless they might be. On 10/11/05 Van Velsen therefore asked his IFC-contact to try and get the “Première” postponed. IFC refused. On 2/12/05 Van Oldeniel nevertheless mailed the persons invited that the “Première” had been postponed until January. The date was still to be fixed. A new invitation was to be sent as soon as possible. It never

¹⁹ Fransen should have sent his mail to Van Velsen, because Van Velsen was his contact for HE. Only if he thought Van Velsen did not function properly could he have gone directly to his head. In that case, he should have explained his problem. The behavior of Fransen was the rule rather than the exception for IFC. If somebody in the ministry would not accept an inadequate IFC-product, IFC shopped around until it had found somebody who accepted and didn’t make difficulties.

²⁰ OLAP is short for online analytical processing. This refers to software for getting useful information out of data which depend on many variables. Shortly: a tool for multiple choice information selection. Use of OLAP was cumbersome, and it took a lot of time before one got what one wanted.

²¹ In the directory PPP, under 20051229.

²² And which data precisely. In the PPP-directory, under 20060127.

came.²³ It follows that Van Oldeniel must have known of the difficulties with the PPP.

HE sold the skin of the bear before it had been caught. On 1/11/05 Wim Fliermans, the person responsible for university-information, had to leave the department. Fliermans had worked many years in the section of Dijkstra. He had built a well-working information system.²⁴ His position was said to have become redundant due to the transfer of the information production to IFC.

The system for the production and management of information about higher professional education had been organized differently.²⁵ It was embodied in html-pages, connected by links.²⁶ It had been built by Henk Rademaker. In 2005 he was working in the financial section. He spent at most a day per week on the maintenance of this information system. His other workdays were spent on financial matters. He was asked to end work on the information system, and accept some other, non-related, tasks instead.

Both systems could be used without difficulty by everyone in the department of HE. There were no complaints about them. It was obvious that they could have been improved and integrated at very low cost.²⁷

2006.

Every week the SG wrote a weblog for the intranetsite of the ministry.²⁸ His weblog of 22/1/06 included a remark that showed a serious lack of knowledge of the facts and of awareness of the risks of one-sided information. It could easily hamper the work of people having to do with IFC. Together with the uSG, the SG had attended a meeting organized for him by IFC in conference center “De Sniep”, behind its office building in Zoetermeer. According to the weblog, “this meeting will lead to an even better working IFC, even though this would seem hardly possible if you know how much they already did in the recent past.” Van Velsen was afraid that this and similar nonsense would make it very difficult to get a useful portal. The remark was the opposite of what was needed.

One could comment on the weblogs. The comments were visible for everybody in the ministry and its agencies. Van Velsen therefore decided to write one. The following is the essential part of it:

«It seems that IFC told you nice stories, and that you believed them. Your eulogies are unthinkable if you would have had yourself informed by your own organization. If you had done so, you would have heard that IFC systematically lies about the progress made with (for example?) the policy-portals.

Your people have to negotiate with IFC, and try to get IFC do what it promised and agreed to do. This is not particularly helped by a boss who writes that IFC is doing a fantastic job.

Therefore, I kindly and urgently request, that you let yourself be informed about the performance of IFC by the people from your own ministry who are working with IFC. I trust that this will result in a more careful judgment, which will stimulate ministry and IFC alike to do what they have to do.»

The SG reacted as follows:

«Thank you for your comment. Please call, I would say. In the past 2.5 years as SG I have never been told that something wasn't going as it should. I would very much like to get informed. So that I can do something about it.»

This was followed by a pleasant talk on 7/2/06, and by the following remarks in the weblog of 12/2/06:

«Sometimes the quality of services rendered by our colleagues in Zoetermeer is perceived differently by colleagues in The Hague. In my weblog of 22/1/06 I was rather positive about them, but that was not received with thanks by everybody. Some people commented very critically about IFC. On

²³ It may be a flattering thought that the cancellation of the “Première” was due to the lobbying of Van Velsen, but there is no positive evidence to support this hypothesis.

²⁴ Based on spreadsheets. Simple, versatile, and reliable. The pages were linked.

²⁵ Due to different organizational structures of the ministry in the past, and the lack of (need for) uniformity.

²⁶ Like a website, but accessible through a shared hard disk, and not through the worldwide web (internet).

²⁷ Say at most two years work by someone like Fliermans or Rademaker. Which means at most 0,15 M€.

²⁸ An intranetsite is an internal website of an organization.

the one hand this is regrettable, but on the other hand it informs me of facts which would otherwise remain hidden. So, if something goes wrong, let me know! Don't keep it for yourself, don't deny the problem. Speak up, then something can be done about it. Don't be afraid that it will be held against you, for that's not the way we work in this ministry.»

The sequel will show the value of these words. For now it suffices to note that the weblog does not acknowledge that something is actually wrong with IFC. It only notes a difference of opinion. Even though in the conversation of 7/2/06 Van Velsen had shown proof of the assertions in his reaction to the SG's weblog. He had given the SG the hyperlink to the portals. In a few minutes the SG could have seen for himself that the portals were fake. But in spite of the suggestive "So that I can do something about it" he did nothing.

On 14/3/06 there was to be a meeting of Van Ham, Dijkstra, Van Velsen and Van Oldeniel. It was to take place in pursuance of the request to postpone the "Première". Van Oldeniel defaulted without explanation. In her stead she sent Steven van Spijker, the head of the unit of IFC responsible for the portals.²⁹,³⁰ Van Spijker did as if there was no problem with the portals whatever, nor with the communication about them. He (therefore) gave no explanation of the delay and the bad shape of the portals. Neither did he give a new time-table. In fact, he hardly talked about the portals at all. Instead, he raised the roof about the reaction of Van Velsen to the weblog of the SG. Van Ham and Dijkstra defended Van Velsen. But they showed no concern about the delay of the project and about the unreliable communication.³¹ The only agreement reached in the meeting was a superfluous one, namely to pass on problems which the representatives couldn't solve to a higher management level.

IFC told the representatives of the education departments next to nothing about the internal design or structure of the portals.³² It only told them that a datawarehouse was to be the central part, and shared by all portals. IFC never gave trustworthy information about progress or problems. In due time most of what it told turned out to have been untrue. By means of green lights and smileys in progress reports it gave the impression of progress according to plan. In doing so it misled the top of the ministry.

For some time IFC sent the top of the ministry progress reports that the representatives of the education departments knew nothing about. These reports were sent every two months. They were meant to be input for the periodic bilateral consultations with DG's and/or uSG on the one hand, and the head and other top managers of IFC on the other. Initially, not even the fact of these consultations, their periodicity and participants, were known to the representatives of the education departments.³³ When they found out, they tried to change procedures in such a way that the top was informed correctly, and couldn't get the idea that it could remain idle when its intervention offered the only possibility for correction. The departmental representatives for example tried to see the progress reports and comment on them before they went to the DG's and uSG. This was not always possible, because IFC usually sent the reports to the ministry only a few days before the consultations. It did not send them to the representatives. The DG's and uSG complained, but took no effective action. Neither did they try to get understandable and useful information instead of irrelevant, unintelligible bla bla.³⁴

In December 2005 and January 2006 efforts were made to induce IFC to be more open and cooperative. On Thursday 12/1/06 Van Velsen had a talk with IFC project leader Job van Weeren. Especially about the communication. Van Velsen said he understood that the PPP was a complex project. He could easily imagine unexpected difficulties, and, as a consequence, delays. But as a representative of the financier-user he required an explanation. Including information about the design of the portal. So that he could understand the progress or lack thereof. Van Weeren always promised to change for the better. But he kept denying that the HE-portal should provide numbers per

²⁹ Without prior notice. Van Ham told Van Spijker he was surprised.

³⁰ Together, Van Oldeniel and Van Spijker formed the head-directorate of IFC.

³¹ Probably because they were used to this, or expected nothing else.

³² Neither at this point in time nor later.

³³ Nobody had told them, and it is described nowhere.

³⁴ An annotated report can be found in the subdirectory SU-reports of the PPP-directory, under 20060322.

institution. The progress reports changed in form, but never became reliable. The trickery³⁵ continued unabatedly.

Because of the attitude of IFC and that of the top of the ministry, it promised to become difficult for the education departments to get what they needed and paid for. It was to be feared that a lot of pressure would be exerted on them to accept a useless product. To defend non-acceptance, it would be useful to have an objective and professional evaluation of the portals. By a lucky chance, the department of information policy of the ministry (IP) turned out to have professional expertise for testing ICT-products. It would gladly help. In agreement with IFC (!) a test plan was drawn up. It provided for a basic and an extensive test. The main purpose of the basic test was to find out whether a full test was worth while.

The basic test took place 2/5/06, in the presence of Fransen.³⁶ The test showed a very incomplete and badly working portal. For example, the arrows for going to the preceding page, or forward to the next, rarely worked. Clicking an arrow often gave an empty white screen. A large part of the problems in the list of 29/12/05 had not been solved. The governmental directives for websites had not been implemented. The experts who found this were visibly shocked. They got the impression that the directives had not been consulted at all.

The results of the basic test were reported to the management of HE and IFC. IFC replied that it did not agree with the report. But not in writing, and it gave no arguments. The extensive test was cancelled. A new basic test would be held after elimination of the main defects.

In a meeting of the head of IFC with DG Renk Roborgh on 23/5/06, Van Oldeniel complained about HE. HE shouldn't make so much trouble. It should accept release 1.³⁷ In pursuance of this complaint, Roborgh organised a meeting of the people from HE and IFC who took part in the PPP. It was held on 28/6/06. Roborgh observed that IFC hadn't produced what it had promised. Could it be that the level of ambition had been too high? Did it have technical problems? IFC didn't reply. Roborgh requested IFC to be more open in its communication.

In 2006 most of the discussions HE-IFC had two subjects: the specification of the contents of the portal, and the solution of the problems in the list of 29/12/05. Progress was very slow. There was no credible time-table. There was only little discussion about the web-directives. Since it had become clear that IFC had difficulties with them, the representatives of the education departments made inquiries about the nature and importance of the directives. They found that most of them were conclusions everyone would draw who would think responsibly about building, using and maintaining a website before starting to build it. It was only natural that they had been included in the *Portal requirements*.

On 23/5/06 Fransen announced that on 1/07/06 the portals would comply with the "minimal set" of governmental web-directives. The remainder of the year would be devoted to implementation of the "optimal set".

In order to avoid asking the impossible and getting stuck in an unsolvable problem, Van Velsen proposed IFC on 14/7/06 to implement the minimal set in release 1, and the optimal set in release 2. In reply, IFC only said that it couldn't guarantee implementation of the optimal set.

In August IP found that the situation had slightly improved, but not substantially.

IFC never explained why no notice had been taken of the web-directives. Even though they were listed in the *Portal requirements*, and most of them could be derived independently by any expert. But the most remarkable fact is that all relevant IFC-people started to deny that the portals should comply

³⁵ Contrary to the code of conduct of the ministry.

³⁶ It concerned only the HE-portal. The other departments did it their way. Their information systems were said to be less extended and/or complicated.

³⁷ Although as a rule points of discussion (points for the agenda) were exchanged before the meeting, Van Oldeniel had not said that she wanted to talk about the portals. This meant that the DG was unprepared. Timely announcement of points for discussion was meant to enable the relevant officer(s) to inform and advise the DG. So this was just another trick.

with the web-directives.³⁸ There was no trace of a constructive attitude towards the directives and their implementation. No discussion, no compromise. Only denial.

From 2005 to mid-2006 progress and problems in the project were discussed in a working group consisting of the representatives of the education departments and IP, and people from IFC. It was chaired by IFC project leader Van Weeren. The secretary was from IFC as well. The meetings of the working group were useless or worse. IFC gave no or no reliable information about progress or problems, and almost never kept its promises. It regularly gave presentations. If none of the representatives of the ministry objected, IFC assumed that the ministry had agreed with the premises, proposals etcetera implied by the presentation. Without saying so.³⁹

The representatives of the ministry therefore developed a proposal for another way of organizing the communication ministry-IFC. The working group was to be replaced by a steering committee with a chairman and secretary from the ministry, a single representative of the four education departments, the IFC project leader, and another PPP-relevant IFC manager. The proposal was accepted by the DG responsible for the PPP, DGPS Rob Kerstens, (also) responsible for the departments of PE and SE. The chairman of the steering committee was Roel Endert, head of the policy section of HE. The secretary was Carry Beekink from IP.

The first meeting of the steering committee was on 19/6/06. It decided that its first job was to get an overview of the state of affairs, and a realistic plan for the remainder of the work on release 1. It asked the education departments to send copies of the plans, and the reports of their tests, to the steering committee. The reports of IFC however remained as obscure as always. The committee got no idea what they were doing. IFC refused to provide a time-table. It periodically promised the education departments to solve the remaining problems “in a few weeks”. But it never did. In other words: the steering committee didn’t get the information it needed to get a grip on the reality of the project.

The uSG and the two DGs responsible for the education departments⁴⁰ let the project drag on without taking any action towards IFC. They gave no sign of concern about the information of the education departments. The representatives of these departments had informed them of the delays and the state of affairs. The uSG and DGs could know that the IFC-progress reports were incorrect and misleading. In June DG Kerstens had replaced the dysfunctional working group by a properly composed steering committee. Not on his own initiative or that of the management, but on that of the representatives. On 28/6/06, when Roborgh fatherly admonished IFC, the delay was half a year, and completion a chimera. The meeting of 28/6/06 reduced the pressure on HE to accept a useless portal. But none of these minimal actions affected the behavior of IFC.

According to the progress reports, the budget for the PPP would be spent by 31/8/06. It was clear however that the work on PPP would not have been completed by then. The money had to come from somewhere, and at the cost of other work. Van Velsen therefore asked IFC to tell the ministry what other budgets it was going to charge for this purpose. Moreover, he asked IFC to give an account of the way the budget of over 4 M€ had been spent.⁴¹ That is: on what activities, products and whatever. Not in the last place because such an account might shed some light on the design of the PP. IFC did not answer these questions. It only told the ministry that no additional bill would be sent.

In October IFC sent a report to uSG about the progress made in May-August.⁴² The following gives an impression of the way in which IFC “informed” the top of the ministry about the progress of the PPP:

³⁸ In chronological order for example Maurice Fransen, Jacques Schellingerhout and Annemiek Scholten.

³⁹ It took some time before the representatives understood that they were being tricked. Not they, but other people were told that this or that had been “approved by the ministry”.

⁴⁰ The DG of PE and SE, DGPS Rob Kerstens, was the representative of uSG for the PPP.

⁴¹ HE had paid half of its part, having promised to pay the other half upon acceptance of the portal. IFC had agreed with this procedure. Due to trickery (probably cheating) by Willem Schutte of IFC, part of the other half was paid during the summer vacation of 2006. K€ 113 remained to be paid.

⁴² The progress report can be found in the PPP-directory, under 20061004.

- The report said that SE and PAE had accepted their portals. This was untrue;
- Under the heading “What went well”, it mentions the communication about the PPP between ministry and IFC. Which is obvious nonsense;
- The PPP is not mentioned in the tables “Matters for improvement” and “Points of concern”;
- “The project proceeds according to plan.” No mention is made of any delay;
- A steering committee has been installed to organize the solution of remaining problems and to manage the expectations of HE. Suggesting that one should not expect agreements to mean what they say;
- Under the heading “Finances” the report states: “Realization within budget”. The preceding paragraph shows that this is untrue;
- Under the heading “How it feels” the project scores a 7 (out of 10). This is the highest mark given in the list.⁴³

The reader cannot help doubting the reliability of the reports about the other projects. The progress report was meant for a meeting of uSG with the head of IFC. According to the notes of this meeting, uSG expressed concern about the progress and financial risks. She asked whether the head of IFC is in control. The head of IFC replied: “Yes, I am. The PPP is going better since the steering committee began its work”. The DGs said they had heard otherwise. The head of IFC promised to check.

That was all.⁴⁴ Nothing has been heard of the checking by the head of IFC.

Due to the efforts of the representatives of the education departments the progress reports have changed in the course of time. But it would be too kind to call the changes improvements. The consequence of the “quality” of the progress reports and other communication of IFC was that nobody in the ministry had a credible idea of what was going on in IFC.

In the autumn of 2006 several of the IFC-people working on the PPP were replaced. Maurice Fransen was replaced by Dick Ravestein. Communication seemed to improve,⁴⁵ and Ravestein added a lot of tables to the HE portal. But the replacements solved no major problem. Nothing was done about the design or the datawarehouse and many other essential elements of the PP.

On 6/12/06 IFC organized a “learning-points meeting” for the representatives of the ministry and some of the IFC-people working on the project. The meeting was chaired by an external consultant, hired and informed by IFC. One of the IFC-people, Annemiek Scholten, wrote a report of the meeting.⁴⁶ She concluded that the representatives of the ministry were unanimous in their judgment that IFC cannot be trusted, neither with regard to technical abilities nor with regard to integrity and the ability to cooperate:

«It was said and not contradicted that:

- IFC systematically doesn’t do what it has agreed to;
- Progress reports were and are incorrect and misleading;
- The quality of some of the portal-products is evidently insufficient.»

By the end of 2006 the two IFC-members of the steering committee were replaced by Jacques Schellingerhout and Esha van der Hulst. Schellingerhout was responsible for a group of projects, including the PPP. His hierarchical position was directly under the head of IFC. The position of Van der Hulst was titled “manager information products”.

⁴³ Note that the comparatively positive mark is consistent with the findings of the next chapter.

⁴⁴ The most relevant (?) section of the notes can be found in the PPP-directory, under 20061016. When asked for the notes, the assistant of uSG only sent this part. It is therefore unclear whether this is all that is relevant for the PPP.

⁴⁵ “Seemed”: appearances improved, and Ravestein may have been well-intentioned, but wasn’t open and reliable.

⁴⁶ It can be found in the PPP-directory, under 20070307. The intention had been that the external consultant would write the minutes. They were written, and commented upon by the participants of the meeting, but said to be lost as a result of the consultant’s departure to another firm. Scholten tried to save and integrate as much as possible of the several contributions.

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As long as there was no substantial improvement in the attitude of IFC, the representatives of the education departments considered talks and new agreements with IFC of little use. The foremost question therefore was: how can IFC win back the confidence of OCW? Somehow a break with the past and a new beginning had to be made. Van Velsen thought IFC could make a new beginning by:

- Ending the pressure on the education departments to accept the portals;
- Giving insight in:
 - The internal structure of the portal;
 - The organization of the work on the project;
 - The way quality is ensured;
- Giving an account and/or evaluation of the work on the portals in 2005 and 2006;
- Explaining why reasonable expectations were not realized;
- Giving a financial account;
- Substantial improvement of the progress reports.

In sum: by much more openness. The replacement of the two main PPP managers seemed to offer an opportunity. Van Velsen requested a meeting with them, to get acquainted and to discuss the situation. The meeting took place on 30/1/07 in the IFC building in Zoetermeer. Schellingerhout and Van der Hulst listened, but did not comment, and promised nothing.

The first four months of 2007 brought no improvement. The new IFC-people behaved just like their predecessors. Van der Hulst put pressure on the departments to accept the portals, and Schellingerhout claimed that IFC needed to implement only a small part of the web-directives. Probably he allowed himself to be informed by people responsible for ignoring them. But he had been warned, and could easily have checked the *Portal requirements* document himself.⁴⁷

For the several decision-making processes related to the project, it seemed wise to have a reliable picture of the current state of the HE-portal. IFC said it had done a lot of work on the portal since the test of May 2006, but it was not clear what worked and what not, and what information the portal contained.⁴⁸ Van Velsen therefore organized a “snapshot” of the portal. Actually it was a test, but it was called “snapshot” in order to prevent bureau-political problems. Like the test of 2006, this one was supported by experts from IP. The basic test was done 15/2/07, in the presence of Dick Ravestein and his colleague Mia Looyestijn. The test showed problems, but not enough to preclude an extensive test.

The extensive test was done by 25 people from HE. They were informed in a meeting with presentations by an expert from IP, by Ravestein and by Van Velsen. They got written instructions and a questionnaire. They could do the testing anywhere in the period of 16/2-15/3/07. The observations of the participants were collected in a spreadsheet. The conclusion was that much information had been added, that definitions and explanations leave much to be desired, that it is hard to check the numbers, and that the portal is very slow. For the last reason the OLAP tool (the instrument for multiple choice information selection) was almost useless. This is important, because most information had to be accessed by the OLAP tool.

IFC said that it welcomed the results. But it wanted to transfer the solution of some elementary problems to release 2. HE didn't agree. It was afraid that postponement would be followed by further postponement (as usual with IFC). HE therefore required problems of release 1 to be solved in release 1.

The delay, the test results, and the lack of explanations made it risky or irresponsible to trust the ICT-system behind the portals. The ministry would furthermore like to know to what extent IFC had implemented the web-directives. If only to check everything that could be checked. In more detail than

⁴⁷ Note that this and other chapters of this report show many cases of “managers” refusing to make simple checks that would completely resolve a question.

⁴⁸ IFC never produced overviews or global descriptions of the state of the portals.

IP could, and preferably measured by an accredited firm. Such a firm was found and hired: Accessibility. In April 2007 it found that 24,8% of the directives is not applicable, that 30,4 % is implemented, and 44,8% is not implemented. The scores were especially bad for the directives for building and structure.⁴⁹ An important practical conclusion was, that rebuilding was probably cheaper than adjustment.

In the discussion about the results of the investigation, IFC asserted that OLAP is inconsistent with the web-directives. If this were true, it would have far reaching consequences. Therefore it had to be double checked. If true, it would be necessary or advisable to look for alternatives.

In a sense, the findings of Accessibility were the death-blow for the project. The findings confirmed what the ministry had feared all the time, but couldn't check: that not only the front of the portals was defective- what the user sees-, but the inside even more. The findings had a great impact on the thinking of the ministry about the project and IFC.

In February 2007 the chairman of the steering committee asked IFC to submit drafts of a Discharge protocol (DP) and a Service level agreement (SLA). The DP was meant as a conclusion of release 1. It should show that the past could be left alone, and that the ministry could trust IFC to solve the remaining problems. For these reasons, the DP would include the points 2-5 mentioned above.⁵⁰ The drafts were to be submitted 31/3/07 at the latest.

They were received 11/4/07. They were grossly inadequate. The following examples refer to the DP. Section 3 said that the documentation had been fully updated. Actually, documentation on paper was nonexistent, and the documentation in the portal was scarce and defective. Another paragraph claims that all relevant tests and reviews had been done, and all corrections made. Some IFC-internal tests are mentioned explicitly. They were unknown in the ministry. Audit 3, to be discussed later, found that the reports of the tests had been lost.

Section 7 claims that release 1 satisfied the performance requirements. Without proof, and plainly untrue. No insight is given in the design of the portals and the work done. There is no financial account. The DP asserts that 4,765 M€ was spent on the PPP. But it doesn't specify, for example, how much was spent on the datawarehouse.

In sum: the draft showed that IFC could not be trusted at all.

On 14/5/07 the chairman of the steering committee sent the comments of the education departments to Van der Hulst. With the request to react 15/6/07 at the latest.

By the end of May, deputy head Van Spijker of IFC tried to force an end to the discussion about the Discharge protocol. On 14/5/07, without consulting or informing the steering committee, he sent a mail to Kerstens, the representative of uSG for the PPP. The mail said that the brains of the PP are formed by a datawarehouse, and that this datawarehouse is working well. The mail proposed that the chairman of the steering committee, Van der Hulst and Van Spijker analyze the comments of the education departments, and try to concentrate the discussion on a few main lines. «*Then the three of us start discussions with the departments, hoping to get agreement. If we don't succeed or only partially, which I'm afraid of, we write a memorandum with points to be decided by you.*»⁵¹

The assertion about the datawarehouse was not substantiated. For the ministry, the datawarehouse has always remained a black box. Or rather a black hole, for it devoured millions of euros without letting escape a single ray of light. And the sequel will show that it didn't work properly at all. In other words: that Van Spijker lied.⁵²

The chairman of the steering committee and the education departments shuttled the proposal, and prevented that Van Spijker took over the management of the discussion from the steering committee and/or its chairman.

June 2007 stood in the sign of:

⁴⁹ The Accessibility report is in the PPP-directory, under 20070410.

⁵⁰ "Giving insight in" etc.

⁵¹ Paraphrased. The Dutch version of this report gives a quotation. The original mail is in a file with the correspondence about the PPP of 2007.

⁵² He knew that he could safely do so, since the ministry couldn't check his assertions.

- The adapted DP;
- The reaction of IFC on the report of Accessibility about compliance with the web-directives;
- The formulation of a memorandum of the heads of the four education departments to DGPS;

And to a lesser extent:

- The findings of the “snapshot” (test) of March.

The memorandum of the heads of department was a consequence of the loss of belief that continuation of the discussion with IFC would yield useful results, and the wish to make this known to DGPS. Not only informally, but also in writing. To elicit appropriate action. Because of the half-hearted adaptation of the DP, the unsatisfactory reaction to the Accessibility-report, and IFC’s failure to solve many even old problems of the portals, the education departments no longer believed that IFC would learn the lessons of the learning points meeting of December 2006. They were convinced that only action by the top of the ministry could bring about the necessary change in IFC’s ways.

Communication with DGPS Kerstens about the PPP was infrequent and irregular. Up to this point in time, he had only played a passive role: he had approved the appointment of a steering committee. The steering committee had turned out to be unable to set matters straight. Its chairman admitted that he had underestimated the problem. After a year, experience made him adopt the views of the representatives of the education departments. On 5/7/07 he discussed the situation with Kerstens. He announced the memorandum, and sketched its contents. Important sentences in the memorandum are:

- The portal is at least 1.5 years behind the schedule;
- It doesn’t comply with the agreed specifications and requirements;
- The project has seriously reduced trust in the management and technical abilities of IFC;
- Continuation of the project by IFC seems meaningful only after proof of the necessary abilities of IFC.

The memorandum asks DGPS to approve the following recommendations:

- Do not accept the portals;
- Let an independent competent party answer the question whether OLAPs and web-directives can be combined, and at what cost;
- Let an appropriate committee advise about acceptance of the datawarehouse;
- Improve the organization of the management of IFC by the ministry.

Kerstens agreed. He promised to defend these opinions and recommendations in his next periodic meeting with IFC. The promise gave chairman Endert of the steering committee hope. He told the representatives: there is light at the end of the tunnel.

The meeting with IFC took place 17/7/07. The participants were: Kerstens, Endert, Van Spijker and Van der Hulst. In his introduction Kerstens said that he wanted to talk at least about the quality of the portal and the damaged trust. IFC continued with a presentation about the results of the project up till then, and a proposal for continuation. The presentation suggested that although a few things remained to be done, IFC had not received complaints about the functionality. IFC had delivered a good product. It was being actively used. Van Spijker said that an audit of an internal reorganization of IFC had concluded that users in the ministry found the portal satisfactory. Formal acceptance was not very important for IFC, but it did want to get paid the remainder of the budget.

Endert said that he didn’t understand where a positive judgment could have come from. Kerstens cited the negative judgment in the memorandum. He asked Endert to provide proof of the inadequacy of the portal.⁵³ Endert promised examples. He elucidated the memorandum. He said that in his opinion work on release 2 should not start⁵⁴ before release 1 had been accepted. He proposed to evaluate the datawarehouse separately.

Kerstens spoke as if he were a mediator instead of representative of the customer. He seemed to see only two quarrelling, equivalent parties. He showed no interest in the project agreement and the

⁵³ Again: Kerstens could and should have taken a look himself.

⁵⁴ And money promised!

product. And he seemed to be biased too. He requested Endert to substantiate his assertions, not Van Spijker.

During the meeting, Van der Hulst said that the requirement about the web-directives had not been put in writing. When Endert sent her the *Portal requirements*, she replied: "Shall we have a talk after my vacation?".

Kerstens got his examples. But did nothing.

The audit mentioned by Van Spijker had been held by Ed Smid of the audit department. The report of this audit was not known in the ministry. Furthermore, an inquiry taught that nobody from the education departments had given a (positive) evaluation of a portal. Van Velsen therefore asked Smid for the source of the evaluation. Smid confirmed that it didn't come from the departments (the only users). It came from Van Spijker. It follows that Van Spijker had lied to Smid. Moreover, the suggestion in the meeting of 17/7/07 that it was the conclusion of an inquiry by an independent auditor was deceptive. The auditor had simply copied the assertion of an interested party without checking.

A few months earlier, Van Velsen had informed Smid about the problems surrounding the PPP.⁵⁵ He had advised Smid to check whatever IFC asserted. What every professional auditor should do anyway. Notwithstanding methodological requirements and this warning, "auditor" Smid had decided to believe Van Spijker at face value.

After a lot of minor difficulties, a bureau, VKA, was selected for the investigation of the compatibility of OLAP and web-directives. It should answer the following questions (abridged):

- Is it possible to build an OLAP tool which complies with the web-directives?
- If so, what would be the cost and time needed for realization?
- In not, what alternatives are available, and what are their main characteristics?
- If only partially, which web-directives can be ignored from the points of view of accessibility and durability?⁵⁶

Even though VKA had formally agreed to answer these questions, it took a lot of pressure to get it done. This applies especially to the third and fourth questions, and to questions about costs. Another remarkable observation is that VKA let itself be guided by the information it got from IFC and from persons mentioned by IFC. Even though VKA had been warned by the ministry that there were serious communication problems. The attitude of VKA made it difficult for the ministry to know to what extent VKA's results were reliable, or colored by IFC. The failure to mention alternatives as requested by the third question could reflect the thinking (or absence thereof) of IFC, or lack of knowledge, creativity and/or time of VKA.

The final report contains concise reports of consultations of the four education departments. They give evaluations of the portals and project. They contradict the "finding" of the audit of the reorganization of IFC quoted by Van Spijker in the meeting of 17/7/07.

The final report of VKA is dated 17/12/07.⁵⁷

On 15/12/07 Kerstens was appointed quartermaster for the fusion of IFC and the Information Administration Group (IAG), the other agency of the ministry of education. He was also made responsible for the information policy of the ministry. He was no longer responsible for the departments of PE and SE.

Before moving on to 2008, mention should be made of a development that started as a consequence of the PPP, but evolved rather independently.

We saw that in June the representatives of the education departments had concluded that the behavior of IFC in the PPP would not improve of its own accord. They saw no other solution than appealing to uSG and their DG's. But as shown for example by the failed attempts to get the progress

⁵⁵ In an accidental meeting. Van Velsen and Smid knew one another from the past.

⁵⁶ The unabridged questions can be found in the report of VKA, under 20071221 in the PPP-directory.

⁵⁷ It can be found in the PPP-directory, under 20071221.

reports improved through these same channels, success was far from guaranteed.⁵⁸ Apart from this, Van Velsen felt that the way his colleagues and he himself were mistreated by IFC representatives, and, to a lesser extent, by uSG and the education DG's, was shameful and unacceptable. He didn't understand why they had to accept behavior that is clearly incompatible with the code of conduct of the ministry. The code says: «Our behavior with respect to each other and to the outside world should be open, service-oriented, respectful, impartial, and reliable.» In fact, he felt the misconduct to be the most important problem of this project. The utterly dishonest behavior of all IFC people made the work most unpleasant and nearly impossible. IFC seemed to consider integrity as a superfluous luxury instead of necessary for cooperation.

Having tried to find out how the code could be used to realize improvement, and after consulting Endert, Van Velsen decided to contact an integrity officer, and ask advice. In the course of the project he had seen that really everybody was afraid of the consequences of speaking out openly. Even though logically speaking the problems in the PPP could impossibly be limited to the PPP, the annual reports of the integrity officers gave no sign of systematic violation of the code. For this reason, Van Velsen chose an integrity officer working in another ministry.

Endert, the integrity officer and Van Velsen saw two alternatives:

- 1) Submit a formal complaint through an integrity officer;
- 2) Appeal to the SG to take appropriate action.

It was expected that the first alternative would evoke a defensive, denying attitude, and not produce anything positive. Therefore, and because the SG regularly presented himself as a champion of integrity, and to give the ministry an opportunity to correct itself, Van Velsen adopted the second alternative.

He requested and got an appointment with the SG. On 11/10/07 he told the SG that his colleagues and he wanted to work and be treated in a normal way, with mutual respect, in agreement with the code of conduct of the ministry. IFC violated the code systematically. He appealed to the SG to maintain and enforce the code. Van Velsen had chosen the defective and misleading reports as the most important and provable example. After all, reliable reports are crucial for management. He had brought a few examples, and the main plans, in order to show evident contradictions.

SG listened patiently, and seemed to take things seriously. But he wanted confirmation. Which was provided by Endert on 7/11/07. Among other things, Endert said that IFC was very good at making promises, but very bad at keeping them. He saw three problems: IFC, a ministry unable to deal with the problem IFC, and the fact that the problems are not reported. SG suggested talking with IFC. Endert and Van Velsen thought that would be useless. SG decided to order an audit, a quick scan.

The audit was done by Robert Pijl and Kees van der Putten of the audit department of the ministry. They based their report on documents and interviews. Endert, Van Velsen and other people commented on a draft. The final report was given to the SG on 4/12/07.⁵⁹ The conclusions were soft. According to the auditors, a more thorough inquiry would lead to “a further break in the cooperation” with IFC.⁶⁰ On 13/12/07 the SG personally gave Endert and Van Velsen copies of the report. He proposed that uSG, using this report, would start a series of talks with DGPS and the head of IFC, to solve the confidence crisis. He invited Endert and Van Velsen to send him their comments, if desired.

Endert and Van Velsen were amazed by the report. They concluded that it was faulty, and unsuitable as a basis for useful talks with IFC. They contested the assertion that a more thorough inquiry was impossible without hurting the relation ministry-IFC. They took it amiss that the auditors had refused to evaluate the progress reports. They therefore proposed the SG to order an audit specified as follows:

- Collect the progress reports, and order and evaluate them;
- Answer the following questions:
 - Do the progress reports give a correct and useful picture of the state of affairs in so far as relevant for management purposes?

⁵⁸ DG's and uSG had been informed about the untruths in the reports and about the misleading presentation of nearly everything, but had taken no or no effective action to improve the reports.

⁵⁹ In the PPP-directory under 20071204.

⁶⁰ Of course a rather curious and significant remark.

- Are they open, user-oriented, and reliable?

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In reply, the SG told Endert and Van Velsen that he had requested Diana van der Stelt to perform a supplementary audit in agreement with their proposal.⁶¹ Van der Stelt was the acting head of the audit department.

Henceforth this audit will be called audit 2.

In the meantime the project continued as before. The top did nothing that promised improvement. There was no sign of appropriate communication within the top. In agreement with Endert, and in an attempt to get things moving, Van Velsen mailed the SG some questions and information.⁶² He asked when the report of audit 2 could be expected. He noted that the decision making about the documents *Information policy education 2008-2010* and *Information plan 2008* completely ignored any problem. The documents assumed that IFC was competent and reliable, and that the communication ministry-IFC left nothing to be desired. According to Van Velsen it was most unwise to proceed without a thorough evaluation. He wrote the SG that Endert, his colleagues and he himself tried to do everything possible. He gave information about their actions. He pointed out that the discussions might be helped by an audit report.

The SG sent the mail to Van der Stelt, who didn't reply. On behalf of her audit she interviewed Endert and Van Velsen 8/2/08. She didn't know when her audit would be completed. In reply to a later mail she said that she hoped to complete the audit in a few days.

Only 29/4/08 did the SG inform them about the report. He didn't give them a copy. He only read out what he said to be the most important conclusions. They confirmed the assertions of Endert and Van Velsen, with one exception. According to the report there was no malicious intent.⁶³ Still, the report confirmed corrupt practices and customs, and said that Endert and Van Velsen deserved thanks for reporting them. Which SG told them he took note of.

As far as known to the present author, the report of audit 2 has always been kept secret.

The above was known only to the participants. We now return to the mainstream.

An *Information plan 2008* was being written by Marianne Bos of IP and Paul Kuyt of IFC.⁶⁴ The plan said things about the continuation of the PPP too. But there had been no communication about the text with any of the education departments or the steering committee of the PPP. They hadn't even heard about the plan. In other words: IP was talking with IFC about the PPP without consulting any participant from the side of the ministry.

When the education departments found out, they contacted Bos, and arranged a meeting of Bos, Christianne Mattijssen (head of the section of IP responsible for the plan),⁶⁵ Endert and Ron van der Meer (head of the financial section of HE). The meeting took place 17/1/08. At the request of Endert and Van der Meer IFC was not invited. Endert argued that a plan as proposed is only meaningful after the solution of a number of problems. To wit. The ministry should know how to manage IFC; it should organise its vertical and horizontal communication properly; and it should have agreement about the defects of IFC. He said that these basic requirements were elaborated in an advice for the uSG which he was writing together with the education departments.

Mattijssen said that the information plan was being written at the request of Kerstens and IP. In preparation for the plan, IP had asked IFC what it can and cannot do. The actions proposed in the plan are meant to solve existing problems. For that reason, IP welcomed the proposals of Endert. The proposals seemed to offer good opportunities for getting a better hold on IFC. Endert couldn't understand why IP had asked IFC about its possibilities, while it knew about the problems, and also knew that the education departments were working on a joint proposal. He saw this as an example of

⁶¹ On 13/1/08.

⁶² The mail is dated 24/1/08. In the Dutch version of this report the mail is quoted in full.

⁶³ This is incompatible with for example the untruths in the progress reports.

⁶⁴ Kuyt also had a management function in the PPP. See the document under 20050201.

⁶⁵ The secretary of the steering committee came from another section of IP.

defective internal communication in the ministry. It undermines the confidence of the education departments in the successful conclusion of the PPP. Bos admitted that it could have been done better.

IP promised to integrate the remarks made in the discussion in the plan. Endert would promote synergy of the joint advice with the plan. Endert and Van der Meer would get an opportunity to comment on the revised plan before it was forwarded.

Endert and Van der Meer received the adjusted plan on 21/1/08. It was to be sent to the meeting of the Central Committee Information Policy Education (CCIE) of 29/1/08.⁶⁶ The document was entitled: *Note for decision making about production and accessibility of IFC information*. In his comment of 25/1/08 Endert expressed surprise about the title. He thought that it had been agreed on 17/1/08 that the CCIE would discuss, not decide. Too many points have to be thought out more thoroughly. The proposals on page 1 of the note don't match the main text.⁶⁷ Furthermore, the remark that the plans have been discussed with the departments suggests that they agree, which is untrue. I would say: "they have been discussed with the departments, who still have many questions".

In reaction, Mattijssen wrote a long mail, but gave no answers. However, close reading of her mail shows that Endert was right. But it was worse than Endert thought. For the CCIE meeting was not devoted to the information plan, but to "Getting production in order". This concerned the solution of specific problems, related to the datawarehouse. What problems was unclear however, for the relevant document excelled in vagueness.⁶⁸ Anyway, Endert and Van der Meer had not been informed about this.

The management of IFC by the ministry, that is: by uSG and the DG's, seemed to consist of nothing more than allowing IFC to blunder on independently and indefinitely, and providing it with all the money it asked, without bothering about results. However, in the light of what had happened in the PPP, Van Velsen felt stung, cheated, by this "Getting production in order". Because of the vagueness of the relevant document he suspected that this project was meant to repair and cover-up untold failures. Probably failures related to the PPP. He decided to write a mail to uSG, to inform her and to elicit action, but also to deprive her of the possibility to wash her hands in innocence.⁶⁹ The mail explains that the situation, and many (in)actions of both IFC and the top of the ministry, are indefensible. It shows contradictions in words and deeds. It notes that a few years ago, IFC proposed a number of separate portals. Now it proposes a fusion of some of them (at a cost, of course). The rules for project management, prescribed by the uSG herself, are completely ignored. The mail notes that there are periodic progress reports covering all current activities. They never report serious trouble. Why then suddenly this need of "Getting production in order", as if something isn't? And why the need to hurry? Why was the problem submitted to the CCIE and not to the periodic bilateral consultations of the top of the ministry and the top of IFC?⁷⁰

The mail can be summarized in the following three statements:

- As regards information products, IFC listens too little to the education departments;
- With regard to everything related to IFC, IFC manages the ministry instead of the other way around;
- IFC doesn't account for its activities; for the ministry it is a black box.

uSG replied that she and her assistant, Michaela Schouten- van den Boom, would think about it. The results of this thinking are unknown.

There are no formal minutes or conclusions of the meeting of the CCIE of 29/1/08. The DG of HE was represented by Erik Martijnse of HE. Martijnse wrote a concise report about the meeting. With

⁶⁶ The CCIE was a consultative body. Formally at least it couldn't take binding decisions. In practice it did. It was composed of high "managers", on the level of DG. With the exception of the head of IP and possibly others. It was presided by Kerstens. It was a tool of IP, used to circumvent or avoid normal procedures.

⁶⁷ A far too common trick. The implicit suggestion that the proposals (or conclusions or whatever) are based on argumentation in what follows is simply untrue.

⁶⁸ And yes indeed, everybody present accepts that, nobody wants to know what this is all about.

⁶⁹ Remember that the SG had said that «In the past 2.5 years as SG I have never been told that something wasn't going as it should.»

⁷⁰ There was no sign of any form of coordination.

respect to “Getting production in order” he noted that much was unclear, including the costs. IFC will talk with the departments “to get things clear”. HE never got things clear. In spite of its promise, IFC didn’t call on HE.

In the projects report of February 2008 for the periodic top consultations ministry-IFC, IFC wrote that it was giving the highest priority to getting production in order, and that this priority had been approved by the CCIPE. It said that in the information plan which was being written at the request of Kerstens, it made a proposal for wrapping up and continuing the PPP. The proposal is: integrate the portals,⁷¹ and build a separate system for more detailed information. In other words: IFC ignored the PPP steering committee and the proposals of the education departments, and abused these periodic top consultations to get its way.⁷²

Don’t forget that the datawarehouse (“production”) should have been completed (and operating) in March 2006. The state of the datawarehouse was as clear as mud. The question why IFC would be able to do in 2008 what it couldn’t do in 2005 or 2006 had been asked in Van Velsen’s recent mail to the uSG, but had not been answered.

The work on an advice for the uSG by Endert and the education representatives was laborious. It was difficult to make credible recommendations without offending the management. In addition, the information requirements and situation of the education departments differed substantially. HE suffered most from the failure of the PPP; PE said it could manage easily.

Early versions of the memorandum tried to discuss the organization of matters which are related to IFC in the ministry, and the management of IFC by the ministry. Nothing of this got unanimous consent.⁷³ Only three out of the four education departments thought that solution was impossible without changes in the areas of organization and management. The consequence was that the final memorandum considered hardly more than technical questions. But not all teeth had been pulled. uSG was asked:

- Not to accept the PP;
- To request keeping the present portal up to date and working until an alternative is realized;
- To answer the question “which table in which portal?” in connection with the portal fusion, and not in connection with the PPP;
- To allow the education departments to put out the production of an application for the consultation of multi dimensional data to public tender.

Refusal to accept also meant: no payment (of the remainder).

The fourth point meant abandoning the truck-system. That is: the obligation to let IFC, and/or IAG, the other agency of the education ministry, do every job that had to be done in the field of ICT for the ministry. Which was a matter of principle, and thought to be almost impossible.⁷⁴

11/2/08 was the date of one of the periodic meetings of the top of the ministry with the top of IFC. The draft-minutes of the meeting were distributed 4/4/08. They contain the following remark: «[In the opinion of DGNEA⁷⁵ \[=Kerstens\]](#) [this is the right time to deal with the troubled relation between IFC and HE, whereby the past is to be left alone. Action: AM \[= Agency management\] organizes a session with DGHPS⁷⁶ \[= Roborgh; who was absent\] and IFC.](#)» The “session” has not taken place. Probably because the memorandum of the four heads of the education departments put the “troubled relation” in perspective. All of them had problems with IFC. Note that Kerstens was well-informed, and

⁷¹ That is: the policy portals with at least two other kinds or groups of portals.

⁷² The projects reports were too late for comment by the education departments.

⁷³ Please note: majority rule was considered unacceptable.

⁷⁴ This impossibility was “public opinion” in the ministry. It was based on a yearly agreement ministry-IFC, the so called performance contract (PC). See p. 18 of the pdf-file 20080307_PC2008 in the directory Project and agency management. The important thing to note is that the PC was changeable. Moreover, it could not be so all-embracing as thought or suggested, for it is obvious that IFC cannot be asked to do what it cannot. After evaluation of years of failures, the article in the PC could and should have been dropped.

⁷⁵ The DG of the new education agency. Please remember: What’s in a name?

⁷⁶ The DG of HE, PAE, science, and emancipation.

nevertheless proposed no action but more talking.

The next of the periodic meetings was on 14/4/08. Among other things, it would discuss the projects report January-February 2008. As was the custom, the departmental representatives were asked for their comments. In reply, the representative of SE, Jaap de Hoog, mailed 7/4/08 to Schouten:

«If I look at the progress and problems of projects I see inconsistencies. In section 2.1.15 on the PPP the report says that the datawarehouse doesn't work as it should. IFC gives the highest priority to the solution of this problem. This is the same datawarehouse that is used in project 2.1.10, Education flows. The datawarehouse is mentioned, but not the problems. Project 2.1.9, Early school-leavers, also uses the same datawarehouse, but this isn't mentioned. According to me, IFC should tell us what is wrong with the datawarehouse, and what are the consequences of the problems for the projects which depend on it. [...] IFC should tell us which data have been included in the datawarehouse. »⁷⁷

Van Velsen subscribed to these remarks in a mail to Schouten of 9/4/08. Both De Hoog and Van Velsen had more questions. Nothing was done with them. They got no answers.

Until at least mid-2010 it would remain unknown what was wrong with the datawarehouse. Even though at that time a new project "Datawarehouse" had begun, with new money. We shall return to this later on.

One of the ways people try to show that they don't need to act, is by denying or belittling the problem that has to be solved. On 23/4/08 the memorandum of the heads of the education departments was discussed by the uSG, DGHPSE, DGNEA, Endert and Schouten. In the minutes of the meeting Schouten writes that "the portals do not comply for 100% with the requirements". The most important decision was to request a third audit. At short notice there would be a meeting with Van Spijker and Frank van Loon of IFC in which these gentlemen would be able to admit errors without fear for repercussions. The minutes don't ask them to explain why they lied systematically about the progress, and why henceforth the education departments could trust them.

The meeting took place on 13/5/08. Present were the uSG, DGHPSE, DGNEA, Endert and Schouten, Van Spijker and Van Loon. Later the same day, Endert wrote a concise report of the meeting. The report distinguishes past, future and present. The main points under "The past" are the following:

- uSG said that the portal doesn't comply with the requirements, that communication had been inadequate, and that the management of IFC by the ministry hadn't been clear;
- Van Spijker said that the problem was wider. IFC not only had to build portals, but first of all a datawarehouse. There are problems with the datawarehouse, and with the organization of IFC. These are being solved;
- Van Loon said that communication was difficult because of its technical character;
- Endert pointed out that the education departments need correct and timely policy information. IFC had always said that the datawarehouse was in order. Therefore the education departments concentrated themselves on the portals. In their eyes, the communication is more of a problem than the product;
- Kerstens wants clarity about the technical problems. It is not only communication, but primarily the question: is the datawarehouse in order, can IFC tackle big projects?⁷⁸ Therefore he wouldn't restrict the audit to the PPP;
- Roborgh noted that in projects such as this, difficulties are unavoidable. That need not be a problem, if the communication about them is honest and open.

There was a heated discussion about the portal being sufficient or not. Van Spijker said that a red plane had been delivered instead of a blue one.^{79, 80} Endert and uSG said that the plane didn't fly. It was decided that the product was insufficient, but that a line would be drawn under the past.

⁷⁷ Abridged. Italics of the original. For the full quote please see the Dutch version of this report.

⁷⁸ Note that he very well knew that the datawarehouse was not in order. It will turn out that he also knew that IFC could not properly do similar projects. If it could do them at all, then certainly not efficiently and effectively.

⁷⁹ Van Spijker actually compared with a car instead of a plane. In English a plane is more convenient.

⁸⁰ How could that be if there were serious problems with the datawarehouse?

The main points under “The future” are:

- uSG wants an audit to see if IFC can make this type of product. If not, why not. She wants the audit department of the ministry to do this audit;
- She asks whether the policy portal should be put out to public tender. IFC replied that it did so itself. And that IFC wanted to remain involved;
- It was decided that the main question for the audit would be: can IFC build a dataware-house, portals and similar products, and is it properly organized for such a job. But it should also look at the organization of the ministry with respect to its management of IFC as an agency;
- The draft of the audit request would be discussed with those present, and submitted for approval by the Strategic i+i council.⁸¹

Finally there is a section “The present”. Its main points are:

- On short notice, the education departments will discuss specific agreements with IFC.⁸² Roborgh once more stressed the need for honesty and openness of IFC. It should not make claims beyond its abilities. The education departments should not be cynical but professional;
- Endert and the steering committee are discharged. Kerstens will appoint someone [else] to coordinate the communication ministry-IFC;
- Because the PP doesn’t work as it should, uSG will not pay the remaining 0,6 M€ for the project. Van Spijker says IFC needs the money to keep going. He wants the audit to decide whether the portal works or not. Roborgh notes that it is as clear as daylight that the portals don’t work, that this has been concluded earlier, and that this attitude of Van Spijker doesn’t help. IFC will have to prove that it cannot solve its financial problems by itself. uSG will ask the financial controllers to see what has to be done, and IFC will not be allowed to fail. But whatever the findings, the education departments will not have to pay the remaining budget.

The report of Endert says nothing about the admission of errors. The remarks of Van Spijker suggest the opposite: that IFC persists in its denial of having made mistakes.

Endert sent his report to Schouten for comment. She didn’t react. Of course, professional management (and common sense) requires that official minutes of such an important meeting are made and distributed among those concerned.

On 28/5/08 uSG called a meeting about the PPP with the heads of the education departments. HE was represented by its acting head, Erik Martijnse. uSG informed the heads about the situation and the results of the meeting of the 13th. Views were exchanged about the most suitable auditors for the job and about the organization of the audit. Next, it was discussed what could be done on short notice. What are the quick wins? Agreements should be clear and kept. Problems should be escalated immediately to Kerstens or Van Spijker.⁸³ Up to now the project had been characterized by promising everything and producing nothing. It was decided to start the discussion with the education departments about quick wins as soon as possible.

The above is a summary of the report of Martijnse immediately following the meeting. No minutes of the meeting were made.

Friday afternoon, 27/6/08 4:09 pm, Van Ham, the head of HE, was told that Monday morning, 30/6/08 9:00 am, there would be a meeting of the heads of the education departments, the chief auditor Ed Smid, and Nico Slooff, the financial assistant of uSG. It was to be chaired by Kerstens. The meeting was meant to discuss the draft plan of the audit which was appended to the invitation. 4:47 pm Van Ham asked Endert and Van Velsen to prepare the meeting for him. The request reached them only after the meeting of Monday. Van Ham was the only head present. PE and SE were represented,

⁸¹ i+i= information and implementation. This council was composed of heads of department (in practice their representatives), and chaired by the SG or a DG.

⁸² Agreements about what? Nothing more specific is said in Endert’s report. The report is part of the file CorrBelPortCfl2008b. Search for “blokken”.

⁸³ Sic.

and PAE was absent.

Note that Kerstens was responsible for the project, and therefore an interested party.

Before Friday afternoon, 27/6/08 4:09 pm no draft or part of the plan had been known to any of the education departments. No communication with the education departments about the plan had taken place. A reliable colleague told the author that a draft had nevertheless circulated already for weeks, and had been discussed with IFC. One can only conclude that the procedure was expressly intended to preclude influence of the education departments, while formally abiding by the agreement of 13/5/08.

Analysis of the draft plan showed that it probably wouldn't provide the insight needed to take measures to restore confidence in the continuation of the PPP. It would not answer the question whether IFC can make this type of product. It contained contradictions which made it possible to study or ignore whatever the auditors wanted. Interviews were mentioned as an important source of information. Such use of interviews assumes reliability of the persons being interviewed, while this reliability was part of the problem to be investigated. For these reasons Van Velsen didn't accept the approval of the draft by the meeting (and Kerstens' trickery, for that matter). He wrote a draft memorandum from the four heads of the education departments to uSG with proposals for correction of the draft plan. Speed was imperative, for no change would be possible after uSG had sent the approved plan to the departments. She, and/or Kerstens, was too late to do that. PE didn't want to cooperate, but on Friday 4/7/08 the memorandum could be sent to uSG with the signatures of the heads of HE and PAE and that of the acting head of SE.

The memorandum noted that section 1.2 of the draft correctly stated that the audit was to find out whether IFC was competent to develop products like the PP. However, the definition of the purpose of the audit at the beginning of section 2.1 restricted the audit to the development of policy portals. The memorandum gives an alternative formulation. It proposes to strike out the first two of the four "audit questions" because of irrelevancy. The first question was about expectations of ministry and IFC, the second asked to what extent the present portal answered these expectations. The memo proposes to replace the last two audit questions with a specification of the central question of the audit. It asks the auditors to specify the competencies needed to develop products like portals. As examples of competencies it mentions technical, organizational, managerial,⁸⁴ and communication. It asks for a comparison of the actual competencies with those needed. It asks for examples of products which show that IFC can indeed develop such products. It finally asks to evaluate the abilities of the ministry as manager of an agency that develops ICT-products.

Part of the proposals has been adopted in the definitive audit plan. Details don't matter, for the auditors have not done by light-years what they were asked to do. Neither did they do what might have been expected of them as independent professional auditors.

Tuesday 8/7/08, 4-6 pm, Endert and Van Velsen were interviewed in behalf of this third audit. The interviewers were Smid, Madan Ramrattansing (of the EDP auditpool), en Ender Atalay (EDP auditpool).⁸⁵ Smid limited the discussion to the PPP. Endert and Van Velsen protested, referring to the failure of other projects and the central question of the uSG. In vain. Smid wanted to know if the portal satisfied 90% of the requirements. If so, talking should solve the problem. Van Velsen replied that it would be better to say that it doesn't work at all, because the portal doesn't satisfy basic web directives, and because the OLAP tool doesn't work at all.⁸⁶ This is important for two reasons. Because it shows that IFC is not competent, and that it doesn't communicate openly. Talking has been tried for years. Some things have to change before talking can be expected to be fruitful.

The auditors didn't seem to understand that more than 90% of the information of HE has to be accessed by OLAP. Van Velsen explained that student data have many dimensions, and that this implies very many numbers.

The people from EDP said almost nothing. A few times they asked for elucidation.

Van Velsen thought that the decision making about the audit plan was incompatible with the

⁸⁴ Internal and external; the last with respect to other organizations, such as the ministry and subcontractors.

⁸⁵ At the time Google could not find anything meaningful about this "EDP" on the internet. It should have been part of the government.

⁸⁶ Even if this would represent only 1 of 1000 requirements.

promise of uSG, with the way people were supposed to cooperate in the ministry, and with the code of conduct. Therefore, and as a continuation of their earlier discussions, he sent the SG a mail with a concise evaluation of recent events relating to the PPP and IFC. The mail is dated 9/7/08. Van Velsen mentioned the incompatible interests of Kerstens. He noted that it was about a year ago that he appealed to the SG to enforce the code of conduct, and that no improvement was visible. He didn't understand the need of a third audit. Where there's a will, there's a way. He said he was beginning to doubt the ability of the ministry to correct itself.

On 14/7/08 the SG reacted by mail. It shows no trace of friendliness. The SG denies all wrongdoing, and sees no reason for action. He has no reason to doubt the integrity of Kerstens.

The lack of arguments, the bluntness of the denial, and the "no need for action" was too much for Van Velsen. He sent another mail, showing that the thoughts in the first mail were well-founded. Already a year ago he had informed the SG about the lack of openness and reliability of the progress reports of IFC, and their uselessness for management purposes. He had requested the SG to maintain the code. The SG had agreed that self-correction was better than a formal complaint through an integrity officer. But until now there is no visible improvement. Especially not in the progress reports.

As a consequence of this mail, on 19/8/08 uSG asked Van Velsen to drop in, so that she could explain things. Slooff was present too. He was temporarily acting as account manager for IFC, until a successor for Schouten had been found. uSG began with the audit. She repeated what she had said before, but had not been involved in the formulation of the draft plan for the audit. Van Velsen told her that Endert and he had not perceived the interview with Smid c.s. as inspiring confidence. He made the remarks mentioned earlier. In addition he said that Smid seemed not in the least interested in knowing and understanding how the project had gone wrong. He widened the subject to the progress reports. This however will be treated separately, in the next chapter.

Undoubtedly, the main purpose of this meeting was to appease Van Velsen. uSG took a passive stance. She tried to make an impression of empathy if not agreement. But impressions aren't reality, words aren't deeds, and, last but not least, the words spoken to Van Velsen need not be equal to the words spoken to others. Neither before nor after this meeting did uSG do what she had to do. In all the years of the PPP she never once called a meeting of the representatives of the education departments to explain her management of IFC and the projects. Van Velsen could not believe that uSG really thought that it was sheer coincidence that the meeting to decide about the audit plan took place less than one working hour after the plan had been distributed to the participants, and that this sudden and unheard of haste was in accordance with the "respectful and service-oriented" attitude required by the code of conduct.

The value of words of uSG can be seen in the discussion about the remainder of the budget for the PPP. HE and IFC had agreed at the beginning of the project that HE would pay half of the budget immediately, and the other half upon acceptance. In the meetings of 13 and 28 May 2008, uSG had told IFC that the portal would not be accepted, and that the education departments would not have to pay what was left of the budget. There were no minutes of these meetings, and there was no formal confirmation (on paper).

For his work on budget estimates, John Uitendaal, of the section finance of HE, needed clarity about the necessity of a reservation for payment for the remainder of the HE part of the PP costs. Asked about this, the successor of Schouten, Faïrouz ben Salah, told him that she couldn't find any relevant information. She therefore proposed [«to await the outcome of the audit of the policy portals»](#).

Uitendaal asked Van Velsen for help. Van Velsen sent Ben Salah the report of Endert. Van Velsen also referred to a progress report of IFC which was incompatible with denial of Enderts remarks about the payment.⁸⁷ He noted that the audit was not meant to establish whether the PP should be accepted or not. It should tell us whether IFC can make this type of product. Therefore, it is useless to wait for the report of the audit. He asked Ben Salah to ask uSG to confirm the above. Whereupon uSG told her that she (uSG) wanted to await the outcome of the discussion about the audit report. To Uitendaal this seemed to contradict the decision of May, which in the meantime had been confirmed by Endert.⁸⁸ He

⁸⁷ Sec. 3.5.2 of the document under 20080611 in the directory PPP. For more details see the Dutch version of this report.

⁸⁸ In the time between consecutive mails.

therefore asked Van Velsen to react. On 23/9/08 Van Velsen wrote Ben Salah that the earlier decision had not been conditional.⁸⁹ He concluded his mail with a reminder of the existence of a code of conduct requiring openness and reliability. He suggested Ben Salah to give uSG the report of Endert. «It might refresh her memory. Of course she may have changed her mind. If so, she can simply say so. But she should not deny that on 13/5/08 something else was decided.»

Ben Salah showed this mail to uSG, who felt insulted and became very angry. She thought she was accused of lying. Actually, the purpose of the mail was to show her a way out, and to avoid accusations.

Some time later DGHPE Roborgh dropped his formerly unbending resistance against payment, and joined the chorus that wanted to wait for the audit report.

Because of his offending mail of 23/9/08 Van Velsen had to appear before Roborgh. Van Velsen explained the mail, and promised to contact uSG in order to explain it to her as well. Next they discussed the PPP. Roborgh thought the ministry had been cheated by IFC. He recalled a presentation of IFC of the beginning of 2005, in which IFC painted a far too optimistic picture. He nevertheless wanted to wait for the audit report. He showed nothing like a strategy with respect to IFC, or a long term policy aimed at correction.

The call on uSG was 10/10/08. uSG claimed full integrity. She said that the meeting of 13/5/08 had ended in noisy chaos, and that Endert probably hadn't picked up a reservation which she had made in that situation.⁹⁰ She had been irritated especially by the many copies Van Velsen had distributed of his mail. Van Velsen answered that the recipients were the same as those of the preceding mails, that he had no choice. He advised uSG to have her assistants always make minutes of meetings. That prevents misunderstandings such as this.

On 10/10/08 uSG talked a lot, very much more than on 19/8/08. She was full of self-pity (or play-acted). She could do little if the DG's didn't report and didn't take their responsibilities. She set her hopes on the successor of Van Oldeniel and the audit. In other words: she hoped that things would turn out well of their own accord, without her doing anything. She was well informed, and could and should have acted many times before, but had done nothing. (At least nothing constructive). There was of course plenty of reason to doubt her integrity.⁹¹

Friday afternoon 17/10/08 Smid sent the draft audit report to those concerned. The covering mail asked the recipients to check for errors, and to point out assertions which were insufficiently argued.⁹² Comments were to be sent 5/11/08 at the latest.

On 28/10/08 there was to be a meeting of uSG with the DG's. Two days later, on 30/10/08, there would be a meeting of uSG and the DG's with the top of IFC. To prepare DGHPE for these meetings, Endert and Paul Meltzer of PAE wrote a memorandum with an analysis of the draft report.⁹³ These are some of their more important remarks:

- The executive summary gives the impression that IFC is in order, the technology too, and that only the ministry needs to make a step forwards;
- This is not supported by facts;
- The report tells us nothing that we didn't know;
- The remaining 0,6 M€ should not be paid for the PP. It might be paid to reduce existing risks in human resources, and also for answering ad hoc information requests;
- The report notes that there was no continuing dialogue about portal requirements. But it doesn't look for the cause of this communication problem;
- The report says that IFC tested the portals once, and that the results cannot be found. Though very significant, this fact is not discussed. How is it possible that the portals were

⁸⁹ The mail can be found in the file CorrBelPortCfl2008b. Search for “ontkennen”.

⁹⁰ Don't forget that Endert had sent his report to her assistant for comment, and received none.

⁹¹ This is further substantiated in chapter 4.

⁹² The question about errors is problematic. Auditors should check the facts before they begin with analysis, with drawing conclusions and with the formulation of recommendations. Not afterwards. The author had seen this procedure before. In that case (too) the facts were seriously wrong. The facts were corrected, and the conclusions and recommendations should have been, but weren't. Helping to correct errors may help mislead. Absence of factual errors suggests good work, reliability. If realized in this way wrongly.

⁹³ Van Velsen was on holiday.

tested only once in three years? How could IFC claim good performance if it didn't test? How could the results get lost? Please note: all this in a situation where the education departments regularly complained about the performance, and nothing can have been more welcome to IFC than proof of the ministry being wrong;

- Conclusion: the report is a badly founded effort at soothing.

When Van Velsen returned from his holiday, he noted that people had reacted to the draft as if it were the final version, and as if they should hurry instead of making good use of the time till 5/11/08. They seemed to act as if the meeting of the 30th would consider the report as final, and make decisions. Maybe they thought so on the basis of rumors, misunderstandings or wishful thinking. To Van Velsen however it seemed unwise to make decisions on the basis of a draft when suggestions for revisions could still be sent in. Furthermore he needed time for reading the report⁹⁴ and writing a well-founded and useful comment. He therefore took action to prevent decision making in the meetings of the 28th and 30th. Together with Endert he wrote a proposal for a procedure. By mail of 29/10/08 Endert sent the proposal to DGHPSE. It consisted of the following steps:

- Until 5/11/08 people can draw attention to errors of fact and fundamental differences of opinion;
- The audit department adjusts the report;
- The final report is sent to uSG (who commissioned the audit);
- If desired, uSG formulates an opinion about the report, and draft proposals for action;
- uSG sends opinion and proposals for comment to the departments concerned;
- On the basis of the comments uSG decides.

The mail adds that the meeting of the 30th should be a brainstorming session, where no decisions are taken except about the procedure.

Ben Salah wrote the minutes of the meeting of the 30th.⁹⁵ They show how top managements discuss a real problem. They show a terrible gap between their world of words, and the reality shown in this chapter. They show a management hiding behind euphemisms, and failing to communicate clearly and openly. Maybe these people think they understand each other. But at least the minutes, that is, the report of their words, is ambiguous and unclear.⁹⁶ For example, the minutes say that there is agreement about the need of "a new fresh team", and "a change of team". What they don't say is that this only refers to the representatives of the education departments. To the people who refused to accept the unacceptable. In IFC and the top of the ministry nothing was to be changed at all. Even more telling is the fact that nobody cared to look at the portal. As noted before, it would take only a few minutes to see that it was useless. None of the supposed errors of the ministry could have prevented IFC to make a useful portal.

After a cursory reading of the draft report, Van Velsen smelt a rat. Therefore, and because of the great importance of the audit, he thought it might be useful to write a comprehensive comment. He wanted to preclude the reproof: "why didn't you tell us before?". The result of the analysis was sent to those concerned.⁹⁷ Some of the most salient points are the following:

- The auditors deny that there was agreement about the web-directives. This is untrue, and shows that their work is unprofessional;⁹⁸
- The auditors assert that IFC followed the rules of uSG for project management. This is untrue;⁹⁹
- Chapter 4 of the draft report asserts that IFC is ready to resume the dialogue. IFC is said to be very disappointed that earlier attempts at dialogue have failed. It would very much like

⁹⁴ Of 30 pages plus 20 pages appendices.

⁹⁵ In the directory PPP, under 20081030.

⁹⁶ There is no proof of their understanding each other correctly. Obscurity, ambiguity etcetera are incompatible with accountability anyway.

⁹⁷ It can be found in the directory PPP, under 20081105.

⁹⁸ As noted before: the requirement is included in the *Portal requirements* (= Programma van eisen, adopted in August 2005).

⁹⁹ As shown in the Dutch version of this report (and in the file under 20081105).

to succeed this time. But the auditors don't explain why the earlier attempts have failed, and why the string of useless meetings and broken promises ended. They don't give a single reason for believing that IFC has turned reliable;

- The description of the measurements of the performance of the PP by the auditors is incomplete to such an extent that they are irreproducible.¹⁰⁰ The findings of the auditors do not agree with the findings of the education departments. Which the auditors ignored;
- The auditors don't seem to understand the difficulty of making multi-dimensional data accessible. They didn't ask themselves whether IFC had simply been too pretentious;
- Many opinions in the draft report are formulated as objective facts, but without proof or reference.

The final report was distributed on 26/11/08. Important comments had been laid aside without adequate refutation. Even when they concerned errors of fact.

For the recommendations of the report the reader is referred to the report. No attention is given to them here, because they completely ignore (or even deny) the real problems, and because they played no role in the sequel. Nobody took the audit seriously.

The process of discussions and decision making following the distribution of the report was murky and chaotic. But on 8/12/08 uSG sent a memorandum with her draft conclusions to the DG's, with the request to comment on them, if desired. An earlier draft had been seen and commented by the representatives of the education departments. Only a small part of the comments had been assimilated, and there was no agreement about this new memo. uSG proposed:

- To change the formal status of the PPP from project to running concern. This change was to be accompanied by an inquiry into the performance of the PP;¹⁰¹
- A PPP 2 will start with a new team. It will be managed by DGHPE and the head of PE;¹⁰²
- IP and the communication department develop a proposal for professional management of IFC by the ministry;
- The remainder of the PPP-budget will be paid in advance under condition of demonstrable improvements of quality care and communication.¹⁰³ The final decision about this will be taken after the change mentioned in proposal 1.

Note that none of these points touches underlying causes. Nothing is done to restore the confidence of the education departments in IFC.

Proposal 1 has not been incorporated in the performance contract (PC). The inquiry has not taken place. Proposal 2 means: the project will be continued, with people who are hampered by a lack of knowledge; and the members of the "old" (ministerial) team will be sidetracked. Proposal 3 went down the drain. It was useless anyway. The problem was not the question what had to be done, but doing what everybody knew had to be done. Proposal 4 can only have been meant as a cover for the wish of uSG to pay regardless. She did so in the last days of 2008.

The comment of DGHPE required adjustments of the proposals, but nothing was done with it. Whatever other DG's may have said about them, the final decisions didn't deviate from the proposals. The decisions were laid down in a letter of uSG to the head of IFC of around 19/12/08.¹⁰⁴ The letter concludes with [«thanks to you and your co-workers for constructive co-operation with the audit, and](#)

¹⁰⁰ Of course this is unacceptably unprofessional.

¹⁰¹ It seems that uSG and her assistant did not notice section 4 of appendix 1 of the audit report. The title of this section is: "Inquiry into performance and user friendliness".

¹⁰² Yes, two people. It would take a lot of time before duties/ responsibilities were distributed among these two. It was a waste of time, for nothing came of PPP 2.

¹⁰³ The apparent contradiction is in the original.

¹⁰⁴ It can be found in the PP-directory under 20081219. The letter is signed, but not dated. The letter wants the proposal for the management of IFC, requested by proposal 3, to be submitted in the first quarter of 2009. The proposal never came. Even the formation of a new team turned out to be difficult. In the education departments everyone knew for a fact that the PP didn't work. Nobody wanted to replace colleagues who had defended their interests as they should have.

the elaboration of solutions».¹⁰⁵

The texts of uSG, or the top of the ministry for that matter, seem to try and create a fantasy world. Due to the (known) lack of agreement between words and reality, the letter can only be seen as an effort to mislead possible outside investigators, such as the General Accounting Office.¹⁰⁶

To Van Velsen it seemed that every opportunity to correct misconduct should be seized. He therefore wrote a mail to the SG, expressing concern about the dubious audit report and decision making, and the lack of appropriate action. The mail is dated 11/12/08. Decisions had not yet been made. Van Velsen said he had been startled by the lack of quality of the audit. By selection and half truths, the auditors seem to try and prove a favorable picture of IFC and the PPP. He regrets that they show no interest in the information needs of the education departments. Why does nobody give an ear to their rightful complaints?¹⁰⁷

He drew attention to the risks of auditors lacking integrity. He advised to deal with this problem as soon as possible. In fact, the integrity problem seemed to him much wider than he thought a year ago. He feared that the proposals of uSG would confirm the existing culture instead of purging it. IFC is allowed to do what it likes. The top of the ministry suppresses bad news. It doesn't defend the interests of the education departments and their people.

The mail noted that the proposals of uSG can easily give the impression of a gap between words and deeds. It continued: You, the SG, can avoid this by telling those concerned that many IFC-projects are not running as they should, and that you require professional management, including reliable reporting. You could use your weblog to make this known. Finally, to avoid giving a misleading signal, I advise you to stop the PPP, and to start a discussion with the education departments about their information needs.

By the way, did you know that at the end of last century IFC failed in a similar project, "datawarehouse HBO"?¹⁰⁸

The SG did not react.

2009 and 2010.

Especially section 4 of appendix 1 of the audit report about the performance of the portal was amazing. Before 5/11/08 there had not been time to study this section thoroughly. In January 2009 the dust of the discussions and decision making about the audit and portal had settled. There was time for more analysis.

The text of this section 4 makes a strong impression of bias, manipulation and/or outright deceit. Positive judgments never mention reservations, negative judgments always mention mitigating circumstances. Performance problems are admitted, but not specified. As in the main text of the report, the tests of the education departments are ignored. There is no empathy with their complaints. As indicated above, due to an unprofessional description, the performance measurements were not reproducible and could not be checked. For one thing, the questions the auditors had tried to answer are not mentioned. Relatively many (simple) test questions concerned only a relatively small and simple part of the portal.

Van Velsen was unable to reconcile the findings of the auditors with the tests of HE, and with what he had heard from his colleagues even recently. He simply didn't understand. Only an experiment could resolve the mystery. He formulated some random information questions, and described his efforts to get them answered by the portal in such a way as to make them instructive and reproducible. The questions were neither simple nor complicated.¹⁰⁹ The main conclusions were the following:

¹⁰⁵ No words of thanks have ever reached the ears or eyes of the representatives of the education departments. The acknowledgement makes the letter hard to understand, or even inconsistent. The letter began with «[...] to prevent history from repeating itself.» What has happened that should not happen again?

¹⁰⁶ In Dutch: Algemene Rekenkamer.

¹⁰⁷ Of course, the heads of the education departments should have given their representatives much more support.

¹⁰⁸ HBO= hoger beroepsonderwijs, higher professional education. In the time of the present project, this education was the responsibility of HE, the department for higher education.

¹⁰⁹ Relative to the data characteristics and the portal requirements.

- Making tables with the OLAP tool takes much more time than suggested by section 4 of appendix 1. Even for relatively simple tables. Working with the portal is forbiddingly frustrating. The buttons for definitions and elucidation for example simply don't work.¹¹⁰
- The auditors may have given only the “run-times”, the time the user must wait after having made all selections and other preparatory actions. If so, the auditors should have reported that the necessary preceding actions (such as making selections) take much more time than the final calculation.

In short: the section gives a completely incorrect picture of the performance and user-friendliness of the portal.

For the detailed report of this experiment the reader is referred to Appendix 2-1 of the Dutch version of this book.

Van Velsen had not expected intentional deceit, but could not interpret the results otherwise. The more so since the results were shown to be reproducible on the computers of the head of his section, and that of Ron Minnée, the successor of Van Ham as head of the department HE. Martijnse nor Minnée showed any surprise. None.

To show that the deception of the auditors was not limited to a single subject, two more subjects were analyzed: the web-directives as part of the portal requirements, and compliance with Prince2, the project management method prescribed by uSG.¹¹¹ These subjects were chosen because of their importance, and because correctness of the corresponding information in the audit report can be established objectively. It turns out that in these cases too, the auditors conceal or smooth over defects, and do not hesitate to dish up lies.¹¹²

It follows that text selected for checkability, but apart from that at random, is incorrect. Therefore one should not trust the other part of the text.

It also follows that the auditors have not worked in accordance with their (professional) code of conduct.¹¹³ The auditors are part of the problem. The fact of a third audit in itself already shows that something more or “deeper” must be amiss. A single audit should have been sufficient. If a management cannot solve a problem after two audits, why after a third? Worse, given that no action was taken after the first two audits, and given the repressive behavior of the top management of both the ministry and IFC, the hypothesis that the audit was ordered to provide a positive evaluation seems highly probable. Fact is that the auditors and their superiors¹¹⁴ have been instrumental in a cover up of misbehavior and failures of IFC and the top of the ministry.

The audit department is the final instrument for self-correction of an organization. The fact that it failed its professional standards¹¹⁵ and isn't independent means that the organization cannot correct behavior that involves its top. And in a hierarchical organization the top is almost always involved.

In the first months of 2009 it was very unclear how the PPP was going to be continued. Nothing much happened. On 24/3/09 Bas Derks¹¹⁶ of HE and Van Velsen were asked to see DGHPSE Roborgh in connection with a visit that Roborgh would pay next day to IFC. Roborgh didn't know what was expected of him in the PPP. He said he hadn't done anything about it since the end of 2008. He said he didn't know the letter of 19/12/08 of uSG to the new head of IFC, Jan Jurgen Huizing. In this letter she tells Huizing that DGHPSE will head a “new team” for the PP. Roborgh told Derks and Van Velsen that he would go to IFC to see how the PP worked. He would operate the computer himself. He didn't

¹¹⁰ This had not changed since 2 (two) or even 3 years ago. There were more problems which had been reported to IFC in 2006 or 2007 but had not been resolved. The auditors should have tried to find out why.

¹¹¹ The instruction and a description of the method can be found in the directory Project and agency management, under 20071130.

¹¹² For the detailed reports of these analyses the reader is again referred to Appendix 2-1 of the Dutch version of the present report.

¹¹³ Which can be found in the directory Integrity. The directory includes the INTOSAI and IPPF codes, and, under 20100831, the text of the web-pages of the audit department of the education ministry and the flyer with “principles of proper auditing”.

¹¹⁴ Who co-signed the report.

¹¹⁵ On the website of the audit department it presented itself as the ultimate standard of integrity and reliability.

¹¹⁶ He was the successor of Endert as head of the policy section. Endert had become deputy head of SE.

want preparation. He wanted to be as unbiased as possible.

When he came back from his visit his judgment about the portal was devastating. He said it simply didn't work at all. He was nevertheless positive about the visit. Many IFC-people had been present at the test, the new head of IFC among them. Huizing admitted that the portal didn't work, and said he would very much like to get it in order.

This visit can be considered to mark the beginning of the end of the PPP. The remainder of this chapter is devoted to transition phenomena and the activities which came in its place. This is important mainly because it confirms that the PPP produced nothing useful. In addition it shows that no lesson was learned, and no improvement realized.

The PPP was replaced by two other projects: a project datawarehouse, and a project, or at least a working group "Policy, information and cooperation" (PIC). From the beginning of the PPP, IFC had said that most of the budget for the PPP would be spent on building a datawarehouse (DWH). Even if this could not be seen in the progress reports.¹¹⁷ The DWH was to be the brains of the PP. And of other portals. But it would be paid by means of the PPP. As a consequence of inadequate information and progress reports, the ministry never understood what this DWH was or was meant to be.¹¹⁸

On 6/4/09 the (top) management team of the ministry, abbreviated MTM, was asked to agree with a proposal for four "infrastructure projects". They were to be carried out for the greatest part by IFC, and for a minor part by IAG.¹¹⁹ One of the projects was called "datawarehouse and public portal". According to the document describing the proposals, the purpose of the project was to fill the DWH with data about individual pupils and students, and to make aggregated data available through a public portal (website). In a summary of the given situation, the document says that at this moment the DWH only contains aggregated data. For information about for example efficiency and location dependent performance and developments, data about individual pupils and students are necessary. At present, such information is derived by IFC-people, "by hand". This may result in double work and human error. IFC expects an increase in information requests, and as a consequence a shortage of human resources.

The document gives several (dubious) answers to the question: "What goes wrong if the project is not carried out?". It says that the DWH has to be filled, managed and made accessible. At present, there are serious problems with all three processes. Consequences of these problems are indicated.

The project activities consist in "adjustments" of the three processes. The "adjustments" are not specified. No mention is made of documents where specifications can be found.

The project had not been discussed with the education departments.

A budget of M€ 2,3 is requested for the project.

The document implies that the PPP has not produced the DWH and portals that had been promised. The DWH should have been ready and working. It was the principal part of the PPP, and must have cost about 3 M€.¹²⁰ The document continues the black box policy of the PPP.¹²¹ What was realized in the PPP, what went wrong, what has to be done, and what will be the result? The document gives no answers. In fact, the work of the past four years is completely ignored.

The minutes of the MTM-meeting say that a risk analysis will be made for the DWH. And that the project plan will be discussed with the DGHPSE-departments.

The risk analysis was made by Bram Gakeer of IP. He discussed the risks with Van Velsen. Gakeer knew nothing about the present state of the DWH. He didn't know how a DWH was to be described.

¹¹⁷ Indeed, as far as the progress reports were concerned, the DWH could as well not exist at all. For information about the DWH, the ministry depended fully 100% on what IFC told it.

¹¹⁸ Of course, the ministry should never have accepted this refusal to explain and account. Lower levels didn't, but were let down by their top "management".

¹¹⁹ See the papers under 20090402 and 20090403 in the directory Project and agency management. The papers of 20090403 include notes by Van Velsen.

¹²⁰ Excluding the costs of the time and energy of ministry employees, and the costs of harm done to people, and of additional corruption of the ministry and IFC.

¹²¹ And all other projects, see the next chapter.

The discussion resulted in agreement about risks that should be mentioned, and about a plan for the restoration of confidence. But Gakeer kept none of his promises. He didn't send Van Velsen a copy of the documents he sent to the MTM. It had been agreed that the risk analysis should ask the question: can IFC do what it is supposed to do in this project? But it wasn't. It was tacitly assumed that IFC was competent, and that its abilities had not been overestimated. The "risk analysis" bristled with rhetorical trickery making light of risks and exaggerating opportunities. Even lies were thought to be necessary to "convince" the reader. The analysis suggests that the failure of the PPP was caused by lack of clarity about portal requirements. Which is nonsense: there was no lack of clarity at all. Gakeer gave no estimate of the size of the risks, if only on the basis of experience. If estimates had been made honestly, the chances for success would have been found to be very small.

But the dirtiest trick of the "risk analysis" is in the tail. It asks for approval not only of the risk analysis, but of the project proposal as well, including the budget. The amount of which isn't mentioned.

The document "Risk analysis DWH" was dealt with in the MTM-meeting of 11/5/09. According to the minutes of this meeting «all proposals in the risk analysis are approved. But a progress report is to be included every 3 months in the risk scan for the MTM.»

The risk scan of the second quarter of 2009 reported as follows:

«The development of the DWH is followed critically by the education departments. This is a consequence of experiences with similar projects in the past. One of the most important success factors of the project DWH is the support of the education departments. They must gain confidence in steering by demand, and in the usefulness of the products of the project. [...] The timetable of the project can only be determined after specification of the information which is to be included in the DWH.»¹²²

That support of the education departments is one of the most important success factors wasn't mentioned in the risk analysis.

The report says nothing about progress. The remark about the timetable is peculiar. The education departments had specified this information years ago, at the beginning of the PPP. Gakeer had been told so. Obviously, his behavior didn't exactly inspire confidence or support.

Of course the education departments didn't believe in a speedy solution of the problems with the portals or DWH. Therefore they were looking around for other ways to get the information they needed. Already for years there were arrangements with IFC for the handling of ad hoc information requests.¹²³ After the failure of the PPP, the departments took coordinated action to get money that was earmarked for technical solutions reallocated to the expansion of human resources for answering ad hoc information requests. This action was successful, even though implementation took time. MTM charged a working group with answering some questions about ad hoc information requests and the organization of the answering. Questions of which the answers were already known.¹²⁴ The document defending the proposal shows that the PPP has not achieved its purpose, even if shrouded in mendacious phraseology: «The project policy portals 1 had started from the unrealistic assumption that the instruments could be made suitable for everybody.» Anyway, the document doesn't assume the least help from a portal.

In a draft note "Project policy information/ policy portals" by Jaco van Rijn of PE and Sjerp van der Ploeg of IFC, dated 26/11/09, one finds the following paragraphs:

«The education departments use the policy portals hardly or never. For ordinary people the portal is

¹²² The risk scan can be found in the subdirectory Project reports of the directory Project and agency management, under 20090511. The risk scan mentions the SG as the manager responsible for this project, and Arnold Jonk, head of IP, as his representative for this project.

¹²³ These are questions that cannot be answered by websites or other computer systems. The arrangement of HE was laid down in the performance contract. The arrangement prescribed who was authorized to ask or receive questions, and how many days answering might take. HE also had an arrangement for urgent information requests, for example related to questions of parliament.

¹²⁴ As far as HE was concerned, the arrangements were adequate. IFC may have run the risk of insufficient capacity (people), but whether or not this risk was serious is not known to the author.

too complicated, for specialists it offers too little surplus value as compared to working with the complete data files which are supplied periodically. [...]

The education departments hardly use the present policy portals. The portals seem to be based on an incorrect policy theory: the expectation that the people in the education departments could extract all of their policy information from the portals themselves has turned out to be unrealistic.»¹²⁵

As if not the portals, but the users are the problem.

The note was written for the working group i+i. Next it was sent to the Strategic i+i council. This was chaired by the SG. From the minutes of the Strategic i+i council it is impossible to gather what was decided. Fortunately, this is shown very clearly in the “Consolidated progress report risky projects ministry” for the first quarter of 2010.¹²⁶ Under “Policy portals” one can read:

«The Strategic i+i council has decided to stop the development of the policy portals per 1/1/2010. This has been done. [...]

The Strategic i+i-council has decided

With respect to technical aspects:

- To stop the PP¹²⁷
- To continue the development of the public portal

With respect to organization:

- To secure the positions of the information specialists in the education departments

With respect to the cooperation ministry-IFC:

- Strengthening the relation ministry-IFC on the interface policy-data by thematic bundling of expertise. [...]

The risky project PP has been ended. Therefore it is proposed to stop the progress reports about the PPP.»

Don't forget that the information systems that existed until the beginning of 2006 had been dismantled, and that the people who had kept them up to date had been fired, and left the ministry. With the money wasted on the PPP these people could have maintained and even improved the system for over ten years. Those who have proven their dishonesty and incompetence have kept their jobs and work on other projects. Some of them were promoted to the top of the fused agency NEA.¹²⁸ The conclusion is that due to the PPP both the provision of information and the organizations have deteriorated.

2.5. Epilogue.

At the end of 2007 Frans Dijkstra, the head of the section Information and analysis of the department of higher education, retired. He left what his colleagues called a “testament”.¹²⁹ a document entitled “Some aspects of policy analysis higher education”.¹³⁰ It analyses some subjects of policy in historical perspective. Chapter 11, Information policy, contains the following paragraphs:

«Policy portals are the sequel of the data depots on which IFC was allowed to spend much money and energy from 1999-2002. The purpose was the same: to save quantitative data, and make them accessible for users in policy departments.¹³¹ The concept “portal technology” has a strong mystifying effect. Put simply, it means that one can use various computer applications through a single interface. In this case a website. Nowadays, such an interface can be used by every computer, without special software. A web browser suffices. (Possibly apart from complications arising from, for example, lack

¹²⁵ The file in the PPP-directory is dated 20091207. The author couldn't find the version of 26/11/09. The quoted text is the same in both versions.

¹²⁶ In the subdirectory Project reports of the directory Project and agency management, under 20100414.

¹²⁷ Yes indeed, the policy portals, not the project (PPP).

¹²⁸ See the next chapter.

¹²⁹ In the sense of last will.

¹³⁰ In the PPP-directory, under 20071100.

¹³¹ Policy departments: such as HE, PAE, PE and SE.

of tools to read Java-scripts). Access by means of the internet is the great advantage of the policy portals. But behind the interface lie the same problems as of the KIS-system¹³² or the datawarehouse HPE¹³³: the information must be saved in a structured way, and be easily accessible and aggregatable. A system which can present every imaginable combination of numbers on the computer monitor at the request of the user in a very short time is infeasible. It is necessary to find a compromise, and select, calculate and set out frequently used tables.

Since 2004 IFC is busy developing a policy portal for HE, PAE, PE, and SE. At the time of writing, August 2007, the results have not been accepted by any department. To all appearances, it seems that we have once more fallen in the pit Wouter Keller warned against in 1993 (see above)¹³⁴: *Projects which are too big to complete with a small team in a single year can better not be started.* The PPP has a sizable team, and is in its third year. The team has been changed during the project: both the external and internal project leader, and the software supplier have been replaced. Most continuity can be found in the senior collaborators of IFC and the representatives of the education departments.

Another pitfall often encountered, is the tumbling of new projects one over the other(s). This has to do with drawn out timetables.¹³⁵ The policy portals of HE, PAE, PE, and SE were far from completed when IFC began with a public portal, which was to make quantitative information about education accessible for the public (such as journalists, schools, and researchers). Furthermore, it opened a supervisor portal.»¹³⁶

Dijkstra discusses more of this kind of projects. He concludes that the problems, including the lack of learning from experience, are systematic. But his testament is not only interesting because of this evaluation, but much more because he only makes these observations at his farewell. Dijkstra was the head (“manager”) of Van Velsen. When he asked Van Velsen to succeed Veen as representative of HE, he warned Van Velsen against some aspects of the behavior of IFC. But although the testament might make you believe otherwise, he never supported Van Velsen actively.¹³⁷ On the contrary, in situations where he may have perceived pressure he publicly deserted him.

As can be inferred from the quote and the testament, Dijkstra had appreciable talents. Moreover, outside an organization like the ministry or IFC (and so on), he probably was a kind and honorable person. But he was not only unable to resist the influences of his corrupt environment: he collaborated actively. Nevertheless, the quotation shows that even after 30 years of working in a madhouse he had not lost all common sense.

¹³² Unknown (and irrelevant: no more than false pretensions).

¹³³ HPE= higher professional education, later part of HE.

¹³⁴ The “see above” refers to text in the testament.

¹³⁵ It even causes them to be delayed.

¹³⁶ The quote is from p. 94. Please take care: in the quote, opinions, assumptions, etcetera are often phrased as facts.

¹³⁷ Not passively either (say under four eyes). Except in the meeting with Van Ham and Spijker in March 2005. At that time he may have thought Van Velsen had the backing of the SG.

Chapter 3.

Project and agency management by a ministry.

Table of contents of this chapter.

1. Summary and conclusions.
2. The origin of this chapter.
3. The project management of the undersecretary-general.
4. The project reports and the merger of IFC and IAG into NEA.
5. Notes about some specific projects.
6. Accounting for the maintenance costs of studylink by IAG/NEA.
7. To conclude. The General Accounting Office evaluates the consequences of its ICT-reports.

3.1. Summary and conclusions.

1. All except 1 of 9 randomly selected IFC projects were delayed for more than 2 years, had appreciable budget overruns, and/or failed to realize their goals. The exceptional project had a delay of (“only”) 2 years.
2. The author knows of no project that was completed successfully in the time and for the money allotted. Many projects produced nothing useful.
3. None of the projects was preceded by a cost-benefit analysis. The projects were motivated by arguments pro, and, sometimes, claims that arguments contra were irrelevant. For none of the projects it was even plausible that benefits would exceed costs.
4. In important respects the reports about the progress of the projects were incomplete, untruthful and inconsistent. This can be concluded from a comparison of successive reports. This has been reported to DGs, uSG and SG. uSG promised to do something about it. But she didn’t supervise the implementation of her words, and no substantial improvement took place.
5. After the merger of IAG and IFC the progress reports became worse or disappeared. After the merger, only central organs of the ministry received reports, and only about so-called “risky projects”. For the selected projects they gave more information than previous reports. But in important respects they remained incomplete and unreliable.
6. The projects seem to have been approved on the basis of advertising and wishful thinking. Although the relevant documents may just as well have been intended to mislead for example external auditors of the DGAO.¹ None of the projects had been properly thought out. The projects seem to be based on the illusion that everything that can be imagined can be made. Sometimes a project would result in doubling existing services. As in the case of education statistics.²
7. In all projects difficulties and risks were underestimated.³ By both ministry and agency. Often there wasn’t even reason to assume that the agency had the required competencies. On the contrary: experience had shown that it lacked them, and that failure was very probable.
8. Neither ministry nor agency applied available know-how, learned from experience, or reasoned competently about (new or current) projects. They did nothing constructive with critical remarks. Examples of available know-how are Prince2 and the reports of the DGAO.

¹ DGAO= Dutch General Accounting Office.

² For decades, these had been collected only by CBS, the (Dutch) central office for statistics. CBS was financed by the ministry of economic affairs, and otherwise independent.

³ Or not estimated at all, or in a useful way, as in the new datawarehouse project. See the chapter on the PPP.

9. In particular, no lessons were learnt from the failures of projects.⁴
10. uSG had prescribed Prince2 as the method for project management. But in practice no method was followed at all.
11. The words of uSG don't agree with her deeds. She doesn't supervise the implementation of decisions and agreements.
12. The ministry always provides money to cover up failures. Projects may always be repeated with new money. If desired under a new name, as if it were something new.⁵
13. The higher management of the ministry actively represses signals about malfunctioning. It tries to prove that they are unwarranted, or ignores them. The internal audit service actively supports this policy, thereby violating its professional code.
14. None of the minutes of management discussions about topics discussed in this and other chapters betrays any willingness to mention real problems, and the ability to analyze, let alone solve them. There is no open discussion. This picture is consistent with all other available information.⁶
15. The merger of IFC and IAG seems to have been dictated by SG without good reason. No tenable motivation has been found. The merger has not been discussed openly. The argument of overlapping activities ("waste") is false. In general, activities were complementary, and overlap minimal.
16. The merger was attended by a change in the formal relationship between the new agency and the ministry, and with changes in staff. "Managers" of IFC got relatively high positions in the merged organization NEA.
17. In the ministry, the contract management of NEA was centralized at the cost of the education departments.
18. For the contract management of NEA the SG was represented by a temporary contract manager. After two years this function was supposed to have made itself redundant. The person charged with the contract management had no previous experience with agency management, and eliminated everybody who had been critical of IFC from the relevant network. The past should be left alone, a fresh start was necessary.⁷
19. There was no reason to assume that the organizational structure had caused any problem. Neither was there reason to assume that the merger and attending changes would bring improvements. In fact, they might as well cause deterioration.⁸
20. The problems with the projects can be explained easily and completely by incompetency and lack of integrity of all "managers" involved. There being no positive proof of competency except the competency to conceal the falseness of their pretensions and those of the political bosses.
21. None of the authors of the documents quoted in this chapter can be accused of openness. In discussions about projects, nobody notes that a goal has turned out to be unrealistic. Nobody

⁴ Which can be explained as a consequence of their denial: no failure, no need for explanation and improvement.

⁵ This was already seen in the previous chapter, with the PPP. The renewal project of the IAG, to be reviewed in chapter 5, is another example.

⁶ Most importantly, that there is no improvement.

⁷ In other words: he wanted to start from zero, and didn't want to learn from experience.

⁸ According to the present author the people are much more important than the organizational structure.

acknowledges that problems and failures are the rule, and tries to analyze the causes of their systematic character. Nobody connects the problems with the ICT-reports of the DGAO.⁹

22. The prolonged resistance against the misconduct in the PPP was exceptional. The author thinks he would have heard if colleagues in other projects had resisted similarly. But he heard nothing. Most colleagues remain passive, some collaborate actively.
23. The code of conduct of the ministry (applicable to the agencies as well) plays no role in the projects whatsoever. Even though SG was asked explicitly to enforce it. The code can only be meant to mislead outsiders.
24. In the higher management nobody acts responsibly. As (s)he would if (s)he knew his/her actions were public.¹⁰
25. Summarizing. Only on the basis of a most superficial analysis can one conclude that the problems are caused by difficult ICT.¹¹ The evidence presented in this chapter proves that ICT projects are started due to overly simplistic thinking, arrogance, insufficient self-knowledge and insufficient knowledge of the organization, far too easy money,¹² and unwillingness to think about the (well-known) requirements of a successful project. Projects fail for these reasons, and because of a host of other deficiencies such as lack of integrity in communication, lack of the ability and willingness to learn, and, last but not least, (de facto) absence of external control.

The summaries and conclusions of the sections on Studylink and the 2012 DGAO report are not included in the above. They can be found directly under the heading of the corresponding section.

3.2. The origin of this chapter.

The responsible managers of the ministry remained passive under the reports about the problems in the policy portal project (PPP). They never gave active support to their representatives, and never recognized the seriousness of the problems. Even after years of problems and failures, the top did no more than order a third inquiry.

Soon after the first problems in the PPP, the attitude of their managers made the representatives of the education departments skeptical about the help they could expect from the top of the ministry. The DG's seemed not to be surprised. They implicitly or explicitly suggested that the problems were of minor importance, and solvable by "good discussions". And after all, whatever the problems in the PPP, the other projects were running smoothly. The last assertion was unproven however. If true, it was hard to explain. Why was PPP exceptional? How to explain that the IFC people working in the PPP lie, cheat and fail systematically, while behaving decently and competently in all other projects?

When correction of the PPP turned out to be hard or impossible, the doubts of Endert and Van Velsen about the other projects increased. But more information was needed to get certainty. Information was not only important for understanding what was going on, but also to determine a line of conduct with respect to IFC and the management of the ministry. If the PPP was not an exception but the rule, the case for action by the management would be much more compelling.

In June 2006, at the request of the representatives of the education departments, DGPS Rob Kerstens, representative of uSG for the PPP, had installed a new steering committee. Halfway 2007 Endert, the chairman of the committee, told DGPS that the committee had not been able to realize the required improvements, and that IFC systematically failed to provide necessary information and keep its promises. DGPS remained passive. He only approved a proposal for an inquiry into the possibility of making multi-dimensional tables available through the internet, and to do this in a way consistent

⁹ Reminder: ICT= information and communication technology.

¹⁰ If he or she could, which has to be doubted. In fact, it is a little bit misleading to say that the concealment is due to competence. It is actually due to competence *in combination with the (ab)use of power*.

¹¹ A difficulty which is moreover relative.

¹² And the absence of a need for proper accounting.

with the applicable governmental directives. On the basis of the results of this inquiry the representatives of the education departments should make a proposal for the continuation of the project.

Parallel with, and independent of the above actions, Van Velsen had shown the SG that IFC systematically violated the code of conduct of the ministry. He requested the SG to ensure that the code was respected. This development will be described in more detail in the next chapter. For the present it suffices to note that initially the discussion SG-Van Velsen looked promising. And that SG actually did little or nothing helpful. His attitude underlined the importance of information about the other projects and activities of IFC. But reliable information was hard to get by. Colleagues involved in projects and activities were unable to give a clear picture. They only gave impressions. Except that it was obvious that there were hardly any meaningful project documents. And that there were no progress reports beside those sent to uSG.

It had been very time consuming to arrange a meeting of Endert with DGPS.¹³ There was no question of an “open door” or “dropping by”. In fact, there were only few opportunities for discussions with DG’s or (u)SG in or outside formally organized meetings. One could do next to nothing with remarks about IFC projects unless one had a function that required supporting a DG or the uSG in his or her role as contract manager of IFC. Such a function would, in principle at least, also provide information about the other IFC projects. Van Velsen decided to look around for such a function, and for an opportunity to get it.

The opportunity came when his section Analysis was discontinued because of budget cuts and the retirement of its head. The duties of the employees of the section were distributed among the remaining sections of the department. Where useful or desired, duties were reshuffled among employees. In this situation Van Velsen offered to take over the contract management IFC from a colleague who wanted to get rid of it.¹⁴ Towards the departmental management Van Velsen was clear about the way he would fulfill his duties. As examples he mentioned his contract management of IAG and the way he worked in the PPP. In other words: the management of the department knew what to expect of him. He said he only wanted the job if they agreed. They did. So by 1/1/08 he moved to the section Management, and became his departments’ contract manager for IFC.¹⁵

3.3. The project management of the undersecretary-general (uSG).

The first thing Van Velsen was asked to do in his new job was to help advising uSG about a proposal of IFC for a project Accounting. The project was part of the program Rounding off Customer Oriented Services. There were three projects in this program. The other two were called Financing and Digitizing. Each of the projects had a (proposed) budget of 3 M€. The following are some of the remarks Van Velsen made about the proposal:

- The proposal is too vague about what will be done or made. There is no sketch of the present and future situations;
- There is no specification of the quality norms for the products;
- The proposal doesn’t indicate how it can be ascertained that the products have been completed and satisfy the norms;
- The costs are not properly substantiated, and not related to the products;¹⁶
- The section about the benefits is formulated in abstract (vague) terms, and lacks proof. Risks are said to exist, but are not specified;
- The proposal suggests that there are relations, and possibly overlap, with other projects and activities. It should specify them, so that their importance can be evaluated;
- For a project of this size the ministry should ask the advice of an independent external expert.

¹³ This may have been, or probably was, malicious intent.

¹⁴ Note that this is not purely accidental. In job vacancies as in the supply of used cars and homes and many other items, defective items are over represented.

¹⁵ In addition to that for IAG.

¹⁶ Later in this chapter it will be proven that the claim for the maintenance costs of Studylink had no acceptable foundation whatever. It can have been guess, but may as well have been no more than a seemingly realistic amount, and an effort at shoplifting.

Of course, the expert will need more information than provided by the proposal. The additional information should also be given to uSG;

- Progress should be evaluated periodically by an independent external expert;
- The role of the users of the final products should be described less vaguely and noncommittal;
- The proposal suggests that a sequel is necessary. This looks like salami tactics, and should be explained and taken into account in the evaluation of the proposal.

He concludes that the proposal cannot be accepted, and that IFC should be asked to write a proposal that takes account of the above remarks.¹⁷ The proposal was nonetheless accepted unchanged. According to the assistant of uSG for IFC, Michaela Schouten- Van den Boom, “remarks about details” could be dealt with in the project initiation document (PID), which was to be written in a following stage.¹⁸ Van Velsen replied that uSG should only agree and sign if it was sufficiently clear what she agreed with.¹⁹ As yet, this simply could not be the case.

According to its timetable, the project should run from August 2008 to February 2009. In March and April 2009 the results would be tested, put into use, and evaluated.

The acceptance of the proposal is hard to reconcile with a resolution of a meeting of uSG with the top management of IFC on 29/5/07.²⁰ According to the minutes of the meeting, the ministry and IFC will further professionalize their collaboration. Especially with respect to projects. It had been found that agreements had not been made properly, and that this had caused problems with payments. Sometimes there was no project proposal or instruction signed by uSG.²¹ From now on Prince2 will be applied wherever possible.

On 30/11/07 this was followed by a memorandum of uSG to the DGs with a description of a slightly modified Prince2, and the request to put it into practice.²² The DGs are requested to pass the request on to the heads of their departments.

The proposals for the two other projects in the program, Financing and Digitizing, had already been accepted in 2007. They were just as defective as that for Accounting. Van Velsen did not understand why the prescribed procedure, Prince2, had been ignored, and why these utterly unprofessional documents had been accepted. He asked Schouten for an explanation. She asked her assistant, Martijn van der Valk, to reply in her stead. In his reply, Van der Valk sketched the history of the program.²³ He said that preparatory documents were considered as the documents required by ministerial procedures and Prince2. (Even though their contents was very different from what was required of such documents). He concluded that the program involved quite a lot of money, and that Prince2 had been “adapted” for that reason.²⁴ Of course, the “adaptation” consisted in non-application, while the size of the program should have been reason for more instead of less careful decision making.²⁵ From their experience with other projects, uSG and her assistants should have known that IFC projects are always very risky. This should have been reason to ask IFC to think and prepare more and better (instead of less), and to show that it had done so.

In retrospect it seems that somehow 9.5 M€ had been found. The question was whether this money could be invested in such a way as to pay itself back in time, with a dividend. This question is not answered convincingly in any of the available documents. The documents suggest that IFC had at most a vague idea of what to do with the money. They suggest that it still had a lot of thinking to do, and that the result might very well be that there were not enough possibilities for spending so much

¹⁷ The mail with the advice is dated 18/1/08. It can be found in the directory for this chapter.

¹⁸ The PID is part of Prince2, a method for project management.

¹⁹ Agreement with the proposal meant commitment of the money, 3 M€.

²⁰ In the directory of this chapter, under 20070529.

²¹ Still according to the minutes.

²² The memorandum can be found in the directory of this chapter, under 20071130. Under the same date one finds the two appendices of the memorandum. They describe Prince2 as adapted by the ministry.

²³ The mail can be found in the file CorrCfl_Overig_2008.

²⁴ In other words: at first he suggests that Prince2 has been applied correctly, only to admit a few sentences later that it has been “adapted”.

²⁵ The reasoning of Van der Valk is a typical after the fact reasoning.

money profitably.^{26, 27}

Remarks about the further development of these projects can be found in section 3.5.

The activities of IFC in a calendar year, the budgets which the ministry makes available for them, and other agreements with respect to activities, products and the cooperation ministry-IFC, are described in a “performance contract” (PC). It is signed by the uSG and the head of IFC. The document has the form of a contract, but doesn’t really play a formal role. It has real significance all the same. If in the course of the year the ministry asks IFC to do something additional, IFC will refer to the PC and ask for additional money, or say that some other job has to be skipped or temporized. In other words: in the periodic discussions ministry-IFC the PC plays a normative role. But first of all, it provides clarity to everyone concerned by listing activities, and by eliminating at least some of the ambiguities about products, services, and duties of the contracting parties. Examples of PC’s can be found in the directory of this chapter.

Theoretically the PC should be ready before the year begins. But as in the preceding years, the PC for 2008 had not yet been completed in January. This gave Van Velsen the opportunity to ask the editors to include a section about project management. He proposed a text which asks for compliance with the instruction of uSG mentioned above. The proposed text includes the following sentences:

«For each project a progress report will be sent to the representative of uSG for the project at least once every two months. The report will deal with each of the topics mentioned in the project proposal or similar documents. It includes a summary. The representative is responsible for the correctness of the report. He confirms this with his signature. The summary is sent to the periodic meetings of uSG with the IFC management, where necessary supplemented by comments and recommendations of the representative.»

This request was complied with. The text is included in section 4.8, “Project management” on p. 20 of PC 2008.²⁸

The request was an effort to try and improve the reporting practice. In general there were no progress reports deserving the name.²⁹ Once every two month there was a meeting of uSG with the top of IFC. A few days before these meetings IFC sent uSG a paper with unreliable³⁰ micro-reports of over 20 projects. These papers had not been seen or checked by anyone in the ministry. Of course, without relevant and reliable information, management is impossible. Section 4.8 of the PC was meant to bring about three important changes:

- There would be useful and reliable reports for all projects;
- Ministerial representatives became responsible for the reports, and were provided with a channel for communication with their DG and with uSG on a regular basis;
- The reports would no longer be fixed one sidedly by IFC.

In the course of 2008 study of successive papers related to the contract management of IFC showed that many of the IFC projects had serious problems. Often, as in the case of the PPP, the reports IFC sent to uSG were untruthful. They always were too rosy. They hardly gave any useful management information. Section 4.8 of the PC was not carried out. Not at all. There is no indication that uSG or her assistant(s) have done anything to have it put into practice. Worse: they didn’t do anything to put

²⁶ Considering that it is clear anyway that the people involved don’t bother about integrity, one wonders if the documents have been written as a cover up for the reservation of 9.5 M€ for IFC, in order to suggest that the approval of uSG was well-founded. In other words: to make it seem on paper that everything had been done properly. The program may well be a kind of conspiracy of uSG with IFC, effectively to cheat the taxpayer.

²⁷ Regarding integrity and accountability it is noted that the project proposals and the documents mentioned by Van der Valk in general don’t mention the names of authors or those responsible. Under “File Properties” one sometimes can find a name, but this need not be the name of the auctor intellectualis, and in general is not the name of the person who is responsible.

²⁸ PC 2008 is included in the directory of this chapter, under 20080307.

²⁹ The author checked this with the departmental representatives of the ministry for the projects. It turned out that there were papers called “report” for 9 out of more than 20 projects. (In no case the name “report” was justified). At a later moment this state of affairs was confirmed by Frank van Loon, top manager of IFC. Van Velsen asked him to produce the reports, and he only sent these 9. This matter will return in the main text.

³⁰ Often misleading, and sometimes simply incorrect on important points.

Prince2 into practice, or to evaluate the effects of her memorandum of 30/11/07.

On 4/2/08, Schouten sent the IFC projects report about November and December 2007 to the contract managers in the different departments. That is, to Van Velsen and his colleagues. She asked them to send her their remarks 7/2/08 at the latest. The report and the remarks were meant for the meeting of uSG with the top of IFC on 11/2/08. After consulting his colleagues of PAE and SE³¹ Van Velsen sent Schouten a mail that included the following:

«The public database/ public portal is not mentioned. It may have been renamed “Facts and figures” (treated in section 2.1.13), but if so, that should be noted. If 2.1.13 is about the public portal, it [= the section] is useless for uSG.

The report doesn't give a useful picture of the progress of the projects. It seems to say no more than: everything goes well. However, this definitely isn't true for the projects I know of. If I compare the report with the recent draft-information plan, I do not understand why the report says nothing about the problems which that plan proposes to solve. Such as the pretended need for “ordering of the production process”.

I don't understand what uSG can do with a report like this. I wouldn't have this problem if the report would comply with Prince2. Therefore, I propose that uSG requests IFC to include at least the following elements in its project reports:

- The products that should have been delivered in the reporting period, and those actually delivered;
- The products that are to be delivered in the next reporting period;
- The state of affairs regarding the solution of problems reported earlier;
- New problems and proposed solutions;
- Financial state of affairs and expected development;
- Risks;
- The names of the departments that are going to use the products of the project, and the representatives of these departments for this project;
- The name of the responsible representative of uSG for this project.

In earlier mails I have given several examples of incorrect reports. To ensure the reliability of the reports they should be confirmed by the representative of the ministry who is in daily contact with IFC about the project. Also on behalf of Ed van der Groep (SE) and Peter Lourens (PAE) I would like to ask you to request uSG to put the above proposal on the agenda of her next meeting of uSG with the top of IFC.³²,³³

Schouten answered in a mail of 8/2/08. She thought “Facts and figures” referred to the public portal, and agreed that this could have been indicated more clearly. With regard to the projects report she thought that it was already much better than a year ago. In 2008 further improvements might be made. But a distinction should be made between reports for project leaders and those for the top management. According to Schouten Prince2 was to be applied mainly by project leaders. She doesn't mention a source for this assertion, and doesn't explain it. And even if it were true, she would have to say what Prince2 means for the higher management, what kind of reports it should get and so on. Obviously, the higher management should at least check that the project leaders work professionally, and receive meaningful reports.

Schouten uses two arguments (tricks) to show that there is no need for action by uSG:

- “in Russia it is even worse”;³⁴
- “not I but somebody else should do something”.

Schouten commented on specific points as if she could speak for uSG. She denied incorrectness of the projects reports, with the possible exception of some PPP reports. Only the department of HE had

³¹ Reminder: HE= higher education, PAE= professional and adult education, PE= primary education, and SE= secondary education.

³² Jaco van Rijn, the representative of PE, had been contacted as well, but had not replied, and could not be reached in time.

³³ The mail can be found in the file CorrCfl_Overig_2008. Just like the reaction of Schouten.

³⁴ “Better than the worst” doesn't mean sufficient or good.

complained about incorrect reports.³⁵ She promised to discuss “the good suggestions” with IFC, but said it was too late to discuss them in the coming meeting uSG-top IFC.³⁶ She didn’t mention the next meeting of this kind. She promised to inform Van Velsen about the results. But she didn’t. And nothing changed.

Van Velsen didn’t leave it at that. He replied with a mail showing that Schouten could very well know that much more was wrong than the reports about the PPP, and that she elicited the suspicion that she tried to cover up malfunctioning.³⁷ It was misleading to suggest that only some of the PPP reports had been wrong: they had never been truthful at all. If only HE notices errors, that only goes to show that other departments fail to check the reports properly. Van Velsen gave examples of other incorrect reports, and examples of inconsistencies and obscurities. Such as the “ordering of the production process”. To support better information and management, he suggested to make a spreadsheet with all basic information about all projects, with links to the basic project documents and the progress reports. In such a way that everyone concerned could consult it/ them.³⁸ Without far better information, it will not be possible to correct the course of projects appropriately.

The next projects report, about January and February 2008, was discussed in the meeting of uSG with the top of IFC on 14/4/08. According to the report there were problems with the datawarehouse. The problems were not specified. It had always been said that the datawarehouse was part of the PPP. Just like Van Velsen, the representative of SE thought that only forceful intervention of uSG in the PPP could solve the problems. When De Hoog and Van Velsen were asked to comment on the new projects report, they pointed out that the situation around the datawarehouse was utterly unclear. The obscurity included the financial situation and the costs of the proposed solution. They requested uSG to demand clarification. In addition, Van Velsen repeated his requests concerning contents and structure of the reports. Neither request had a noticeable effect.

Monday 2/6/08 Schouten sent the departmental representatives the projects report about March and April 2008. She asked them to send her their comments on Thursday 5/6/08 at the latest. The meeting of uSG and the education DG’s with the top of IFC would be held on Monday 9/6/08.

Van Velsen wrote a more or less comprehensive comment.³⁹ It started with a review of earlier remarks about inadequate project documents and reports and the requests for improvement. It notes that the inadequacy of the documentation makes effective project management virtually impossible. It therefore proposed uSG to order the setting up of an information system about IFC projects. The system should be accessible for everyone in the ministry and IFC who is involved in these projects. The content of the documents should be improved in such a way as to make them useful for decision making in the meetings of uSG with the top of IFC.

The comment mentions the policy, public and parent portals, the information bank, the education number project and the datawarehouse as examples of projects for which the reports are grossly inadequate. Another project, “Facts and figures release 3”, is treated in some detail. It is recommended to stop this project for the time being. IFC should write a note describing and explaining the problems and possible solutions. Including consequences for timetable and finances. The future users of Facts and figures should be asked to comment on the note of IFC. Note and comments should be discussed, and a decision taken, in the meeting of uSG with the top of IFC of 9/9/08.

After observing that sometimes nothing is heard about the results of the meetings of uSG with the top of IFC, the comment ends with the request to be informed about what uSG or the meeting had done with the comment.

³⁵ If true, this can easily be explained by the fact that everybody knew from experience that such complaints are useless, as amply illustrated in this and the preceding chapter. Van Velsen didn’t stop complaining because he didn’t want “not to be” (from “to be or not to be”), and because he wanted to compel actors to show their true colors.

³⁶ This is nonsense, because the progress of the projects is one of the few main topics of these meetings, and because of the well known instruction of uSG about Prince2 and section 4.8 of the PC. But if it were true, then she should conclude that IFC should submit the projects reports earlier, and ask IFC to do so. She didn’t.

³⁷ The mail can be found in the same CorrCfl_Overig_2008.

³⁸ That is: by intranet or a shared hard disc.

³⁹ The mail with the comment can be found in CorrCfl_Overig_2008.

Schouten replied the following day.⁴⁰ On the basis of an argumentation which was inconsistent with the facts and internally, she concluded that the format of the projects reports was adequate, although minor improvements might be useful. She called the idea of an information system about the projects “very good”. She said she would ask IFC to work out a proposal. She denied errors in the reports about the projects listed by Van Velsen. She said that only Van Velsen alleged that there were errors or other important inadequacies in the reports. She saw no need for the recommendation about Facts and figures release 3. She would not forward the request to discuss the subject in the meeting of 9/6/08.

In spite of the “very good”, no action was taken with respect to an information system.

The denial of errors in the projects reports made Van Velsen quite angry. To end this “discussion” he sent Schouten a mail pointing out evident lies and misleading remarks in several projects reports.⁴¹ To avoid being misunderstood he noted that he didn’t want to suggest that absolutely nothing goes well. Only that uSG and the departmental representatives are not informed in such a way as to enable them to evaluate the situation reliably, and that there is no open communication about the inadequate information.⁴²

In the meeting of 9/6/08 DGHPS was represented by Erik Martijnse, the head of the section Management of the department HE, and deputy head of this department. He was kept informed by Van Velsen. As a consequence the minutes of the meeting of 9/6/08 show some realism. Acting DGHPS noted that the people managing projects need comprehensive progress reports. For a number of projects such reports are not available. Moreover, for some projects it isn’t clear who in the ministry is involved or responsible. The projects reports should give the names of the principal contact persons in ministry and IFC. The head of IFC agreed. It was decided that the ministry will make an inventory of its information requirements, and together with IFC make a proposal for the inclusion of this information in the project(s) reports. Martijnse will take part in this process as representative of the education DG’s. The possibility of exchange of project information by means of a shared hard disc will be studied.

As from one of the following projects reports names of contacts were mentioned, but none of the other decisions was carried out.

The next meeting of uSG with the top of IFC would take place 9/9/08.⁴³ At that date, almost three quarters of the year would have passed. If nothing was done in the summer months, this time would have passed without any improvement of the project(s) reports. Fearing that nothing would be done if the pressure wasn’t kept up, Van Velsen wrote Schouten a mail pointing once more to the instruction of uSG of 30/11/07 and to section 4.8 of the performance contract. He asked Schouten to collect the progress reports of all projects, and to pass them on to the contacts in the ministry. Because of the meeting of 9/9/08 he proposed to ask IFC to send the reports Friday 22/8/08 at the latest.⁴⁴

Everyone Van Velsen spoke about an information system for the IFC projects as sketched above was positive about it. He inquired into the technical possibilities.⁴⁵ He found out that a hard disc won’t do, because there was no hard disc shared by the ministry and IFC. So it had to be an intranet or internet application. From work on information management some years ago he knew that there was a government website where employees of all ministries could make and use “collaboration sites”.⁴⁶ A collaboration site is a collection of web pages that is accessible (only) for members: ministerial employees on a list made by the administrator of the space. The space is provided with applications

⁴⁰ The mail can be found in CorrCfl_Overig_2008.

⁴¹ In the directory of this chapter, under 20080613.

⁴² The mail had its intended effect: Schouten stopped claiming correctness of the projects reports.

⁴³ And the first one after that in November.

⁴⁴ Most ministerial project representatives had only seen the micro progress reports. Knowing the situation, this made it highly improbable that comprehensive reports existed for the projects of these contacts.

⁴⁵ The help of people from the information policy department is gratefully acknowledged.

⁴⁶ The ministries paid a yearly contribution for this.

which enable collaboration and information sharing. Members can place documents in the space and work on them. The application keeps track of who wrote or changed what and when. There are mail and agenda applications adapted for use by a group of collaborating people.

Both ministry and IFC had access to the system. To see whether it was not only a nice idea but useful in practice, Van Velsen made a trial space for IFC projects. For each project he made a directory. In the directories he copied the documents he could find. The conclusion of the test was positive: it could be done, and was relatively easy.

The chapter on the PPP has reported about the first part of a meeting of uSG with Van Velsen on 19/8/08.⁴⁷ The meeting took place after complaints by Van Velsen about the fixing of the plan for audit 3 of the PPP. When the discussion about the audit was finished, he drew attention to the management of IFC and the progress reports of the projects. Van Velsen told uSG that he had asked Schouten (who had just left the ministry) on 25/7/08 to collect the progress reports of all running IFC projects, and to do this in time for the meeting of uSG with IFC on 9/9/08. Schouten had replied that she would leave the request to be handled by her successor. Van Velsen reminded uSG of her instruction of 30/11/07 to adopt Prince2. He wasn't interested in the letter but the spirit. Because of the importance and clarity of Prince2 he had made the reports his spearhead. At his request a section on this subject had been inserted in the performance contract 2008. He noted that comprehensive reports are necessary to check the micro reports. uSG remarked that the projects reports were always too late. They should be timely; otherwise her meetings with IFC should be postponed for one or two weeks.

In this meeting of 19/8/08, uSG acted defensively. She tried to excuse herself. She was very critical of her meetings with the education DG's and the top of IFC. She said that her possibilities were very limited. She said she had difficulties with the distribution of duties between herself and the DG's. In case of problems, the DG's rarely reported them. If the DG's didn't report them, there was nothing she could do. This was obvious nonsense. Van Velsen noted that the minutes of the meeting of 11/2/08 show that the Education Supervisor asked for a progress report about the parent portal project.⁴⁸ The responsible DG, Kerstens, was present. But he said nothing. The minutes say that the staff of uSG will try to find out. Half a year later there was still no report.

The remarks of uSG about the distribution of duties between herself and the DG's contradict statements she made in her farewell interview with the magazine of the ministry.⁴⁹ She had been manager of the change program Apollo.⁵⁰ In that connection and together with SG Van der Steenhoven she had introduced the "SG-DG-model".⁵¹ According to the interview «[This clarified who is responsible for what](#)».

Roos had been uSG since february 2005. If responsibilities were not sufficiently clear, she could and should have done something about it.

The discussion of 19/8/08 incited uSG to order a meeting of representatives of the ministry and the contract manager of IFC, Frank van Loon. The meeting took place on 22/8/08.⁵² The resolutions of the meeting can be seen as implementation of the instruction of uSG of 30/11/07 and section 4.8 of the PC. They were supplemented by an agreement about the setup of an information system accessible for both ministry and IFC. The comprehensive monthly progress reports of the projects would be made available through this system. Until the system was working, IFC would send the reports to Bhim Mahabier for distribution in the ministry. A proposal for the digital system would be written by Van

⁴⁷ The only other person present was Nico Slooff, financial assistant of uSG. He filled the gap between the departure of Schouten and the arrival of her successor Faïrouz ben Salah.

⁴⁸ In the directory of this chapter, under 20080211.

⁴⁹ The magazine is called "Punt". The interview in "Punt.08.2009" can be found in the file with date 20090900 in the directory Integrity.

⁵⁰ In 2004.

⁵¹ The model is described in section 4 of the "100 days plan" of Van der Steenhoven, in the directory of this chapter under 20031210.

⁵² Minutes written by Bhim Mahabier can be found in the directory of this chapter, under 20080822. Mahabier worked in the financial department (of the ministry of education). Together with Slooff he was involved in the financing of IFC.

Velsen.

Some days before the meeting, Van Loon had sent the participants of the meeting the projects report of May-July 2008.⁵³ Beginning with this projects report some changes were introduced:

- the state of a project is summarized by three traffic lights: for quality, time and money;
- the names of the two main representatives are given: one for the ministry and one for IFC;
- it notes whether or not there is a more comprehensive monthly report for the project.

Although more comprehensive reports were submitted for only 9 out of 22 projects, and this only once, in all micro project reports except one it is said that there is a monthly progress report.

Sometimes it is said that the “frequency depends on developments”, or that it “will be made”. In both cases the micro report should have said: “No”. The exception is the micro report of UO Accounting. It promises: “As from September”.

In preparation of the meeting of 22/8/08 and the meeting of uSG with IFC of 9/9/08, Van Velsen called on all project contacts in the ministry. He asked them whether the micro project reports had been discussed and agreed with them, and whether they knew of more comprehensive reports. All contacts answered both questions in the negative. At least for a year they hadn’t seen anything more comprehensive. For this reason Van Velsen was quite astonished when in the meeting of the 22nd he heard Van Loon saying- without the least trace of uneasiness- that the micro reports had been discussed and agreed with the contacts, and that comprehensive reports were available for all projects. Because he found this lying unacceptable, and wished to talk about the information system, Van Velsen asked Van Loon after the meeting for a date to talk things over. Van Loon agreed.

This meeting under four eyes took place in the cafeteria of the IFC building in Zoetermeer (Netherlands), on 10/9/08. It was the day after the meeting of uSG with the top of IFC, including Van Loon. In the preparation for the meeting it had become clear that there were progress reports for at most 9 of more than 20 projects. In other words: in the meeting of the 22nd of August Van Loon lied about this, and thereby prevented discussion of the problem. Van Velsen told him that he had furthermore found out that the (micro) reports had not been discussed with the project contacts in the ministry. That Van Loon had lied about that too. Van Velsen said he hoped that this would not happen again. When Van Loon admitted his lies, no muscle in his face or change of color betrayed shame or anything special. He said that the missing reports would be made and sent as soon as possible. (They never came). Regarding the digital system for project information Van Velsen described his successful test with the collaboration sites on the government website. Van Loon had “only one point of doubt”: he was afraid that the documents would be seen by the wrong people. He wanted to guard access very carefully. He wasn’t able to motivate or specify this fear. Van Velsen didn’t understand. He noted that access was limited to selected people. This didn’t reassure Van Loon. But he said he would defer to the decision of uSG. He moreover wanted to discuss the proposal with Ben Salah, the successor of Schouten. His doubts were quite remarkable, because both Van Loon and Ben Salah were present at the meeting of uSG with IFC the day before. The system had been discussed and agreed on, and the minutes say nothing about doubts. Van Loon didn’t refer to the meeting of the day before in any way whatever. Regrettably, Van Velsen hadn’t seen the minutes.⁵⁴

The fear simulated by Van Loon contradicted the pretended efforts of IFC to become more transparent. These efforts are proclaimed in a special section “Transparency” in the preface of the performance contract 2008: [**«the transparency between ministry and IFC should be further improved and professionalized».**](#)⁵⁵

In the ministry, everybody was positive about the digital information system for the projects.⁵⁶ Except Ben Salah. She didn’t have any clear objections, but “found it difficult”. To allay fears of user(un)friendliness, Van Velsen proposed a demonstration. It was given on 3/12/08. (Time goes on!). It was attended by Ben Salah and Slooff. The demonstration convincingly showed how simple it was.

⁵³ Without the section about the financial situation. In the directory of this chapter under 20080828.

⁵⁴ He received them only much later. They can be found in the directory of this chapter, under 20080909. The minutes approved the format and contents of the projects report for May-July 2008. The report should have the approval of the project contacts of the ministry.

⁵⁵ The PC is in the directory of this chapter. Of course, the quoted sentence can also be interpreted cynically

⁵⁶ At least said so.

Neither Ben Salah nor Slooff voiced any problem. But Ben Salah still didn't know what to think of it. She promised to think about it. She never informed Van Velsen about the result of her thinking. And he stopped asking. In his opinion, the information system was primarily the responsibility of other people, who should translate their responsibilities in appropriate actions. He moreover realized that the system couldn't work if it wasn't actively supported by the management. Which it clearly wasn't.

Until the realization of the digital project information system, IFC had promised to send the comprehensive reports at least a week before the meetings uSG-IFC to Bhim Mahabier of the ministry.⁵⁷ This was done only once, and only partially at that. Namely for the meeting of 9/9/08. Van Loon sent them on the 4th, later than promised, and too late to be taken into account in the preparation of the meeting of the 9th. Van Velsen wrote to Ben Salah to record the main facts. He asked her to tell uSG that IFC had sent a comprehensive report for less than half of the projects, and later than promised. In the interest of management and transparency he advised uSG to request IFC to normalize the situation as soon as possible.

The minutes of the meeting of the 9th say nothing about the comprehensive reports.⁵⁸

3.4. The projects reports and the merger of IFC and IAG into NEA.

In 2009 the reporting about the projects changed. This was due to the merger of IAG with IFC. The merger was accompanied by changes in management, including procedures. The changes in the reporting can only be understood in the light of the merger. Apart from this, the merger can be seen as a project of a special kind, and as such a useful addition to the collection of projects reviewed in this chapter.

The earliest mention of the idea of a merger of IAG with IFC is found in documents from the beginning of 2007. On 11/4/07 the Supervisory Council of IAG is asked what it thinks about the relation between the renewal project and collaboration with IFC. «[The Council replies that cooperation should take place on the basis of choices](#)».^{59, 60}

In spite of the mutual respect, openness and transparency prescribed by the code of conduct of the ministry, the idea of a merger can at most have been discussed in a very small circle. It was never discussed with the people working with IAG or IFC on a regular basis.

The agreement about the (contractual) relations between ministry and IAG and IFC before the merger dates from 2003. At that time, SG Harm Bruins Slot replaced the centralized management of IAG and IFC by more decentralized management. The departments using the services and products of the agencies got a more prominent role and responsibility. In particular in the formulation of the performance contracts. For each department the PC got an appendix specifying the services and products to be delivered in the given year, and the budget which the ministry would make available for them. The projects were mentioned too, but only roughly. Details were left to specific project documents.

In general the departments were happy with this arrangement.⁶¹ They didn't want to return to the situation of before 2003, which was characterized by little contact between those doing the work and the people it is done for. And whatever one may think of the arrangement: the merger and management changes were not based on any evaluation. No evaluation has taken place. Reasons for the merger cannot be found in the documents. Sometimes one heard vague talk about a "Voigt advice". But the author has not been able to find a document that one could refer to by such a name.

⁵⁷ According to the minutes of 22/8/08, in the directory of this chapter, under 20080822.

⁵⁸ As noted before, the minutes can be found in the directory of this chapter, under 20080909.

⁵⁹ Rather cryptic indeed. Regrettably, that's how it is.

⁶⁰ The document can be found in the directory of the renewal project, under 20070411.

⁶¹ Up to and including 2007 the contacts of IAG and IFC in the ministry met periodically with the assistant of uSG for IAG and/or IFC. In one or more of these meetings the arrangement has been evaluated (informally). (A long time before the merger). Nobody saw a reason for change. The appendix of the PC of IFC for the department of HE was called "service agreement". When this service agreement had to be abolished in 2010, both HE and IFC saw this as a problem. It is simply convenient to have your agreements recorded somewhere for future reference. Trouble is much more likely if you don't have a document like a service agreement or PC.

He came closest with a section “Summary of Voigt advice” in a paper “Policy and implementation: follow up of the Voigt advice”.⁶² The summary only concerns the management of agencies by the ministry. Not the merger. There is no trace of argumentation or weighing of costs and benefits.

Both what can and cannot be found calls forth doubts about the wisdom of the merger and the other changes. No reasonable grounds can be found. No mention is made of problems to be solved.⁶³ Only minor efforts are made to show that a merger has benefits. The available documents show no trace of documents with substantial argumentation. Nothing contradicts the hypothesis that thinking only started at the end of 2008, and that up till then there was no more than the idea of a merger and the decision to merge IAG and IFC.

The situation can be inferred from a presentation given at a meeting on 4/12/08 of the management team of the ministry (MTM) with the management teams of IAG and IFC, and from the minutes of this meeting.⁶⁴ There was no discussion about the merger. The discussion was about the relation between the ministry and the merged agency. The merger was accepted as a matter of fact, as a premise. Beside the absence of any reference to inefficiencies or problems that could motivate a merger, one is surprised by the fact that “image building” is one of the six chapters of the presentation. As if the image is more important than reality. The minutes suggest that the presentation was based on no more than interviews. The absence of references to an evaluation is compatible with the hypothesis that no serious research was done, and no serious analysis made. In fact it would have been difficult to assert that IAG or IFC had not been functioning properly. That could not have been tallied with the appointments of for example Kerstens, Van Lochum and Van Loon in top positions of the New Education Agency (NEA). These people had long been responsible for IAG and IFC.

The conclusions of the meeting of 4/12/08 were discussed in the meeting of the MTM of 12/1/09. It decided that NEA will be an agency of the ministry, that its head will be a DG (“DGNEA”: Kerstens), and that as from 1/4/09 DGNEA will be a member of the MTM. The duties of uSG with respect to IAG and IFC will be split. The management part will go to the SG, and the policy part to the MTM. The periodic meetings of uSG with the top of IAG and IFC are replaced by a periodic discussion of one hour monthly by the MTM.⁶⁵

DGNEA was asked to develop a proposal for the practical implementation of the new relationship and procedures. He would be advised by Ruud Voigt (and as many other people as he wanted). The result was the paper “Policy and implementation: follow up of the Voigt advice” mentioned earlier. It was discussed by the management team of the ministry on 9/2/09.⁶⁶ The team was asked to approve:

- The first elaboration of the different subjects;
- The terms of reference for a set of working groups;
- The proposals for the process.

The team approved.⁶⁷

A following version should have been made, but could not be found.⁶⁸

In the meeting of the MTM on 6/4/09 Voigt gave a presentation about the different roles played and to be played with respect to NEA by people in the ministry.⁶⁹ Voigt presented the results of an inquiry that Bob Fuchs and he had made at the request of the MTM. The inquiry consisted of interviews with people in the ministry. Fuchs and Voigt found that much goes well, but that attention is given mainly to what doesn't. In the ministry, many people are involved in work of the agencies.

⁶² MTOCW 90114, included in the directory of this chapter, under 20090209.

⁶³ Of course there may have been unmentionable perceived problems, such as dysfunctional groups of people. Since dishonest people with proven management incompetence were placed in the top of the merged organization, and since the results show that the merger made things worse (in agreement with the first observation), it seems meaningless to try and rationalize the process. (In terms of accountable reasons that is).

⁶⁴ In the directory of this chapter, under 20081204.

⁶⁵ The MTM met weekly. In other words: in one meeting per month an hour is reserved for NEA.

⁶⁶ The minutes can be found under this date, 20090209, in the directory of this chapter.

⁶⁷ With one reservation: it requested DGNEA to clarify the role of the finance department of the ministry, and to make better use of the capacity and know how of this department.

⁶⁸ In particular, it was not found among the documents of the MTM.

⁶⁹ The following is abstracted from the minutes of this meeting. The minutes can be found in the directory of this chapter, under 20090406.

But their knowledge of the agencies is limited. They have serious doubts about price, quality and correctness of data provided by especially IFC.

The recommendations to improve the situation stress reciprocity: people in the ministry should learn more about the work of the agencies, and people in the agencies should learn about policy. The MTM assumes responsibility for this process.

Reciprocity should also characterize the improvement of the process leading to the work portfolio and the performance contract. For this subject there will be one contact on both sides.⁷⁰ NEA will get a director Policy and Implementation,⁷¹ and the ministry a program manager order portfolio. The last function was said to be needed for two years only. The manager order portfolio should professionalize the process, and make himself redundant, or at least reduce his job to such an extent that the remainder can easily be taken over by the SG. He should present a plan for his work to the MTM.

DGNEA is to improve the quality of the work of NEA. In the first place by quality improvement in the direct sense, and in the second place by harmonization (or simplification) of regulation within the given policy framework. He is to submit a plan for this to the MTM.

There is no indication for other support for the recommendations than opinions expressed in the interviews. Even though in the meeting of 4/12/08 it had been noted that «the picture presented is derived from opinions of participants. This should be a reason for carefulness. There is a dangerous risk of generating your own problem. Objective, empirically supported findings are not presented»⁷².

With regard to the relation between ministry and NEA, SG and MTM chose what can be called a revolutionary approach. The old ways were wrong and are thrown overboard. We know better, and replace everything with what we know to be good. In general, as in the present case, such claims are not supported in any reliable way. In general there is no reliable (empirically tested) theory to support the changes. Neither are there truly comparable situations where the changes work as supposed to. If no open discussion is permitted, as in this case, every set of proposals can be defended by simply ignoring costs and disadvantages, and by prohibiting comparison with other proposals.

The revolutionary approach is the opposite of the incremental approach, where relatively small changes are made on the basis of experience, reasoning and trial and error, and in such a way as to be able to modify or undo them at low cost.

We now show how the reorganization affected the reporting about projects.

Already in the performance contract (PC) for 2009 a section about project management or something similar is missing. Section 4.8 from the PC 2008 has been deleted. PC 2009 says the following about the reporting:

«3.1.5. Reports and (performance) indicators.

IFC reports about work done and performance. Performance is measured with the performance indicators mentioned below.

Until April 1, 2009 there are two lines of reporting:

- By projects reports: reports with highlights and exceptions. Beside current projects the reports present projects to be approved and proposed in 2009;
- By progress reports uSG: reports about the execution of the PC, in particular about expenditure.

As from April 1, 2009 the management model is changed. The SG will assume the role of formal commissioner for NEA. In practice the management part of the role formerly played by uSG will go to the SG, and the policy part to the MTM. Details and the way of reporting will be worked out by NEA in collaboration with the ministry.»⁷³

For IAG the changes were similar. As a consequence, the report of IAG about January-April 2009

⁷⁰ This may be presented as something new, but it wasn't. The new arrangement cannot work better, because the central contacts can only have (very) limited knowledge of often specialized and technical work being done for specific departments.

⁷¹ There was already such a functionary, Jacob Smit.

⁷² Minutes of the meeting of 4/12/08. In the dossier under 20081204.

⁷³ PC 2009 can be found under 20090324 in the directory of this chapter.

was the last one sent to the department of HE.⁷⁴ The last analogous report of IFC concerned October-December 2008. Nevertheless, the performance contracts for both IAG and IFC for 2009 still had departmental appendices. The reports were abolished on instructions from the SG.⁷⁵ A reason for the abolition of the reports wasn't given. The abolition is obviously incompatible with professional (good) management.

As from 2010 the two performance contracts (with IAG and IFC) were replaced by one management agreement (MA, with NEA). With respect to the reporting, the development begun in the PC's for 2009 was continued in the MA for 2010. Words like "project management" and "Prince" cannot be found in the MA. About the reports, p. 39 says the following:

«Reporting structure.

Between NEA and the ministry the following reports exist:⁷⁶

- Management reports
About the realization of the agreements in the MA. For the 4-monthly talks of DGNEA and the SG. The 3rd report is the annual report;
- Monthly reports for the MTM.
About the cooperation policy and implementation, exceptions in agreements and signals about the work of NEA.
- Specific information for policy departments.⁷⁷
There will no longer be reports about the work for specific policy departments. The same information elements will be made available in the format of information services.

Information disclosure.

Within the ministry the binding rule is that all information which should be supplied in case of an appeal to the law about the accessibility of public administration documents, is public. In other words: "information is public unless". NEA actively publishes information which is relevant for education, unless other agreements have been made.⁷⁸

In the list of types of reports the quarterly report about risky projects is missing. But they were still made, and submitted to the MTM.⁷⁹

In practice the third point meant that no information was given at all.

The abolition of the reports for the policy departments was coupled with the abolition of the periodic meetings department-agency about the realization of the PC. From 2009 on there were only ad hoc meetings, which obviously couldn't be supported by the reports.

The reality behind the "public unless" is very different from what the text suggests. The reality is that one could only see what one managed to find. Even after the introduction of the digital archiving system Edoc, there was no public hard disc and no transparency.⁸⁰ ("Public" and "transparency" in this case referring to the ministry only). For example the management reports of the first point were

⁷⁴ IAG sent three reports a year, each reviewing a period of four months. They were called the 4-month, 8-month and 12-month reports.

⁷⁵ This bit of information is based on informal communication with the present author. The abolition wasn't even formally communicated. People were surprised when the reports didn't come around the time they normally came.

⁷⁶ The rather strange language is adopted from the original.

⁷⁷ The concept "policy department" is somewhat wider than "education department". It includes for example the department of science policy and that of emancipation. These departments do not only make policy, but also laws, and they are also responsible for the financing of students and institutions such as schools and research institutes. They prepare the budget law.

⁷⁸ The MA 2010 can be found in the directory of this chapter, under 20091217. The MA was signed in 2009 before it was ready, because the SG wanted it to be signed in 2009. As a consequence it contained many ambiguities and errors, and had to be corrected in many places. SG should have started the process earlier, and managed the process more closely and better. (If he could).

⁷⁹ They can be found in the directory Project reports. The report about the 3rd quarter of 2009 is missing because I couldn't find it. I may never have received it, possibly because it was not made.

⁸⁰ Before Edoc, each of the departments had a separate disc (or partition) for its employees.

nowhere to be found.⁸¹

As noted earlier, from about the middle of 2009 one hour of one meeting of the MTM per month was devoted to NEA matters. The monthly progress report was a standard point of the agenda. In the beginning of a quarter the report about the risky projects in the preceding quarter was put on the agenda. The reports and the accompanying discussion papers went to the MTM via successive meetings of groups “information and implementation” at two levels. The low level “working group i+i” and the higher level “strategic council i+i”. The last was chaired by the SG. The groups could request changes in the reports and accompanying papers. Ultimately only the SG could be held responsible for the text submitted to the MTM.

3.5. Continuation of notes about specific projects.

Introduction. The program User Oriented Services 2.

This section gives an impressionistic picture of the evolution of selected projects, as it emerges from progress reports and other documents. The only criterion for the selection of a project was active involvement of the present author. The involvement may have been little more than a request to advise a DG or the uSG, and/or information of colleagues. In other words: no systematic study has been made of the progress of all (current) projects. Neither have the selected projects been studied in detail. The main purpose of the inquiry was to check the picture that had arisen from the policy portal project. Because his involvement was accidental, the author considers the selection representative. On 1/1/08 he became representative of HE for IFC, and on 1/8/11 he retired. These dates define the approximate boundaries of the timeframe of this section.

The project policy portals was part of the program User Oriented Services (UOS). UOS was followed by a program Rounding off UOS, shortly UOS2. As with many names in politics, the name of this program should not be misunderstood: there was customer orientation before UOS. And whatever its intentions, UOS2 didn’t round off or complete the projects of UOS. The policy portal project was far from completed. But it was not included in UOS2. The policy portal project moreover shows that the user orientation is not to be taken seriously.

In 2007 IFC had budget problems, and ideas for several new ICT projects. IFC told the ministry that these projects could realize the efficiency improvements needed for structural budget reductions.⁸² The reductions were imposed by the government, with approval of parliament. Even though they never checked whether IFC could accomplish its tasks properly with the given or less money. The paper of IFC about the financial problems and their solution, the *Notes of the mini-taskforce financial framework IFC*, suggests that UOS2 was meant to address the financial problems in the short as well as longer term. The budget for UOS2 was 9.5 M€. This was for 2 years,⁸³ and can be compared to IFC’s annual budget for “going concern”⁸⁴ of 48 M€.⁸⁵

The paper, an agreement of 13/11/07,⁸⁶ and the letter of uSG permitting IFC to carry out UOS2⁸⁷ assume that all products of the program will be completed in 2009. The letter asks IFC to submit the PID’s, i.e. more detailed plans, for UO Financing and UO Digitizing in resp. January and February 2008.⁸⁸ The letter does not mention UO Accounting explicitly.

⁸¹ Some colleagues thought that the changes in the reporting were made to get rid of the critical commentaries of the present author.

⁸² See the file “20070906_Notitie mini-taskforce financieel kader Cfl” in the directory of this chapter.

⁸³ 2008 and 2009, see the “Notitie mini-taskforce financieel kader Cfl” mentioned before.

⁸⁴ That is: excluding projects. For this classification of costs see PC 2009 p. 12. The PC can be found in the directory of this chapter, under 20090324.

⁸⁵ See PC 2009.

⁸⁶ See the file “9,5_M€voorSU_komende_jaren.htm” about the signing of this agreement (“convenant”).

⁸⁷ This is the file “20071113_Brief pSG aan HDCfl met opdracht voor SU2.pdf”, in the directory of this chapter.

⁸⁸ Reminder: PID= project initiation document.

The notes on the following pages frequently refer to reports submitted to meetings and to minutes of meetings. The reader may be surprised about the passivity of the meetings and their participants, and the lack of action where action is clearly required. Without suggesting that it explains or excuses the passivity, it should be noted that the meetings (the group of people present or represented) are never formally responsible. Only the SG (Van der Steenhoven) or uSG (Roos) is formally responsible. Informally the responsibilities of meetings and their participants may be considered proportional to the openness of SG and uSG; their receptiveness for criticism. In this regard, the situation under Van der Steenhoven and Roos was clear: they didn't accept criticism, even though they tried to create an appearance of openness. There was a repressive instead of open atmosphere. And if this doesn't excuse the inaction of other people, it certainly makes the SG much more responsible for what the ministry and its agencies did and did not.

In addition it should be kept in mind that the participants of all meetings mentioned in this chapter are more or less dependent on the chairperson and/or (u)SG. Both with respect to their work and their career.

Beside the meetings there is always a hierarchical line procedure. The line procedure was formally independent of the meetings (and conversely). Only in the line procedure documents are initialed; and only initials validate documents. There was no clear, let alone formal, coupling of the line procedure with meetings. No significance can be attached to the apparent agreement between opinions expressed in a meeting and the decision of (u)SG. In general people only express opinions which they think will be welcomed by (u)SG. The more so if SG and/or uSG have somehow shown that they have a dislike of certain types of remarks. Never make the mistake of thinking that decisions are taken democratically, or that a ministry is a democracy.

The roles of SG and uSG until and after 1/4/09 are described in section 2.2, Framework, of the PC 2009 of IFC.⁸⁹ It distinguishes three responsibilities:

- «Commissioner: only uSG is formally responsible for the activities of IFC and for the costs of its activities;
- Delegated commissioner: DGPS, DGHPE, uSG,⁹⁰ SG, and ES⁹¹. They are responsible for the contents of the activities of IFC and for the payment of the costs of these activities;
- Agency head: the head of IFC, responsible for the management of the agency and the financial results.

As from 1/4/09 the SG becomes commissioner for IFC. After 1/4/09 “uSG” should be read “SG”».

The distribution of responsibilities (duties) between (u)SG and DG's is therefore unclear. Although it is clear that the “delegated” implies that the (u)SG can always sidetrack the DG and assume full responsibility. It is furthermore clear that the DG's should keep themselves well-informed about the activities they are supposed to pay for. And shouldn't keep silent when these activities are not carried out properly.

Before the merger, IAG and IFC seem to have had a formally different status. This may explain the fact that the PC 2009 for IAG only mentions uSG, calls her the representative of the minister, and doesn't mention the SG, DG's and ES.

We now turn to some individual projects.

UO Financing.

The project proposal describes the purpose and goal as follows:

«The program⁹² financing under architecture implements user oriented financing of the sectors SE, PAE and HE. [...] The program realizes full adjustment of the components and the addition of extra functionality, so that regulation applicable to SE, PAE and HE can be implemented through the

⁸⁹ In the directory under 20090324.

⁹⁰ In those cases where there is no other delegated commissioner.

⁹¹ ES = Education Supervisor.

⁹² Sic. It would have been more consistent or correct to use the word “project”.

components».⁹³

In the course of the project four PID's were written. To wit: SE 28/4/08, SE additional 20/10/08, PAE 11/11/09, and HE 22/2/10.⁹⁴ The timetable of the letter of uSG was exceeded by more than a year. The PID for HE was not submitted in February 2008, but two years later. The PID's clarify purpose and result. Even though they do not- for example- sketch the initial situation, and describe what has to be done to realize the final situation. It is unclear how realization of the promised result can be verified. The PID doesn't include an acceptance procedure. A lot of testing has been done nevertheless. According to the documents the project produced well working systems.

The documents suggest that the project tried to rebuild (hard- and/or software) systems in a more logical, uniform and flexible way, and to adapt them to new and/or coming regulation.

UO Financing was managed in a far better way than all other projects known to the author. The project documentation was more clear and useful, and the informal delegated commissioner, Ron van der Meer, head of the section Finance of HE, hired external consultants to monitor the work of IFC critically. The consultants informed and advised him monthly.

UO Digitizing.

The proposal distinguishes three phases:

1. Digitizing information collection;
2. Digitizing execution;
3. Digitizing output.

For each phase some of the results are specified in more detail. Some seem to be verifiable. But only some, if only because the original situation is not described.

According to the proposal, phase 1 will be executed in 2008, phase 2 in 2009, while phase 3 should be completed in the summer of 2010. According to the financial section at the end of the proposal, the estimated total cost of the project is 3.5 M€.⁹⁵

The questions and comments in the following paragraphs come from a mail which Van Velsen sent to uSG assistant Ben Salah in answer to her request to comment on the projects report for October-December 2008.⁹⁶ He found the statements on UO Digitizing in this projects report puzzling, and tried to get more light by comparison with earlier projects reports and the project proposal.⁹⁷

The projects report about November-December 2007 reports that the project proposal has been approved. The projects report for October-December 2008 implies that a year later there still is no PID.⁹⁸ Are purpose and results still to be specified? Why does this take so long? Why is no mention made of contact persons in the ministry?

On p. 6 of the projects report about August-September 2008 one reads the following:

«The functionality of an electronic post office which can receive the e-forms is realized by extension of an existing solution. This should require a minimal effort.

The present authorization tool of IFC turns out not to be suitable for e-forms. IFC begins with a project to develop a new authorization tool. This development takes place in IFC.nl and therefore falls outside the scope of the project digitizing.

The training of the form makers and administrators has begun. After the training the development of the first two forms will be started in collaboration with ICTA.»^{99, 100}

This suggests that the project was begun without sufficient knowledge of what is to be done to

⁹³ From the proposal for UOS2, in the directory under 20071107.

⁹⁴ All of them in the directory, under the dates given.

⁹⁵ 20071107_Offerte afronden SU_def, p. 12 (timetable) and p. 17 (costs).

⁹⁶ The mail is dated 6/2/09, and part of CorrCfl_Overig_2009.

⁹⁷ All documents mentioned can be found in the directory of this chapter, or its subdirectories.

⁹⁸ P. 6 of the projects report October-December 2008, in the directory Project reports, under 20090206.

⁹⁹ ICTA= ICT Agency, a government agency. (= ICTU, ICT Uitvoeringsorganisatie).

¹⁰⁰ According to the project proposal, the project would be regauged 1/9/08. Why is the projects report for August-September 2008 silent about that? (This remark was included in the mail of Van Velsen to Ben Salah).

realize the desired goal.

On p. 6 of the report about October-December 2008, one reads:

«**Most requirements and wishes of the Program of requirements for the e-forms are fulfilled.** However, three requirements and eight wishes are not fulfilled yet. Solution of this problem is necessary for realization of the goal of the project. The findings have been submitted to ICTA for an answer.¹⁰¹ As a consequence the timetable has to be adapted. The reaction of ICTA will show whether we can go on with the e-forms and at what costs in terms of money and time.»

How is it possible that these problems were not discovered earlier? (Answer: Because no feasibility study had been made). How can the traffic light for finances show green if extra money is necessary, and the amount unknown?

The report continues:

«**ICTA answers 14/1/09. In the week of 23/1/09 the internal steering committee will be advised about the continuation of the project Digitizing.**

The projects report is dated 4/2/09. The problems and risks clearly are substantial. Why has the text of the micro report for this project not been supplemented by a summary of the answer of ICTA and IFC's conclusions? Discussion in the meeting of uSG with the top of IFC (on 11/2/09) seems to be necessary, but can only be meaningful if more information is provided.¹⁰²

Ben Salah didn't answer. Neither did she send the minutes of the meeting of uSG with the top of IFC for which the questions and comments were supplied.

The projects report about October-December 2008 was important for another reason as well. The agreements of August and September about the reporting seemed to have been forgotten already. In addition, two more formal documents, PC 2008 and the memorandum about Prince2, ask for monthly reporting about the projects. But on p. 3 of the projects report it is said that in the micro reports (in the projects report) it is indicated whether it has been agreed that a more detailed monthly report for this project will be made. As if one would be free to choose, and as if such an agreement had not been made already. The remark on p. 3 is no more than a misleading way of saying that the agreement about the reporting will be ignored.

The story of UO Digitizing is continued in a mail of half a year later, with a reaction on the progress report IFC for May-September 2009.¹⁰³ The mail reflects the regress in the information of the ministry in general and the policy departments in particular. The mail furthermore shows that the lack of supervision by the ministry has enabled NEA to swindle the tax payer out of an amount of 400 k€.

As representative of HE Van Velsen says to miss the reports about the execution of the parts of the PC concerning higher education and HE. These reports gave much more information than the new ones. He reminds Ben Salah of a promise she made in the beginning of 2009. She promised that the abolishment of the reports for the policy departments would be compensated by an expansion of other reports. But none of the present reports is more comprehensive or informative than those of a year ago. They don't solve the information problem. In Van Velsen's opinion, the information deficiency hampers the supervision of NEA by the ministry. Effecting timely changes becomes more difficult and sometimes impossible. He therefore asks Ben Salah to advise the SG to reconsider the ways of reporting.

The mail gives several examples of inadequate reporting. For the sake of brevity only two are mentioned. The first concerns a project "stabilizing components". According to p. 22 of PC 2009 it has a budget of 3.85 M€. Three sections of the report are devoted to this project. The sections on pp. 4 and 27 are short and almost identical. Appendix 3 gives more details. The texts are full of pretensions, but don't tell the reader what it is all about. They don't explain the significance for other IFC systems or activities. Nothing is said about the timetable and expenditures. The significance of the project could possibly be shown if IFC (or NEA) had a 4-year plan, and indicated the position of the project in that plan. In other words: the problem isn't restricted to this particular project, but concerns the

¹⁰¹ This cryptic sentence probably reflects truths which cannot be expressed without betraying gross errors.

¹⁰² The mail of Van Velsen to Ben Salah is dated 6/2/09. It can be found in CorrCfl_Overig_2009.

¹⁰³ In the directory under 20090929. The mail of Van Velsen is dated 13/10/09.

management of system maintenance and renewal in general.

The second example concerns the involvement of ICTA. It is discussed in the last part of the mail. This part dealt with UO Digitizing. It shows a contradiction in the documents about UO Digitizing. In appendix 4, Budget, of the proposal for Rounding off UOS¹⁰⁴ it is said:

«regarding the acquisition of an e-form provision we assume the ICTA solution. If this solution is not sufficient (yet), we will realize a temporary solution within the same budget (100 k€).»

The proposal doesn't mention any agreement with ICTA. It only says: "It is [several times] assumed that ICTA" etcetera. No mention is made of communication with ICTA, and no reason is given for believing that the assumption is realistic. The mail then asks how this state of affairs is to be tallied with the following paragraph on p. 31 of the present report:

«1. Due to the failure of ICTA to deliver a working solution as promised, IFC has to build [e-]forms itself. This causes a cost overrun of 500 k€ (already spent on ICTA).¹⁰⁵ ([The] Information [department] agrees with the contents of this proposal)¹⁰⁶

Van Velsen advised the SG not to approve the request for the additional 400 k€, to ask IFC when what agreements have been made with ICTA, and to submit documents to support the answers.

The mail concludes with a repetition of the request to let the sender know what has been done with his comments and those of his colleagues.

Ben Salah did not react.

The report about the risky projects for October-December 2009 is as vague as ever. Phase 1 doesn't seem to be completed:

«To relieve pressure on the organizations involved in the project it has been decided to distribute delivery of the digital forms over a number of releases. Delivery is adjusted to the natural dates for submission of these forms. The last set will be delivered 15/7/10».¹⁰⁷

Nothing is said about results of the phases 2 and 3. But 15/7/10 is still supposed to be the last day of the project. Under the heading "Money" the report states:

«In July 2009 a new PID has been approved. The costs of phase 1 of the project are 755 k€ higher than originally estimated. Partly due to extension of the scope, and partly because the ICTA e-form building block was not forthcoming».

The section about "I-principles" is the only one with a yellow traffic light (the others are green). The reason given is «that the UOS2 solutions may not be NEA-proof». This is explained as follows: «In order to make NEA sustainable, an agreement has to be made about the use of components which were used by the former IAG and the former IFC». In other words: the project had been designed without regard to circumstances before and after completion of the project. Of course, when uSG approved the proposal for UOS2 she (and those around her) knew that IAG and IFC were to be merged.

The report about the risky projects for April-June 2010¹⁰⁸ has a surprise: «Timetable: Phase 1 until 15/7/10. Preparations for phase 2 and 3 have begun». Even though the report about the 4th quarter of 2009 explicitly stated that the project would be finished 15/7/10 (in accordance with the original planning). The new report nevertheless says: «The project is executed in accordance with the agreed planning». And a little further on: «Phase 1 will be completed in June according to plan. These days the structure for administration and possible new e-forms is developed. The definition study for phase 2 will be discussed in June».¹⁰⁹

With regard to "Money" the report says that the «project is being executed within the agreed budget». But no financial account is given.

¹⁰⁴ Dated 7/11/07. The project proposal can be found in the directory of this chapter, under 20071107.

¹⁰⁵ The meaning of "(...)" is a mystery to me, i.e. the present author. The obvious interpretation, that this money has been paid to ICTA, seems impossible.

¹⁰⁶ There are more cost overruns; the total amounts to 1200 k€. See the same p. 31 of the progress report (Voortgangsrapportage PC) dated 20090929.

¹⁰⁷ See the directory Projects reports, under 20100118. The "organizations" probably include schools.

¹⁰⁸ To be found in the directory Projects reports, under 20100830.

¹⁰⁹ Note that an outside reader who gives the ministry the benefit of the doubt is completely cheated. The lesson is: never believe what you read, always check! The least you can do is compare.

The project is 2 years behind schedule. The report gives the impression that it is unclear for how long the (as yet hypothetical) results can be used. And therefore, whether benefits outweigh costs.

In the section about project supervision, the Information department requests transfer of the responsibility for the project to the department Concern Support (CS). This request is said to be motivated by the remark that in the phases 2 and 3 the internal organization of IFC plays a central role.

All traffic lights are green.

The report was discussed in the MTM of 30/8/10. In the minutes of this meeting nothing is said about UO Digitizing.¹¹⁰ This means that the proposals included in, or implied by, the report must be assumed to have been approved. This is confirmed by a remark in the section about the project UO Accounting in the report about risky projects for the 3rd quarter of 2010.¹¹¹ The remark asks attention for «the fact that the project Digitizing of UOS2 has stopped, and transferred to the line organization».

These are the last words about this project. In the meantime it is completely unclear what the last mentioned transfer means. To put it in perspective, it can be noted that IFC had tried to transfer the policy portals to the line organization at a time when the portals were still in the first stages of development, and completely useless.

UO Accounting.

The origin and beginning of this project in 2007 and the first months of 2008 have been sketched above. This section continues with June 2008, when Van Velsen and his colleagues of the other education departments were asked to comment on the projects report of IFC about March-April 2008.¹¹² In this report, the reports about UO Accounting and the closely related project SiSa were treated separately, without any indication of a relationship.¹¹³ The close relationship is clearly shown in the project proposal. On the basis of a suitable quote the comment of Van Velsen concluded that these projects and their financial aspects should be taken together.

Mails of Pio Tulp of IFC and of Schouten, both of 6/6/08, confirmed that SiSa HE is part of UO Accounting.

In the projects report about May-July 2008 SiSa isn't mentioned any more. It only mentions UO Accounting.¹¹⁴ The report says that in June the ministry has approved the PID. The PID is dated 4/7/08.¹¹⁵ It doesn't cover the whole project, but only the processing of annual accounts. The PID distinguishes four phases: Preparation, Design, Realization, and "Test and after-care".

The following quote from the projects report about the last quarter of 2008 is not only interesting in itself, but even more in comparison with reports of one and a half year later:

«Furthermore it has turned out that the release planning of components and the planning of the project don't fit any more. Everything is done to get realization as close as possible to the original planning (15/4/09). The impact will be discussed with the Steering committee.

In the OG-ON of 12/12/08 [that is: the meeting of uSG with the management of IFC] it has been agreed that [the department] Accounting organizes the process of getting the signatures of the education departments under the Requirements program (RP). The draft status of the RP is a risk for the project: every change may require extra work».¹¹⁶

The first paragraph shows that the project is delayed. But the report doesn't say by how much. From the second paragraph it follows that there is a (draft) RP, and that there is no agreement about it. Nevertheless the author of the paragraph doesn't want any more changes. He wants signatures. He doesn't say what the difference of opinion is about. And doesn't seem to understand that he doesn't show that the RP is right as it is. And that a lack of communicative abilities and an authoritarian

¹¹⁰ The minutes can be found in the directory of this chapter, under 20100830.

¹¹¹ This report can be found in the directory Projects reports, under 20101006.

¹¹² The report can be found in the directory Projects reports, under 20080602.

¹¹³ SiSa= Single information Single audit.

¹¹⁴ The report can be found in the directory Projects reports, under 20080828.

¹¹⁵ It can be found under that date in the directory of this chapter.

¹¹⁶ The report can be found in the directory Projects reports, under 20090206.

attitude towards users are important risks for a “user oriented” project.

The underlying problem was the lack of a description of the goals of the project in the PID. According to the delegated commissioner for the project, Anita Schilperoort, they would come in the RP. But they didn’t. It was completely unclear what was going to be done in this project. That’s why some departmental representatives didn’t agree.

The projects report for the 4th quarter of 2008 is the last report that gives the financial situation per project. It can be found in chapter 6 of the report. It says that of the 1864 k€ available for this project, 767 k€ was spent in 2008. It is useful to note the spending speed in order to evaluate the reliability of qualitative remarks about the financial situation in later documents.

According to the projects report about the 2nd quarter of 2009, there still was no agreement about the RP half a year later. The report tells of all kinds of changes in plans. It makes one wonder whether one knew what one wanted with this project when it was approved and started, and whether it is known by now. The last paragraph of the report reads as follows:

«The costs of the original project until the middle of 2009 are already about 1.2 M€. Large part of this has to be written off. However, part of the costs resulted in products which are also useful for the new approach. Only those costs will be charged to the project.»^{117, 118}

Even the information department notes that the text of the report is incompatible with the green traffic light under “I-principles”. IP concludes that one of the goals of the project, a sustainable accounting system, will not be realized. IP notes that there should have been a project start architecture (PSA, a document), and that this should be adjusted when necessary in the course of the project. For UO Accounting no such document had been made.

In this project the department of HE was represented by Pieter Veen. In a memorandum of 24/9/09 to the delegated commissioner of the project he sketched the history and problems of the project.^{119, 120} The memorandum was meant as a complaint, but also to inform the head of his section (Finance). The following gives an impression of the contents.

«In January-February 2009 the project was suspended because of insurmountable problems. The idea of the new architecture and use of components turned out to be infeasible. In August the sounding board group was approached about a revised project. On August 31 we have discussed the PID and part of the RP. Among other things, I noted lack of clarity about the products and finances of the project. I made suggestions for improvement. In the second meeting, last Tuesday September 15 [2009], I reiterated my objections, and indicated that more time is needed, for example to make a list of products. In reaction it was said, to my surprise, that product descriptions are being written. The next two hours were spent discussing the list of requirements in the RP. This cost a lot of time, but helped getting an idea of the list of products.

I see that a substantial effort has been made to keep track of changes in the RP and their motivation. Irrelevant requirements have been deleted, which is an improvement. At the same time a list of adjustments of the PID remains to be made. Together with other problems this problem seems to be structural.

The structural problem has the following elements, which I will explain below:

1. No mention of the products;
2. No picture of what will change in the relation between, and function of, systems;
3. The RP is a list of desirables which either have to be checked for feasibility, or are irrelevant;
4. The budget lacks substantiation;
5. There is no business case;
6. There is no sounding-board of education departments and no PSA;

¹¹⁷ The report can be found in the directory Projects reports, under 20090903.

¹¹⁸ Of course, everything is paid by the taxpayer. The suggestion that IFC pays something out of its own pocket is misleading nonsense.

¹¹⁹ The mail can be found in the directory of this chapter, under 20090924.

¹²⁰ “delegated commissioner”: delegated by, and representing, the Inspector-general (= the head) of the (organization for) Education Supervision.

7. The project is not XBRL-ready.^{121»}

The report about risky projects for April-June 2010 shows that the problems were not solved yet. It seems that the project was based on false pretensions, unfounded budget estimates, and, maybe mainly, the availability of money. The report says nothing about results. It does show that the project is in decay:

«On 29/6/10 the Steering Committee has decided that a new planning will be made. [...] The timetable is inelastic. The results may not be ready for the reporting about 2009.

Since the middle of May the project has a new NEA project leader. After a thorough evaluation, the new project leader has concluded that the project is on its way to exceed its planning by 4000 hours.¹²² This is caused by a number of factors, such as illness of the replaced project leader and incorrect estimates. In the Steering Committee of 30/7/10 NEA has indicated that the total calculated overrun for the project may amount to 8000 hours. By descoping phase 4 and tight project management the excess can be limited to 3400 hours. The costs will be fully born by NEA. [...]

Following the Steering Committee of 29/6/10 it has been decided together with NEA that the project will look for cooperation with UO Digitizing for elements touching that project. Talks with the commissioner and management of that project have started. A risk analysis for this scenario will be made. After approval by the commissioner on 3/8/10 phase 4 has been removed from the project. This means that some improvements for the reporting about 2010 will not be realized.»¹²³

The report about risky projects for April-June 2010 was discussed in the MTM of 30/8/10. The relevant section in the minutes reads as follows:

«UOS2 Accounting.

There have been thorough discussions with the Education Supervisor about this project.¹²⁴ Everything has been gauged anew. Some requirements have not been met, but agreements have been made about this. Frank van Loon (NEA) assures that the support of the education institutions remains ensured.»¹²⁵

In a formal note of 18/10/10 to the head of his department, Veen tells him that the project UO Accounting had been stopped in August.¹²⁶

Datawarehouse.

The beginning of this project was described at the end of Chapter 2, about the policy portal project (PPP). The most important goal of the PPP was to build a datawarehouse (DWH) that could be used by all kind of portals. The goal had not been realized. Even though the third audit had given a positive evaluation of the DWH.¹²⁷ The reality was that the portals were useless. But problems and/or errors had not been acknowledged, and there was no reason to assume that they had been corrected. It was therefore unclear why the next DWH project would be successful. And it wasn't.

For an informal plan of the new project the reader is referred to the document under 20090605 in the directory of this chapter. The document doesn't give a picture of the initial situation. It doesn't say what has to be done. It doesn't say how it can be determined whether the goal has been reached. But in some other respects it is quite clear. In the section "Results of the project" one reads for example:

«The datawarehouse is meant for once-only storage of all policy data of guaranteed quality. All policy information will be acquired from the datawarehouse.»

This is clear and seems ideal. But it is also déjà vu, and unbelievable. It is easy to use the word

¹²¹ This means: it is not sustainable. Probable developments will make it useless.

¹²² At a cost of about 100 € an hour.

¹²³ The report can be found in the directory Projects reports, under 20100830.

¹²⁴ ES acted as delegated commissioner.

¹²⁵ The minutes can be found in the directory of this chapter, under 20100830.

¹²⁶ The "nota" can be found in the directory of this chapter, under 20101018.

¹²⁷ See chapter 2.

“all”. But extremely difficult or impossible to realize.¹²⁸

A timetable isn’t given. Intermediate products aren’t mentioned. But the document concludes with a section:

«Planning of the results.

The project datawarehouse is planned in such a way as to produce a recognizable result every 3 months. IFC will submit a proposal for the planning of these results.»

This would mean that every quarterly report can report the passage of a milestone.

In the report about the risky projects for the 4th quarter of 2009 one can read:

«The planning is part of the PID. In the middle of November the PID has been approved by the Steering Committee DWH. The first part of the project concerns PAE (landing, enrichment, and making available). This part will take 3 months. Because of the time needed for organizing the project (including the users) and the Christmas holiday, completion of this part is expected in March 2010.»

In the report about the risky projects for the 1st quarter of 2010 one can read:

«The project DWH has produced a working prototype MVE.»¹²⁹, ¹³⁰

This remark is repeated in the report about the risky projects for the 2nd quarter of 2010.¹³¹ The new report also mentions a delay:

«The project will take longer than expected. NEA will make a new timetable. It will be discussed in the Steering Committee DWH. The delay has 2 causes:

1. An extra phase is necessary for flow data.¹³² Estimate: 3 months extra;
2. Necessary resources became available later than planned. This has resulted in a delay of 2 months;
3. More time is needed for coordination with NEA users. For PAE the available time was only just sufficient. For SE and HE the processes are more complex. NEA is trying to find out if 3 months is enough for each of these sectors.»

In addition, it is expected that the costs too will exceed the planning. No indication is given of the amount.

In the report about the risky projects for the 3rd quarter of 2010 one can read:

«The first milestone (delivery of MVE) was passed October 1, in agreement with the new planning».¹³³

At another point, this same report calls this milestone “prototype”. So it isn’t clear what has been realized. Furthermore, MVE is only a part of PAE. PAE should have taken 3 months. But as we see, already a part of PAE took 9 months.

The project may go slower than expected, but the speed of money spending exceeds the estimates:

«In the MVE phase the budget was exceeded by 200 k€. An audit has tried to find the causes. On this basis an action plan has been made for tighter project management. This resulted in stricter planning. Up to now progress is according to plan. The budget overrun is expected to remain restricted to MVE. [...] In the program Infrastructure this has been taken into account. For this program a budget of 4.5 M€ is requested for 2011. In the motivation it will be indicated what additional budget is necessary.»¹³⁴

The text doesn’t say what has been spent in 2009 and 2010. Is the originally requested budget of

¹²⁸ One might object that the text should be taken with a grain of salt. But if “all” doesn’t mean all, what does it mean?

¹²⁹ MVE= Mid-level vocational education, a part of PAE.

¹³⁰ The report about the risky projects for the 1st quarter of 2010 can be found under 20100414 in the directory Projects reports.

¹³¹ In the directory Projects reports, under 20100830.

¹³² Flow data describe the transition from the situation at one moment to the next. At any given moment, people are at certain places in the education system (in certain schools or type of education, and at certain levels). At different times they are at the same or different places. A collection of data describing the transitions is called flow data. For more on this subject see below, in the section about PIEN-flows.

¹³³ The report can be found in the directory Projects reports, under 20101006.

¹³⁴ We’re still quoting from the report under 20101006.

2.3 M€ already exhausted? Furthermore it remains unclear where the 4.5 M€ comes from. According to the MTM documents of 2/4/09¹³⁵ the budget for DWH in 2011 is 2.3 M€ minus what was spent in 2009 and 2010.

The report about the risky projects for the 3rd quarter of 2010 was discussed in the MTM of 25/10/10. The minutes of the meeting contain the following paragraph:

«DGHPS has questions about the DWH in the report about risky projects, where a budget overrun of 300 thousand euro's is reported. Marianne Bos explains the overrun, and the decision making about it in the Steering Committee. It is agreed to discuss this subject more fully next time, and also the question how to finance this type of budget overrun.»

The minutes of the three following meetings of the MTM make no mention of the DWH. Perhaps “next time” should be interpreted as the next MTM meeting with a NEA block. In other words: next month. Or the meeting with the next report on the risky projects. But in none of the minutes of these meetings could anything related be found. Neither is there any sign of results of a discussion as requested by DGHPS.

The report about the risky projects for the 4th quarter of 2010¹³⁶ continues:

«After a prototype the project DWH has produced a working production MVE. SE is ready to be taken into production».

Under “Implementation” the report notes:

«Employees of NEA/IP¹³⁷ are becoming more and more enthusiastic about the project, because the results become visible».

Even visible! Wow! But the remark is incomprehensible if the assertions of the top of IFC and the report of audit 3 would be correct. If they were, the datawarehouse was already fully operational two years ago, in 2008. So at least one of the remarks is untrue.

Under “I-principles”, “Risks”, the report notes:

«The architecture of DWH is not compatible with ROSA of the enterprise architecture of NEA».

In other words: the project was begun without proper thinking, and will have to be redone in a different way.

And under “Remarks”:

«The datawarehouse must be made accessible. This is arranged in the project Public Portal, which should be completed in 2011. Attention will have to be paid to the coupling of DWH and this portal».

In other words: whatever the DWH may be, it is useless without an additional project and additional money.

By way of intermezzo we give an example of the exertion of pressure by the management to bend the truth.

The chapter about the implementation of the renewal plan reports about a discussion about an inquiry by Ernst & Young into the causes of the failure of the implementation of this plan. In this discussion, one of the investigators notes that on their way to the top traffic lights have a tendency to become greener. The present chapter shows that this is no different in the ministry. In general the mechanisms responsible for the change in color are invisible. The following quote is an exception. It shows the SG as a source of pressure for greening. He even seems to order changing the color, by euphemistic (false) use of the word “propose”:

«6. Reports about risky projects (Appendices 11 and 12)

Summary of this item: every quarter MTM gets a report about projects marked as risky. The report pays special attention to risks. Renewal System Studyfinancing and Public Portal have been added to the report. Points requiring special attention are listed in the accompanying memorandum. The chairman proposes that in the next meeting all red lights have changed to green. IP has the lead in this. Risks outside the domain of the ministry should be escalated to find a solution. The report goes to the MTM».

¹³⁵ Which can be found under this date in the directory of this chapter, under 20110125.

¹³⁶ In the directory Projects reports under 20110125.

¹³⁷ IP= information products, the name of a department of NEA.

The quote is from the minutes of the strategic i+i council of 14/4/10.¹³⁸ It is the report of the discussion in this “council” of the report about the risky projects for the first quarter of 2010. The chairman was SG Koos van der Steenhoven. The quote is unabridged. It clearly says nothing about an interest in, or discussion about, the causes of the red lights. How can anybody in the council or MTM know that these problems can be solved within a month? It looks as if the SG is irritated by the red lights, and wants it to be understood that he doesn’t want to see them again.

About the other projects the present author has only little more information than the projects reports and a few haphazard other documents. The “little more information” was provided by people who were personally involved in the projects. The information gives additional support to, and shows nothing incompatible with, the conclusion that the misconduct shown above is widespread and structural. Even if it would show nothing new, it is important as a check.

PIEN-flows.

“PIEN” stands for: policy information education number. The education number is a personal number. By coupling educational data with the education number, information can be obtained about the education history of a person. This was not entirely new. Flow data can also be obtained without a personal number. The Dutch Statistics Office had done so for decades. However, putting the basic data in a computer system can greatly enhance their usability. They may for example be coupled with other digital personal data.¹³⁹ Due to the availability of computer systems and storage capacity, much more personal data are collected and stored than before. Since data are very portable and transferable, many new kinds of analysis can be made. In principle such analyses can be used to improve the education system.¹⁴⁰

People “move” through the education system. They go from one grade to the next, from one school(type) to another etcetera. At a given moment, someone is in a certain place (in a certain school or type of education, at a certain level). At different times one is at the same or another place. The series of data about a person at successive times defines his education history (in terms of these data). And the set of such data for a group of people defines education flows. An example of a specific kind of such data is the education matrix. The two axes of the matrix enumerate the different levels or types of education. Let A and B be items on the X and Y axis resp. Then the cell (A,B) of the education matrix contains the number, or percentage, of people who last year were in A, and are in B this year.

For several reasons it isn’t always possible to define education flows both unambiguously and measurably. For example because the “places” aren’t defined unambiguously, because the system is different in different parts of the country, or because it has changed frequently. At any one time, there may be more than one relevant system of places. For statistical (and policy) purposes this can be a real problem. A problem that often can only be “solved” at the cost of reliability.¹⁴¹

The purpose of the project PIEN-flows was to define a useful collection flow-variables, and make a basic flow dataset. The project was part of the portfolio of DGPS Kerstens. The principal contacts for the project were Erik Smits of IFC and Kasper Weekenborg of the ministry. The original budget was 360 k€.¹⁴² The project did not produce what was intended. In July 2008 a report with the “final results”

¹³⁸ In the directory of the present chapter, under 20100414.

¹³⁹ At least much more easily. Or so much more easy that what was practically impossible “by hand” can be done easily with computers. But don’t forget that what is possible in principle cannot always be done in practice. Not even with computers. One needs competent people, and these people need time and other facilities to do their work properly.

¹⁴⁰ The “can be” should be stressed. Improvement is not logical. On the contrary. Chapter 9 shows why governments and politicians have reasons to avoid the improvements which would most benefit other people.

¹⁴¹ That is: it cannot really be solved, and what is done to produce the published numbers increases the uncertainty, or error margin. Note that if the flow data are important, then stability of the education system is important too. Without stability there are no (detailed, reliable) flow data.

¹⁴² This is the IFC budget. Costs made by the ministry usually are substantial but ignored. If a project runs well and needs little attention, the costs of the ministry are small. But if not, (very) much attention and discussions may be necessary. This can easily cost several fte’s, at more than 50 k€ each.

was distributed all the same. It would be discussed in a meeting of 17/9/08. The representative of the department of HE for this project, Martine Warmerdam, was prevented from going, and asked Van Velsen to go in her stead. That's why the author has studied various documents of this project. He concluded that the "results" were defective, and that a lot of work remained to be done. The relation between the "results" and the original plan was very weak. The documents lacked logic and consistent terminology. Which are quite important for definitions which have to form the basis for data collection and analysis. The more so if they have to be reproducible by different people. The discussion of 17/9/08 confirmed these observations. All participants called the report unfinished, even though some said to find it a beautiful piece of work already. It was concluded that there should be a sequel.¹⁴³

The following nicely typifies the meeting. The representative of the department of SE, Jaap de Hoog, asked to use the same definitions in all working groups of the project. The IFC representatives,¹⁴⁴ Erik Fleur and Frans Verboon, didn't agree. Each of the working groups kept using its own definitions.

The micro report about this project in the projects report about the 4th quarter of 2008 says simply: «This project is completely finished». ¹⁴⁵ Nothing else. This was simply untrue. Which also can be concluded from the fact that p. 39 of the performance contract 2009 for IFC mentions a follow-up project. Requiring 1000 hours at 100 € an hour, in other words a budget of 100 k€. This continuation was not declared risky. Therefore it does not appear in the reports which remained after the merger/reorganization.

The meeting of the working group PIEN of 17/2/09 discussed the follow-up. The minutes of the meeting say: «The platform policy information is a continuation of the Steering committee PIEN, and will occupy itself with general flow information (cohorts)». ¹⁴⁶ "General flow information" was the subject of PIEN-flows. Somewhat further in the report, the text under the heading «Cohort: towards a new IFC project» clearly shows that PIEN-flows was unfinished. The items listed under this heading should already have been completed in the earlier project.

Information bank.

The purpose of this project is outlined in the projects report about November-December 2007:¹⁴⁷

«IFC realizes (a first phase of) an information bank with consistent answers to questions of ICE.¹⁴⁸ The information bank will be accessible, through the intranet of IFC, for all employees of IFC, the ministry and the Education Supervisor [ES]. The information bank contains information about pupil-dependent financing [of schools], examinations, and matters related to the cost of personnel».

The report continues with a summary of the actual state of the project:

«The technical part of the bank has been realized. A large part of the contents has been stored in the bank. Adaptation and supplementation are continuous processes. The ministry has been connected to the bank. With the ES there are still technical problems. It works temporarily with a CD ROM of the bank.»

The report concludes with a remark about an informal evaluation and its follow-up:

«Reactions on the information bank have been evaluated. In February 2008 the results and an advice about a possible continuation will be submitted to the Strategic i+i council.»

The information bank was a relatively simple and small project. In principle it was no more than making a (internal) website for the publication of a relatively small number of existing texts. It was part of the portfolio of uSG.

¹⁴³ Without giving a reason, Weekenborg was absent. According to Warmerdam this was rule rather than exception.

¹⁴⁴ That is, the representatives of the people actually doing the project.

¹⁴⁵ The report can be found in the directory Projects reports under 20090206.

¹⁴⁶ The minutes can be found in the directory of this chapter, under 20090217.

¹⁴⁷ The report can be found in the directory Projects reports under 20080207.

¹⁴⁸ ICE= Information center education, part of IFC/ NEA.

The report about the financial situation of the projects in January-February 2008¹⁴⁹ states:

- That the budget was 65 k€;
- That the budget had been spent.

A professional and reliable approach requires that a product is evaluated by people who are independent of its production. The project information bank however was evaluated by people who worked on the project. Their report was positive, and advocated continuation. (Even though it was not made clear why continuation was needed or useful). The report was obviously biased. Critical remarks were dismissed with false arguments.¹⁵⁰ The projects report May-July 2008 says the following about the evaluation:

«IFC has evaluated the pilot of the information bank. The Strategic i+i council has discussed the evaluation and the recommendation to continue. There have been talks about the size and publicity of the continuation. [...] it has been decided to continue with the technique of the pilot, except for some minor improvements, to expand the contents, and with stronger involvement of the people in the ministry and ES. In the beginning of September this proposal will be submitted to the Strategic i+i council for approval.»

Note that the bank is only called a pilot in the context of a request for continuation, and that the “pilot” has not been defined.

The last projects report, about October-December 2008, says the following about the project:

«In October IFC was requested to implement the project Continuation Information Bank, in agreement with the proposed PID. The project is the sequel of the pilot done in 2007-08. It will fill the bank, make it available to the ministry and ES, and adjust the texts in agreement with the policy departments and ES. For this purpose a process plan will be made, which will also be used for keeping the bank up to date. The involvement of the policy departments and ES will be strengthened by publications on intranet, presentations and meetings in different places about the contents».¹⁵¹

The budget for the sequel is 181 k€. This is rather amazing, for almost three times the cost of the first phase, which according to the projects reports of November-December 2007 had produced an almost finished information bank. The relatively high costs may be caused by the problems with ES. But if so, that should have been noted, if only because it remains a risk until solved.

From parent portals to connection points.

The author couldn't find a description of the original purpose of this project. It must have been something like the publication, through a public website, of information which is of interest to parents. For example when they have to choose a school for one of their children. Such as information about success rates, proportion of pupils going to different forms of higher education, the proportion of (un)qualified teachers and so on.

The project was part of the portfolio of DGPS Kerstens.

On 23/1/07 the decision to build a parent portal was communicated to, or taken by, the CCIPE.¹⁵² According to the minutes of the meeting:

«DGPS announces that a parent portal will be built, and that the backside (such as the findability by search engines) will be arranged properly. The CCIPE approves this proposal.»¹⁵³

The necessary data should be stored in, and retrieved from, the one and only DWH. Since the portal was to be public, there could be no doubt about the applicability of the web directives of the government.

¹⁴⁹ The report can be found in the directory Projects reports under 20080407.

¹⁵⁰ Source: statements of people personally involved.

¹⁵¹ The projects report October-December 2008 can be found under 20090206 in the directory Projects reports.

¹⁵² CCIPE= Central Committee Information Policy Education.

¹⁵³ The minutes of the meeting can be found in the directory of the present chapter, under 20070123.

In connection with the projects report about January-February 2007,¹⁵⁴ and the preparation of the periodic meeting of uSG with the top of IFC on 27/3/07, Edwin Streefkerk of the department of PE sent his DGPS a memorandum¹⁵⁵ with the following conclusion:

«Questions.

In the projects report IFC suggests that no clear choice has been made about the organization which will host this portal. As indicated above, the working group has reached agreement about this.

Questions you could ask are:

- Why has IFC not begun writing a PID?
- What ideas does IFC have about the integration in the PID of the decisions made by the working group about hosting by Infonet, and input from ES and IFC?
- Can IFC make an estimate of the additional costs due to participation of Infonet?»

In the minutes of the meeting of 27/3/07¹⁵⁶ one can read:

«Parent portal (4.1.1.): It is not clear how this project is to be continued. The department of PE chairs the working group. Conclusion: together with the department of PE DGPS organizes a meeting with the heads of IFC and ES to bring about progress in this project».

The projects report about May-July 2007¹⁵⁷ devotes two paragraphs to the parent portal:

«Parent portal: DGPS has stopped the project for the time being. DIP,¹⁵⁸ IFC and the departments of PE and SE will collaborate in writing a memorandum for DGPS and MTM. The memorandum will make proposals for choices related to the disclosure of public information and for choices about the infrastructure and instruments (the datawarehouse).

[...]

At the request of PE and as part of its public information policy IFC has made preparations for building a parent portal that should have been ready on 1/11/07. Together with PE talks have been held with organizations of parents. An inventory has been made of requirements and wishes for the portal. [...] However, the ministry was not yet sure about the desirability of a parent portal. After discussions with PE and DIP, DGPS has decided to stop the preparations as yet. DIP has been asked to prepare, in agreement with IFC, a memorandum for the MTM of 10/9/07 about the vision on the desired future datawarehouse of IFC.

It is expected that in autumn a decision about building a parent portal can be taken by the MTM. Of course, if this portal is to be built, realization can take place in spring 2008 at the earliest».

These paragraphs clearly show that the people in the CCIPE of January, first of all DGPS, didn't know what they were talking about. They show how the top management of the ministry works. Irresponsibly.

Note that the datawarehouse seems to play a central role in the problem. A vision on the DWH should be developed in the framework of the parent portal. At the same time it had been said for years that most of the money for the policy portals went to building the DWH, and that this DWH could then be used for other portals as well. The members of the CCIPE knew this.¹⁵⁹ Moreover, at this time the PPP was still running.

At the time of writing, nothing could be found any more of the meeting of the MTM of 10/9/07. The conclusions of the MTM of 8/10/07 specify some of the problems with the parent portal:

«Progress Information Policy Public (70796)

¹⁵⁴ The report can be found in the directory Projects reports under 20070323. The following concerns sec. 4.1.1 on p. 8.

¹⁵⁵ In the directory of this chapter, under 20070326.

¹⁵⁶ In the directory of this chapter, under 20070327.

¹⁵⁷ In the directory Projects reports, under 20070829.

¹⁵⁸ DIP= department of information policy.

¹⁵⁹ Could know and should know. They had been informed, and pretended to be competent to take decisions related to it.

The second phase of the program Information Policy Public is almost completed. The purpose was to make as much information public as possible. Apart from some minor problems progress is good. Because of problems of availability and performance the parent portal is delayed. An improved public database will be delivered at the end of October, two months later than planned. At the end of October MTM will receive a proposal for the third phase of the project.»¹⁶⁰

What the “availability problems” are is unclear. The “performance problems” remind one of the policy portals. Note that “performance problems” can mean that the portal simply doesn’t work, or too badly to be of use.

The last part of section 2.1.13 of the projects report about August-October 2007 reads as follows:

«On 25/7/07 DGPS, advised by DIP, decided not to request IFC to build a parent portal. Of the 240 k€ ES had made available for this project only 50 k€ were spent. The remaining 190 k€ is still in the IFC account. ES has great problems with the decision, because without the portal parents do not have an adequate source of information. ES feels forced to spend extra money for improvements of the ES website.»

The “problems of availability and performance” are not mentioned any more, but seem to be considered unsolvable. The text furthermore gives the idea that ES has been kept outside the decision making process. Which is rather strange, given its great interest in the project, and the (related) conclusion of the meeting of 27/3/07 with uSG quoted above.

The lesson isn’t learnt. The communication with ES remains insufficient. Witness the minutes of the meeting of 11/2/08 of uSG with the top of IFC:

«8. Final round of questions.

ES asks for the state of affairs in the parent portal project. The status of this project is “on hold”.

Via DIP an inquiry is made. The staff of uSG will ask DIP for the state of affairs, and report to ES».¹⁶¹

It took months before this was done. Van Velsen reminded Schouten of this promise in a mail of 13/6/08.¹⁶² After the above quote from the minutes of 11/2/08, he quotes from the minutes of a similar meeting on 14/4/08:

«Action 15: Find out state of affairs parent portal, and report to ES. The staff of uSG has not heard from DIP. It expects DIP information soon».¹⁶³

Van Velsen asks why this takes so long. Why could the information not be given immediately? Why couldn’t DGPS or DGNEA (or their representatives) give a decisive answer either 11/2 or 14/4? The project is on hold for more than 4 months, and nobody in this meeting knows why? What reasons have uSG and the management of IFC to believe that the obviously serious problems are dealt with adequately? Schouten did not reply.

Sometimes Schouten sent the minutes of a meeting of uSG with the top of IFC, but often she did not. When Van Velsen wrote his mail of 13/6/08 he didn’t know that in the meeting of 9/6/08 something had been said about the parent portal:

«Action 9: The Education Supervisor says that the scope of the project parent portal depends on the extent to which the ministry facilitates the sector. After this summer the scope will be determined on the basis of the information policy plan».¹⁶⁴

Things turned out differently. The minutes of the next meeting of uSG with the top of IFC, on 9/9/08, say the following:

«At the moment this [parent portal] project is inactive because continuation depends on decision

¹⁶⁰ The minutes of this meeting could not be found either. The quote is copied from a mail of 20080613 of Van Velsen to Schouten. Note that “as much information as possible” clearly cannot be taken literally. But at the same time it is completely unclear what information is meant. In the PPP similar promises had been made.

¹⁶¹ The minutes can be found in the directory of this chapter, under 20080211.

¹⁶² This was the mail that was written in reaction to Schouten’s assertion that she had not received any notice about problems with other projects than the PPP. It can be found in the directory of this chapter under 20080613.

¹⁶³ The minutes can be found in the directory of this chapter, under 20080414.

¹⁶⁴ The minutes can be found in the directory of this chapter, under 20080609.

making about the project Information Policy Public in the next CCIPE. For 2008 no new activities in the project parent portal are expected. If possible ES proposes to reprioritize the remaining budget for other ES projects.

Conclusion: Parent portal will be put on the agenda of the next CCIPE.»¹⁶⁵

On 20/10/08 the working group parent portal sent a draft memorandum to the working group i+i for forwarding to the strategic i+i council.¹⁶⁶ The memorandum proposed to offer a prize for suggestions for innovative use of education information. The reason given was the lack of ideas for spending the remainder of the budget ES had paid for the parent portal project. In preparation of the meeting of the strategic i+i council the draft was discussed in the working group i+i of 22/10/08. The working group rewrote the proposal as follows:

«Regarding the publication of education data of the ministry a policy of restraint has been agreed upon (see the criteria in the plan for the program i). Market and education institutions are much better than the government in reaching target groups. Still, the ministry will have to make its data available as complete, reliable and up to date as possible.»

The revised memorandum¹⁶⁷ concludes:

«Points for discussion

- What (dis)advantages does the strategic i+i council see in extra stimulation of the market for education data? Does the council share the line to organize a prize contest if necessary?
- Does the council approve of the use of the remainder of the ES budget for making the ES quality cards and reports better readable, understandable and findable (in a way which respects the architecture requirements)?»

The minutes of the council meeting could not be found, and the answers to these questions are unknown. They don't matter much, for texts such as those quoted clearly show wide support for the idea that the money which ES had made available for a specific purpose should be spent anyway, on a contest if necessary. It is clear that ES is not free to dispose of its money anymore.

In order to shed even more light on the way projects are born and die in this ministry, we go back in time a little. The following is a quote from chapter 3, Projects in the phase of proposal, of the projects report about January-February 2008:

«3.2.2. Windows for Accounting (was Horizontal accounting)

The project Windows for Accounting started in December 2007. It concerns a project for the SE council.¹⁶⁸ For IFC the development of central indicators, derived from data managed by IFC, is the most important part of the project. [...] In the beginning of March there was a first meeting of a working group with representatives of schools and managers. This group is supported by experts from IFC, ES and other organizations. Prof. Dr. R.J. Bosker of the Groningen Institute for Education Science gives scientific support. IFC was present at the first meeting of the working group. Further contributions of IFC still have to be decided upon. The purpose is to have the definitions of the central indicators ready and published on the website by the middle of 2008.

IFC has not yet been requested to make human resources available for this project».

Note that earlier reports and meetings about the parent portal do not mention Windows for Accounting (WfA).¹⁶⁹

In the following projects report WfA is still listed as a project in the phase of proposal. The text nevertheless implies that the project has started. About a formal request (order) or budget nothing is said.

In the first report about risky projects, the one about the 2nd quarter of 2009, one finds the following description of the goal of WfA:

¹⁶⁵ The minutes can be found in the directory of this chapter, under 20080909.

¹⁶⁶ In the directory of this chapter, under 20081020.

¹⁶⁷ The memorandum of the working group i+i to the strategic i+i council can be found in the directory of this chapter, under 20081023.

¹⁶⁸ The SE council consists of representatives of the schools providing secondary education.

¹⁶⁹ These "windows" have nothing to do with Microsoft.

«[The project intends to] Facilitate horizontal accounting by schools, by making available indicators about school performance and corresponding benchmarking. The indicators can also be used in the management of the school.»

Indicators about school performance and corresponding benchmarks are of prime interest for parents. So clearly the new project overlaps with the parent portal project. If that still exists. It probably doesn't. It isn't mentioned in the risky projects reports at any rate.

As regards financial aspects, the report says that the first phase has been completed within the budget, and that 4 M€ has been requested for the sequel. A (positive) decision (advice) is in the line.¹⁷⁰

The report about risky projects in the 2nd quarter of 2010, a year later, is more specific:

«1.2 M€ 1st phase (paid and spent)
4 M€ 2nd phase (approved for present phase)
3.7 M€ transition phase (budget requested for 2011).»¹⁷¹

The last mentioned amount may include 0.5 M€ of the parent portal project. This may be inferred from a remark of DIP at the end of the report about WfA in the risky projects report about the 1st quarter of 2010:

«A decision has still to be made about a parent portal requested by the SE council, and for which an additional subsidy of 0.5 M€ is requested. DIP has set conditions regarding portal policy and I-principles, so that the portal will be generic and reusable.¹⁷² A definitive proposal for the subsidy will follow, but the amount has already been included in the budget notification of SE to the SE council.»

The report about risky projects in the 3rd quarter of 2010 shows that the project WfA has run into difficulties with respect to both contents and management. The difficulties are due to interference with a new project “Connection point Sector” of DIP.¹⁷³ At the end of the report DIP explains its new (additional) conditions as follows:

«The purpose of the coupling of WfA and the connection point sector is to ensure that after completion of the project WfA the structural administration is facilitated by a connection point sector. The proposal of the SE council for an administrative organization for WfA is being adapted, whereby DIP advises about boundary conditions and subsequent steps. The adaptation is somewhat delayed, but for the time being this doesn't cause risks»^{174, 175}.

The connection point sector was an idea of DIP. DIP was unable to explain what it was and what it was good for. Outside DIP nobody saw the use. See for example the report about risky projects in the 3rd quarter of 2010.¹⁷⁶ For this reason coupling of WfA to the connection point causes serious risks for WfA.

3.6. Accounting for the maintenance costs of Studylink by IAG/NEA.

¹⁷⁰ Meaning that someone at the base of the hierarchical organization has written a draft decision (letter to IFC, to be signed by the SG), and that the draft is on its way through the hierarchy to the SG. Via the head of the employee, his head of department, the DG and possibly via others, such as the head of DIP. All these people have to initial the advice, to show they have seen it and agree with it. (I'm calling it a draft because it may be changed by anyone along the way).

¹⁷¹ This concerns WfA. The report can be found under 20100830 in the directory Project reports.

¹⁷² These conditions are part of the web directives of the Dutch government.

¹⁷³ According to the report about risky projects in the 4th quarter of 2009 the connection point sector has the following goal: «The connection point sector contributes to an effective and efficient exchange of information in the education chain by means of agreements about a shared infrastructure, concepts and standards. The connection point is the natural landing ground for ICT projects in the education sector». According to this report the budget is 5.5 M€. The lack of support for the proposal wasn't due to the purpose, but to the budget and the “landing ground”, which made everybody suspicious. Why couldn't the goal, a set of agreements, be realized without any additional money?

¹⁷⁴ Report risky projects 2010 Q3. In the directory Project reports under 20101006.

¹⁷⁵ I-principles are rules for ICT-systems or applications.

¹⁷⁶ In the directory Projects reports, under 20101006.

Summary and conclusions.

1. The management of IAG/NEA claimed money for the maintenance of a Studylink system without having the slightest idea of the character and amount of the required maintenance work. It had no plan for system development, and no plan for the transition period from old to new. There is nothing that proves that it had thought seriously about all this. The claims for compensation lacked even the least argumentation. In particular they are not founded on any calculation;
2. Some argumentation was obtained once and only once, for 2008: after more than a year and after credibly threatening with non payment in the beginning of 2009;
3. The information about the Studylink-related activities in 2008 showed that the management of IAG/NEA had no plan for what had to be done;
4. IAG/NEA had asserted that the claim was for structural (= permanent) work. The information showed that large part of the work was not structural but incidental (= temporary);
5. Until at least mid 2011 IAG/NEA refused to account for its claims and expenditure. It refused to give insight in the changes in its activities due to Studylink, and to justify its claims in an understandable manner;
6. The ministry nevertheless kept paying what IAG/NEA claimed;
7. Even though it is very well possible that the costs have not risen but fallen, or would have fallen if IAG/NEA had adapted its activities to Studylink competently;
8. IAG/NEA didn't stand by the relevant agreements in the performance contract,¹⁷⁷ and didn't keep promises made in meetings on the subject;¹⁷⁸
9. The deadlock in the talks ministry-IAG/NEA aren't solved because IAG/NEA sticks to its refusal to describe and explain the changes due to Studylink, and because IAG/NEA knows from experience that the top of the ministry will always pay;
10. The management of IAG/NEA lacks integrity. It submits unfounded financial claims, refuses to provide supporting argumentation, and gives incorrect essential information about the character of activities. It behaves as if it were accountable to no one;
11. The management of IAG/NEA is incompetent. It has insufficient knowledge of its own organization, and is, partly for that reason, unable to plan;
12. The management of the ministry knows that IAG/NEA doesn't comply with imperative and generally accepted professional and integrity norms. But the ministry doesn't do anything about it;
13. IAG/NEA has shown that one cannot cooperate with it on the basis of ("high") trust. Claims of IAG/NEA should not be believed at face value;
14. The ministry behaves as if money rains from the sky, and as if it is accountable to no one;
15. Benefits (services rendered by IAG/NEA) remained the same, costs have (substantially) increased;
16. The case therefore shows a mechanism for decreasing efficiency;
17. If it is true that reasonable people (can) solve problems by talking, then vital positions of ministry and IAG/NEA are occupied by unreasonable people.

Introduction.

The history of the justification of the claims of IAG for compensation of costs due to Studylink answers several important questions which are answered nowhere else in this study. There is no overlap with any of the other cases in the study. It is really supplementary. For these reasons it is described in some detail. Nevertheless, like most individual cases, this case is not necessary for drawing the conclusions of the study. So if that is the only or main thing you are interested in, you may skip this section without causing an essential gap in the argument.

Studylink is a system which connects student administrations of institutions for higher education with IAG. For communication it uses the internet. It supports information exchange between student and institution, between student and IAG, and between institutions as regards application and

¹⁷⁷ Another example: It didn't monitor the costs due to changes in activities due to Studylink, as it had promised.

¹⁷⁸ Sometimes it is hard or impossible in talks to deny a reasonable argumentation or say no to a reasonable proposal. The trick is to forget everything you don't like (for reasons you cannot make public, and account for).

registration of students. It is a system of the education institutions, and maintained by them. The system provides services formerly provided by the student administrations of the institutions.

Studylink is also the name of the organization which manages the system. This organization is independent of the ministry of education, IFC or IAG.

Before the introduction of Studylink, students sent their application to IAG, and registered at one or more institutions. IAG informed institutions of the applications, and the institutions sent information about the registered students to IAG. Now students communicate only with Studylink about their (application and) registration.¹⁷⁹ It is therefore clear that the corresponding processes of IAG have to change. Change costs money. The “incidental” costs of IAG were compensated by the ministry.¹⁸⁰ The department of HE thought that the structural costs of IAG after adaptation of the systems would be less than they were before Studylink. This was a reasonable assumption because Studylink took over work without causing new work. IAG nevertheless claimed that its costs increased.

At the end of 2007 Studylink had not yet been completed. Several new releases had been planned. The planning extended to beyond 2008.

December 2007.

On 12/12/07 representatives of the department of HE and IAG discussed the HE part of the (draft) performance contract for 2008. The representative of IAG, Jacob Smit, asked an increase of the yearly budget with 400 k€ for the maintenance of Studylink. This extra budget was to cover structural costs.¹⁸¹ The representative of HE, Van Velsen, replied that he could not believe without further arguments or proof that Studylink causes net additional costs. It was clear that the activities of IAG had to change because of Studylink. But as far as HE understood, Studylink should reduce the (net) workload of IAG. The costs should decrease instead of increase. In his opinion, IAG should try to describe the changes in an understandable manner, and make a plan for the changes needed in 2008. He said that he could not agree with the requested budget increase without insight in the changes in IAG activities due to Studylink. IAG should show that the changes add up to an increase in the workload equivalent to 400 k€. Smit accepted this request as being reasonable.

2008.

The discussion of 12/12/07 resulted in the following paragraph in the proposal of IAG for the PC 2008:

«3. Studylink

Since release 2.3 [of Studylink] IAG has maintenance costs for Studylink. At this moment 3.5 fte have been budgeted for process management. This is equivalent to 400 k€. The costs of the departments ES [Education service] and I&O [Infrastructure and operation] have not yet been clarified. Clarification is difficult due to obscurity about the procedure for drawing lots [for courses with a restricted number of students]. Release 2.4 will further increase management and I&O costs. IAG will monitor both savings and extra costs due to Studylink. IAG will give HE insight in the changes in the workprocesses due to transfer from the AS-application¹⁸² to Studylink».¹⁸³

This is how IAG told HE that the 400 k€ was not all. Supposedly the costs made or to be made by ES and I&O were not included in the 400 k€.

On 7/3/08 HE received a memorandum with a specification of activities of I&O.¹⁸⁴ The cost of

¹⁷⁹ It is possible that students still have to send their application to IAG. Maybe only in some cases. For example when the number of new students in a course in a given institution is restricted. The documents don't provide a decisive answer. The lack of clarity may be related to legal regulations, and to the fact that the change of address for application would mean loss of a job and loss of jobs for IAG.

¹⁸⁰ Out of the regular budget for system development. Amounts spent can be found in the progress reports, collected in the directory Progress reports IAG (Voortgangsrapportages IBG).

¹⁸¹ To be paid yearly, and to be distinguished from incidental costs, which have to be paid once only.

¹⁸² AS= Application and selection. This is a department of IAG.

¹⁸³ See the directory Maintenance Studylink, under 20080114.

¹⁸⁴ In the directory Maintenance Studylink, under 20080307.

these activities had been calculated with a model, as a percentage of the “basic” amount of 400 k€. In other words: they were not based on specified or described changes in activities. The calculated costs were 81 k€. Even if the model were correct, the basic amount of 400 k€ remained unfounded. IAG didn’t say what the 3,5 fte which were paid by these 400 k€ were doing or going to do. HE could only conclude that IAG tried to pull in as much money as it could.

Between 4 and 11/4/08 IAG announced that the costs of the line departments amounted to 95 k€. This brought the total amount to 576 k€.

Because time went by and because uSG wanted to finish the PC 2008, the ministry decided to agree conditionally. The following text of the PC was approved by both parties:

5. «The costs of the diplomabank, code of conduct and Studylink are covered by the means which have been explicitly marked as “item to be monitored”. The year after stabilization of the costs, the item will be transferred to the basic funding;
6. The amount listed for Studylink [576 k€] covers the maintenance costs up to release 2.3. Costs to be made due to later releases will be additional;
7. IAG monitors both savings and extra costs due to the introduction of Studylink;
8. IAG makes a plan that clarifies the changes in the activities of IAG as a consequence of the introduction of Studylink in 2008 and following years. The plan gives a well-substantiated estimate of the savings and extra costs. The plan will also describe the situation when Studylink operates as intended. This plan will be sent to HE in July 2008 at the latest. The plan will serve as basis for the discussion about the PC 2009».¹⁸⁵

There was voluntary agreement about this text. Nothing was dictated, and there was no trade-off. IAG nevertheless wasn’t able or willing to do what had it promised. In a mail dated 18/7/08 Smit gives a list of facts and remarks which according to him explain why the plan cannot be made. In a reaction of 25/7/08 Van Velsen shows that the conclusion doesn’t follow from the facts and remarks listed.¹⁸⁶ Moreover, Smit contradicts himself:

«When we try to map the costs for 2008 and later, we meet with the following difficulties:

[Follow five remarks which do not show that a plan as promised cannot be made].

In fact we don’t have a good picture of the effect of Studylink on the activities of IAG, certainly not for 2009 and later».

So after this mail of Smit it was more of a mystery than ever how IAG could have presented a precise amount in December 2007.¹⁸⁷ Van Velsen concluded that HE will probably not agree with the additional 576 k€ unless IAG gives the insight requested in the PC 2008. He didn’t understand how a meaningful discussion and advice about the PC 2009 would be possible without much more and better information. He furthermore noted that the cost monitoring in the 4-monthly progress reports had hitherto given very little useful information.

The most important characteristic of structural costs is that they come back every year. And that once approved, it is very hard to get rid of them. In other words: the costs claimed by IAG amounted to a lot of money. It was important not to acknowledge them until they had been properly described and accounted for. HE had no people who could check and evaluate the assertions of IAG about Studylink-related activities in past, present and future. For this type of work the ministry had an audit department (AD). However, AD claimed that it had no staff available. Priorities had been fixed by uSG, and only she could change them.¹⁸⁸ Therefore HE formally asked uSG to order AD to make the inquiry as indicated.¹⁸⁹ Such a request was a rather unconventional and surprising. It didn’t have the desired effect. AD simply didn’t want to cooperate. In a discussion with Van Velsen on 22/7/08, the head of the section Inquiries of AD, Femke Aarts MBA,¹⁹⁰ play-acted as if she didn’t understand what

¹⁸⁵ See the directory Maintenance Studylink, under 20080516, part 2.

¹⁸⁶ Both mails can be found in Corresp_PPC2008_IBG.

¹⁸⁷ It could have said that it was an estimate only, and could have offered to monitor activities and costs. Instead it didn’t show any doubt.

¹⁸⁸ In other words: AD didn’t want to cooperate. For what reason wasn’t clear.

¹⁸⁹ See the documents under 20080716 in the directory Maintenance Studylink.

¹⁹⁰ She always put “MBA” behind her name, even though the ministry (of education!...) didn’t use titles. Not on the nameplates of rooms, not in attendance lists or wherever.

HE wanted.¹⁹¹ She said that AD made three types of inquiry. What HE wanted didn't fit any. Aarts used all inventiveness she could muster to prove that HE should not ask AD but somebody else. With the help of examples and a lot of patience Van Velsen showed that AD had adequate expertise, and had done similar inquiries. It was only natural that HE would call on AD and that AD should help HE to take an accountable decision about acceptance of the claims of IAG. Given the knowledge of AD of the ministry and IAG, help of AD would be much more efficient than that of an outside consultancy firm.

After a very long talk HE promised to forward the plan of IAG to Aarts immediately upon receipt. After having studied the plan, HE and AD would discuss what to do.

The plan never came, and the contact with the AD got no follow up.

Time went on, and by the end of 2008 the PC for 2009 would have to be written and discussed. For this purpose IAG sent HE at the end of November a memorandum about "HE items to be monitored in 2009".¹⁹² The memorandum claimed that the maintenance costs for Studylink in 2009 would amount to 790 k€. While the mail of Smit discussed above, and the 4-monthly progress reports, clearly showed that IAG had only the vaguest possible idea of the changes in work due to Studylink.

The talks of the education departments of the ministry with IAG about the PC 2009 were coordinated by Alice van Gent, assistant of uSG for IAG. She asked the departmental contacts for their comments on the documents sent by IAG. Speaking for HE, Van Velsen replied that Studylink is the only difficult subject. And that it had already been extensively discussed. But that as regards the 579 k€ IAG had not submitted the argumentation which had been promised. Neither has adequate argumentation been provided for the 790 k€ of 2009. IAG asks HE for blind faith. HE is the wrong place to ask for that. Van Velsen said that for a year he had asked the questions every good civil servant should ask. He promised to ask his department what it wants, but that he would advise it to protest to uSG against the failure of IAG to send the promised plan, and against continuation of payment of the claims related to Studylink.¹⁹³

2009.

The ministry rejected the proposal of IAG. The PC 2009 mentioned no budget for Studylink. The text of the PC says the following:

«Before the 4-monthly meeting of April 1, 2009, IAG will provide insight in the savings and extra costs of the processes of central application, the drawing of lots, and selection, in the calendar year 2008 due to the introduction of Studylink. IAG will also explain the savings and extra costs in 2009. In the meeting of April, ministry and IAG will discuss the size of the budget which is to be made available for these processes in 2009».¹⁹⁴

This text was imposed by Van Gent and/or IAG without voluntary agreement of HE. HE disagreed because more processes could be affected than those mentioned, because it wanted to know what it could expect in the coming years, and because it wanted IAG to think seriously about the organization of its activities and about their planning. HE saw no convincing reason to deviate from the text in the PC 2008.

Nothing would be paid to IAG in relation with Studylink until it had explained how the money of 2008 had been spent, and how the requested budget would be spent in 2009. The threat was convincing. On 16/3/09 HE received a memorandum with a rather clear accounting for 2008 and a corresponding estimate for 2009.¹⁹⁵ It mentions total costs of 416 k€. Among other things, the memorandum shows that at the end of 2007 IAG had not seen some sizable cost sources, and, even more important, that many costs were incidental instead of structural. It was completely unclear what the structural costs would turn out to be in the end (if any). The memorandum gave rise to the suspicion that IAG tried to create a new source of money beside the fixed and booked up budget for

¹⁹¹ There is a short report of the discussion in Corresp_PC2008_IBG.

¹⁹² In the directory Maintenance Studylink, under 20081128.

¹⁹³ The mail is dated 3/12/08, and can be found in Corresp_PC2008_IBG.

¹⁹⁴ See the PC 2009 for IAG (= IBG), in the directory Maintenance Studylink under 20090218.

¹⁹⁵ In the directory Maintenance Studylink, under 20090316.

system development.

The next periodic meeting of HE with IAG was at 26/3/09. Two weeks after that meeting, Van Velsen wrote his counterpart Smit a mail thanking him for the memorandum with information about activities of IAG connected with Studylink. According to Van Velsen the memorandum was a useful basis for the discussion about the budget changes in the PC 2009. He noted that the meeting had shown that both IAG and HE believe that 2009 will be quite different from 2008. Problems solved in 2008 need not be solved again, but new problems may arise. The costs are hard to foresee. It is obvious that they have to be monitored. December 2009 or January 2010 a report should be made similar to that of 16/3/09. We agreed, the mail reminded Smit, that the realization 2008 is the best estimate for 2009.

As an appendix to the mail, Van Velsen sent a copy of the memorandum of 16/3/09 annotated with corrections, questions, suggestions and remarks. He asked for example for an additional section (roughly) describing the changes in IAG activities due to Studylink in 2008, and those expected in 2009. This may help relative outsiders understanding some of the information in the memorandum.¹⁹⁶

Smit promised to have the memorandum corrected and supplemented. But no more was heard of it.

14/12/09 IAG sent HE a memorandum about the costs for Studylink in 2009.¹⁹⁷ Its format was very different from that about the costs in 2008. It doesn't give insight in processes and changes, and it cannot be considered as an accounting for the costs. It doesn't show what is incidental and what is structural.

2010.

Beginning with 2010 the performance contracts with IAG and IFC were replaced by a single management agreement (MA) with the merged NEA. Van Velsen had been sidetracked, but was frequently asked for information and advice. The following shows how the ministry dealt with the NEA claims for Studylink under his successors.

In a mail of 14/12/09 Ron van der Meer, head of the section Finance of HE, asks Smit to account for 2009 and the estimates for 2010. He wants NEA to explain why Studylink causes cost increase instead of decrease.

Smit answers the same day. He gives no argumentation whatsoever. He says that NEA estimates that the costs in 2010 will be 800 k€. He wants this money to be marked as structural, and to make it part of the (structural) basic funding. He says there will be no savings, and that the 800 k€ is the sum of savings and extra costs.

On 19/1/10 Van der Meer replies that HE refuses to treat the costs for Studylink as structural. He wants to have the argumentation of NEA checked. Before long there will be a meeting of Van der Meer, Smit and the head of Studylink about costs and savings due to Studylink. After this meeting we may resume the discussion about structural costs.

In response to a request of Van der Meer, Van Velsen sent him a summary of the history of the IAG/NEA claims as given above. He advised:

- To ask NEA to remain monitoring and accounting for the costs until it has become clear that the work processes have stabilized;
- To remind NEA of the promise to account for the costs in 2009 in the same way as for the costs in 2008 (so that it provides some understanding).

The MA 2010 does not have appendices per policy department. The MA is sketchy, and rarely specifies. It mentions an item "Extra work Studylink", with the explanation: "Equal to forecast 2009".

¹⁹⁶ The mail ended with a paragraph about another financial claim of IAG. Namely a financial claim for the "helpdesk function". Van Velsen replied with a reference to a letter of IAG explicitly stating that there would not be costs for the taxpayer, and that there is no financial risk. The letter requested permission for the helpdesk function. Permission was granted under this condition. The claim will therefore not be honored. IAG did not refute Van Velsen's observation, but kept claiming nevertheless.

¹⁹⁷ It can be found in the directory Maintenance Studylink, under this date, 20091214.

Such a forecast was not known in HE, unless NEA meant the conclusion of the memorandum of 14/12/09. In March 2009 it had been agreed however that the realization 2008 would be used as forecast for 2009. Another forecast had never been discussed or accepted.

By the end of 2010 there still was no agreement between HE and NEA. Bhim Mahabier of the Finance department had begun with the preparations for the MA 2011, and needed clarity. On 20/10/10 he asked Smit and Van Velsen to provide it. Van Velsen forwarded the mail to his successor, Ber van Zanen.¹⁹⁸ Van Zanen reminded Smit on 2/11/10 of his (Smit's) promise to send a memorandum explaining matters. Van der Meer and Van Zanen had told Smit that they didn't understand what was happening at NEA. Referring to the request of Mahabier, Van Zanen asked Smit when he could expect the promised memorandum.

Smit replied the same day with a promise to discuss the question with financial people, and let Van Zanen subsequently know when to expect the answers. Having heard nothing for two weeks, Van Zanen sent Smit a reminder on 16/11/10. Smit replied by mail on 25/11/10.¹⁹⁹ Before Studylink, and towards the present author, Smit had always seemed to be polite, kind and forthcoming. This mail however was simply rude. It was hardly more than a string of assertions without explanation. Several of the assertions moreover were untrue. Costs had not been (acceptably) accounted for every year. Approval of an aggregated annual account does not imply approval of the separate accounts of all underlying activities. Even formally this isn't true, but practically it is complete nonsense.²⁰⁰ The mail made no effort to inform, explain or argue. HE simply had to believe that in 2010 the extra costs had grown to 1000 k€ (1 M€).²⁰¹ HE should stop arguing. The mail concluded that the decision making should be escalated to the DG's and SG as soon as possible.

On 30/11/10 Van Zanen replied by asking for the document with the formal agreement HE-IAG about the work of NEA for Studylink. Smit didn't send such a document, but sketched the history of Studylink as a project.²⁰² He said that the ministry had ordered IAG to cooperate. Costs for system development were to be paid from the regular budget for system development, and the costs for regular use of the new system (initially) via items to be monitored. In response to a question of Van Zanen Smit remarked that NEA would very much like to include the costs structurally in the basic funding, thereby ending the discussion.²⁰³

This didn't address the real problem, which was the explanation of a supposedly large net increase of the (structural) costs. In addition, it was clear that an unknown part of the present costs and those of recent years were incidental. Without substantially better information and explanation, present costs said nothing about future structural costs. It would be totally irresponsible for HE to transfer the present costs to the basic funding.

In the evaluation of discussions like this, one should keep in mind that they are part of the yearly cycle of the performance contract or management agreement. In other words, that there is the pressure of time, and that there may be a shortage of time and practical possibilities.

HE didn't know what to do. A month had gone by, quite a few mails had been exchanged, but Mahabier was none the wiser. Van Zanen told Mahabier that the costs of Studylink should be paid from the basic budget. Mahabier didn't agree, because there was no reliable forecast of the costs in the coming years. He wanted to include Studylink in a table under the heading: "Other work". Paul van

¹⁹⁸ Successor of Van Velsen as representative of HE for NEA. This job was possibly transferred for more than one reason, but an important one was ensuring a smooth transition. Van Velsen would leave the ministry 31/7/11. Van Velsen himself had taken the initiative for the timely transfer of his duties.

¹⁹⁹ The mail was addressed to Van Zanen and Mahabier.

²⁰⁰ Formally, acceptance of an annual account only means that the accounting is numerically correct, that no money has vanished. It doesn't mean that the money was spent well, effectively or efficiently.

²⁰¹ The mail implied that there were still incidental costs, and that a stationary state had not been reached.

²⁰² In a mail of 30/11/10.

²⁰³ From 2008 to 2010 the claims increased steadily. There is no end in sight, so it is highly improbable that agreement now will end the discussion. The more so since HE has shown to accept everything, if only after a lot of protesting.

Capelleveen, the acting head of Van Zanen's section, protested.²⁰⁴ Studylink does not introduce a new task, but another way of doing the same task. A task prescribed by law. Due to lack of information and explanation HE cannot judge whether the new way costs more or less. HE therefore sees Studylink as part of the activities which have to be paid out of the (unchanged) basic budget. If Mahabier saw things differently, DGNEA should be asked to send a mail to the ministry²⁰⁵ with the NEA point of view.

A few days later, 7/12/10, Van Capelleveen sent Smit a mail with the views discussed with Van Zanen. Including the suggestion to ask DGNEA to put the NEA viewpoint in writing. Smit answered the same day. Apart from a repetition of remarks from earlier mails, he showed by "logical reasoning" that Van Capelleveen's ideas lead to ridiculous conclusions:

«At the time the ministry ordered IAG to use Studylink in the application process. If we had been allowed to set priorities by ourselves, I don't know whether we would have chosen to get our data from Studylink.

In several reports we have explained that there are extra costs for NEA. In your opinion this seems to be insufficient, and that's why you conclude that you cannot determine whether there is more or less work. In 2008 the explanation has resulted in payment of the costs, and in 2009 in a claim which was approved by a chartered accountant.

From your reaction I infer:

- The claim for 2009 will not be paid;
- The costs in 2010 and following years will not be paid.

If this is the conclusion, not much can be done except asking DGNEA to send a letter to the SG explaining the problem. And are you saying that NEA is completely free to set its own priorities, and to determine its relation with Studylink?

Did I understand you correctly?»

Of course not. In a mail of less than an hour later, Van Capelleveen and Van Zanen gave further explanation:

«Independent of the choice for Studylink in 2008 and the corresponding incidental costs paid in 2008, it remains important for the MA 2011 to know how the savings and extra costs in the going concern [= basic budget] add up.

Maybe Studylink causes extra costs- although we find the amount mentioned by NEA quite implausible- but on the other hand there are cost developments in other areas around application and selection: savings and extra costs. The integral cost development and its causes have not been explained satisfactorily.

The request to increase the basic budget because of Studylink can only be answered after clarification of the integral picture. If this is done for 2011, it should by inference be possible to find out whether the costs for 2009 and 2010 are structural or incidental, and do or do not pay themselves back in other areas [...].

We would be grateful if we could comment on the draft letter of DGNEA about the entirety of savings and extra costs. After all, the requested clarity benefits everyone ministry-wide».

Smit mailed a thank you for this reaction.

The author has no information about the continuation of the discussion, only about its results as witnessed by MA 2011, dated 5/1/11.²⁰⁶ In a table on p. 57 one reads:

«To be covered: 800 k€.

Explanation: Other work ministry 2010 added to Basic Contract (not covered in budget estimates)».

This is explained (to some extent) on p. 58:

«3.4 Other work ministry

²⁰⁴ By a mail to Mahabier of 7/12/10.

²⁰⁵ This is formally incorrect, since NEA is part of the ministry. The mail could be addressed to the SG, or to HE's DGHPE.

²⁰⁶ The text of the Dutch original contains a lot of strange word sequences. An effort has been made to make the text a bit more understandable while keeping the style intact. Assuming of course that the present author understood the text sufficiently to be able to do this.

As from this management agreement the following Other work Ministry from 2010 is structurally added to the Basic contract. In 2010 they were still monitored, per 2011 NEA considers them sufficiently stable to be included in the Basic contract. [...] It concerns [list of items]. Per 2011 Studylink too is a structural part of scope Basic contract. Where it is understood that the costs for Studylink (800 k€) have to be paid additionally».

And confirmed on p. 64:

«The basic budget ministry is 170.4 M€. Of this budget, 162.6 M€ is covered by the budget estimates 2011²⁰⁷ [...] plus 7.8 M€ still to be covered [“found”]. The 7.8 M€ consists of several items which have to be covered incidentally or are not yet included in the long term budget estimates for NEA. This concerns:

[...]

0.8 M€ Studylink (HE) NEA wants structurally in Basic contract 2011, covered incidentally for 2011 and following. Studylink has been an item to be monitored. NEA refers to the PC’s of 2008 and 2009.

Because of their nature, these 7.8 M€ still to be covered Basic contract 2011 belong to the structural covering Basic contract».

It follows that NEA has succeeded in getting a structural budget increase of 0.8 M€ because of Studylink. For work which at least in part is temporary. And without providing an understandable account of what is done for this money.²⁰⁸

3.8. To conclude. The General Accounting Office evaluates the consequences of its ICT-reports.

This section consists of quotes from a report of the Dutch General Accounting Office and remarks about them.²⁰⁹ The report is entitled *How the government deals with ICT 2012- Lessons learned*. The report evaluates the effects of recommendations in earlier reports. The report was submitted to the chairman of the Tweede Kamer of Dutch Parliament by letter of 28/3/13.²¹⁰

«1. ABOUT THIS INQUIRY.

[...]

Partly in response to our inquiries of 2007 and 2008 the minister of Internal Affairs has announced measures for the development and execution of ICT projects. Such as the employment of various instruments for managing and accounting: the introduction of chief information officers (CIO’s), project portfolio management, ICT feasibility tests, a framework for weighing sourcing, business cases, the ICT dashboard, and Gateway Reviews. The present inquiry intends to give an overview of the way government organizations dealt with ICT in 2012. In particular we want to find out whether the lessons of our earlier inquiries have been used in the management of ICT projects

[...]

Framework of the inquiry.

The purpose of this inquiry is to contribute to an efficient approach to ICT by the government. The central question we want to answer is: “To what extent does the present approach of ICT by government organizations guarantee efficient ICT management in the government?”. In our effort to

²⁰⁷ Probably the budget estimates of the Dutch central government, the Rijksbegroting 2011. See p. 177 and following of the Begroting OCW 2011, Memorie van Toelichting, Kamerstuk 148632. The “162.6” (162,6 in Dutch notation) could not be found. It probably has another source, because this publication only uses rounded numbers. But 161 could not be found either. It didn’t seem worth while to investigate.

²⁰⁸ And the “chartered accountants” did indeed approve. This is relevant in connection with chapters 7 and 8, and should therefore be kept in mind.

²⁰⁹ The quotes are slightly abbreviated by dropping irrelevant words which hinder readability. The full original text is in the dossier. As always, omitted clauses and sentences are indicated by [...].

²¹⁰ The title of the report is “Aanpak van ICT door het Rijk 2012- Lessons learned”. It can be found in the directory of this chapter, under 20130328. The letter is printed on the first page of the report. The reports of the inquiries of 2007 and 2008 are included in the PPP directory, under 20071129 and 20080701.

find an answer to this question we will focus on the management of ICT projects».²¹¹

«2. CONCLUSIONS AND RECOMMENDATIONS

[...] For the management of these [ICT] projects several instruments are available. Although these instruments don't guarantee flawless progress of ICT projects, they can reduce the risk of failure, and help timely adjustments. We therefore evaluated how government organizations adapted and implemented some important management tools. This resulted in the following picture.

If we compare the present approach to ICT projects with the situation at the time of our inquiries of 2007 and 2008 we conclude that the government organizations have given an important impulse to efficient management of ICT projects. However, we conclude also that optimal management has not been realized by far».²¹²

«APPENDIX 2. METHODOLOGICAL JUSTIFICATION

[...] This appendix describes the method of inquiry.

[...]

Norms

Because of the “lessons learned” character of the inquiry, we apply the norm that organizations have learned from the lessons of earlier inquiries».²¹³

«Method of inquiry

To answer the questions of this inquiry, we began by studying the application of instruments for managing and accounting with the help of available documentation. For this purpose we also used reports of other inquiries, including reports from foreign sister organizations.

In addition to the study of the documentation, we held interviews with:

- the department of information policy government- chief information officer government;
- 11 ministerial CIO's/ CIO offices;
- 16 project managers of large or high risk projects;
- the head of the Gateway Office;
- IT auditors Audit Service Government.

For the interviews of project managers we focused on managers of large or risky projects which started after 1/1/09, because the instruments following from our inquiries of 2007 and 2008 may be applicable to these projects. We investigated which instruments were applied and how. Where possible we have performed this analysis for all the large and risky projects of the *Annual report management government 2011*.²¹⁴ Where this wasn't possible, the questions about the application of instruments were asked in the interviews. In this way an overview was obtained of the application of the instruments. Next the added value of the application of the instruments was evaluated, against the background of the lessons from ICT projects which we formulated in the past.

After verification of the findings we submitted the draft report of the inquiry to the minister for Housing and Government Organisation, for his administrative comment.²¹⁵ His comment and our reaction on it were assimilated in the report».²¹⁶

P. 62 of the report gives an idea of the kind of results obtained from the interviews:

«Our interviews with both the CIO's and the leaders of the large and risky projects show a preponderantly positive picture of the Gateway Reviews. [...] The CIO's mention some specific attributes of the instruments as most important explanation of their positive experiences:

- the employment of outsiders gives fresh insights, and their scrutiny has a relatively large

²¹¹ Aanpak van ICT door het Rijk 2012, p. 7.

²¹² Aanpak van ICT door het Rijk 2012, p. 10.

²¹³ Aanpak van ICT door het Rijk 2012, p. 67.

²¹⁴ Jaarrapportage Bedrijfsvoering Rijk 2011. (Not in the dossier).

²¹⁵ The formulation in the report, “bestuurlijk wederhoor”, is very vague, or even undefined.

²¹⁶ Aanpak van ICT door het Rijk 2012, p. 68.

- influence;
- the confidentiality of an instrument stimulates open and safe exchange of information and insights;
- a short application time yields quick results;
- a review team consisting of peers [...] means that situations are recognized, that much knowledge and expertise is available, and that the probability of acceptance is high;
- the fact that the Gateway reviews do not threaten personal interests contributes to a constructive and helpful atmosphere, in which people can learn from one another».

Remarks.

1. The inquiry was held in 2012. It investigates only larger and risky projects which started after 1/1/09.²¹⁷ Theoretically it might cover some of the projects described in this study. But it certainly doesn't cover all of them. However that may be, the question whether some of the projects studied above satisfied the selection criteria of the DGAO is practically meaningless. For it is obvious from the project descriptions in this and the previous chapter that the DGAO report doesn't give a reliable picture of the project management in government organizations. Even if the (comparative) conclusions would be formally correct, they mislead by hiding a much more relevant truth.^{218, 219}
2. Here as well as in the inquiry of integrity to be described in the following chapter, DGAO only looks at the application of instruments. DGAO asks whether an instrument has been applied, not whether there is a noticeable or measurable (positive) effect on the project results. The results of the application on projects are not studied.²²⁰
3. It is evident that the DGAO reports of 2007 and 2008 gave no positive "impulse" to the management of the projects of the ministry of education and its agencies. The reason is simple: the reports were completely or almost completely ignored.²²¹ Where the "almost" refers to the fact that as from a given date uSG got the additional title of CIO. It didn't change her ways in the least.²²²
4. Why didn't DGAO look for improvements in projects which started before 1/1/09? Since DGAO had studied them before it would have been relatively easy. Are these projects running better due to application of new instruments? Much money is spent on them, and they should perform important functions. So why ignore them?²²³
5. Was there anything new in what the CIO's told the Accounting Office about positive characteristics of Gateway reviews? Isn't what the CIO's do much more important than what they say? P. 63 of the report says that the project leaders assert that «[the recommendations of the Gateway](#)

²¹⁷ The definitions of "large" and "risky" should be checked, as well as the way projects were identified and selected. Did the DGAO select, or the government organization?

²¹⁸ In making this remark a generalization is made from the ministry of education and its agencies to government organizations in general. This is justified by the analyses in a later chapter. Put simply: the same (fundamental) mechanisms cannot but have the same (or very similar) effects in different places. The analyses uncover the mechanisms.

²¹⁹ Improvement need not result in something that is good or adequate. Something can still be insufficient after improvement. Lesson: especially when a politician or manager says that things have improved, ask whether they have sufficiently improved. And what reasons (s)he has for this opinion.

²²⁰ Note that both the "instruments" and their "application" are vague and elastic. "Elastic" meaning that application of an instrument may be effective, have no positive effect(s), have negative effect(s), or everything in between.

²²¹ Why should it be otherwise?

²²² In Dutch the saying is: A monkey may don a golden ring, it still remains an ugly thing.

²²³ DGAO seems to assume implicitly that for project managers to act professionally, it is sufficient for DGAO to tell them how that is to be done. DGAO seems to assume implicitly that its advice is followed up. Isn't this irresponsible nonsense?

[reviews are acted upon»](#). Shouldn't this be checked?²²⁴

6. The report says nothing about checks of what people told in the interviews. It doesn't discuss the interview as a method of acquiring information. It seems to assume that the people they interview speak the (complete relevant) truth. Even when it should know that they have an interest in giving a rosy picture. Moreover, people may not only lie and tell half truths, but make mistakes as well.
7. What is meant by "verification of the findings"?
8. In connection with other "inquiries", it is noted²²⁵ that only people high in the hierarchy were interviewed.
9. The DGAO does not explain how the central question of the inquiry can be answered by the method used. Furthermore, the conclusion of the DGAO gives no estimate of the extent to which the present approach guarantees efficient ICT management. It only says that the situation is better than it was, and that it is far from optimal. It doesn't say for example that the project management has improved sufficiently, or that it is still insufficient.²²⁶ Does it know or doesn't it? Wouldn't that be the most relevant thing to tell?
10. The report shows that the General Accounting Office is part of the problem.

²²⁴ And even if it were true, what does it mean?

²²⁵ By the present author.

²²⁶ Even though both assertions are (logically) compatible with what DGAO does say. Of course, the political formulations suggest that the project management is still very inadequate.

Chapter 4.

Integrity in the Dutch ministry of education, and government.

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6. Quotes from the Code of conduct of the ministry of education.
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8. Improving integrity in public administration: OPIPA and DGAO.

4.1. Summary and conclusions.

1. In the policy portal project, the SG was asked personally and explicitly to enforce the Code of conduct of the ministry. According to the Code «[Our conduct with respect to each other and the outside world should be open, service-oriented, respectful, impartial, and reliable. In a single word, honorable](#)». Initially the SG procrastinated by claiming a need for inquiries; later on by a combination of denial, pretexts, and a trumped up inquiry.¹
2. There were three formal inquiries of the PPP. The first was a defective quick scan. The second may have been better, but its report was kept secret. The third was an exercise in cunning and deceit.
3. Cunning and deceit by auditors supposed to respect not only the code of conduct of the ministry, but also their professional code. This was pointed out to the SG. He did nothing.
4. SG and uSG lie systematically.
5. The SG preaches integrity. He personally signed the Code of conduct. But he doesn't live up to it, and doesn't combat violations.
6. IFC, DGPS, DGHPE, SG and uSG are the opposite of “open, service-oriented, respectful, impartial, and reliable.”²
7. In combination with shows of indignation given by politicians when someone dares to cast doubt on their integrity, the code of conduct of the Dutch ministry of education can only be meant to give outsiders the idea that the integrity of the ministry is beyond doubt. In other words: it is intended to mislead.

¹ In this chapter, “Code” with a capital refers to the code of conduct of the ministry of education. SG means secretary-general, the highest officer in a ministry. He is only responsible to the minister, the political head(s) of the ministry. “uSG” stands for under secretary-general. In the ministry of education there was only one uSG.

² DG= director general. A director-general is responsible to the SG and/or uSG, and is head of a number of departments. For the other abbreviations see chapter 2. (The precise meaning does not really matter in the present chapter).

8. In the case Spijkers:
 - a. For over 20 (twenty) years Fred Spijkers was terrorized by government officials and accomplices for refusing to collaborate with structural deceit by the Dutch ministry of defense;
 - b. For most people in and around the Dutch government “Befehl ist Befehl” is decisively more important than integrity;³
 - c. Nobody has been punished for misconduct or crimes;
 - d. In spite of codes of conduct and the fact that many people who must have known of serious violations of codes and laws, nobody but Spijkers blew a whistle;
 - e. No member of the government or parliament judged the events sufficiently unacceptable to stubbornly request correction, or to refuse to cooperate any longer with colleague(s) who contributed to the violations, or condoned them;
 - f. Government and parliament have made documentary evidence inaccessible. So that none of their members and their accomplices can be prosecuted, and justice cannot be done.
9. The publications of the Office for the promotion of integrity in public administration (OPIPA)⁴ and of the General accounting Office (GAO) suggest that in the Dutch government integrity violations are marginal and unimportant, and that everything possible is being done to ensure integrity. They do not warn of a serious integrity problem.
10. Nothing in the publications of OPIPA and DGAO shows understanding (if knowledge) of the reality shown in the case reports of this study. There is no trace of an analysis of the case Spijkers. They ignore the alarming paper of Van der Vliet in the magazine Public Management about this case.
11. Neither OPIPA nor DGAO informs readers about the limitations of their publications and inquiries.
12. OPIPA and DGAO are part of the problem.

4.2. Introduction.

“Integrity” is one of the most important concepts in this report. The dictionary definitions are too vague for unambiguous and meaningful discussion of some of the main topics of this report. Therefore the chapter begins with a section about the definition of concepts related to integrity.

The following section describes efforts to get the SG to actively enforce observance of the code of conduct in the PPP. Next it is shown that in interviews SG and uSG try to paint a picture of themselves that is incompatible with their actual conduct.

In the preceding chapters, the sequence of examples of misconduct is never broken by effective proper conduct. The facts presented seem to be incompatible with a large majority of other information. It is quite understandable that this filled the reader with doubt or disbelief. Let the reader therefore keep in mind that facts remain facts. And that words can be chosen and spoken arbitrarily. The air is patient. Furthermore, the last chapter of this report will show that there are good explanations for the scarcity of reliable information and the erroneous rosy picture of the management of public administration. But for the moment it should suffice to give an example of a case which, possibly even more than the cases of the chapters 2 and 3, shows that very many people actively and passively contributed to extremely gross misconduct, and that in over twenty years there were no effective exceptions. (And that there is no happy ending). Even on its own, this single case, named after its unheroic hero, Fred Spijkers, is logically speaking sufficient to disprove all theories about the adequacy of our present government and law systems. It is a case moreover which is not explained by

³ “Befehl ist Befehl” is German for: “an order is an order [and has to be obeyed irrespective of your personal opinion or conscience]”. It was the answer many nazi’s gave when asked why they committed war crimes.

⁴ In Dutch: Bureau Integriteitsbevordering Openbare Sector (BIOS).

any of the theories taught at present day universities.

The final section of this chapter describes pretended efforts by Dutch government agencies to improve the integrity of public administration. None of them takes account of the reality of the well-known whistleblower cases and the financial crises, let alone the internal functioning of organizations. They talk about a purely imaginary world.

This chapter was mostly written directly after the chapter on the PPP, or shortly before that chapter was completed. After rereading it after completion, there seemed to be no good reason for substantial change.⁵

4.3. Defining "integrity".

Before giving a less ambiguous definition, which is furthermore adapted to the context of this book, we quote some definitions from the literature.

The Merriam-Webster dictionary gives the following definition:⁶

«**Integrity** [...] Firm adherence to a code of esp. moral or artistic values: incorruptibility».

This only means something if you know the code, and/or meaning of “incorruptibility”. Merriam-Webster gives a very broad definition of “corrupt”, including “characterized by improper conduct”, making integrity a rather stringent norm.

Similar definitions can be found in almost all dictionaries.

ISSAI 30, chapter 2, of the International Standards of Supreme Audit Institutions (ISSAI) of the International Organization of Supreme Audit Institutions (INTOSAI) gives the following description:

«Chapter 2. Integrity.

12. Integrity is the core value of a Code of Ethics. Auditors have a duty to adhere to high standards of behavior (e.g. honesty and candidness) in the course of their work and in their relationships with the staff of audited entities. In order to sustain public confidence, the conduct of auditors should be above suspicion and reproach.
13. Integrity can be measured in terms of what is right and just. Integrity requires auditors to observe both the form and the spirit of auditing and ethical standards. Integrity also requires auditors to observe the principles of independence and objectivity, maintain irreproachable standards of professional conduct, make decisions with the public interest in mind, and apply absolute honesty in carrying out their work and in handling the resources of the SAI.»

The English language Wikipedia page “Integrity” begins as follows:

«Integrity is a concept of consistency of actions, values, methods, measures, principles, expectations, and outcomes.

Barbara Killinger offers a traditional definition:

Integrity is a personal choice, an uncompromising and predictably consistent commitment to honor moral, ethical, spiritual and artistic values and principles.

In ethics, integrity is regarded [by whom?] as the honesty and truthfulness or accuracy of one's actions. Integrity can stand in opposition to hypocrisy, in that judging with the standards of integrity involves regarding internal consistency as a virtue, and suggests that parties holding within themselves apparently conflicting values should account for the discrepancy or alter their beliefs.

The word "integrity" stems from the Latin adjective *integer* (whole, complete). In this context, integrity is the inner sense of "wholeness" deriving from qualities such as honesty and consistency of character. As such, one may judge that others "have integrity" to the extent that they act according to the values, beliefs and principles they claim to hold.

⁵ Many important conclusions can be drawn without knowing everything.

⁶ For this study use is made of the edition which is part of the Encyclopaedia Britannica 2002 for computers.

A value system's abstraction depth and range of applicable interaction may also function as significant factors in identifying integrity due to their congruence or lack of congruence with observation. A value system may evolve over time while retaining integrity if those who espouse the values account for and resolve inconsistencies.»⁷

This is followed by ill defined text, which is hardly or not substantiated. It seems to suggest that integrity is no more than consistency. Nothing is said about the relation between this definition and the dictionary and/or INTOSAI definition. Obviously, the last group agrees with common parlance, while the consistency definition misses essential characteristics.⁸

The definition which is used in the present report agrees with the dictionary and INTOSAI definitions, but is more explicit. It is furthermore adapted for use in the context of this book. It leaves less room for ambiguity and cheating. The concept is defined by its constituents. Some of them are not independent but related and overlapping. For clarity this redundancy has not been eliminated.

Definition. Integrity is a characteristic of behavior which is relevant to others; relevant in their opinion. The others may be addressees, people whom one is supposed to represent, the public, taxpayers, and so on. By definition, integrity requires that one:

- Is truthful;
- Is open: informs timely, fully and correctly about everything that may be relevant to others, in their opinion. The “others” include the people to whom one is accountable;
- Is aware of one’s knowledge and abilities (has sufficient self-knowledge);
- Is consistent;
- Has no false pretensions;
- Acts in accordance with applicable knowledge, know-how, norms and values;
- Acts in accordance with applicable codes (in so far as compatible with those listed here);
- Does not accept a job which requires false pretensions. That is: which requires more knowledge or abilities than one actually has. And about the execution of which one will not be able to account in an acceptable way;
- Executes a job properly. In accordance with the job description and purpose, and appropriate norms (and which are accountable)⁹. So “properly” does not mean: “as usual”, or “as good as possible”;
- Keeps promises, agreements and so on. Makes only promises one has reason to believe one can fulfill. Where applicable draws attention to risks;
- Doesn’t pretend that a job is executed properly if it isn’t;
- Isn’t bribable;
- Acknowledges errors and mistakes;
- Only deviates from any of these norms after permission has been granted beforehand in accordance with these norms by all people concerned.¹⁰

The underlying Dutch study uses the (Dutch) adjective “integer” for behavior and persons: an “integer persoon”. There seems to be no perfect (“1-1”) translation for this adjective. Because of the following descriptions of related terms in the Merriam-Webster the next best translation seems to be “honorable”.

«upright
[...]

⁷ Wikipedia 29/11/13.

⁸ At least seems to, or explicitly. For on the basis of the paper *Communication and norms* (to be found as pdf-file on the internet), it can be shown that the definitions are identical if the language agreement is assumed. But this is probably not what the author(s) of the wiki page mean or understand.

⁹ Or in agreement with the dictionary definition of integrity. Covering up may be a norm, but isn’t accountable towards those who pay, and not in agreement with the dictionary definition of integrity.

¹⁰ All: not only a majority.

syn upright, honest, just, conscientious, scrupulous, honorable mean having or showing a strict regard for what is morally right. upright implies a strict adherence to moral principles <a stern and *upright* minister>. honest stresses adherence to such virtues as truthfulness, candor, fairness <known for being *honest* in business dealings>. just stresses conscious choice and regular practice of what is right or equitable <workers given *just* compensation>. conscientious and scrupulous imply an active moral sense governing all one's actions and painstaking efforts to follow one's conscience <*conscientious* in the completion of her assignments> <*scrupulous* in carrying out the terms of the will>. Honorable suggests a firm holding to codes of right behavior and the guidance of a high sense of honor and duty <a difficult but *honorable* decision>.

In this report, an honorable decision is defined as a decision in accordance with the requirements of integrity enumerated above.

4.4. Codes and integrity management put to the test: the three audits of the policy portal project.

Most of this section has already been told in the chapter on the policy portal project. It is included in this chapter for clarity and convenience, and to make the present chapter more self-contained. But if you have read the chapter on the policy portal project and still have it in mind, you can skip the present section without missing much.

2007, autumn. An appeal to the SG. The first audit.

In the autumn of 2007¹¹ Van Velsen called on the SG, and informed him about the course of the PPP. In particular about the way IFC reported about the project. Van Velsen pointed out that the behavior of IFC in this project was incompatible with the Code of conduct of the ministry. He said that his colleagues and he himself wanted to be treated decently. As required by the Code. He explicitly requested the SG to enforce the Code.

He had taken the project plan and a recent progress report with him, to show and convince the SG.¹² The plan gave a timetable. It showed that the PP should have been ready in April. The progress report nevertheless says that the project is proceeding according to plan. There were more untruths. Van Velsen gave the SG his report of the project.¹³ He told the SG that he had contacted an integrity officer. For the time being only to get informed and advised. He said that he would prefer self correction of the ministry to correction by external agencies.

The SG wanted to know if other people involved in the project could confirm this report. He wanted to talk with them as well. So about a month later the SG was visited by Endert and Van Velsen. Endert confirmed the report of Van Velsen. Whereupon the SG decided to ask the audit department to do a "quick scan" inquiry (audit).

On 13/12/07 the SG asked Endert and Van Velsen to drop by. The SG had just received the report of the quick scan.¹⁴ The report diagnosed a crisis of trust. HE didn't trust IFC. The report advised to work on restoration of trust. It didn't say how. The report didn't note that HE and the other education departments had good reason to distrust IFC. The report suggested that the main problem was that IFC and the education departments had different expectations. The report contained inconsistencies. The facts which it presented showed that IFC had informed the ministry incorrectly, also as regards essentials. The auditors concluded that further inquiry made no sense, and that no special measures were needed. The SG said that he was afraid that a more comprehensive inquiry would strain relations with IFC even more. He proposed to talk with uSG and the head of IFC about restoration of trust. He asked Endert and Van Velsen to think about the report and his proposal.

¹¹ To be precise: 11/10/07.

¹² This could and should have been sufficient proof and reason for action. But the SG didn't react at all to these documents; he ignored them.

¹³ That is: the first version of the first part of chapter 2, ending with the summer of 2007.

¹⁴ The report, of 3 pages, including a summary, is in the PPP-directory, under 20071204.

In a memorandum of 20/12/07 Endert and Van Velsen argued that the quick scan was inadequate. They asked the SG for a better one. They submitted questions which a further inquiry should try to answer. The SG said he agreed with them, and ordered a second audit.

2008, spring. The second audit.

Endert and Van Velsen never saw the report of the second audit.¹⁵ The SG only read out some of the paragraphs he said were the most important. They confirmed the assertions of Endert and Van Velsen. Except that the auditor thought that there was no malicious intent. Endert and Van Velsen disagreed. In their opinion it was impossible to explain the facts without the assumption of malicious intent.

The only time the SG said something positive about the efforts of Endert and Van Velsen with respect to the PPP was at the end of his reading from this audit report. The auditor concluded that there had indeed been misconduct, and that those who had reported it deserved appreciation. Looking up from the text, the SG said: “whereof notice is taken”.

He took no (observable) action. Nor did the uSG.

2008, autumn. The third audit and its consequences.

In a mail of March 2008 the heads of the education departments told uSG that notwithstanding great efforts nothing useful had come out of the PPP, and that the result could not be accepted. The mail explained why the departments didn't trust the technical and communication abilities of IFC anymore. The heads requested permission to look outside the ministry and its agencies for a company which was better equipped to make the desired product.

The mail caused many meetings on the level of heads of department and higher. They induced uSG to order a new audit. In one of the meetings she promised to formulate the instruction for the auditors in agreement with the education departments. She and/or DG Kerstens nevertheless kept only the letter of this promise, and gave the education departments almost zero time to read and comment the draft instruction before it was finalized. Fast action by the departments reduced the damage. Van Velsen informed the SG of the underhand procedure, which according to him (Van Velsen) was incompatible with the Code of conduct of the ministry. The SG denied this.

The report of the third audit was distributed on 24/11/08. The report asserts that IFC was able and willing to build policy portals. The report was neither impartial nor independent. It shows that auditors of the ministry don't work in agreement with their professional and integrity norms. It gives a far too rosy picture of the project and its results. In several cases it is untruthful. It does not acknowledge any serious error. As a consequence, it gives no recommendations which would help to avoid repetition. It doesn't want to look at the past, but only to the future. In other words: it doesn't want to learn from errors.

It had been agreed that the remainder of the budget for the PPP would be paid to IFC after acceptance of the result. In the mail of March 2008 the heads of the education departments had told uSG that the result wasn't acceptable. Their position hadn't changed. In the last days of 2008 uSG nevertheless ordered payment of the remainder.

uSG never spoke with the representatives of the education departments for the PPP.¹⁶ She never explained to them what she did and did not do with respect to the PPP. There is no evidence suggesting that she ever looked at the PP which she ordered to be built. She did however order the education departments to appoint other representatives, a “new team”, for the replacement projects.

¹⁵ Nor the specified request (order) by the way: the matters to be investigated, questions to be answered. No explanation was given for keeping the report secret.

¹⁶ Except of course the present author. But they never discussed the project as a project, only specific management aspects.

In December Van Velsen told the SG by mail that the report of the 3rd audit shows that the integrity problem of the ministry is much deeper and wider than he thought a year ago.¹⁷ He offered to formulate proposals for improvement. SG didn't reply. Because Van Velsen wanted to know what one can expect of this SG he explicitly requested a meeting. Because of the seriousness of the subject he wanted to be accompanied by his integrity officer. An appointment was only made after a reminder. The meeting took place on 9/6/09. According to the SG there was either no integrity problem, or it was solved by the merger (of IFC and IAG) and the reorganization. Things went well, and would go better. Van Velsen concluded that an open and meaningful discussion with this SG is impossible, and that this SG will not do anything to maintain the Code of conduct. That for this SG the code is no more than an instrument to mislead.

2009. Round up.

In the first months of 2009 there was an unstructured and intransparant discussion about the continuation of the PPP. There were no meetings with the education departments about this subject. The result was that two new projects were to be started: an project datawarehouse ("Getting production in order"?), and a project policy information. The most important observation is that the documents can only be understood if it is assumed that the PPP had produced nothing useful.

In other words: the facts clearly show that the education departments were right in concluding that IFC doesn't have the technical an communication abilities necessary for a project like the PPP. The facts show that SG, uSG and DGPS have done whatever they could to keep the failure hidden, up to and including ordering the audit department to violate the applicable codes. Nevertheless, by approving the replacement projects they implicitly acknowledged failure.

The delegated commissioner for the PPP, DGPS Rob Kerstens, did almost nothing with the signals about problems in the project, and about the incorrect progress reports. He did nothing effective at all.¹⁸ In other words: his incompetence as manager has been proven. The SG knew the facts. He nevertheless made Kerstens DGNEA, head of an organization of about 600 employees.

Director and deputy head of IFC Steven van Spijker and contract manager Frank van Loon of IFC were responsible for the IFC projects and the reporting about these projects. In several meetings where decisions were to be made about these projects they gave influential incorrect information. The first of these two men kept his high function, the second was promoted contract manager NEA.

SG and uSG have been shown unambiguous proof of integrity violations of IFC, and of structural incompetence regarding many essential aspects of project management. It is evident that they had much to explain. They never did. What they did was show that employees who report problems are sidetracked, and that denial of problems and help in covering up failure results in promotion.

The chapters 2 and 3 on the PPP and project and agency management have shown the extent of the integrity problem. As far as IFC projects are concerned it is nearly all-embracing. The failed appeal to the SG to enforce his Code of conduct has shown that the problem includes the audit department. It obviously includes the managements of the ministry and IFC. The section about the costs of Studylink in chapter 3 furthermore shows that at least the contract manager of IAG is guilty of unacceptable integrity violations. But also that the integrity problem of IAG cannot be limited to him. (Which will be confirmed in the next chapter).

In most cases the management ignores its own and professional norms for project management. There are no sound project proposals. The progress reports are not open and reliable, and practically useless for management purposes. Signals about problems from people close to the project are belittled or ignored. Messengers are misled or sidetracked. No corrective action is taken. On the contrary: new money is made available for more of the same. The management is characterized by lack of openness, transparency, reliability and mutual respect. Because their pious words are broadcast widely and most (mis)deeds are hidden, many employees are misled. Some collaborate. A few remain critical. Almost nobody can or does fight the corruption.

¹⁷ The mail is in the directory Integrity under 20081211.

¹⁸ As noted, not even the cover up was effective.

4.5. Words of SG and uSG.

The behavior of SG and uSG shown in the preceding chapters and section is incompatible with the Code of conduct signed by the SG himself, and with many of their public utterances. It is incompatible with the image they try to paint of themselves in interviews. The interviews do however show that they perfectly well know what is expected of them. In the interviews they implicitly acknowledge that the difference between words and deeds is important.

The following are examples of utterances of respectively SG and uSG which suggest a state of affairs which is almost the opposite of the reality shown in this report.

Words of the SG.

Don't obstruct good behavior.

In the section *Saying "yes" while doing "no"* of the article "Don't obstruct good behavior" (!) of the December 2003 issue of the magazine "Punt" of the ministry, the SG is heard to say:

«The cynicism about the changes [in the ministry], finally, is the most painful point that struck me. "Chaos in the ministry of education" was the heading of the Volkskrant Thursday last week.¹⁹ These are not my words, but they must come from somewhere. It [= the cynicism] should be eradicated by recognizing that things don't go well. One should diagnose well. And denial of the displeasure is very wrong». ^{20, 21}

Seven years after the quoted article, the Volkskrant could have run a story based on the chapters 2 and 3, and concluded that in such a environment cynicism is inevitable, and that SG Koos van der Steenhoven is its principal cause.

The following are examples of contradictions between the quote from Punt and the reality shown in the chapters 2 and 3 and above:

- Good behavior²² is definitely obstructed. In the first place by structurally ignoring prescriptions of de Code such as openness and mutual respect. And also for example by sidetracking people and formation of a "new team" (without any or without adequate explanation), and by promoting people who misbehave and fail systematically;
- Failure is admitted only in highly exceptional cases.²³ As a rule, errors and failures are covered up (contrary to the requirement of openness);
- Open diagnosis is obstructed, when "necessary" by pressuring auditors, and allowing or requiring them to ignore their (professional) codes of conduct;
- Justified displeasure is denied;
- Cynicism is not eradicated but created or enhanced.

uSG Simone Roos: honorable and transparent.

In his weblog of 13/7/09 the SG wrote:

«Simone Roos

After years of hard work for our ministry Simone Roos got another job. She applied for membership of the Council for the Administration of Justice, and was chosen. I can very well imagine that they chose her. Simone is a modern, ambitious civil servant, who knows how to tackle things. A

¹⁹ The Volkskrant is one of a group of approximately 5 Dutch newspapers with the most subscribers.

²⁰ The article is in the dossier under 20031200.

²¹ Perhaps the SG will object that this is not meant generally. But general formulations can be misleading. If the beautiful phrases are not meant to apply generally, the SG should explain when denial of facts is required, and when problems should not be diagnosed properly. Of course he will never do that.

²² Good behavior= behavior in accordance with the norms of the Code of conduct and the general regulation for civil servants ("ARAR").

²³ No significant example is known to the author.

role model, one might say. She combines the typical properties of a perfect leader: clear about the goals for everybody, good in giving compliments to people who deserve them, and in settling unwanted situations and behavior. Honorable and transparent. And I might continue like this for quite a while. It is difficult to choose a good successor for her»²⁴.

This isn't only quoted because of the untruths. The quote also shows that dishonorable and incompetent functioning is rewarded. And that the SG has no scruples about someone like that occupying an influential function in the top of the Administration of Justice.

The defense that at farewell parties one should only say nice complimentary things is irresponsible, and incompatible with the Code of conduct. But even when it is admitted that on such occasions there is only place for niceties, there is still no need for lying. After all, almost everybody has some positive qualities. In other words: it is almost always possible to say nice things without violating the truth.²⁵ And if not, then one can better keep one's mouth shut and say nothing.

Note by the way that SG and uSG said nothing or nothing positive in quite a few situations where that would have been no more than natural and good management.

Don't be afraid that it will be held against you.

Chapter 2 gave the following quotes from weblogs of the SG from January and February 2006:

22/1/06: «This meeting will lead to an even better working IFC, even though this would seem hardly possible if you know how much they already did in the recent past.»²⁶

12/2/06: «Sometimes the quality of services rendered by our colleagues in Zoetermeer is perceived differently by colleagues in The Hague. In my weblog of 22/1/06 I was rather positive about them, but that was not received with thanks by everybody. Some people commented very critically about IFC. On the one hand this is regrettable, but on the other hand it informs me of facts which would remain hidden otherwise. So, if something goes wrong, let me know! Don't keep it to yourself, don't deny the problem. Speak up, then something can be done about it. Don't be afraid that it will be held against you, for that's not how we work in this ministry.»²⁷

These quotes can be seen as an example of integrity and professionalism as communicating vessels. It was unprofessional to trust an interested party at its word, without any check. In the time between these two weblogs the SG had been shown (not only told) that IFC (at least) sometimes misbehaves and fails. But in the weblog of February the SG acknowledges no mistake by himself (rash judgment), nor any failings of IFC. He doesn't even admit of the possibility of such failings. Without undue insult, he could have said that even IFC isn't perfect and sometimes makes mistakes. He didn't.²⁸

Of course, it has been clearly proven in the preceding chapters that criticism is held against the messenger. The fear and silence of the overwhelming majority of the employees is only too justified.

In principle a civil servant should serve every political leadership.

The following paragraphs from the weblog of 25/5/09 consider the question whether requests (interests?) of members of the government are more important than integrity:

«The present discussion about the PVV and civil servants is an interesting one.²⁹ There are civil servants who have publicly declared already that they don't want to serve under a PVV minister. Commentaries immediately connect this with the Second World War. You know: Queen Wilhelmina and her government moved to London, and ordered the SG's to stay and keep doing their job. Some SG's have been reproached for this.³⁰

In the meantime minister Ter Horst has given a correct answer to the question from parliament what she thinks of civil servants who don't want to stay if the PVV becomes part of the government.

²⁴ Weblog 232 of 13/7/09.

²⁵ At least if half truths are counted as truth (which I don't).

²⁶ In the file with the weblogs, search for "22-01" or "week vol met hei".

²⁷ In the file with the weblogs, search for "12-02" or "heisessie".

²⁸ Not in talks with Van Velsen either.

²⁹ The PVV is a right wing political party.

³⁰ The Dutch text (too) is not as clear as it could have been. The SG seems to avoid unambiguity.

Namely that a civil servant should in principle serve, and be able to serve, every political leadership. The Dutch civil servant is by definition loyal to the political leadership, irrespective of its color.

Another situation arises when the civil servant is asked to do things contrary to the law. In such a situation a civil servant can refuse to do what was ordered.³¹

I agree with the argument. You do your job, until you are confronted with a situation which isn't lawful. Then you run amok,³² and that could mean leaving your job of civil servant.³³

The SG doesn't seem to know that even the most criminal governments have laws, and that lawful cannot be equated with "acceptable" or "good". He doesn't seem to realize that national laws can be incompatible with international laws, and that neither requires integrity. He doesn't even mention human rights. Very strange is the opinion that a civil servant should resign if his organization (systematically?) violates the law. Shouldn't there be legal instruments enabling a civil servant to take effective action against such violations?

Both Ter Horst and Van der Steenhoven seem to assume integrity of every political leadership, or create ambiguity about the relative importance of integrity. They ignore the problem of survival "as good as possible" under a repressive government.

The opinions in the quote, together with their vagueness and (implicit) contradictions, are consistent with the events described in the preceding chapters. These events would be unthinkable if the SG were able to reason consistently about integrity, if he really believed what is written in the Code of conduct, and if the wanted to live and work in accordance with it.

Erwin has to do what was agreed.

Erwin is a pupil who is coached by the SG. In his weblog of 11/4/10 the SG writes the following:

«Erwin has a new schedule, which he didn't send me. I'm making a point of that. After all, agreements should be kept. He was scared. In the future he will do what was agreed.»

So the SG knows very well what is proper, and what he has to say to get a positive appreciation from his audience.

Words of the uSG.

As regards uSG Simone Roos, the chapters 2 and 3 and the preceding sections show that her words have no connection with the practical reality of the ministry.³⁴ In particular with respect to integrity and project management. The interpretation which is most favorable for her is that she thinks she is a God. Who only has to speak to change reality, automatically and faithfully. She doesn't supervise implementation, and seems not to know what happens in the ministry (and its agencies). As a member of the Council for the Administration of Justice she has a very important social position. To better understand such people and their selection, it may be useful to compare her behavior as shown in the preceding chapters with what she tells about herself in interviews.

I like things to run well.

The September 2009 issue of the magazine PM ("for decision makers in public administration") has an article "The move of... Simone Roos to the Council for the Administration of Justice".³⁵ With the main title, in fat capitals: "Not afraid of new things". The article suggests that she could react to a number of questioning remarks, or keywords. In reaction to "Lies awake from" she wrote:

«I'm happy not to be of the worrying kind, and mostly sleep like a log, but may lie awake if important things don't go as I want. If I don't feel in control, in balance. That can be personal or work related. I'm a quite a perfectionist, and like things to run well».

In reaction to "Headache dossier":

³¹ If the law permits refusal!

³² This wouldn't make much sense, and one wonders whether the SG knows what this means.

³³ This is weblog 225. Search for "25 mei" or "Participatieportaal".

³⁴ Unless hiding and covering up are seen as a connection.

³⁵ In the directory Integrity, under 20090911.

«As uSG I was in charge of the digitizing project Edoc, which was aimed at the transition from paper to digital. Everybody, at all levels of the organization, has to take part. Technically the project is almost completed, ready to be rolled out, but it is terribly difficult because you have to change the behavior and culture of your people. It needs a lot of cooperation, but many people just don't like change, and don't see the use of it. The vulnerability of the project is its width. It is very difficult to get the whole organization so far, while at the same time this is connected with a big risk of failure».

Edoc digitizes little. The system should integrate things which had already been digitized, digitize procedures for signing formal documents, and decentralize the official archive. When Roos left, a third project leader had just been appointed. After a failed pilot a restart would be made with a new ordering structure. Edoc was far from ready to be rolled out, at least with a reasonable chance of success. What Roos means with “technical” isn’t clear. But in the beginning of 2010 many important adaptations of the generic software to the ministerial environment remained to be made. Note that Roos doesn’t explain why Edoc hasn’t been rolled out yet. She claims that a change in the behavior and culture is necessary. She doesn’t add that she has done absolutely nothing to realize that change, or to convince her people of the use of Edoc, and the improvements it would bring (if any...³⁶). In the project Edoc she was just as absent and uninterested as in the PPP and other projects mentioned earlier.

In the introduction to the interview the editors of the magazine wrote the following about Roos’ career:

«During her law study in Amsterdam she acquired a juridical-management-scientific background, got acquainted with the practice of the world of management at the Association of Dutch Municipalities (ADM)³⁷, and learned management in public administration. In addition her experience as a project director of the change program “Apollo” in the ministry of education will come in handy. Roos: “Much has changed in the ministry in the past eight years, and in the administration too there will be change. The revision of the judicial map is a far reaching operation. It requires people acquainted with change management”».^{38, 39}

Someone sincere, open and honest.

This is not the only instance where uSG suggests to be an experienced and competent change manager. In her farewell interview in the Punt of September 2009 she is quoted as having said:

«Besides these experiences at ADM my management experience in public administration comes in very handy. The more so since the Council asked for a lot of “change experience”, because the administration of justice is on the eve of substantial changes, such as a revision of the judicial map of the Netherlands».

After having read that she finds it “terribly difficult” to change people’s behavior and culture the following paragraph may surprise:

«What I’m very proud of, is the speed with which we succeeded to order the organization of the ministry. [...] The organization actually improved in no time, as confirmed by the audit service and the [D]GAO».

Didn’t this require a change of behavior and culture?⁴⁰ It seems clear anyway that Roos wants the reader to believe that the organization of the ministry is in order.⁴¹ And that we should be grateful to her for accomplishing that.

A little later in the interview we read:

³⁶ Nobody was sure. Some people thought Edoc was only meant to support budget cuts on archiving. Lots of people had already been fired, and more were to follow. Of course, due to “unforeseen” difficulties and many extra costs in the project this may have been, or probably was, a result of gross miscalculation.

³⁷ ADM in Dutch: Vereniging van Nederlandse Gemeenten (VNG).

³⁸ The present author was involved in part of the Edoc project. But at the time he couldn’t spend much time on it. As a consequence he cannot give a meaningful description and evaluation. It certainly is an interesting case, even though “added value” for the present report may be limited or absent.

³⁹ Note that the quote, and the interview-article as a whole, are examples of irresponsible and misleading journalism. Clearly no serious checks have been made.

⁴⁰ Probably little or nothing, for the project was mainly fake, empty words. There wasn’t much ordering to do actually.

⁴¹ Though it isn’t clear what she means by “the organization of the ministry”.

«How do you want your staff to remember your leadership? “I hope that they think of me as someone sincere, open and honest, human, but also as somebody who wants you to keep your promises. The biggest compliment they could make me is to find me trustworthy. This at least is what I tried to offer. And that is different from being thought of as always kind. For the other people in the ministry, the people I didn’t manage, I hope to have been someone who knew how to achieve things forcefully”».

Trustworthy and forceful! You may not believe your eyes, but this is really what she is supposed to have said.

In short: what Roos says is almost the opposite of what she did. She is an example of extreme deceit or self-deception. The last corresponding with a complete lack of self-knowledge and self-criticism. And like the SG: she knows very well what is expected of her.

Remark and two observations.

One has to conclude that SG and uSG are first of all play-actors who employ words (and power) to keep up appearances. Maybe their cheating is meant to serve a higher purpose which is never publicly accounted for. But the cheating may just as well be a consequence of specific mental abnormalities. Regrettably psychology offers neither insight nor explanation. But whatever the explanation, it doesn't make SG and uSG suitable for their functions. Neither does it relieve them from responsibility and liability for the damage they caused.

The facts presented give rise to the question how these people have been evaluated when they were selected. Have their words been trusted blindly? Or have they been selected expressly because of their ability to act and lie unnoticeably (“perfectly”)?

Some other aspects of integrity become visible through the following comment by Richard Pauwels on reactions to weblogs of the SG:⁴²

«Private life in Weblogs of the SG

For once I would like to let you hear something positive about the Weblogs of the Secretary-General. Besides typical work related matters he also discusses events in his private life. He mixes them into an amusing and informative Weblog with information which is really useful for us as staff members. In a short text he gives much important information which we normally get in long letters only, or not at all. He furthermore has an eye for life outside the ministry: the events at home. He only does this marginally and in a concise and meaningful way. For just like him the average employee of the ministry too has this kind of experiences.

In this way he shows that nothing human is alien to him, and that he is one of us, and imagines himself in our position with respect to for example the reorganization and staff reduction. We're in luck with our top manager. Which is positive!

Why then always these poor spirited reactions to his Weblogs by people who seem to have gotten out of bed on the wrong side? Be positive! Where is the real ministry-of-education-spirit!»⁴³

The text suggest a continuous stream of negative reactions on the weblogs. Regrettably it doesn't give examples. The present author has seen critical reactions only very rarely. He doesn't understand what Pauwels refers to.⁴⁴ In any case there never was a real discussion between the SG and someone who had reacted critically. Perhaps Pauwels considers everything poor spirited or negative if it isn't downright laudatory.

The “one of us” and the “real ministry-of-education-spirit” suppose a group spirit and uniformity which don't exist in the reality of the ministry.

Pauwels works on the same floor (of 15 floors) as the three members of the government responsible

⁴² The reaction is of Wednesday 28 April 2010, 08:47.

⁴³ You may think too much attention is paid to this almost ridiculous bootlicker. But don't forget that this person has a relatively important position in the ministry. And more important: understanding people who form and maintain the given system is one of the most important goals of the present report (study). It isn't sufficient to know the top. It is just as important to understand why they are supported and (more than) obeyed.

⁴⁴ Of course, this excepts the reaction of Van Velsen of January 2006, quoted in the chapter on the PPP.

for education,⁴⁵ the SG, uSG and DG's. He works in the department which supports these people.

In more than 25 years at the ministry the present author has met very few or no people who would write a text such as that of Pauwels. But there are two things the author finds even more amazing than such a text. Namely the ability of his superiors to select someone like Pauwels, and the fact that they want such a mindless bootlicker as an assistant.

To complicate the puzzle some more, I quote Gérard Maas, an integrity officer of the same ministry:

«I think that it is positive that we have relatively few reports of integrity violations. Of course this may be a consequence of the fact that this ministry is not directly involved in major streams of money, and therefore less tempted to slips or missteps. But I think the most important reason is that we have a decent organization, where colleagues with strict norms are willing to address one another on the integrity of their behavior».⁴⁶

This is written under the heading “Transparency is the basis”.

Direct involvement is ill defined. The logical necessity is not particularly clear.⁴⁷ The budget of the ministry of education is the third largest of the Dutch ministries: in 2009 it spent over 30,000 M€.⁴⁸ In other words: Maas' argument doesn't show that the temptation is relatively weak. But Maas may believe it. And maybe he doesn't see, or misinterprets what he sees. Or all of this.

4.6. Quotes from the Code of conduct of the ministry.

The Code of conduct of the ministry of education was introduced in 2005, when Van der Steenhoven was SG.⁴⁹ His signature is under the foreword. The first sentence of the foreword is the following:

«Our conduct with respect to each other and the outside world should be open, service-oriented, respectful, impartial, and reliable. In a single word, honorable».

The following is from pp. 4 and 5:

«The code applies to everyone working in the ministry of education. [...] The managers have a specific role. Their conduct should be exemplary. They should be aware of this, and be open towards their subordinates about their conduct in certain situations.

[...]

Rules of thumb are:

- Act in the spirit of this code when the occasion arises;
- Don't do anything you wouldn't dare tell your superior, colleagues or in public;
- Be open about dilemma's. Discuss them with your manager or colleagues. If you don't want to discuss certain situations with your manager or colleagues, you can go to an integrity officer».

The following is from pp. 7 and 8:

«The management team of the ministry finds the following central values of the utmost importance. They show how the ministry wants to work. They have an internal and external effect: they concern both our mutual relations as colleagues and our relations with outsiders.

- Subservient and respectful conduct

We treat citizens, relations in the education sector, and each other correctly and respectfully.

We take opinions, views and contributions of other people seriously. We help and stimulate

⁴⁵ And science, culture (including media and museums) and emancipation.

⁴⁶ P. 21 of Punt 9 of 2010. This page can be found in the directory Integrity under 20101008.

⁴⁷ For example Wilbert van den Berg and Jo van Ham, former heads of the department of HE, got nice jobs in the top of universities after they left the ministry. The ministry is certainly directly involved in “budget defense”: in efforts to prevent reduction or realize budget growth. Success may be rewarded. What is a salary of 200 k€ compared to an institutional budget increase of say 10,000 k€?

⁴⁸ Thirty billion. P. 82, 20080909_Miljoenennota 2009_Tekstgedeelte. In the directory Integrity.

⁴⁹ The Code can be found in the directory Integrity, under 20050620.

colleagues, are open for criticism, and handle it constructively. Central concepts are customer orientation and cooperation.

- Impartiality/ Independence
Civil servants represent the general welfare. Therefore we should evaluate on purely objective grounds, and not allow improper or personal motives to play a role. We should not favor one citizen or institution more than another. Decisions about exceptions have to be taken on objective grounds. Every appearance of intertwining of interests should be avoided.
We do our job in the framework of the political responsibility of the minister. This means that our work should be directed primarily at the realization of the policy goals of the minister.
- Transparency/ Openness
We cooperate in an open way. This means that we inform one another correctly, exchange the right data, and do not withhold information.
We motivate each other and cooperate to obtain results. We do this by involving the right colleagues at the right time, and by exchanging arguments, information and ideas. We explain what contribution we ask of each other.
We are open about our goals and purposes in our external communication too.
- Reliability.
Reliability means that the citizen must be able to trust that we keep agreements and promises. This trust stands or falls with the reliability of the individual civil servant. With respect to your colleagues too: say what you do, and do as you say.
Reliability also means that we do our work carefully, and handle (confidential, politically or privacy sensitive) information carefully. We use this information only for the purposes for which it has been provided.

[...]

Elementary rules of conduct are:

- “Saying yes” means “doing yes”;
- Be clear about what you need of someone;
- Give your opinion when appropriate, and don’t gossip;
- Differences of opinion are necessary, but should be settled;⁵⁰
- You may make mistakes, but not intentionally, and not twice the same mistake;
- Advise quickly, follow suit, and be assertive».

The chapters 2 and 3 (and 5) clearly show that this is no more than empty talk.

4.7. Reality check: some facts of the case Spijkers.

After having been confronted with so much conflicting information it is quite understandable that a reader doesn't know what to believe. This section is inserted to help the reader keep in touch with reality. This goal can probably best be realized by telling the history of J.J. Spijkers. This is probably the best example because:

- Everyone can easily check the facts on the internet;
- It concerns avoidable causation of lifelong suffering and loss of life;
- It is a relatively simple story;
- It is clear that Spijkers was right (and the others wrong);
- The harassment of Spijkers (by members of government and their dependencies) has no equal in recent Dutch history;
- The case shows that many people have actively and knowingly contributed to deceit, knowing this would hurt innocent people;
- No legal means were available to force the political powers to end their extreme misconduct. In particular, no “human rights” could be invoked.

⁵⁰ This assumes that this is always possible. Which it isn't. See *Communication and norms*, or *The law of logic* (Het recht van de logica, Eburon, Delft, 2003).

The history furthermore shows that from all the organizations which have contributed to make the case as shameful as it is, nobody leaked crucial facts to media, or stepped forward to effectively defend Spijkers. (A few people did help, but were not sufficiently powerful to be effective).⁵¹ In other words: even in cases of very serious and clear violations, where everybody in the know should blow the whistle, almost everybody keeps silent.

The following chronicle only presents events which show persons or organizations which clearly violated integrity norms.⁵² The names of these persons and organizations have been set in italics.

1970.

The *Royal Dutch Army* used mines of the type AP-23. The mine was produced by a company called *Eurometal*. Since 1970 the army knew that this mine was seriously defective.

1983.

On 18/7/83 in a classroom in the town Oldebroek there is an accident with an AP-23 mine. Five soldiers are killed, eleven wounded, of whom two so heavily that their lives are threatened.⁵³

1984.

On 14/9/84 mine expert Rob Ovaa is killed by an accident with an AP-23 mine.

At this time Spijkers is a company social worker at the ministry of defense. He is requested to tell the widow of Rob Ovaa, Marjolein Ovaa, that her husband has died as a consequence of his own mistake. But because of the earlier accidents Spijkers suspects that mines of this type are defective. In his conversation with the widow on 14/9/84 Spijkers lets it transpire that he was sent and did not agree with the message.

Subsequently Spijkers starts an inquiry. He discovers that the defectiveness of the mines was known since 1970. Whereupon *his manager* asks the *Information Service of the Royal Dutch Army (ISRDA)* and the *Information Service of the Royal Dutch Marine* to investigate Spijkers.⁵⁴

1985.

A secret investigation of *the military police* asserts that Rob Ovaa had been imprudent. Therefore the widow could not claim damages.

1986.

On 13/5/86 Spijkers is qualified “political criminal” by the *ISRDA*.

1987.

Spijkers is examined psychiatrically. *Company doctors* declare him paranoid and schizophrenic. He is declared unfit for his job.

1988.

Spijkers successfully fights his dismissal. But *the top of the ministry* doesn’t allow his return.

1989.

In front of the McDonald House in Huis ter Heide *two soldiers* shoot at Spijkers. Spijkers isn’t hit. The soldiers get disciplinary punishment.

1991.

⁵¹ And the powers that be didn’t respond.

⁵² The sources are De Pers (a daily) of 6/3/08 and the Dutch language Wikipedia of 7/6/11. Editing was mostly limited to abbreviation. Qualifications of persons or organizations are copied from the sources. The sources can be found in the directory Spijkers.

⁵³ De Pers of 6/3/08 says that 7 died, and 9 were crippled for life.

⁵⁴ In Dutch: Landmacht Inlichtingendienst (Lamid) and Marine Inlichtingendienst (Marid).

Spijkers contests the falsified medical report. *The commission of appeal of company doctors* rejects his complaint.

1993.

Spijkers wins a lawsuit. But he loses his unemployment benefit because he refuses to sign a declaration stating that he is unfit for work. (*Unknown organization(s)*). He is jobless and without income.

1997.

The ministry of defense appeals against the lost lawsuit at the Central Appeals Council (CAC), and wins. The media report about a prejudiced judge *Vermeulen*. Government lawyer *G. de Groot of the firm Pels Rijcken & Drooglever Fortuijn* knowingly gives the CAC incorrect information. With his lies he unjustly makes a fool of senator J. F. Glastra van Loon, who defends Spijkers.

The chairperson of the Tweede Kamer, Jeltje van Nieuwenhoven, tries to prevent that members of parliament ask the under-minister of defense “difficult” questions.⁵⁵

1998.

Per 1/9/98 payment of Spijkers’ income and pension benefit are stopped. (*Unknown organization(s)*).

1999.

In pursuance of reports in the media about the case Spijkers, national ombudsperson Oosting starts an inquiry into the AP-23 accidents of 1983 and 1984. The ombudsperson calls the attitude of the ministry of defense in this case “shocking”.

2001.

In a report requested by under-minister Van Hoof of the ministry of defense, KPMG⁵⁶ writes that for years Spijkers and the widow of Ovaa have been misled on purpose by *the ministry*. [What did and does parliament do? JFCvV]

2002.

A battle of years is followed by mediation by the national ombudsperson and an inquiry by KPMG. In a settlement agreement of 29/11/02 *the ministry of defense* acknowledges that for eighteen years it had systematically misled Spijkers, parliament, the media and society.⁵⁷ Spijkers is promised damages, and compensation for legal and medical costs.⁵⁸ Spijkers will be rehabilitated, and qualifications like “political criminal” and “political psychiatric case” will be purged from his files. Marjolein Ovaa and her children will be paid damages too. Both Spijkers and Ovaa will be awarded royal honors. Spijkers will be compensated for non payment of salary by the ministry in 1993-2011.

2003.

Spijkers is given 1.6 M€ tax free damages. After questions of Krista van Velsen in parliament, under-minister of defense *Van der Knaap* promised to get the promised royal honors awarded to Spijkers.

2005.

On 29/8/05 *Van der Knaap* tells parliament that the archive of the case Spijkers will become publicly accessible only 50-70 years after Spijkers’ death. He also says that he will not reimburse legal and medical costs.

⁵⁵ A “difficult” question is a question that cannot be answered in an acceptable way without seriously endangering the position of the person giving the answer.

⁵⁶ The accountancy and consultancy firm.

⁵⁷ For eighteen years!!! Again: what did and does parliament do? There certainly was no control!

⁵⁸ Note that “the ministry” need not mean more than the top of the ministry, and includes the minister. A ministry is not a democracy, and even in a democracy only the least majority (of “representatives”) is needed for a decision.

In September Spijkers receives a tax assessment of 0.9 M€ because of the 1.6 M€ damages. Like the non reimbursement this is contrary to the settlement agreement. (*Ministry and Van der Knaap collaborate*).

2006.

In October the book “Man against the State” by Alexander Nijeboer is published. It gives a rather detailed account of the case Spijkers, at least of the part that is publicly known. It shows that in their information of parliament members of the government lied 49 times. Van der Knaap misled parliament at least 20 times. The book concludes that notwithstanding the settlement agreement of 2002 Van der Knaap still refuses to correct the results of the fraud wherever possible.

2008.

On 21/1/08 Van der Knaap becomes mayor of the town of Ede. He keeps this position until his retirement (30/8/17).⁵⁹

In March the magazine “Public management” publishes a paper with the results of an inquiry into the case Spijkers by a team of scientists from Amsterdam University. The title is: “A constitutional state without self-criticism and self-correction”. It concludes that Spijkers’ life has been destroyed by political, governmental, and judicial officials in the name of the Dutch state. Instead, they should have praised Spijkers. For 23 years they misused their official powers and means to commit injustice. They may be called “bad” or “malicious” because of their indifference to this injustice. They have done this to save their skin, or in the perceived interest of their ministry or political party.

In April the municipal council of the town Culemborg decides unanimously to send a letter to *prime minister Jan Peter Balkenende*. It asks Balkenende to “step over his own shadow” and to accept responsibility for the liberal implementation settlement agreement of 2002. The council had written a similar letter in March. Balkenende’s reply is judged too meagre and formalistic.

In May a number of political parties calls upon under-minister Jack de Vries of defense to try and reach agreement with Spijkers. The signatory parties have half of the seats in parliament.⁶⁰

In July it becomes known that *Balkenende* has pressured Pieter van Vollenhove, chairman of the Research Council for Safety, to withdraw his offer to act as mediator between Spijkers and the ministry of defense.

At this point we let the chronicle rest.

The chronicle shows that behavior which is incompatible with integrity is widespread, and dominates other behavior. Lack of integrity is not the exception but the rule. Even when it is clear that the misconduct causes very much harm and suffering. For more than twenty years almost everyone concerned is doing as if “defense of defense”, including denial and cover up of wrongdoing, is an inviolable priority.

The case shows that in the much praised constitutional state of The Netherlands somebody who resists wrongdoing by government officials can be defenseless against their unjust and illegal retaliation. In other words: that in this state common people have insufficient means to defend themselves against unjust and unlawful treatment. And that this implies that government officials don’t have to worry about consequences for themselves, and employees have to fear the worst (a fate like that of Spijkers).

Finally we note that:

- Nothing is known of any action taken by the *General Accounting Office*. Even though it asserts that its goal is “to evaluate and improve the licit, efficient, effective and honorable functioning

⁵⁹ Cees van der Knaap was born 27/1/51.

⁶⁰ This is from the Wikipedia. It doesn’t say whether they have a majority...

- of the government and related organizations".⁶¹ Are defective mines licit and efficient? Were the amounts of money the ministry of defense spent on cover up and on the persecution of Spijkers licit and efficient? Let alone honorable. Was there no good reason for remarks or an inquiry by the DGAO, already in 1983? (Of course there was);
- Already after the first accident (all employees of) Eurometal could and should have given full and correct information about its product;
 - "Independence" of persons or organization doesn't guarantee independent evaluation and behavior;
 - Nothing is known of actions taken against those responsible for the wrongful use of the AP-23 and the harassment of Spijkers;
 - Parliament has never taken effective action;
 - Parliament has approved the hiding of the archive, and thereby helped preventing that the law can take its course;
 - Publicity by the media did not prevent over twenty years of extreme harassment. It didn't inspire parliament to take effective action, to claim damages from those responsible,⁶² or to ensure preventive punishment.

4.8. Improving integrity in public administration: OPIPA and DGAO.

Government officials and government publications regularly try to give the impression that the government gives high priority to integrity, and that the government and associated organizations work in accordance with strict standards of integrity. The formation of an Office for the promotion of integrity in public administration (OPIPA) can be seen against this background. OPIPA began its activities in March 2006. According to its factsheet: «OPIPA wants to stimulate that organizations related to the government have a wide, purposeful and effective integrity policy, which includes a coherent set of measures».

Publications on specific subjects.

Summary. The publications mentioned are useful but superficial, insufficient and ineffective. They fail to compare the theory with the reality shown in the case Spijkers (and cases to be treated in chapter 8). Comparison with the reality of the case Spijkers would show the theory to be fatally flawed. Moreover, even if the publications told all there is to tell about motives, causes, etcetera, these motives, causes, etcetera are not addressed by the present measures, regulation, codes and policy.

Publications are an important instrument for the realization of the goal of OPIPA.⁶³ One of them is the *Guideline: The integrity officer and the relation with the (top)management* of 2008. The following is a quote from this publication:

«For integrity policy to be effective, and for an integrity officer to be able to function optimally, the management should at least:

- tell and show that it attaches great importance to integrity;
- be pro-active and bring up integrity questions and dilemma's;
- be an example of integrity in words and deeds;
- abide by agreements, rules and procedures;
- know and know to find the rules, and make them known and followed;
- have an eye for, and link up with (dilemma's in) daily practice of employees;
- prevent that its behavior seems to be incompatible with its words;
- dare to be vulnerable;
- address employees and colleagues with respect to the integrity of their conduct;
- accept responsibility for the organizational structure and -culture;

⁶¹ Factsheet of the Dutch GAO, June 2010. In de directory Integrity, under 20100600.

⁶² Without which only the taxpayer is charged.

⁶³ Several of them can be found in the directory BIOS of this chapter. (BIOS is the abbreviation of the Dutch name of OPIPA).

- be accessible (open door policy, make time available, be willing to talk, to discuss questions or dilemma's);
- have a straight back and act resolutely when necessary, irrespective of rank and station;
- provide sufficient means for integrity policy (time, money, human resources, schooling)).⁶⁴

As shown, all of these prescriptions are violated wherever deemed necessary to deny and cover up misconduct and failures. Which means structurally.

Another publication is the “Help brochure” *Motives for dishonorable conduct. Social psychological factors of 2010*.

«This help brochure tries to answer questions like:

- Why do people do things they are not allowed to do?
- Why do employees break the rules of the organization?
- Why do other employees decide honorably?»⁶⁵

The answers of the help brochure can be compared with the known examples of dishonorable behavior. This shows that they give at most part of the answers. In addition the answers don't match the integrity policy. These assertions are substantiated in the following.

The help brochure claims to present the results of recent research on the behavior of people in organizations by social and organization psychology, and the management and policy sciences. As “important, typical” insights it mentions:

1. It isn't always simple to identify a single indisputably wrong action;
2. Often there is a gradual process consisting of actions each of which can be judged differently;
3. There can be conscious and subconscious, rational and emotional causes of the behavior;
4. There is no clear character profile with respect to corruption;
5. There are insufficient counter forces.

As frequently occurring “factors and mechanisms” are mentioned:

1. Denial of normative aspects, and/or reasoning them away;
2. Choosing the easiest way, and finding an excuse for that, such as: “There is no real choice” or: “This is the responsibility of X”;
3. Ambition;
4. Influence of authority. «In general people do as they are told. Furthermore, implicit or explicit behavior of managers has an important influence on subordinates, and is an important integrity factor in an organization»;⁶⁶
5. Identification with a role or duty, coupled with absolutizing instead of relativizing the importance of this role or duty;
6. Conservatism: sticking to a chosen line, and lack of willingness to reflect and change;
7. Conformity to group behavior, avoidance of “deviant behavior”;
8. Organizational incentives. «People tend to do what is rewarded, and to avoid what is punished. This may seem logical, but there are still quite a few organizations where honorable conduct is not (explicitly) stimulated and dishonorable conduct isn't punished or sometimes even (implicitly) rewarded».⁶⁷

Undoubtedly these insights, factors and mechanisms are relevant. Both 5 and 6 in the list of factors and mechanisms can easily lead to fatal derailment if they affect the top of a large organization. For example if it is imagined that the public image of the organization or its head are goals in themselves, that the end justifies the means, and if interests (including norms) are weighed arbitrarily.

Still, the insights, factors and mechanisms explain almost nothing of the reality shown in the case Spijkers and the many other cases studied in this book. A striking omission seems to be the insight that

⁶⁴ P. 8.

⁶⁵ P. 7.

⁶⁶ P. 15.

⁶⁷ P. 17.

efforts to deny or cover up mistakes and failures are an inexhaustible and cancerous source of integrity violation.⁶⁸ And the insight that in hierarchical organizations this mechanism can poison the entire organization. In fact, the list doesn't mention any fundamental cause of non-integrity. Such as a discrepancy between duties of a job, and actual abilities. On the other hand, the ambition of point 3 need not cause misconduct. It only does when it makes a person accept a job he cannot fulfill properly.

But even if the publication would have mentioned all relevant causes, this nor other publications try to answer the question whether existing regulation sufficiently addresses them, or cancels their effects. Are the counter forces sufficiently strong? Is dishonorable behavior sufficiently discouraged and/or punished? Again the case Spijkers is ample evidence of the answer "No, not at all".

The assumption that people try to do what is rewarded, and to avoid what is punished, is one of the grounds for criminal law. But it seems to be unknown in the integrity policy of the Dutch government, its whistleblower regulation, and the *Code for good public management* to be considered below. They don't ask themselves what it means that the whistle was blown for good reasons. They don't ask themselves what the good reasons say about the people who caused the good reasons. No attention is paid to measures for prevention of repetition, and/or punishment of those responsible. Shouldn't justified whistle blowing have consequences for those who gave rise to the need to blow the whistle?⁶⁹ Can such people be said to be sufficiently competent and honorable for their jobs? Nothing is said about these questions.

In spite of "factor or mechanism" 8, the whistleblower regulation of 2009 creates serious risks for whistleblowers, and none for those who give cause for whistleblowing.⁷⁰ According to article 28 of the regulation, costs for legal assistance will be reimbursed to a maximum of 5000 €. But only if the judge's verdict implies that the whistleblowing was justified. Everybody who is acquainted with the costs of lawyers knows that 5000 € is a trifle. It can be compared with the 81,000 € Spijkers had to spend on legal costs to force the ministry of defense to fulfill the terms of the settlement agreement.⁷¹ Of course, this was only a minor part of the costs Spijkers had to make in 1984-2002. No limit should have been mentioned in the regulation. At least as long as the opposite party is allowed to spend unlimited amounts. According to De Pers of 6/3/08 under-minister Van der Knaap alone has spent 700,000 € in efforts to cover up the dossier Spijkers.⁷² Limitation of the costs of only one party yields inequality in legal assistance. And why shouldn't the responsible managers⁷³ have to pay the costs if the judge puts them in the wrong? Why are whistleblower and management treated differently? Why is the management, and not the whistleblower,⁷⁴ supposed to represent the organization, even if the verdict could imply that it is unfit to lead and represent the organization?

The yearbooks Integrity.

Since 2010 OPIPA publishes a Yearbook Integrity with interviews and articles.⁷⁵ The articles are mainly theoretical. They may be correct- in a certain sense- and even somewhat useful, but they almost always ignore an essential part of reality.⁷⁶ None of the contributions betrays understanding of the functioning of hierarchical organizations. Nobody suggest that proven misconduct in ministries should have consequences for the responsible managers and members of government.

The conclusion of the analysis of the yearbooks is similar to the conclusion about the other OPIPA publications: they may be interesting and useful, but have no more than marginal significance. The

⁶⁸ The omission is striking because the phenomenon is well-known from politics.

⁶⁹ Yes, the need. For whistleblowing supposes that internal complaints have failed. In other words: the organization and its management have failed to operate appropriately.

⁷⁰ The regulation can be found in the directory Integrity under 20091215.

⁷¹ Source: letter of under-minister De Vries of defense of 4/9/08. In the directory Spijkers, under 20080904.

⁷² Unhindered by parliament or DGAO.

⁷³ Of course, including the responsible members of government, like Van der Knaap.

⁷⁴ Or both of them, or neither.

⁷⁵ The yearbooks 2010, 2011 and 2012 are in the directory OPIPA. The yearbook of year N is published at the end of year N-1. The yearbook 2010 for example was published in November 2009.

⁷⁶ Essential because it falsifies most theories about good government.

reason is that they ignore a crucial part of reality, and principal causes of integrity violations.

By ignoring inconvenient parts of reality, OPIPA and its experts make themselves part of the integrity (and competence) problem. They waste money, and preclude effective measures.

The yearbook 2011 contains an interview with Saskia Stuiveling, president of the Dutch General Accounting Office (DGAO). Some of her remarks concern the report of an inquiry into systems of integrity care in organizations in public administration. In order to be able to evaluate the remarks the present author studied the report in some detail. The conclusion is that like the ministries of education and defense, Stuiveling and the DGAO falsely claim integrity.

OPIPA and DGAO are fully paid by taxpayers' money. They are (should be) supervised by government and parliament. There is no evidence showing that they really are.

Yearbook 2010.

This yearbook has an interview with Andrée van Es, DG at the ministry of Internal Affairs. The interview has the title: *Everything you do should be able to bear the light of day*. She explains:

«Integrity requires transparency and openness. Confronted with a dilemma, the question every manager, and even every civil servant, should ask himself is: can I tell and explain the public? Can I be open about this? If not, alarm bells should begin to ring. "In case of doubt: don't" says Van Es».⁷⁷

It is clear that these words have nothing to do with reality. Still, they can help whistleblowers when they are told that something should have been kept secret.

Farther on in the interview Van Es is quoted as having said:

«If Dutch integrity policy is compared with that in other countries we score pretty well, we're in the top ten. Of course, in spite of this policy, incidents still occur, and may sometimes even be serious. That may be bad for image and trust, but can also be an indication of a culture where people are less afraid to report misconduct».⁷⁸

The incidents are not specified. Note that Van Es tries to shift the focus from something bad, the "incidents", to something good: an indication of a better culture.⁷⁹

Under the heading *Whistleblowing should be normal* she claims that real progress has been made with the "Whistleblower dossier". She shows no doubt about the new regulation (mentioned earlier). No remark is made about the unequal treatment of the two parties, and about the fact that the regulation assumes that the management is honorable.

She doesn't explain why her optimistic attitude should impress potential whistleblowers more than what she keeps silent about. Such as the facts that all whistleblowers fared badly, and that all responsible politicians and managers could keep their positions of power, and pursue their careers unhindered.

The article of Hans van den Heuvel and Leo Huberts⁸⁰ has the title *Management integrity today*. In their introduction they note that in the past 15 years much has been published about integrity questions. They continue as follows:

«In our opinion it is problematical that much [literature] has a normative character, recipe booklets and prescriptions for good conduct, sometimes based on common sense, sometimes on ideas of a philosophical-ethical school, and sometimes on individual feelings and insights.⁸¹ What is lacking is empirical research, and the formulation of theories based on empirical research».

They don't pretend that their article will change this. They only try to review the development of integrity policy, and to answer, with the help of surveys, the question how managers and civil servants think about integrity and integrity violations. They conclude:

⁷⁷ P. 23-4.

⁷⁸ P. 24.

⁷⁹ Which is supported by the illogical "Of course".

⁸⁰ Hans van den Heuvel and Leo Huberts are professors in the Research group Integrity of management of the department of Management sciences of the Free University of Amsterdam.

⁸¹ Sic: the original is no sentence either.

«Dutch public management scores well on integrity. There is a lot of attention to integrity; Dutch policy development leads the way, and the number of integrity violations- as far as visible- seems to remain within the bounds of what we find acceptable.⁸² But this doesn't mean that complacency is justified. The glass is half full, but also half empty, and work remains to be done, for a next phase. [...] The present government makes a beginning with the *Code for good public management*.⁸³ Openness, integrity, participation, decent contact with the citizen, effectiveness, efficiency, legitimacy, the capability of self cleaning and the willingness to account regularly, are important ingredients. On the other hand codes- soft law- should not distract attention from the need of hard law and its maintenance».⁸⁴

After having noted a lack of empirical research it surprises that these authors are not more cautious in their conclusions. What is the meaning of a soft code, and what is hidden behind "as far as visible"? Here nor anywhere else in the yearbooks it is noted that politicians and civil servants may have an interest in lying and cheating, and that they have the means and power to keep them hidden or cover it up. That this and only this can explain their disproportional reaction to whistleblowing, and the scarcity of whistleblowers.

The article of Mark Bovens and Gerolf Pikker⁸⁵ has the title *Whistleblower regulations: useful but insufficient*. «In the course of 2008 these regulations have been evaluated [...] at the request of the minister of Internal affairs.⁸⁶ [...] The central questions were:

1. Do the regulations contribute to internal reporting and discovery of misconduct?
2. Do the regulations offer adequate legal protection to whistleblowing civil servants?»⁸⁷

The evaluation is based on a survey. The conclusions are summarized as follows:

«The conclusions [...] are serious: the regulations stimulate internal reporting and discovery of misconduct only to a limited extent and hardly offer legal protection. For a part of the civil servants the lack of protection is an important reason not to report suspected misconduct. The interviews show that suspicions of "serious" misconduct (where the management is involved) are reported only by people who can afford negative consequences, or are willing to risk them».⁸⁸

The conclusion about the Commission Integrity Government (CIG) is remarkable:

«In recent years, the CIG, the external organization where people from government, police, the defense organization,⁸⁹ and the provincial governments can report suspected misconduct, has played no role of any significance. The commission is unknown, and isn't trusted. There are many barriers on the road to the commission. It doesn't operate as an inquiry commission, but as a commission for objection and appeal [a formal legal procedure]⁹⁰. Of the 43 reports which were submitted to it in 2002-2007, it admitted and dealt with only 10. In the period indicated the commission advised about 7 of them. In no case did the commission establish misconduct.»⁹¹

The introductory section of their article is entitled *Whistleblowers: well-known, but unbeloved*. They mention the names of some well-known whistleblowers, and observe:

«Civil servants and other employees who report misconduct without permission, like Spijkers, Schaap, Van Buitenen, or Bos have gradually become well-known Dutchmen. At the same time they

⁸² "we find acceptable". Who? How do the authors know? Could "we" do something about it? Or is everything acceptable as long as no politicians are shot and government buildings blown up? In fact, people cannot even ask for a referendum about matters like this.

⁸³ The code is in the directory Integrity, under 20090609.

⁸⁴ P. 37.

⁸⁵ Bovens is professor of management science at Utrecht University, and research director of the management and organization department of this university. Pikker is enterprise scientist, and senior advisor and researcher at the department aforementioned.

⁸⁶ Note that contracts with a ministry inevitably create a dependency.

⁸⁷ Pp. 38 and 40.

⁸⁸ P. 42, end of section 3.

⁸⁹ Denoting army, navy, and air force.

⁹⁰ As always, [text in black] is by JFCvV.

⁹¹ P. 41. Note that this is noted by scientists, not by parliament or the DGAO (efficiency...).

are tragical figures: they are well-known mainly due to the dire straits they landed in».⁹²

Bovens and Pikker do not note that it is very improbable that politicians or managers will permit publication of reports of misconduct for which they are responsible. Neither do they answer the question what these dire straits imply about the integrity of the responsible politicians and managers.

The chapters 8-11 strongly support the remark by Van den Heuvel and Huberts, quoted earlier, «that much [literature] has a normative character, recipe booklets and prescriptions for good conduct», and that «what is lacking is empirical research, and the formulation of theories based on empirical research». The introduction of the Yearbook 2010 summarizes these chapters as follows.

«In chapter 8 Paul van Tongeren and Marcel Becker, two philosophers [...], discuss virtue ethics as an alternative approach for connecting integrity with rules and codes. As the four cardinal virtues they mention courage, measure, justice, and good sense. The honorable civil servant or manager is the one who knows how to do his duty courageous, just, sensibly, and without excess. The virtuous civil servant isn't virtuous because he works dutifully, but because he tries to do it better.

In chapter 9 the ideal integrity officer is presented as a rebel with cardinal virtues. The first integrity officers are retiring. A good reason to put them through their paces one last time, and to ask them what wise lessons they have for integrity officers of today. The question is answered by Jur Teders, who was head of the department Integrity of the ministry of transport and waterworks from 2004-2007, Alex Belling, who was coordinator of integrity policy for public administration at the ministry of internal affairs from 2002-2008, and John Dirks, who held the portfolio integrity of the police corps of mid and west Brabant from 2003-2009.

Their answers are not worth a quote or summary.⁹³

According to Edgar Karssing and Sacha Spoor the Netherlands needs a third generation integrity policy. In chapter 10 they assert that integrity 3.0 means careful, explainable and steadfast behavior. Integrity is connected to the quality and effectiveness of work. It isn't a hygiene factor any more. In policy priority is given to managing on the basis of trust, to offering a framework, and to accounting for work done, to professional pride and to organization-learning.

In chapter 11 Tica Peeman criticizes the Taylor bureaucracy, and discusses the characteristics of high trust organizations. As common denominator high trust organizations give employees full trust. According to Peeman, the important and beautiful job for the managers in public administration in the coming years will be: be an example, spread the culture and vision on integrity, and be transparent in that».⁹⁴

The concept of “high trust” enjoyed great popularity among the managers of the ministry of education around 2010. It should be the basis for the relation between ministry and its agency NEA. In that case it seems to be primarily meant to suggest that the past should be buried and forgotten, and to avoid serious evaluation.⁹⁵ This attitude guarantees repetition of errors and failures, and is incompatible with the code for good public management, which prescribes learning and self cleaning.⁹⁶

The yearbook ends with some “good practices”. They breathe a cheerful and optimistic spirit. They may be useful. But the reports are based on interviews, and the words need not be related to the facts.

⁹² P. 38.

⁹³ Their functions show that these are establishment people, approved by the suspects. Which is confirmed by what they say. An example. On p. 68 Teders asserts that when he became head of the Integrity department he introduced three motto's: integrity is normal, integrity is fun, and integrity is rewarded.

⁹⁴ Yearbook 2010, p. 15.

⁹⁵ Karssing and Spoor please note: no accounting, no learning.

⁹⁶ The code for good public administration can be found in the dossier for this chapter. It is named: “20090609_Code voor goed openbaar bestuur_BZK.pdf”.

The practices seem to contain a high percentage of wishful thinking. The authors seem to know nothing about the internal operation of public administration. They seem to know nothing about the true character of the managers.⁹⁷ The effect of the instruments mentioned can easily be “neutralized” by contrary “exemplary” behavior of managers.⁹⁸ Undoubtedly even the ministry of education could furnish good practices. Just ask the SG to mention a suitable spokesperson or other contact.

The yearbook 2011, and the role of the DGAO.

This yearbook was edited by Suzanne Verheij and Edgar Karssing.⁹⁹ In their introduction on p. 6 they write:

«Like last year we chose a format with interviews and contributions from science and practice. By interviews of prominent people we try to map the field in its full width. The other chapters probe its depth. Where we tried to find a balance between theoretical exploration of central concepts and instructions for the implementation of integrity policy».

But for theoretical exploration and instructions for implementation of policy to be effective you should know and understand reality. And as said before: the reality behind the whistleblowers and financial crises is at most touched upon. If you want to address the true problems of integrity, these yearbooks are almost useless. Someone who really wants progress would compose very different yearbooks.

About the interview with Saskia Stuiveling,¹⁰⁰ president of the Dutch General Accounting Office (DGAO), the editors say the following:

«The DGAO is an important guardian of the integrity of the Dutch government, because it examines the effectiveness of government policy.¹⁰¹ Integrity is also important for the DGAO as an organization. The president claims that her organization is honorable: employees are required to think in advance of the rules».

These are big words. It is impossible¹⁰² to reconcile them with the reports of the DGAO.

On 25/3/10 the DGAO published a report *State of affairs integrity care government 2009*.¹⁰³ On p. 13 of her interview with Ronald Jeurissen and Sacha Spoor¹⁰⁴ in the yearbook, Stuiveling says the following about this report: «**The recent inquiry of the DGAO into the integrity care policy in the government shows that work remains to be done**». Which is true, but not concluded clearly and prominently in the report. In fact, the report is full of ambiguous diplomatic assertions. On the one hand it suggests that the report is restricted to systems of integrity care, and does not consider integrity as such. On the other hand it tries to respond to the lack of confidence in the integrity of managers of many people who took part in the survey:

«More than half of the people interviewed indicate that exemplary behavior and ethical leadership of the management are invisible, or even have a negative opinion about these aspects».¹⁰⁵

The DGAO shows no surprise. It asks no questions about the cause of the negative opinion, and doesn't consider the possibility that it has good reasons. Even though most instruments for integrity care assume integrity of the management, and the system requires the management to act as examples

⁹⁷ As opposed to the image they try to broadcast of themselves, as shown above for the SG and uSG of the Dutch ministry of education.

⁹⁸ Even by a single exemplary instruction. Let alone promotion or sidetracking.

⁹⁹ Suzanne Verheij worked at OPIPA, Edgar Karssing at Nyenrode Business University.

¹⁰⁰ An ex-politician, ex-member of government.

¹⁰¹ The “because” is logically incorrect.

¹⁰² “Hard to reconcile” would be expressing the state of affairs too weakly.

¹⁰³ The report can be found in the directory Integrity, under 20100325.

¹⁰⁴ Ronald Jeurissen is professor of corporate ethics at Nyenrode Business University and director of the European Institute for Business Ethics (EIBE) of this university. Drs. Sacha Spoor is senior advisor and trainer at the EIBE.

¹⁰⁵ P. 11 of the DGAO report.

in relation to the “soft controls”.¹⁰⁶

The first conclusion of the report is:

«Since 2004 nine ministries have strengthened their system of integrity care. In the last four years, four of the thirteen ministries have made little progress in the implementation of the system of integrity care».¹⁰⁷

In other words: it has remained the same or has become better. And although a change from “very bad” to “bad” is an improvement, the reader is probably expected to think that it went from good to better.

A system of integrity care is no goal in itself. It is a means to accomplish another goal, the integrity of the government (or public administration). The DGAO says that it considers the integrity of government very important. It observes that a majority of the government employees doesn't have a positive opinion about the integrity of their managers. How then can the DGAO ignore the question whether it may be assumed that the given systems of integrity care ensure adequate prevention and self-correction? It even allows itself to be seduced to false pretensions by suggesting that it can hardly be done better:

«We have ascertained that the ministries, and the agencies and other organizations involved in this inquiry, in general have a rather complete set of regulations for integrity».

One wonders what can be meant by “in general” and “rather complete”. Does completeness mean that there is a reliable (independent?!) procedure for establishing that a manager violated the code of conduct? That adequate measures are taken after this has been established? (Of course not). If “complete” would mean that the system works, there should be a significant difference between the answers given by employees in organizations where the system is complete, and those given by employees where it isn't. This is not the case. The studies in the present report clearly show that it is ridiculous to suggest that there is an effective system of integrity care. The system is fatally incomplete. It doesn't work properly at all. The conclusions of the DGAO cannot be correct. They are misleading, a sop.

P. 30 of the DGAO report shows a table with an overview of the state of integrity care in the different ministries. The table gives a qualification for each of 11 instruments, for the years 2004 and 2009. For 2009, the ministry of education gets 10 pluses, and one symbol for “partly provided for”. The last is given for the indicator “Risk analysis”. From the reports in the preceding chapters it follows that an organization with a management that violates integrity as a matter of course can have a system of integrity care that is qualified as good by the DGAO. So the indicators say absolutely nothing about the integrity of the organization. One may nevertheless ask oneself how an inquiry into systems of integrity care can give such a positive picture. The answer has at least four components:

1. What DGAO calls a good system of integrity care doesn't say anything about integrity in practical reality (this was shown above);
2. The set of instruments is clearly inadequate. Many instruments are useless as indicators for the quality of a system of integrity care, and all instruments assume integrity of at least the management (for example: code of conduct, policy evaluation, audits);
3. Integrity and having a good system of integrity (as defined by the DGAO) are two different things;
4. The three methods used by the DGAO:
 - a. «We have made an inventory of the system of integrity care and compared the situation in 2009 with that of 2004;
 - b. We conducted a perception inquiry by an internet survey of randomly selected civil servants of the same organizations;
 - c. We analyzed the integrity reports, integrity violations and punishments».¹⁰⁸

¹⁰⁶ What is called soft controls has more to do with soft than with control. P. 7 of the DGAO report gives a definition by examples: training for dealing with dilemma's, conferences about subjects related to integrity, and exemplary behavior of the management. Probably the brochures and yearbooks of OPIPA have to be counted as soft controls as well.

¹⁰⁷ P. 9.

¹⁰⁸ P. 25 of the report.

The comparison of point a is no more than that. Its relevance depends on the quality of the reference system. That is, on the quality of the system the DGAO calls “good”. As shown, what the DGAO calls good is utterly inadequate.

The survey of point b is only relevant if the people who answer the questions know and understand what is happening in their organization,¹⁰⁹ and if they are competent and honorable.

The inquiry of point c assumes integrity, which the system of integrity care is to ensure, and therefore may not be assumed.

A good researcher is a critical researcher. He asks himself whether his conclusions are consistent, plausible, and could be correct. In case of doubt he checks, tries to explain etcetera. In the DGAO inquiry the results of the survey are incompatible with the hypothesis of good systems of integrity care. But the report doesn't try to explain the discrepancy, as good researchers should. The discrepancy is explained above: integrity and a good system of integrity (as defined by the DGAO) are different things. What DGAO calls good isn't. The report should have stressed the difference. Furthermore the result about the systems of integrity care is implausible. Only the survey results are compatible with for example the daily news and the whistleblower cases. (The most important cases had not been solved in the period studied).¹¹⁰ The DGAO and its report seem to have solved the implausibility by not looking beyond the system of integrity care. That is: by not thinking and not asking plausibility and other critical questions.

The DGAO is part of the government, and just like the ministries gives an incorrect and misleading picture of itself:

«In my opinion [= that of Stuiveling] it is important that all employees of our organization reflect on integrity and address one another about the integrity of their conduct. When something goes wrong in another organization, it is good to understand that something like that can happen in our organization too. We introduced a new code of conduct. In work conferences we often discuss integrity questions. At the end of last year we organized an “integrity afternoon” to discuss dilemma's we encounter in our work. Talking with one another gives the subject its own dynamics. Knowing that colleagues have similar problems, and that these problems are part of the job makes it easier to deal with them. It isn't a problem with you personally, but a problem of the job. That gives relief, for otherwise people could get into personal difficulties. By talking about it an employee feels himself supported by his colleagues and his organization».¹¹¹

Stuiveling seems to suggest that the DGAO does all that is needed to ensure integrity. But it doesn't, as shown by the report on systems of integrity care. If the report of the inquiry doesn't mislead intentionally, then the pretension of the DGAO to be able to conduct such an inquiry is false. Both are incompatible with integrity.

It is a pity that Stuiveling isn't more specific about the dilemma's, and doesn't give examples. Does she mean that she needs the cooperation of the ministries, and that she fears the consequences of less restrained (more open and truthful) analyses and reports? If the dilemma's are related to the work, why can't they be discussed openly? Could she mean that a compromise has to be found between integrity and effectiveness, or staying in business?

Both OPIPA and DGAO suffer from selective observation. They stake claims in the field of integrity, but neglect to properly analyze whistleblower cases, and ignore the crucial study of Van der Vliet et al. Both lack openness. OPIPA publicizes yearbooks with interviews and articles. But the authors and the people who are interviewed are selected by government officers, and there is no opportunity to react on either interviews or articles.

Both OPIPA and DGAO seem to have resigned themselves to working in the margin.

¹⁰⁹ For about 20 (twenty) years, the present author didn't know or understand. He didn't believe in the integrity of the management, but that is quite different form being able to prove it.

¹¹⁰ According to p. 30 of the report, both the ministry of defense (Spijkers) and that of building (Bos, see chapter 8) had a code of conduct already in 2004.

¹¹¹ Pp. 10-11 Yearbook 2011.

Chapter 5.

Chronicle of a policy claim/ IAG2010!/Renewal program.

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1. Summary and conclusions.

2. Introduction.

3. Chronicle.

 1998-2004.

 2005.

 2006.

 2007.

 2008.

 2009.

 2010.

5.1. Summary and conclusions.

1. In 2005, the Information Administration Agency (IAG) of the Ministry of Education had 1400 employees (fte) at a cost of 70 M€. It had a budget of 30 M€ for external personnel.
2. The budget for the Renewal program was 55 M€.
3. The Renewal program is an example of false pretensions, and of efforts to keep them up with incomplete and incorrect reporting.
4. The program provides numerous examples of evaluations by consultancy or accountancy firms which seriously underestimate shortcomings and problems. The firms facilitated continuation of the shortcomings and problems, and hampered successful completion of the program.
5. The program is an example of failure to learn from experience (and professional literature). It is an example of history repeating itself (unnecessarily). The chronicle explains this. In sum: by absence of control and accountability. There simply is no need of improvement.
6. The Renewal program was preceded by a similar project Redesign. This project was a complete failure. In a letter to parliament of 2000, minister Loek Hermans of the education ministry asserted that the failure had shown that organizational improvements were necessary and had been started. In the following years nobody checked whether the necessary improvements were realized.
7. In 2005 IAG asked or claimed a relatively large amount of money without asking itself whether it could spend that money effectively and efficiently. It actually didn't know what to do with it. It took a lot of time to formulate something resembling a plan. Next it couldn't manage the implementation of the plan. It overestimated its abilities, and/or put its doubts aside to gather in 55 M€.
8. Before starting with something like the Renewal program, ministry and agency should have asked themselves whether the lessons of the failure of the project Redesign had been learnt. Before promising the claimed money, the ministry should have checked whether the necessary improvements had been realized. Nothing like this was done. As long as these questions had not been answered convincingly in the affirmative, neither party should have continued.
9. The chronicle shows no sign of memory or learning. The same errors are made over and over.

10. Because of the similarities of Renewal and Redesign and the lack of signs of improvement, failure was highly probable. The management of the ministry was warned with sound argumentation. The warning was ignored without argumentation.
11. None of the supervisory organizations (DGAO and the audit department) and consultancy/accountancy firms (KPMG, Cap Gemini, PwC) has asked or checked whether the promised and necessary improvements had been completed. None of them noted that this was a condition for success. The consultancy/accountancy firms nevertheless made remarks that should have raised doubts. But they were not openly critical, and did not recommend anything sufficiently radical.
12. The reports of PwC of autumn 2007 could and should have woken the ministry (uSG) from its dream. In spite of obscurities and inconsistencies they clearly showed that IAG lacked essential capabilities, and had not sufficiently learnt the lessons of Redesign. Basic assumptions and conditions were not satisfied. In pursuance of these reports, the ministry should and could have asked for rescheduling and/or reduction of goals.
13. The absence of replies to a mail with the warning of 2005 and the reports of PwC witness one and the same attitude in the management of the ministry: that of rejection of everything that doesn't fit "positive thinking".
14. Action was only taken in 2009, after the program had come to a standstill as a consequence of internal problems.
15. In the decade preceding the standstill many reports of inquiries, audits etcetera have been published about IAG and the Renewal program. But although several of them called attention to risky weaknesses, none of them concluded that IAG pretended too much.
16. Without exception the reports paint a picture of the capabilities of IAG that is too rosy. Risks are systematically underestimated or ignored. The picture is based on research that is methodologically inadequate.
17. Some reports contain inconsistencies. Analysis of the text suggest that the picture was "improved" under pressure of the commissioner. If this isn't done consequently inconsistencies are created.¹
18. The reports do not define the object of investigation clearly. They do not indicate what type of conclusions can and cannot be drawn.
19. Professional norms, including those defining integrity, were violated systematically.
20. An important methodological error that is made in many inquiries is the uncritical use of interviews as a source of information.² If an organization or project is object of investigation, those involved (or responsible) are objects of investigation, but not necessarily reliable sources of relevant information. This chronicle and the preceding chapters give numerous examples of incorrect and misleading information given by participants.

¹ Here (and possibly elsewhere), "consequently" is used to mean: equally or similarly in similar situations, or under similar conditions.

² This may be presented as an explanation, but as an explanation it is erroneous, and it is not an excuse anyway. Interviews would only be efficient if they were reliable. But they are only reliable under condition of both integrity and ability. Which in general is to be proven.

21. By inquiries of insufficient quality, and by defective presentation of results, consultancy/ accountancy firms and audit organizations share the responsibility for undue delay of corrective measures. They cause waste of taxpayers' money.³
22. With regard to the Renewal program, the attitude of the ministry with respect to IAG was irresponsible. The attitude of the ministry was ambiguous and misleading. By asking information from IAG it created the impression that it felt responsible. (Which it was). But for years it didn't do anything with the information. When asked to do so by IAG, it refused to think about a reduction of the portfolio for system development, or alternatives. The ministry didn't manage responsibly.
23. Quite generally the way of working cannot acceptably be accounted for.
24. Important argumentation is made unreliable by obscure language and false pretensions. All actors appearing in the chronicle show an exaggerated opinion of their own capabilities and that of their section/ department/ organization. (Or a lack of modesty and doubt). The risks that this creates are increased by eliminating people who are open and critical.
25. With minor changes, what has been said about the Renewal program as remake of the project Redesign holds just as well for the project System Renewal Study Financing as a remake of the Renewal program.
26. Ministry and IAG behave like swindlers: they defraud the taxpayer on false pretexts.
27. The chronicle shows that participants of a project are selected in such a way as to maximize the risk of failure. People who are open and critical are ignored, and people who equate critical with negative, and only say what they expect to be desired and approved by their superiors, are chosen as participants or promoted.
28. The hypothesis that the top management is honorable and competent and does its best, and that things go wrong due to unforeseeable difficulties, is shown to be incorrect. The top is neither honorable nor competent. It doesn't want to be reminded of past failures: it wants to look only forward. Critical remarks are not evaluated on their merits. They are treated as signals of obstruction and lack of willingness to cooperate. Warnings are given, and suggestions for correction made. But the top imagines to know everything better, is unwilling and unable to discuss matters openly and to acknowledge mistakes. And last but not least it knows that it has the power (and political support) to avoid having to account for its actions.

The Advisory group.

For the Renewal program, uSG was supported by an Advisory group. Both uSG and Advisory group behaved irresponsibly. As if they only had to supply money, and money grows on trees. They acted as if it were permissible to approve things you don't understand, and- according to the chairman of the group- were not even willing to try and understand.⁴ The questions the Advisory group asked IAG nevertheless show that it sometimes felt uneasy about its role. But it didn't do anything about it. The Advisory group and uSG ignored that the opinion, that the ministry is responsible only for financing, is untenable for both political and logical reasons. The group did nothing that could have given uSG better control of the process. For example by asking IAG to make the plan understandable, and to supplement it with well defined milestones (intermediate results), spaced more or less evenly in time. This facilitates objective monitoring of progress. But probably this is asking the impossible. The Advisory group had approved the renewal plan on the basis of documents which suggested that IAG

³ Doubly, in the sense: what is spent on them is wasted, and they cause unnecessary waste in the project or program they are supposed to evaluate.

⁴ He said so in a meeting at the end of 2009, reported in the chronicle.

didn't know what it wanted, and couldn't get its thoughts properly organized. Such a group cannot be expected to ask for an understandable plan and verifiable milestones. Questions like that correspond to management that isn't based on blind trust or absence of responsibility. It corresponds to management that feels responsible and accountable, and tries to ascertain that the people working on the project have the necessary capabilities. Responsible management monitors progress and corrects when necessary.

The Advisory group failed in more respects. It ignored previous experiences and lessons, and never wondered whether IAG could properly manage and execute an exceptionally large program like the Renewal program. It didn't warn of the risk that the fusion of IAG and IFC would seriously reduce the chances of success of the Renewal program. It was clear that the fusion would claim time and energy of everyone in IAG (and IFC), and require rescheduling of the Renewal program. But instead of proposing or aid rescheduling, the ministry (initially) opposed it. The Advisory group and uSG were simply part of the problem.

Advice can be useless.

Most reports assume that it is sufficient to say what has to be done. They do so without having found or looked for changeable causes of errors or failure. Neither do they ask themselves whether it is realistic to assume that the persons addressed by the recommendations can do what they are asked to do. They don't ask themselves whether implementation of the recommendations eliminates the causes of the problems. In other words: most reports assume blindly that their recommendations can be implemented, and that implementation solves the problems. In general this is a mistake. All problems discussed in this book could have been avoided by applying available knowledge (and recommendations). If people ignored relevant available knowledge in the past, why not now and in the future? And indeed, many histories repeat themselves.

Often it is furthermore assumed that those concerned can and will learn. (As from now...). Without investigating the question why they didn't learn from previous experience and apply available knowledge earlier. Moreover, not everybody is willing and able to learn whatever may be needed for a given job.

Similarly it is often assumed that a given team, group or organization can and will learn, without checking for evidence showing that they do (not in words but in deeds). As noted earlier, in the given situation only the contrary is plausible or self-evident. It should be explained why it is reasonable to assume that as from now the necessary changes will be made, and the same (or other) people will behave differently.

In sum: advisors should not only say what is to be done, but also evaluate whether the given or designated people can and will do what is recommended and needed.⁵

Communication problems.

Several reports speak of outdated systems. But what does that mean, "outdated"? Does it mean that a job cannot be done properly (any more?)?⁶ Or only that it can be done more efficiently with a more modern system? Anyway, nobody explains, and one cannot exclude the possibility that people just mimic one another, or don't know or mean what they say but something different. As regards the Renewal program they might mean to say that the system as a whole has grown to be unmanageable due to a long series of adaptations/ accretions. If so, this has little or nothing to do with "outdated". Even a system composed of up-to-date elements can be unmanageable. Moreover, for an evaluation directed at improvement it may be quite important to denote and describe the situation correctly. How can one expect improvement without understanding?

A big problem in the relations of the ministry with its agencies is the fact that the top of the

⁵ This may sound simple and self-evident, but I know of no report doing this.

⁶ A well known example of 2014 is Windows XP. Microsoft ended support in April. A large majority of newspapers and computer journals spoke of Windows XP as being outdated. In general without explanation. Lack of support and the introduction of incompatible new hard and software might pose problems in the future. But apart from that Windows XP worked and works without any problem whatsoever.

agencies is incapable to explain and describe their systems, the nature of the problems with these systems, and how they want to deal with them. This problem affects both temporary and structural activities. It may have two major causes:

- Lack of abilities of the management, both with regard to communication and understanding of their hard and software systems;
- Lack of understanding of the systems as a whole by anybody in the agency.

If true, this would imply that nobody in the agencies can properly analyze the systems and problems, and formulate meaningful plans for improvement. These observations are compatible with everything told in the chronicle (and with the other chapters of the present report).

The communication problems between ministry and agencies preclude adequate supervision of the agencies by the ministry. But the ministry didn't seem to be aware of the problem. Possibly in combination with blind faith in high trust management it tolerated a culture of inadequate explanation and accounting. Studylink and all other projects show that this offers opportunities for abuse, and that both IAG and IFC used these opportunities.

5.2. Introduction.

This chapter describes the history of the most substantial program of the Information Administration Group (IAG) in the first decade of the 21st century. The ministry of education made 55 M€ available for the project. This amount may be compared with the yearly budget of IAG in 2004, the year before the project started: 110 M€. The project lasted from 2005-2009. The author participated marginally in the initial and final phase of the program. The chapter was begun out of curiosity about the intermediate period. The author knew almost nothing about it. The inquiry turned out to be much more instructive than expected. Mainly because in the intermediate period, IAG and the program were evaluated by quite a few external organizations. Their reports make fascinating reading. They can be studied from several points of view. They can be studied as autonomous reports, without regard to the context: for clarity, method, argumentation and consistency. They can also be evaluated in the light of the known outcome of the project. And one can study the management reactions on the reports.⁷

The chapter is mainly concerned with the behavior of the ministry as manager of IAG and commissioner of the project, and with the information that IAG and others provided about IAG and the project. Summary, conclusions and some analysis are given above, in section 5.1. The remainder of the chapter consist of a description of the history of the project and the events immediately following its crash.

5.3. Chronicle.

1998-2004.

The GAO on IAG.

The Renewal program was preceded by a similar program: the project Redesign.⁸ The project Redesign ran aground. The Dutch General Accounting Office (GAO) made an inquiry of the course of the project. The conclusions are given in its report about the financial accounting 1999 of the

⁷ And last but not least they are public, and can serve to instruct every citizen.

⁸ In this chapter, the words program, project and plan are not always used in accordance with their definitions. Where the author felt free in the choice of terminology, the word program denotes a set of projects, and the words project and plan denote what they denote in common parlance. With regard to the Renewal program the terminology is in accordance with the definitions, except in the quotes, where the terminology of the source has been retained. Redesign is often called a project because everyone did so. Even though it was a program. In the present context the distinction is quite relevant, because the coherence of projects, or the absence of coherence, is of great practical importance. Absence of coherence is important because it may imply freedom to cancel one or more projects of the program, or to change the order or time frames in which the various projects are executed.

education ministry, dated 30/5/2000.⁹

«IAG has a Redesign program which consists of three large programs for change: the introduction of integrated customer service, a general reorganization, and a new system for study financing. The first two are almost completed. The third doesn't proceed according to plan. The estimated costs rose from 130 Mf in 1997 to 227 Mf in February 2000.¹⁰ Of the automated systems that should support the new approach, only the “shell”, an application for data retrieval, was available at the end of 1999. The phase difference between organization and application development causes risks for the management of IAG. These risks are amplified by the call that is made on the capacity available for system development.¹¹ The coming years there will be an accumulation of requests for system changes due to many new policy measures. [...]»

The audit department (AD) [of the ministry] investigated the IT management of IAG in 1999 and concluded that the quality of the IT production is adequate, and that the awareness of the need for good management had increased. However, according to the AD the IT management as a whole was insufficient, because the information security policy had not been updated in 1999, and because the fall back possibilities [...] had been organized insufficiently. The AD also made remarks about the management of problems and changes, and about system maintenance. The weight of these remarks has increased greatly due to the decision to temporize the Redesign program and to extend the operational lifetime of existing systems. The DGAO endorses the conclusions of the AD, and has the opinion that there are shortcomings in the organization of the automation by the IAG».¹²

Note that the first paragraph doesn't mention or explain the temporization mentioned in the second paragraph. The DGAO furthermore gives no clear indications about the importance of the shortcomings and problems. It says nothing about the need of external intervention. It implicitly suggests that the risks and shortcomings can be managed by IAG itself. But the fact that it does not say so explicitly gives rise to doubts: don't the shortcomings threaten effectiveness and efficiency, can IAG adequately manage the risks and shortcomings autonomously, or is intervention necessary?

Hermans' letter to parliament about the failure and follow-up of the program Redesign.

The next milestone is the letter of minister of education Loek Hermans to parliament of 20/12/00 about the conclusion of the Redesign program and an evaluation of the IAG.¹³

The first two quotes are from section 1 of the letter, “Change of course IAG”. The first is from p. 2:

«On the basis of the results of this study [by IAG] it was decided to innovate by stepwise renewal. This means that it must be decided which systems are to be renewed first, whether necessary changes can be implemented most efficiently in existing systems, or that building a new system is a better option. Experience has shown that the alternative, simultaneous replacement of all existing systems by an integral new system is not feasible. Maximal use will be made of experience and results obtained. It has moreover been decided not to organize the stepwise renewal as a separate project, but as an integral part of the line organization. The line managers will be responsible for progress, which increases the involvement of the employees in the renewal process».

The second quote is from p. 3:

«The big difference with the old approach is that the renewal of the system software will not take place in a separate unit of the organization, but will be considered as part of daily routine. The necessity of system renewal remains, but will be phased and temporized with emphasis on manageability of the renewal process. Priority will be given to process improvement. Solution of practical problems of the shop floor takes precedence, so that employees of IAG experience the advantages of system renewal directly».¹⁴

⁹ The report is in the directory Renewal, under 20000530.

¹⁰ 1 € = 2.2 f (= "gulden").

¹¹ This probably refers to system development required by changes in laws or policy.

¹² Pp. 15-6.

¹³ The letter can be found in the directory Renewal, under 20001220.

¹⁴ This may be, or probably is, the origin of the earmarked budget of 2.3 M€ for stepwise process renewal. A proof could not be found, but this is how things were done at this ministry.

Section 2 discusses the results of the program and summarizes the financial consequences:

«Of the total amount of investments, 70 Mf has produced useful results, 27 Mf is useful for the continuation of system renewal, and 59 Mf has to be written off.

[...]

In terms of time and money and due to its R&D character the approach chosen by IAG was no longer manageable, but in terms of technological innovation very promising».¹⁵

The following is quoted from the beginning of section 3, “Results benchmarking”:

«In order to find out whether the monopoly position of IAG doesn’t lead to inefficient use of [financial] means, I requested KPMG to benchmark IAG. [...] Within the set of benchmark partners IAG scores average, so sufficient. I conclude that the image of a malfunctioning organization that may have arisen is falsified by this inquiry. IAG scores good where costs are concerned. It may be concluded that IAG works efficiently».

This is being said after having concluded that Redesign had to be abandoned, and that 59 Mf of taxpayers’ money has to be written off.

Hermans is silent about the limited significance of the benchmark. Without hesitation he draws important conclusions on a very weak basis. There is no uncertainty or prudence.

The section about the benchmark ends as follows:

«IAG agrees with the conclusions and recommendations of the benchmark. In some fields action has already been taken. The coming years will show whether these actions have produced visible results».

Section 4, “Formal position of IAG”, considers the legal status of IAG, and the management of IAG by the ministry. The minister concludes:

«I think the ideal would be that in the short term IAG and I make a system of agreements which on the one hand defines the products and services of IAG, and the budget I will make available on the other. The concrete proposals for improvement are:

[...]

- the position of the Supervisory council of the IAG has been clarified. In its supervisory work, the council keeps the political situation in mind. In my periodic conferences [with the council] the supervision of the top of IAG by the council will be discussed. In this way the council accounts for the way it has been supervising».

The annual reports of IAG include a report of the activities of the Supervisory council. It shows that the members of this council (can) spend only a small part of their time on the supervision of IAG. The council meets 4 times a year with the top of IAG, and 2 times with the minister. It is therefore impossible that its supervision is substantial.

It is remarkable that the letter notes that processes of improvement are necessary and have started, but says nothing about the monitoring of these processes. Neither by minister or ministry, nor by the Supervisory council. On the contrary, he will wait and see: “The coming years will show whether these actions have produced visible results”.

Hermans’ letter is defensive and denying. It doesn’t refer to the remarks of DGAO or AD. Let alone that the problems they mention are discussed and dealt with. Parliament (at least: a majority of parliament) nevertheless accepted the letter. No corrective effect could be observed.¹⁶

Who is who in the top.

In the year 2000, Hermans appointed the head of the IAG, Harm Bruins Slot, SG of his ministry. Bruins Slot had been head of IAG since 1998. Hermans was minister from 1998-2002. As head of IAG Bruins Slot was succeeded in 2001 by Chris Spanjaard.¹⁷ As SG Bruins Slot was succeeded in

¹⁵ R&D= research and development.

¹⁶ This is the reason why no effort was made to find the minutes of the relevant meeting of parliament.

¹⁷ P. 8/6 IAG annual report 2001. In the directory renewal, under 20020426.

2003 by Koos van der Steenhoven. Hermans was succeeded in 2002 by Maria van der Hoeven, who remained minister of education until 2007.

The February 2003 benchmark.

In February 2003 another benchmark report was published.¹⁸ The following gives an impression of that report. It is discussed because it may have influenced decision making about the policy claim (the first name of the Renewal program), and because the study of reports of this kind is one of the main subjects of this chapter.

On p. 14 the report answers the question: "Where does the organization come from?":

«History

Since January 1, 1994 IAG [...] is accountable to a Supervisory council. In the last years of the 90's the IAG was radically reorganized by a redesign project. This project has been very taxing, but also brought important progress. The most important benefit of the project was that it transformed a product oriented organization into a customer oriented organization. [...]

In the past period almost the whole executive board was renewed. This causes a fresh wind and clear direction. One of the spearheads in the past period was optimizing processes and the planning and control cycle».

On p. 5 the report concludes:

«In the benchmark of 10 organizations IAG scores around or above average for most of the subject areas. An exception is the rating of IAG by the public, which is below average».

The report concludes as follows:

«Overall consideration

With respect to the benchmark of 2000 IAG made a step forward. Some results have improved. Direction has improved too, and a big step was made in the management of processes. However, if the improvement actions had started sooner after the benchmark report of 2000 even better results might have been obtained. Regarding employees IAG made a small step backwards. This refers to the application of instruments of human resources policy. Some essential points did get attention, so that employee satisfaction increased and absence due to illness decreased».¹⁹

Again a comparative analysis. The question whether the improvements are sufficient isn't even considered.²⁰ Can IAG properly do what it is supposed to do, and what it wants to do in the near future? Can the (generalized) conclusions of the report be drawn on the basis of benchmarking alone? Last but not least: benchmarking isn't benchmarking. In this case there is plenty of reason to doubt its relevance and usefulness. According to the report, the benchmark is based on a study of documents such as policy plans, year plans,²¹ and interviews.²² It was mainly aimed at measuring valuations of performance with respect to:

«goals and spearheads (ambitions) of the Policy plan (version 2002-2004 and draft 2003-2006).

The six ambitions presented there are:

1. pupils and students are significantly more satisfied with IAG;
2. IAG is appreciated as a partner in the education sector;
3. IAG is appreciated by the ministry;
4. Employees are significantly more satisfied than in 2000;
5. With respect to appreciation by the public, IAG wants to conform to the norms of the Charter for Public Accounting;

¹⁸ The report can be found in the directory Renewal, under 20030200.

¹⁹ P. 55. Note that the last sentence reeks of compromise, and of being added to end on a positive note.

²⁰ The answer might be that this question cannot be answered, and that one has to do with benchmarking. This answer can be rejected on the basis of the evidence presented in the preceding and following chapters: nonsense can never be accepted, or approved as being comparatively meaningful.

²¹ As the previous chapters showed, the relation between paper and reality may be absent. Although the benchmark report certainly isn't uncritical, formulations like those on p. 9 suggest that the documents were taken at face value. This may- but need not- have influenced the benchmarking, and should therefore have been discussed.

²² Pp. 9-10.

6. With respect to the INK model [a management model],²³ IAG wants to work effectively and efficiently, and this should become apparent in the realization of the performance contract [with the ministry].²⁴

Excepting 6, these are subjective social valuations. Ambition 6 depends on the quality of the performance contract, which is doubtful. For example because the management information of IAG is insufficient, as noted by the audit department. See below.

Another part of the explanation of the discrepancy between the benchmark results and reality can be found in the sections where the benchmark findings are discussed in more detail. They refer to the going concern. That is: to the standard processes. Which obviously is important, but insufficient for the generalizations of the “Overall consideration”. Furthermore, someone looking beyond the averages can easily find warnings in these sections. Such as: “Innovation and knowledge management can be organized better”. And a remark like “has improved” sometimes seems to be a half-truth hiding insufficiency (and is anyway ambiguous). For example the graph on p. 42 under the heading “Leadership qualities improved” shows that the leadership qualities leave much to be desired. One automatically wonders whether the remark about innovation and knowledge management should be taken to mean that it is actually organized inadequately (or not at all).

All this means that the report isn’t open and independent. The reader should at least read very carefully, and not only take note of what is said, but also of what isn’t said. The report suggest that “insufficient” has been systematically replaced by “can be improved”. This is not accepted social custom however. Imagine school reports being written in this style! Obviously, this kind of report is insufficient for management purposes. It should at least be clear about the consequences of the present state of affairs, and point out insufficiencies that should be dealt with.

In the meantime one can conclude that the report violates the international code of ethics for auditors in the public sector.²⁵ Note that this can be concluded on the basis of a study of only the report. That is: without confronting it with reality. When confronted with reality, the report will be seen to have crucial flaws. Which is incompatible with a positive appraisal of the benchmark, but compatible with the analysis given above.²⁶

Finally it should be noted that a defective benchmark report is harmful. It reduces the pressure to take measures which are necessary to avoid systematic waste and corruption.

How the 2.3 M€ per year for process renewal was spent.

Every year IAG was given 2.3 M€ for process renewal.²⁷ The following quotes indicate how this money was spent. First a quote from the performance contract of 2004.²⁸

«2. Process renewal

The following is an incomplete and tentative list of the most important spearheads for the year 2004 as regards process renewal. [...]

- Realizing efficiency improvement in the processes via the project WorkWiser;
- Implementation of the ICT function including a new project management method;
- Application of innovative technological support in the processes;
- Developing instruments for management development.».²⁹

To show that this short term ad hoc approach was no exception we quote from the corresponding section in the performance contract 2005.³⁰

²³ INK= Instituut Nederlandse Kwaliteit, Institute for Dutch Quality. See IAG AR 2001 p. 18/11.

²⁴ P. 4.

²⁵ The code can be found in the directory Integrity: “INTOSAI Code of Ethics_ISSAI 30.pdf”.

²⁶ Strictly (logically) speaking it is not necessarily incompatible, because “relatively good” only means that the others are relatively bad. They may be (very) insufficient.

²⁷ As noted in connection with the letter of Hermans, this budget may have been created at the end of the Redesign program, to enable stepwise renewal.

²⁸ The PC 2004 can be found in two files in the directory Renewal, under 20040823 (appendices) and 20040824.

²⁹ The quote is from p. 3 of appendix 7.

³⁰ Appendix 7 can be found in the directory Renewal, under 20050727. The definitive version of the PC 2005 came in parts, and late. According to the general part it was to be signed 20/4/05, but the signatures are missing.

«2. Process renewal.

Every year IAG receives 2.3 M€ for process renewal. This is in addition to the basic budget, and supplementary to the process renewal that can be realized with the basic budget. In other words: the total amount available for process renewal is greater than 2.3 M€.

In 2005 the 2.3 M€ will be used for qualitative improvement and a temporary increase of organization and information analysts. The following extra capacity will be employed for this:

- Services P&I:³¹ 1.1 M€ extra capacity (6.4 fte) to implement the process renewal agenda of Services P&I;
- KS/P&I:³² 0.3 M€ for schooling, coaching and on the job training of new internal employees as a consequence of autostrada and [for?] hiring external people for the new internal employees who are being schooled;
- 1 M€ for hiring additional organization and information analysts to increase the capacity of the line (forming pairs of internal and external analysts, to spread know how).³³

No further information is given about the process renewal agenda of Services P&I.

The word “autostrada” does not appear anywhere else in the performance contract.

The quotes clearly show that there is no (“strategic”) long term plan for system renewal or modernization.³⁴ They confirm the remark of KPMG that “innovation and knowledge management can be organized better”. But they also show that the remark is a terrible understatement, which gives an incorrect impression of the quality of the management of IAG. Note that KPMG could and should have known of the earmarked 2.3 M€, and could and should have noted the absence of any long term plans.

2005.

Introduction.

The work done by IAG was done at the request of, supervised, and in a certain sense paid, by the corresponding departments of the ministry of education. The “corresponding” means: work in the field of higher education was done in cooperation with the department of higher education and so on. The “in a certain sense” refers to the fact that the ministry is a hierarchical organization, and that the budgets of the departments are the result of a distribution made by minister and/or (u)SG. Of course after a lot of deliberation. Most of the work of IAG, accounting for about 85% of its budget, was related to study financing. Most of the remainder was for HE. There was also work for primary and secondary education (PE and SE respectively), but not much. For all practical purposes, IAG, like IFC, was the responsibility of uSG.

For the contacts with IAG the departments had a departmental representative. Together with the assistant of uSG for IAG they formed the “IAG team”. The team met periodically to discuss the state of affairs and proposals for the future. HE was represented by Van Velsen.³⁵

A discarded warning about an inadequate plan and the inability of IAG to execute it properly.

In the last months of 2005 IAG sent the ministry documents describing what it intended to do with the ca. 45 M€ the ministry planned to make available for the so called policy claim.^{36, 37} The

³¹ P&I= processes and information. The meaning of this and similar abbreviations is 100% irrelevant in the context of this study. You only need to know that it is the name of a unit in IAG as a hierarchical organization.

³² The abbreviation KS is not explained in the text, but may mean client service (in Dutch: klantenservice).

³³ P. 3 of appendix 7. Due to round off errors the amounts add up to 2.4 M€.

³⁴ In theory process renewal and system renewal may be different, but in practice they go together or coincide. Moreover, since the ministry agreed with the use as shown in the quotes, it is ridiculous to suppose that it would have opposed use for the implementation of any long term plan whatsoever.

³⁵ Already before 1998, but it is not known since when exactly.

³⁶ In 2010 the origin of the name “policy claim” could not be found any more. The “incidental” 45 M€ may have been promised to partly compensate for a structural cut of the budget. It was a standard practice to give back a

documents were discussed by the IAG team. After some rounds of comments on drafts, IAG finalized the text. Everybody approved the text, except Van Velsen. At the end of December he sent Alice van Gent, the assistant of uSG for IAG, a mail with the following:³⁸

«I still have serious doubts about the adequacy of the “Substantiation” [of the plan]. If IAG cannot produce something considerably better, failure like that of the project Redesign is to be expected. Much in the “Substantiation” may have been copied from old documents, and there is far too little discussion of difficulties/ problems/ challenges (!) and how to deal with them.

I'm not saying that there is nothing in the paper that is true and good. But I do think that it is badly structured as regards the description of the problems and the desired changes. It makes the impression of an incoherent collection of text fragments. Much is missing. For example in chapter 7, “Management and control”. It has only two sections: “Starting points” and “Program organization”. Earlier chapters suggest actions of different kinds. But in chapter 7 there is no description of the different kinds of work to be done, and no indication of the order in which it should be done. This may also be of interest for the way the project is financed. What I read elsewhere in the paper suggests that it should be very well possible to say more. I consider the lack of information ominous because I see it as a symptom of inadequate understanding of the organization by its own management, and of the inability to start a major renewal process.

I do see a hotchpotch of reasons for change, and nice starting points, but nothing that convinces me of the ability of IAG to structure and manage the project. What the paper says about the organization of the project is definitely not convincing. (Experience shows that this gap cannot be filled by an external firm. The organization should have enough capable people of itself).

Therefore I stand by my opinion, that we as ministry should not accept this paper as basic document, but that in the course of 2006 ministry and IAG should try and reach agreement about a new document.

Furthermore it would seem to be wise that the ministry hires an expert, for 1 day per week, who has experience with reorganizations of processes in organizations which provide automated services on the basis of large databases. To help the ministry with competent, independent and critical comment. To me this seems to be very efficient from the point of view of cost and benefits.

Of course, the above is supported by experiences like:

- The often wearisome planning and implementation of much smaller renewal processes, and the bad substantiation of their costs;
- The use of the structural 2.3 M€ for process renewal, which was inadequate anyway, but very much more in the light of the new policy claim.

As far as I know, there is no big success that counterbalances these weaknesses.

Contrary to what was said in the presentation, IAG did have regular means for structural updates or improvement. There was a budget for process renewal, and maintenance was supposed to be included in the budgets for the going concern of the policy departments. I have explicitly verified this several times in the past. Maybe I didn't get a full and correct answer, but that seems to be part of the problem.»

Van Velsen got no reaction whatsoever.

The Advisory group. The lack of information about progress.

To support uSG, Van Gent formed a Advisory Group. It was chaired by Hans Haring, financial co-worker of the department Study financing. Van Velsen thought the policy portal project entailed enough extra work and trouble, and didn't like to participate as the only “pessimist” in a group of outspoken optimists. He was not invited, and didn't try to become a member. Still, the project could

small part of budget cuts for special purposes. The reasons given in the documents are invented a posteriori, as a cover. There probably was a need for updating systems and the system of systems, but as the Redesign program had shown, that would be impossible without “updating” management and staff. Witness too the lack of long term plans and the systematic abuse of money intended for process renewal.

³⁷ According to a memorandum 20051219_Notitie bij presentatie beleidsclaim_(AvG).doc of Alice van Gent, The Expert Centre (TEC) helped IAG with the formulation of the claim. From 1997-2003, before he became SG, Koos van der Steenhoven had been director of TEC.

³⁸ The mail is dated 16/12/05.

have consequences for the work of IAG in the field of HE, and the costs of that work. He therefore asked to be kept informed about the progress of the project. This was promised, but not done. When he asked Van Gent in the periodic meetings with IAG he got incomprehensible answers, which nevertheless suggested that there was nothing positive to be told.

Most of the documents used for this chapter have been collected at the end of 2009. The most striking observations of the years 2006-2008 were, that the project seemed shrouded in mystery,³⁹ that it took very long for the plan to be ready and accepted, and that nobody ever told anything comprehensible about the results.⁴⁰

2006.

Policy claim approved.

In a letter dated 29/5/06 uSG wrote the head of IAG that she was happy to be able to tell him that a positive decision had been made about the policy claim.⁴¹

The memo *IAG policy claim 2006-2010.*

In spite of its title, the main subjects of the memorandum *IAG policy claim 2006-2010. Information need of the ministry of education* of 23/11/06 are the management of the program and the responsibilities of various people and bodies in and around the project.⁴² It mentions the following:

«Starting points

- IAG and only IAG is responsible for realization of the trajectory. This means that time, money and quality are primarily managed by IAG. Management by the ministry is restricted to the main lines and political risks;
- As supervisor the Supervisory council should monitor and accompany the program critically;
- Financial means will be made available on the basis of completed plans for the separate projects in the program. The plans have to be approved by uSG before payment will be made;
- Payment takes place in accordance with the budget schedule for 2006-2010 and takes account of the total budget made available by the ministry. The ministry considers the budget estimates as the maximum estimates. Windfalls on the spending side lead to downward correction of the corresponding estimates;
- The long term budget estimates will be corrected for the savings assumed to be generated by the project. IAG is responsible for the realization of these savings».

So the ministry gives IAG two bosses: the Supervisory council and itself.

The quote shows that the ministry considers itself responsible only for the payments, and not for the course of the project. The ministry doesn't say that it will check whether the Supervisory council does what it is asked to do. It even doesn't wonder whether the council is able and willing to do the job.⁴³ The ministry restricts itself to the main lines and political risks. But how does it estimate the political risks? There is a political risk if there is a possibility that a minister has to go to parliament to answer unpleasant questions about something he is responsible for. For example if the media report that students didn't get paid because something went wrong at IAG. Can one estimate this risk by looking only at the main lines? In the case of IAG definitely not. Furthermore, if a risk becomes reality the minister will be informed by the ministry, not by IAG. In other words: at that moment the ministry has to know much more than the main lines.

And by the way: is the ministry saying that it approved a program of M€ 45 on the basis of the

³⁹ Van Velsen heard very little. Why? When he asked, he got no satisfactory answer.

⁴⁰ This is from personal recollections of the author.

⁴¹ The letter can be found in the directory Renewal, under 20060529. It doesn't mention the size of the budget.

⁴² The memorandum can be found in the directory Renewal. It is probably of an earlier date, possibly 11/7/06. The metadata show that it cannot be of a later date.

⁴³ If the council had the same- almost useless- information as the ministry it clearly couldn't.

main lines?⁴⁴

The conclusion is that the position taken by the ministry with respect to the various responsibilities is untenable, unrealistic, and increases the risks (by creating ambiguities).

A masterplan/ PID.

A document called “Masterplan/ PID⁴⁵ 2nd half of 2006” was completed 28/9/06.⁴⁶ Remarkable about this plan is that:

1. it wants to do (very) many things simultaneously;⁴⁷
2. specification of the results is missing;
3. alternative schedules are missing;
4. an exit strategy is missing;
5. in spite of recent negative experiences the ministry accepts this.

Nobody seems to have proposed to start with a more restricted, less pretentious agenda.⁴⁸

An exit strategy is a plan for periodic evaluation of the progress of the project, and allows for the decision to stop parts of the project. To avoid further waste if continuation is found to be ineffective or impossible.⁴⁹ An exit strategy tries to optimize the results of the project even if it cannot be completed, or if parts of the project are too difficult or fail for other reasons. It is a kind of risk management.

The table of products on the pages 42 and 43 of the Masterplan/PID is amazing. It clearly shows that IAG still doesn't know what it is going to do. It only knows that everything should be made better. The table gives a list of goals and corresponding products. The text above the table is the following:

«1.8 Products and services to be delivered

In this section the end goals to be realized are translated into the products and services delivered by the program».

This is how the goals, products and services are “specified”:⁵⁰

Goal	Milestone
Better process architecture	Process architecture delivered
Better system architecture	System architecture delivered
Better processes	New etcetera
Better systems	New etcetera
Fitting organization structure	Reorganization completed
Etcetera.	

Estimates of the costs of the project can be found on p. 53 of the Masterplan/PID. The total costs for 2006-2010 are estimated at 54.2 M€. As from 2010 the completed project should yield savings of

⁴⁴ It didn't even know or understand the main lines. For the most important main lines are described in the mail of Van Velsen quoted earlier, and these admit of only one conclusion: no money for this “plan”, and without proof of competence.

⁴⁵ PID= Project Initiation Document. According to for example Prince2 such a document should specify the project, including goals and intermediate and end results.

⁴⁶ It can be found in the directory Renewal, under 20061002.

⁴⁷ And many things seem to be independent of each other. They could be tackled separately, and at different times.

⁴⁸ Both Supervisory council and ministry could and should have done this.

⁴⁹ People may learn in the course of a project. They may learn that they pretended too much, and should have been much more modest, for example. An exit strategy creates possibilities for such an acknowledgement and for scaling back.

⁵⁰ It is slightly better than the quote from the table suggests, because elsewhere in the Masterplan/PID one can find explanations of the meaning of “better”. But these explanations too are extremely subjective and open, and cannot be called specification. See for example p. 13 of the Masterplan/PID.

5.4 M€ per year.⁵¹ If correct this would mean that the investment is not profitable. For in 10 years most or all of the new or better systems etcetera will certainly be outdated.

2007.

The audit departments of ministry and of IAG express worries.

In the audit department of the ministry of education, Hemke Havinga is charged with IAG. In a memorandum of 7/2/07, she writes that the audit departments of ministry and of IAG recommend frequent audits of the project.⁵² The memorandum explains why this is a risky project. Havinga furthermore notes:

«Realization of the project may be the responsibility of IAG, but there is an undeniable relation with ministerial responsibility in the field of study financing».

Ministry and IAG sign a covenant.

In February or March 2007 ministry and IAG signed a covenant about the policy claim.⁵³ It includes the following:

«Starting points

- Management by the ministry is restricted to main lines, finances and political risks;
 - Only IAG is responsible for the realization of the program;
- [...]
- According to “Substantiation Policy Claim 2006-2010” of January 2006 the goals are:
 1. Improvement of reliability and transparency of study financing for the benefit of students and ministry;
 2. Reduction of development, management, and product costs;
 3. Reduction of the time needed for system adaptation to changes in regulation.»

The first two points confirm similar points in the memorandum *IAG policy claim 2006-2010*.

Information need of the ministry of education of 23/11/06. The covenant asserts that the role of the Supervisory council remains unchanged. With regard to reporting the following is agreed:

«Reports

The reports inform about the realization of the most important milestones or products to be delivered. Deviations from the planning are explained in terms of underlying causes. IAG informs about its plans for solution.

- The accounting of IAG will be aimed at a timeliness and depth which will enable the ministry to act in accordance with its responsibilities;
- Financial accounting will take place in the framework of the regular planning and control cycle. This means that the 4-monthly reports will provide a complete picture, and that there is no need for separate conferences about financial aspects;
- The concise monthly progress reports about IAG2010!⁵⁴ which are used for internal management purposes in IAG will be sent to the ministry as well. The format is given in the appendix;
- IAG will exert itself to provide the ministry additional information at request».

Comments by the audit department on IAG2010! and IAG's management information.

On 7/3/07 the audit department of the ministry published its report about the annual report 2006 of the ministry. The following is quoted from p. 27 of the report:

⁵¹ This seems to be hardly more than wishful thinking or rather wishful argumentation. Something similar can be said of the cost estimates, except that the terminology should be changed from “wishful thinking” to “wild guesses”. At least as long as the project and products are not specified much better.

⁵² The memorandum can be found in the directory Renewal under 20070207.

⁵³ The covenant can be found in the directory Renewal under 20070306.

⁵⁴ Another or new name for the policy claim program.

«In cooperation with the ministry, IAG has started IAG2010!, an ambitious program for renewal of both the management of the organization, the way of working, information systems, technical infrastructure and methods and techniques. We are worried about the limited progress. The scheduled milestones of 2006 have not been realized, and there is no up to date network planning. We will monitor the project closely.

[...]

Quality of management information still insufficient

The systems of IAG are not directed at the flexible provision of information. The architecture with respect to the provision of information for external partners is outdated. Some information processes are integrated in primary systems, and other information can only be obtained by means of easytrieves and queries. For the program IAG2010! it is very important to ensure good, efficient and flexible provision of information about the expenditure of the program budget».⁵⁵

Note that information available for the management of IAG can also be sent to the ministry. Conversely: if management information is so hard to get by, it may as well not be available for the IAG management either. Inadequate availability of management information may explain the lack of IAG accountability seen in the report about the costs of the maintenance of Studylink in chapter 3. IAG cannot give information which it does not possess. But it can at least explain why it can only estimate the costs, and how it did. IAG is accountable to the ministry. It has no excuse for not sharing the information it has available.

An important question for somebody or an organization (like the ministry) who is responsible for the proper functioning of another organization is: does the management of that organization have the information necessary for its management? For checking and improving effectiveness and efficiency? In the case of IAG the information may have been very insufficient. The top may not have known (and understood) what was happening in its own organization, even when it signed claims for specific (possibly imaginary) activities.

Hans Haring as featured in IAG AR 2006.

On p. 23 of the annual report 2006 of IAG one sees a photo of Hans Haring, chairman of the Advisory group. Below the photo one reads the following text:

«Hans Haring, manager in the department of Study financing of the ministry of education

The ministry has given IAG money for a renewal program intended to improve the existing organization. The money is spent well if the communication with the students is client friendly, if adaptation to (future) changes in the Study financing regulation will take less time and give better results, and if IAG works more efficiently. This requires renewal of the systems, so that IAG can obviate existing risks. This will not benefit only students. The taxpayer and IAG employees too will benefit from a properly functioning organization».

IAG's 12-month report 2006 on the progress of IAG2010!

The 12-months report of 2006, the last of the three 4-monthly reports of that year, reports as follows about the progress of IAG2010!:⁵⁶

«IAG2010! (formerly Policy claim)

The program IAG2010! aims at improvement of the processes in the production organization, with study financing as the spearhead, and in the supporting ICT organization. The program extends from the preparatory year 2006 to 2010, when the better and more efficient processes should be realized. In 2006 the project accumulated a delay of 3 months, but this has no consequences for the end date. As from March 2007 the business case and organization and its management will be reviewed by a firm which is enrolled by a European tender. By now the quartermaster organization has become a full

⁵⁵ The report of the AD can be found in the directory Renewal under 20070307. The quote is confirmed and underlined by a note under the table “Finances” in the “dashboard report” of February 2007, made on 22/3/07: «No numbers available due to problems SAP/CATS (IAG-wide issue)». This report can be found in the directory of this chapter.

⁵⁶ The report can be found in directory Renewal under 20070315.

fledged program organization directed by the former head of KS and an externally recruited program director».⁵⁷

(This is all).

At first sight this seems more positive than the report of the audit department. But upon comparison of the two the IAG report must be qualified as tricky. It calls 2006 a preparatory year. It doesn't note that milestones had been defined, and that these have not been realized. It does note delay. It does not mention cause(s) of the delay. It does not explain why the delay need not have consequences for the end date of the program. The announcement that the business case will be reviewed only as of March 2007 suggests that the preparatory phase will not be finished before April 2007. The last sentence, about changes in the organization, increases the doubts about the time schedule, because it takes time for people to work their way in, and for a new organization to start working smoothly.

The first 2 of the 5 sentences of the report are nothing new, and do not belong in a concise report. The paucity of information in the remaining 3 sentences is hard to reconcile with the agreement about the reporting in the covenant of February or March. It certainly doesn't have the «depth which will enable the ministry to act in accordance with its responsibilities».

Obviously, both ministry and Supervisory council should have asked for a more comprehensive way of reporting.

CapGemini regauges the strategy of IAG.

In the spring of 2007 the consultancy firm CapGemini has regauged the strategy of IAG. It did so at the request of, and in collaboration with, IAG. CapGemini elaborated the consequences of the regauged strategy for the organization. This resulted in a report “Expert vision IAG”⁵⁸ with recommendations in the following fields:

- «Organization and management
- Client and market
- Processes and ICT
- Culture and leadership»

The recommendations overlap and interfere with IAG2010!. The minutes of the meeting of the Advisory group of 26/3/07 assert that IAG said that the Supervisory council was told that «about 20% of the present strategic vision differs from the expert vision which is being developed». It is hard to believe that this exercise has simplified the planning of IAG. It seems much more probable that incompatibilities arose, and led to problems.

If it is assumed that the extensive policy claim of 2005 was based on serious reflection on the part of IAG, then it is incomprehensible that it requested CapGemini in the beginning of 2007, supposedly without consulting the ministry, to develop a new organization strategy, and that it rewrote the program on the basis of the new strategy. In any case, it failed to explain why this exercise was held when the program was more than a year underway, instead of before writing a plan for the program.

The ministry decides that the agencies IAG and IFC will be merged.

In the spring of 2007 the ministry announced that IAG and IFC would be merged. In the years 2007-2009 discussions about the merger, and preparations for the merger took a lot of time and attention, especially of managers. The more so since the merger was to be accompanied by a reduction of personnel and by removal of functions from Zoetermeer to Groningen.⁵⁹ Formally the merger became a fact on 1/1/10. But at that date the merging process was not yet completed.

The merger had consequences for the hard and software (systems) of IAG and IFC. The changes in this field would have to be proposed, designed and implemented by people who in normal circumstances worked on system development to implement changes in regulation, and in 2006-2010 also participated in IAG2010!

⁵⁷ The abbreviation KS is not explained in the text, but may mean client service (in Dutch: klantenservice).

⁵⁸ In directory Renewal under 20070705.

⁵⁹ The head office of IAG was in Groningen. That of IFC in Zoetermeer. Very few of their employees worked in offices in other cities.

On 11/4/07 uSG held a conference with the Supervisory council to discuss IAG2010!. The minutes of the meeting contain the following exchange:

«The ministry [= uSG] asks what the council thinks of the relation between IAG2010! and the possible cooperation with IFC. The council indicates that cooperation should take place on the basis of choices made».⁶⁰

Nothing was said about negative consequences for current activities and projects, and about the growth of (political) risks. It is incomprehensible why the council didn't reject the ministerial proposal out of hand, as being incompatible with its earlier decisions and the work program of IAG. Why it did not demand postponement until after the completion of IAG2010!, or proposed (or threatened) to round off IAG2010! as soon and as good as possible, and to continue only after completion of the fusion.

Publication of the Strategic plan IAG, and replacement of IAG2010! by a Renewal plan.

In July 2007 IAG distributed a *Strategic plan IAG* and a *Renewal plan IAG*. Chapter 7 of the last plan gives a concise description of the projects It positions them relative to IAG2010! or the expert vision. The Renewal program replaced IAG2010! One gets the impression that even more irons are put in the fire.

The ministry wants better reports.

On 2/8/07 Van Gent sent IAG a mail with an appendix specifying the required contents of the progress reports.⁶¹ The appendix betrays worries. It concludes:

«N.B. We also want to know who is going to pull what, and how care is taken of sufficient involvement. We also want to see that the original goals still stand».

The appendix doesn't say how often IAG should report. In its meeting of 15/10/07 the Advisory group decided that IAG should report monthly.

The present author hasn't found any report with the information requested.

PwC reviews Business case Strategic Plan 2007-2012 and Renewal Program.

In October 2007 the accountancy and consultancy firm PricewaterhouseCoopers (PwC) reports about a review of the Business case Strategic Plan 2007-2012, which includes the Renewal Program.⁶² The following quotes are from the summary:

«At the request of IAG PwC has reviewed the Business Case Strategic Plan 2007-2012. The purpose of the review was to give an evaluation of the business case (buca) for the implementation of the strategic plan of IAG for the period 2007-1012.⁶³ Objects of investigation were: the strategic plan, the renewal plan, and the buca as defined by an excel file.⁶⁴ The scope of the investigation is the substantiation and the financial calculation underlying the buca, with a focus on the assumptions made, and the commitment of the project organization. A review of the strategy itself, the plans for a new structure of the top management, the financing of the project, and its feasibility in relation with other IAG projects, do not fall inside the scope of this review.

The review was made in September 2007, and consisted in a combination of desk research and interviews with the top managers, program managers and controllers of IAG.

[...]

⁶⁰ Indeed, this seems a ridiculous reaction.

⁶¹ In the directory Renewal under 20070802.

⁶² In the directory Renewal under 20071009.

⁶³ According to Appendix 2 on p. 37/40 of the DGAO report on ICT projects dated 20071129 in the PPP-directory, a business case is «an objective justification of a project. It substantiates use and necessity of a project, supported by a cost-benefit analysis which does not only weigh financial costs and benefits but also qualitative ones».

⁶⁴ The version studied by PwC could not be found. A revised version 6 of December 2007 can be found in the directory Renewal.

In conclusion it can be ascertained that there is a qualitatively good and motivated team with a sound plan. However, because of its complexity and technological challenges the program will demand the utmost of everyone in the organization from high to low. This requires an approach which differs from what IAG is used to. Another complicating factor is the possible impact of the environment of the program (policy agenda and cooperation with IFC). If implemented properly, the given recommendations can amplify one another, and provide the transparency, dialogue and control which the team needs to succeed».

According to the first paragraph the scope of the review is rather limited. But the scope of the last paragraph is much wider than “the financial calculation underlying the buca [...] and the commitment of the project organization”. Someone who reads the report sees that its scope is much more in accordance with the last than with the first paragraph.

The observations of PwC in the report show an organization which was unable to make a good plan and to prepare itself properly for its implementation.⁶⁵ They show an organization which clearly hasn't learnt the lessons of the project Redesign, and a major program with insufficient transparency, dialogue and control. Someone who combines this insight with the fact that the project is already more than 18 months old cannot restrict himself to the conclusion that success depends on conditions which he should know are hard or impossible to fulfill. He should make a remark that to that effect, and say what needs to be done to make success probable (not just “more probable”). The conclusion of PwC can be read as a (covert) warning. But only a much more outspoken warning would have been compatible with the observations in the report, and with the honesty, candidness and regard for the public interest required by the code of ethics of auditors.⁶⁶

The review report itself (as distinct from the summary) consists of a series of observations, implied risks, and recommendations for risk reduction. For brevity we restrict ourselves to topics which are relatively easy to understand. Risks are only mentioned if they aren't obvious. The numbers have been regrouped to fit the headings.

Please remember that IAG called 2006 the preparatory year, and that the observations of PwC concern the situation in September 2007.

With respect to the transparency of the business case and financial accounting.

«Observation

1.11. Costs and benefits have been localized, but are not given per year per section. Financial substantiation has been elaborated with respect to costs and benefits bottom-up, starting with calculations of IAG2010! and Expert vision, and represented in totals according to the subjects listed in the strategic plan. On the basis of this buca it is impossible to find out which project results cause which costs and benefits as a function of time. Total savings (fte) per section are given, but not as a function of time and not coupled with specific project results. Computational rules and rates have not been applied consequently [...] This insight may be obtained by coupling several documents.

1.21. IAG New includes IAG2010! However, on the basis of the buca it is difficult or impossible to trace which project results (including costs and benefits) have been accounted for with the buca of IAG2010! which was approved before.

Risk.

1.22. Insufficient transparency of agreements from IAG2010! may give rise to questions by the ministry».

With respect to project management.

«Observation

⁶⁵ Contradicting the conclusion cited earlier.

⁶⁶ See chapter 4, search for INTOSAI.

1.38. The PID's of the projects remain to be elaborated. At this moment there is no detailed picture of the planning and critical resources. According to the buca results have to be delivered in 2007 and 2008.

1.24. The duties, responsibilities and authority of the program managers and across the programs have not been made explicit.

1.25. It has been decided not to appoint a manager above the program managers.

1.26. Most members of the steering group and the program management have double roles (in line and project).

1.51. The interviews yielded general learning points for IAG: we find it difficult to say "no"; we are too kind for each other; we are bad at honoring agreements and addressing one another about this; we don't show our disappointment if we expect something of someone that isn't delivered; we put too many irons in the fire».⁶⁷

With respect to assumptions and delimitation.

«Observation

1.30. In the interviews of program managers a number of assumptions and boundary conditions were mentioned which were important to get results. At this moment these were mainly implicit assumptions and boundary conditions with respect to external parties, such as the ministry, and internal parties, such as other programs, projects and line activities. A policy quiet period for example. These assumptions and conditions have not been specified and made explicit in the buca IAG New.

1.68. In 2008 a development capacity is needed of 185,000 hours. This is not confirmed yet. There is anxiety about this number. It may be impossibly high. The capacity needed for policy [changes], maintenance and activities for the ministry of health (MH) are not clear yet.

1.69. The maximal development capacity of IAG is approximately 450,000 hours (regular years need between 350,000 and 400,000 hours). For 2008, the present development agenda, maintenance, MH and IAG New together require 525,000-550,000 hours. This seems to exceed the possibilities of IAG.

Risks

1.70. Insufficient capacity to fill the project needs. Delays and failure to realize goals/results and related benefits timely.

Advice

1.71. The competent authority in IAG should take a decision about this as soon as possible. It is very probable that [ambiguous text skipped] choices must be made about what IAG can realistically cope with.

Observation

1.72. Many important positions in IAG are still changing, while IAG New requires a relatively stable organization. It is important that the names of the new head of Client services and the new head of Human resources are announced soon.

1.75. A heavy time with many different priorities awaits the program managers: line, project(s), renewal in the line, future cooperation [with other parts of IAG, IFC].⁶⁸

The question is not only what can be done about defects and problems, but also what the defects

⁶⁷ Note that this refers to interviews of "the top managers, program managers and controllers of IAG".

⁶⁸ Slightly edited ("polished"), as some other observations of PwC, mainly because the original text is slightly illogical, incorrect, ambiguous etcetera. One frequently gets the idea that efforts to find a text compromise have been cut short by some time limit.

and problems say about the organization and its employees, given its history. And whether it is reasonable to expect that an organization which doesn't correct itself after a failure like that of the project Redesign, let alone before starting a similar project- as implicitly shown by PwC- can successfully run and complete such a project. Since the snapshot of PwC shows the project when it has already spent 20 of its 60 months, one may safely conclude that this is very improbable.

But PwC fails to consider its observations in the light of the history of IAG and of the fact that the project is 20 months old. It also ignores the fact that the IAG top management decided to make a new strategic plan at a time that much energy was being spent on a project that intends to renew almost the whole organization. Don't these facts say much about the top management of IAG? And indirectly about the risks of the Renewal program? One furthermore wonders how PwC, notwithstanding its impressive list of observations, can speak of a "qualitatively good and motivated team" and a "sound plan".

Obviously 1.71 is very good advice. Even though it is an understatement to call insufficient capacity in 2008 a risk instead of a certainty. And worse: the advice has been left to rot in the main text. It is not repeated in the summary, which breathes an optimism missing in the main text.

Reaction of the ministry on the PwC report.

Let's now see what the ministry did with the report.

In the minutes of a meeting of 15/10/07 with recommendations for uSG, the Advisory group mentions the report of PwC.⁶⁹ It says nothing about the contents of the report. It tells uSG:

- «As a condition for change, IAG demands: "the ministry implements measures simplifying regulation of study financing". This condition is not realistic. The ministry sees the proposals of IAG as suggestions to be checked on feasibility and desirability;⁷⁰
- As another condition, IAG wants to employ its development capacity only for the implementation of the policy agenda and the Renewal program. If this is not permitted, risks will arise».

The memorandum concludes:

«Risks

The plans require an appreciable development capacity. In 2008 there would even be a shortage. However, on the basis of the known and supposedly unchanged principles, IAG expects the development agenda to be "manageable". The Advisory group perceives this as a precarious equilibrium. The present plans moreover do not take the extra work for the cooperation [= merger with IFC] into account. For this reason the going concern may be endangered.

In addition, in the opinion of the Advisory group, the workload of the program managers is a risk.

Recommendation.

uSG is advised to discuss these points with the Supervisory council. The ministry should press for reduction of the scope, whereby non-related activities IAG2010! should be considered critically».⁷¹

In other words: neither of the conditions will be satisfied.

If this is seen in the light of the observations of PwC, it is clear that the political risks are very high, and increasing. It is almost certain that at least some of the goals will not be reached according to schedule. And that it would be nice if delay was the only price to be paid for asking too much, for PwC also shows a dangerous lack of necessary abilities (even if implicitly).

Note that IAG now has three large scale operations on hand: the policy agenda, the renewal project, and the merger. All three affect the whole organization.

The ministry could have known from the beginning that the renewal plan would demand very much of IAG's development capacity. This is easily seen by comparing the regular yearly budget for system

⁶⁹ The minutes can be found in the directory Renewal under 20071023.

⁷⁰ This interpretation is incompatible with the report of PwC.

⁷¹ The lack of clarity/ ambiguity is from the original.

development of 9 M€ with the budget of 55 M€ for 5 years, or 11 M€ per year, for Renewal. In other words: IAG would need twice as many people for system development. People who are highly trained and hard to find. Where could IAG possibly find them, even in quiet times? Nobody asked this question. The top managements seem to have thought that money can solve everything. Without thinking any further.

The DGAO publishes “Lessons from ICT-projects in the government”.

On 29/11/07 the (Dutch) General Accounting Office published Part A of its report “Lessons from ICT-projects in the government”.⁷² The recommendations can be summarized as follows:

- Be realistic;
- Be a full-fledged discussion partner;
- Phase decision making;
- Do not decide without substantiation;
- Enable review.

The ministry paid no attention to this report. In particular it drew no conclusions from the report as to its way of decision making.⁷³

PwC evaluates implementation of its recommendations.

At the end of its report of October, PwC lists some recommendations which had not yet been implemented at the time of its completion. In an additional report of the beginning of December, PwC concludes:

«For the moment the recommendations which had not been implemented in October have been implemented sufficiently. In our opinion, the conditions for making a good start with the program are fulfilled. The risks mentioned in the report of October remain important points of attention for the project. A prominent place of the program on the agenda of the executive team is important for support, to monitor progress, and to take important decisions. We recommend periodic reporting with respect to the full buca (including a review made outside the program management), for example twice a year, in May and November».

Having read the minutes with the recommendations of the Advisory group of 23/10/07 it is hard to understand that PwC believes that the conditions for success have been fulfilled. Isn't it simply a fact that they are not?

Furthermore, what is meant by “for the moment”? This is especially mystifying in the light of the next sentence, which after all predicts a good start.

2008.

Gakeer makes another risk analysis.

There is a “Risk analysis planning study financing” dated 21/1/08.⁷⁴ It was written by Bram Gakeer, of PPP and datawarehouse fame.⁷⁵ His department Information policy had been asked “whether it perceives risks in the planning proposed by IAG for study financing”.⁷⁶ By which was meant the Renewal program. The analysis concludes with the following section:

«Measures

This analysis is largely based on documents provided by IAG, and is limited to ICT aspects. It is meant to indicate possible risks at an abstract level. It is essential that the indicated risks are discussed with experts from IAG and IFC, to see which risks have been acknowledged and dealt with already,

⁷² In the directory PPP, under 20071129.

⁷³ This was “normal”: in general no attention was paid to external reports, unless the reports had been commissioned by the ministry.

⁷⁴ In the directory Renewal, under 20080121.

⁷⁵ See Chapter 2 on the PPP.

⁷⁶ The analysis doesn't say by whom it was requested.

and which additional measures are needed, if any.

In November 2007 a meeting of ministry and IAG decided that a workshop should be held in January 2008 to discuss the risks, and to see where synergy could yield benefits. This workshop can be seen as a first step towards elaboration of the risk analysis».

Gakeer makes no mention of the risks reported by PwC and those created by non fulfillment of crucial conditions. And to begin with: what was the need of an “analysis” like that of Gakeer, given the report of PwC? And what is one to think of the idea that the third year of a project of 5 years is begun with “a first step towards elaboration of the risk analysis”?

IAG's accountability report 2007.

An accountability report 2007 about IBG2010! and “Renewal IAG” by IAG is dated 31/1/08.⁷⁷ The following quote is the first paragraph of the introduction:

«This accountability report shows the results obtained in 2007 with IBG2010! (until 1/9/07) and Renewal IAG (as from 1/9/07). The date of 1/9/07 has prominent significance because on that day the management was changed radically. The new management is characterized by making those who are responsible for internal processes responsible for the program. They started with reduction of the interdependence of the different projects, so that the whole becomes less vulnerable to disturbances in the parts. The change cost some time, but the loss will be made good in the further course of the program. In other words: the management of the changes is now firmly rooted in the organization, the control of the different trajectories has been improved, and the risks of delay are decreased».

The quote suggests that an important source of risk and delay has been tackled. No mention is made of risks that remain. The report has no summary. It doesn't mention the review of PwC. The remainder of the report shows many (sub)projects, but no relationships. Neither does it explain why the accumulated delays do not require rescheduling of the planning and postponement of the end date of the program.

IAG's 12-months report 2007.

In the 12-months report of 2007, dated 13/3/08,⁷⁸ the following is said about the involvement of the Supervisory council:

«On 13/12/07 the renewal plan, including the corresponding buca, was approved by the Supervisory council and reviewed by PwC. It was agreed that every 6 months a progress report is submitted to the Council, an update made of the plans, and that they will be reviewed».

The second sentence is compatible with the text about the Supervisory council in the annual reports, but not with its role according to the covenant ministry-IAG:

«As supervisor the Supervisory council should monitor and accompany the project critically».

Obviously, the council has not understood the reports of PwC.

Comments by the audit department on Renewal and IAG's management information.

P. 28 of the report of the audit department of the ministry about the Annual report 2007 of the ministry gives the following evaluation:⁷⁹

«*Renewal program gives possibilities, and reasons for anxiety*

[...] In this [Renewal] program IAG has a unique opportunity to repair a number of weak points in old systems and to participate in a proactive way in some current developments in digital government. In the summer of 2007 IAG radically changed the organization and management of the Renewal program, and made the line organization responsible. Partly due to the formulation of new plans, progress in 2007 has been limited, also as regards milestones. The end date has not changed however, and because of the well-filled policy agenda and the merger with IFC we are worried about the feasibility of realizing the totality of projects in agreement with the plans. Because of the accumulation

⁷⁷ The report can be found in the directory Renewal, under 20080131.

⁷⁸ The report can be found in the directory Renewal, under 20080313.

⁷⁹ The report is dated 13/3/08. It can be found in the directory Renewal, under 20080313.

of developments we also see a risk for the quality of the going concern.

Improvement of quality of management information insufficient

One more shortcoming needs to be mentioned. IAG gets many information requests from external parties, and the internal interest in management information is increasing. The present systems of IAG are not very well suited for flexible and fast information retrieval. The architecture of the systems is outdated, and basic data are stored in different systems. This creates the risk of inconsistency. Information is mostly obtained by easytrives and queries».

Why don't the auditors use (and respect) the reports of PwC and the GAO? Why don't the auditors clearly and unambiguously say that for these reasons (to be listed) it seems improbable that the plans will be realized according to schedule, and that it recommends limitation of the scope and/or rescheduling the program in order to prevent accidents? If supposedly independent auditors ("watch-dogs") don't give such obvious and easily founded warnings and recommendations, who will?

uSG replies to IAG requests of a year ago.

Around 4/6/08 uSG replies to a letter of the head of IAG of 6/8/07 (!) with eleven proposals for accommodations of regulation to simplify its implementation.⁸⁰ She notes that some proposals are already being elaborated. She proposes to elaborate some others. She considers the remaining proposals infeasible.⁸¹ She does not indicate how IAG can solve the difficulties which the proposals were supposed to remedy or alleviate.

Advisory group concludes that overall progress is good.

The discussion in the meeting of the Advisory group of 16/6/08 concerned issues of minor importance. The issues were analyzed poorly. There is no awareness of serious problems, and no sense of danger or urgency.

Section 3g of the minutes of the meeting begins as follows:

«Review of PwC and conclusion

The chairman notes that the review of PwC has been a good learning experience. The chairman concludes that overall the progress of the renewal plans is good».

The minutes don't explicate what has been learnt. The remark about the progress may be based on the report by IAG to the Supervisory council, dated 30/5/08.⁸² It suggest that everything is all right.

Haring leaves the Advisory group and Study financing.

The meeting of the Advisory group of 16/6/08 was chaired by Haring. That of 1/10/08 by Nico Slooff, financial assistant to uSG and SG. Haring had left the section Study financing of the department of HE. He had become head of the section Finance of the department of Arts. A new permanent chairman of the Advisory group had not yet been found and appointed.

An audit of the duties, responsibilities and authority in the Renewal Program.

There is a (draft) report of 16/7/08 by the audit department about a "follow-up audit of duties, responsibilities and authority (DRA⁸³) in the Program IAG2010! c.q. Renewal Program".⁸⁴ The audit has the following

⁸⁰ Both letters can be found in the directory Renewal, under the dates mentioned.

⁸¹ The difficulties addressed by IAG are caused, or mainly caused, by parliament and the education minister. They make laws and rules which are at least very hard and costly to implement, and sometimes impossible. For example if they turn out to generate inconsistencies.

⁸² It can be found in the directory Renewal, under 20080530. See especially the conclusions on p. 14. They probably should be qualified as misleading (if not incorrect).

⁸³ Presumably this is a standard form of audit.

⁸⁴ It can be found in the directory Renewal, under 20080716.

«Goals

1. Check whether the distribution of responsibilities and work between NEA and IAG matches, and complies with the “Memorandum Agreements”;⁸⁵
2. Provide insight in the way IAG sets priorities in cases of conflicts of interests between going concern, renewal program, and merger;
3. Find out whether the recommendations from the audit DRA Program organization IAG2010! were followed up in the Renewal program;
4. Find out whether adequate measures were taken to reduce the risks mentioned in the first audit;
5. Find out whether adequate measures were taken to ensure that those line managers (with a full time appointment) who are program manager as well, can deal with the extra work in an acceptable manner;
6. Find out whether in the DRA’s in the new organization of the Renewal program new problems c.q. new risks arise.

[...]

Implementation of the audit

The audit began with the formulation of an audit plan and a framework of norms. The available documentation of the Renewal program was studied.

In a talk with the coordinating program manager he was given the framework of norms with the recommendations of 2007. He was asked to fill in and document the measures taken in pursuance of the recommendations. After a discussion of the framework of norms the measures were evaluated.⁸⁶

The evaluation took place with the help of the documentation and interviews with the most important people in and around the program.

In order to hear both sides, the minutes of the interviews were discussed with the people interviewed».

As regards the conclusions of the audit, the table of contents of the report suffices for the purposes of this study:⁸⁷

- «
 - 2 Audit outcomes
 - 2.1 Distribution of responsibilities and work is clear
 - 2.2 Norms for setting priorities are not described
 - 2.3 Recommendations from audit DRA 2007 were followed up
 - 2.4 Most important risks met in program organization
 - 2.5 Sufficient measures to prevent overburdening
 - 2.6 New risks are acknowledged
 - 3 Recommendations
 - 3.1 Keep clear agreements with NEA about renewal program
 - 3.2 Risk signals may be set up more formally
 - 3.3 Give sufficient attention to organizational part
 - 3.4 Formulate (limited) guidelines for setting priorities
 - 3.5 Keep giving attention to the relation with the ministry
 - 3.6 Report monitor independent
 - 3.7 Take care not to overburden program managers».

Like the other reports, this one contains inconsistencies. An example is that of the new risks. Section 2.6 mentions 3 of them, and concludes:

⁸⁵ NEA= new education agency.

⁸⁶ “measures were evaluated”. How? By documents and interviews, or by evaluation of the (practical) results? The main question here being: is this purely a paper and talking exercise, or are intended practical effects evaluated in the light of program and/or organization goals?

⁸⁷ Several of the original formulations are ambiguous. The ambiguities have not been resolved, but may not be exactly the same as in the original.

«The people interviewed acknowledge the first risk»⁸⁸.

Not the others? Why then does the audit report assert “New risks acknowledged”?

As in the quotes, the auditors only refer to their own reports. Not to any other report. As if DGAO, PwC and others never studied IAG, or don’t exist. According to the report, the audit consisted of the study of two documents⁸⁹ and twelve interviews, all of them with managers who had responsibilities for the program and/or IAG.

The review of PA Consulting Group.

On 31/10/08 PA Consulting Group (PACG) submits a *Review of Results of the Renewal program IAG* to uSG.⁹⁰ The review is defined as follows:

«The review request

The ministry has asked us for an independent evaluation of the renewal program of IAG, in order to gain insight in the risks for the ministry due to the program. The risks may concern costs or time schedule, the quality of (future) services rendered by IAG, or the public image of IAG or the ministry. Beside a critical evaluation, the review request allows for consideration of opportunities and possibilities which can make the program successful».

PACG wants the review to supplement the work of PwC. Of the inquiries made in the course of the renewal program, those of PwC and PACG seem to be the most helpful for understanding its evolution. But just like the PwC report, the report of PACG has weaknesses. A major weakness is that the review request and the contents of the report are inconsistent with the assertion about the supplementary character and the disclaimer, in combination with the absence of a description of the method of inquiry and substantiation of the assertions. In the section *Conclusions and recommendations* the limitations are forgotten. In the end the weaknesses are fatal: the report doesn’t distinguish more and less important issues and recommendations.⁹¹ Which creates the danger that necessary measures are not taken, and- in this case- failure is not averted. The combination of much useful information and essential gaps is characteristic for almost all “official” inquiries studied in the present report.⁹²

For the purpose of its review PACG distinguishes two central topics:

- The management by ministry and Supervisory council;
- The program: planning and implementation.

Apart from the introductory sections, the report consists of a section *Most important observations* and a section *Conclusions and recommendations*.

In the section *Most important observations* we read:

«*The management by ministry and Supervisory council*

1. The program is discussed in bilateral talks between IAG, the Supervisory council, and the ministry. But as regards the Renewal program, IAG reports only to the Supervisory council. The quality of the way in which ministry and council fulfill their roles depends strongly on the relevance and transparency of the information provided. There is a lot of documentation, and IAG makes it available completely and openly.⁹³ For the ministry and the Supervisory council the information is not

⁸⁸ Sic. On p. 8. Amazing but true.

⁸⁹ See p. 11 of the audit report, the first page of appendix 1.

⁹⁰ The report can be found in the directory Renewal, under 20081031.

⁹¹ Isn’t the last recommendation (number 5, see below, in the main text) the most important?

⁹² Much of this can be explained by too heavy, insufficiently critical, reliance on interviews with the interested organizational establishment. P. 13 (of 13) of the report gives a list of the persons interviewed, and their functions.

⁹³ The source of this remark seems to be an interview (in combination with blind faith), for it is incompatible with the report of IAG to the Supervisory council mentioned earlier (document 20080530). This report definitely is not open.

easily accessible, and is sometimes perceived as “concealing”.⁹⁴ There is no contact between the information asked and provided on the one hand, and

- The roles of the different actors
- The goals of the bodies of which these actors are a member.

This has consequences for an effective implementation of the roles of the ministry and Supervisory council, and is not efficient for IAG either.⁹⁵

2. The ministry has the role of financier. Directly or indirectly it will bear the financial consequences of the program. But on account of political risks the ministry is not only interested in financial aspects. It has a great interest in the success of the program. It is not primarily responsible for the program: that role is played by the Supervisory council.

In the “Agreement of ministry and IAG about the financing of and responsibility for the program” it has been agreed that the ministry “keeps a finger on the wrist”, and that “management by the ministry is restricted to main lines, finances and political risks”. The ministry tries to manage the political risks through its role as financier. This has not been made explicit however, and its present role and means do not enable it to serve this interest properly.

3. The ministry tries to limit its financial risks by only making money available when (intermediate) results have been realized. This requires unambiguous definition of those results, and the ability to evaluate the results in the context of the program as a whole.

- The definitions of the results which are financially important lack necessary clarity.⁹⁶ Moreover, the importance of the milestone and the financial consequences are not always proportional;
- The role of the ministry requires the ability to evaluate the relevant results. The ministry lacks this ability.

As a consequence the financing procedure is not sufficiently effective.

4. The lack of clarity about the different roles means that it is not clear who has the final responsibility for the realization of the program (Supervisory council) and the financing (ministry): there is no place or person where both aspects meet. According to the agreement between ministry and IAG, IAG and only IAG is responsible for the realization of the program. The financial flows and the responsibility for them are insufficiently clear.⁹⁷ This may cause risks affecting more than the program budget of IAG. [...]

5. In the evaluation of the functioning of the various bilateral talks it is noticeable that they hardly make decisions. The talks are mostly used to inform one another. It is not always clear what is discussed where. It is furthermore noticeable that if the Renewal plan is discussed at all, it is hardly done from the perspective of the future IAG, even though this should be the basis for managing the Renewal program. The organization of the bilateral talks and the decision making have to be sharpened. A shared vision for the future is an important beacon as regards contents».

The paragraphs about the program are focused on the management of the program and the projects of which it is composed, and on financial aspects. The remarks of PACG are similar to those of PwC. There are lots of doubts and questions, but PACG doesn't say how important they are.

The following is the slightly abbreviated section *Conclusions and recommendations*.

«Program

⁹⁴ Again, this is incorrect, see document 20080530. It is clear as crystal, but far too rosy.

⁹⁵ The text is incorrect and misleading. There was no information for example showing that IAG would be able to run Renewal successfully. After Redesign, progress with improvements (if any) had not been monitored.

⁹⁶ Compare this with the observations 1.11 and 1.21 of PwC. The present remark seems to hide a lot. (What about openness?)

⁹⁷ At least in the formal sense this is untrue. The ministry and only the ministry pays, through uSG. The Supervisory council is not involved.

The road taken has led to visible results.⁹⁸ The challenge is to hold on. If the program is continued without changes there is an appreciable risk of not realizing the desired result(s). In our opinion a purposeful, fundamental regauging of the original framework and approach is necessary. This should be done in a way that supports the progress of the Renewal program and builds upon what has been accomplished.

Management

As a consequence of the most important observations it is insufficiently warranted that political risks are recognized in time. In the given situation the ministry runs risks due to the administrative context of the renewal program. The present role of the ministry is small in proportion to the appreciable interest of the ministry in success of the program. Formally the ministry depends fully on judgments of the Supervisory council. But the question is whether the members of the Supervisory council have enough time to play their role with the necessary thoroughness. Furthermore the role of the ministry with respect to political risks has not been implemented explicitly.

Cooperation

We saw that it is difficult for the ministry to imagine itself in the situation of IAG as the “factory” which it actually is. We also saw that the management of IAG finds it difficult to imagine itself in the role of the ministry with its political responsibility. [...]

Recommendations

On the basis of our observations we have the following recommendations:

1. Make the roles of ministry and Advisory group explicit. Streamline the information flow from the program in such a way as to enable the roles. Less information, but more relevant. Be clear about what is discussed and decided where.
2. Make internal [instead of external] employees responsible for the management of important parts of the program (such as implementation of the rules engine and data management). Selectively recruit talented people who can fulfill this function, can bring things together, persevere and complete.
3. Direct the program more “from the outside in”. That is: direct all programs and activities as much as possible from the administrative viewpoint, the vision of the client and ministry, the services of IAG and the service model. Use this to bring coherence in the programs.
4. Implement the program “Culture and leadership” concretely. The present operation and recent performance problems offer good and concrete points of contact for this. Use them also for concretization of the Renewal program.
5. Regauge plan and buca on the basis of realistic assumptions. It is important to find a balance between ambition and a realistic expectation about what is feasible under what conditions.⁹⁹ Formulate the buca on the basis of the future service model and quantitative information about production volumes which is available in IAG. The savings are a result of this.

It is important to note that much of the information needed to implement the above is available, but spread over many documents and heads of employees. The regauging offers an opportunity to bundle knowledge and insight, and to refocus on goals and results. There are many good building blocks to build on.

To conclude

The formation of NEA is outside the scope of this review, but may have large impact on the realization of the renewal plan and the distribution of roles. In interviews it was said that people are already anticipating on the future situation. This observation, the earlier observations, and the fact that IAG is running into the limits of its capacity, are reasons to review goals, and reset priorities. This

⁹⁸ The results are not described in the report.

⁹⁹ Logically speaking, the sentence means that the ambition need not be feasible. The “important note” following this recommendation reveals a serious lack of coordination and management. This can only amplify existing doubts about IAG’s and the ministry’s ability to successfully define, plan, and execute a program like Renewal. Of course, it also amplifies doubts about the integrity and competence of PACG.

requires close collaboration of ministry and the top management of IAG».

Reactions of IAG and ministry.

A meeting on 3/12/08 with uSG, the reviewers of PACG, representatives of IAG and some co-workers of the ministry agreed about some actions to be taken to implement the recommendations of PACG. In this meeting IAG said that the regauging had already taken place:

«Some of the results are: an updated approach, buca, and milestones for 2009. Attention has been paid to alternative scenario's ("silver and bronze"), and one scenario has been chosen. For this reason the scope has been reduced».¹⁰⁰

It is agreed that the updated approach and buca will be discussed by the Advisory group in its meeting of 18/12/08.

In its meeting of 18/12/08 the Advisory group decides to submit the plan for rescheduling of the program to uSG for approval.

2009.

Doubts about Renewal voiced in the MTM.

Point 11 of the agenda of the meeting of the management team of the ministry (MTM) on 9/2/09 was entitled "Policy and implementation: follow up of the advice Voigt". It concerned the management of NEA by the ministry. The minutes of the meeting include the following sentence:

«DGHPE has been told that the project IAG2010! is not going well. DGNEA will pick this signal up».¹⁰¹

DGNEA must have been well informed. Obviously he didn't want to discuss the project.¹⁰² uSG was present too, and must have been informed just as well. But she too remained silent. In the minutes of the two following meetings of the MTM nothing could be found about the way in which DGNEA or whoever had "picked up the signal".¹⁰³

Van Gent succeeded by Ben Salah. Irritation about the rescheduling of Renewal.

On 16/2/09 Van Gent, assistant of uSG for IAG, moved to another function in the ministry. As regards the Renewal program she was succeeded by Faïrouz ben Salah. On 2/3/09 Ben Salah sent DGNEA a memorandum in preparation of a meeting he would have with IAG about the rescheduling of the program.¹⁰⁴ The memorandum contains the following paragraph:

«Reason

The reason for the meeting is the rescheduling of the Renewal program of IAG. Rescheduling was necessary because the program "old style" had become unmanageable and ran out of hand financially. The decisions were taken at short notice with approval of the Supervisory council, without adequate consultation of the ministry. This gave the ministry the idea of having been checkmated. Formally the ministry has not been informed. For that reason it has not reacted yet».

The rescheduling had been announced in the meeting of 3/12/08.¹⁰⁵ The minutes of the meeting show that both uSG Roos and DGNEA Kerstens were present. Nobody of the ministry reacted to the announcement of IAG. Maybe the ministry thought that this was the responsibility of IAG and Supervisory council. Or the ministry may have been inadequately prepared, or listened badly. Furthermore, delay and rescheduling must have been in the air and expected. The ministry could and

¹⁰⁰ The minutes of the meeting can be found in the directory Renewal, under 20081203.

¹⁰¹ The minutes can be found in the directory Project and agency management, under 20090209.

¹⁰² In spite of the openness required by the code of conduct of the ministry.

¹⁰³ The author didn't look further.

¹⁰⁴ Note that the 12-months report suggested that the rescheduling was a matter of the past.

¹⁰⁵ Moreover, the meeting of the Advisory group of 18/12/08 was explicitly titled "Rescheduling Renewal plan IAG2010!". The minutes of this meeting can be found in the directory Renewal, under 20081218.

should have proposed rescheduling itself, to reduce its risks. See the recommendations of the PwC and PACG reports.¹⁰⁶ As shown earlier, the ministry almost did the opposite.

A progress report full of green, and no red.

A relatively detailed progress report about the renewal project was completed 26/2/09.¹⁰⁷ The report looks like a snapshot. It is not clear to whom it is addressed. For a relative outsider it is difficult to learn something relevant from this report. Except when you trust the traffic lights. They suggest that it can hardly go better. 21 lights are green, one is yellow, and none is red.

The 12-months report of IAG about 2008.

The 12-months report of IAG about 2008 is dated 24/3/09.¹⁰⁸ The following is the section about the Renewal program:

«Renewal plan

2008 was the year of the transition from planning and preparation to actual implementation and realization. Concrete products were delivered, and in autumn a rescheduling was carried through. In accordance with agreements with the Supervisory council (SC), and preceded by an independent evaluation by PwC, the program plans and buca were updated in June. The observations [of PwC] were explicated to and discussed with the SC, and the recommendations implemented. The recommendations of a review by PACG are being implemented in collaboration with the ministry. These recommendations concern roles and information provision as from 1/1/10 (who decides what, who advises whom etc., and what are the corresponding responsibilities). The results will be put on the agenda of the regular 4-monthly meeting of April.

In agreement with the ministry and SC a rescheduling of the Renewal plan was carried through in October. This resulted in the introduction of a year model for the implementation of the Renewal plan with one business object per year. This resolves the cluttering of activities, and enables good management of dependences and critical paths. [...]

With regard to the financial contribution 2008 of the ministry the year plan IAG defined agreed milestones (physical products). At the close of 2008 it can be concluded that all milestones have been realized, except “migration My IAG” and the project “Pro-active information”»

Follows a table with milestones suggesting that everything that should have been realized is indeed realized. Ten times realization is 100%, once it is 98%, and once 95%. In accordance with the progress report of 26/2/09, with the 21 green lights. Given the history of the program and the various evaluations, this seems too nice to be true. In combination with the reports of PwC and PACG the progress reports suggest that the problems are bigger and deeper than the Renewal program.

And then there are hairline cracks:

- What has been rescheduled exactly?
- What does the rescheduling mean for the goals (at least if rescheduling means regauging (as recommended by PACG), as IAG indicated on 3/12/08)?
- What are the financial consequences?
- Is the Renewal plan still to be completed in 2010? If not, what is the new final year?
- It seems that IAG interpreted the absence of a reaction by the ministry to its announcements on 3/12/08 about regauging etcetera as agreement. This would be trickery, since IAG had not given the ministry specific information about the changes;
- Is it true that all recommendations of PwC and PACG have been implemented? Experience has shown that IAG cannot be trusted blindly;

¹⁰⁶ Sheet 22 of a presentation dated 11/12/08 even speaks of an “appreciable risk” of failure. The presentation can be found in the directory Renewal, under 20081211.

¹⁰⁷ It can be found in the directory Renewal, under 20090226.

¹⁰⁸ It is included in the directory Renewal, under 20090324. The quote is from p. 14. The date of 1/1/10 is in the original.

- The Renewal program started in 2005. 2006 was the preparatory year.¹⁰⁹ “2008 was the year of the transition from planning and preparation to actual implementation and realization”. But 2008 was also the third year of a planned lifespan of five years. Only outside evaluations mention difficulties, not IAG. Does this look like open and reliable information? Definitely not. But what is wrong?

Comments by the audit department on Renewal and IAG's management information.

As in the corresponding reports of the past few years, the report of the audit department about the Annual report 2008 of the ministry devotes some sections to IAG and the Renewal program:

«Ambition level Renewal program too high, but going concern all right

On balance, the quality of the financial management of IAG remained the same. IAG had to extend the duration of the Renewal program because the ambition level was too high, and the complexity had been underestimated. In the spring of 2009 the consequences of the rescheduling for employees and finances will be clarified. Together with the ministry priorities will be reset.

[...]

Ambition level Renewal program too high

In 2008 IAG concluded that the ambition level of the Renewal program was too high. This was caused by underestimation of the complexity of the present system of systems. The cooperation of old and new systems turned out to be more complex than expected too. On the basis of audits IAG furthermore noticed that the total capacity needed for the going concern duties, policy agenda, introduction of the education number in primary education, and the merger with IFC, leaves insufficient capacity for the original renewal schedule. IAG has chosen for rescheduling, adjustment of the ambition, and lengthening the program duration. In the first quarter of 2009 and the wider framework of NEA, IAG and the ministry will determine the consequences of the rescheduling for employees and finances. In general, know how, organizational embedding, and relations with other activities should be secured better.

With difficulty IAG has reached the milestones agreed with the ministry. Among others this concerns enterprise architecture, business portal, and a new version of “My IAG”. To improve project management, IAG has introduced a project portfolio.

[...]

Management information/ performance indicators still vulnerable

IAG receives many information requests from external parties. The interest in good internal management information increases. The present systems of IAG are not very well suited for flexible and fast information retrieval. The architecture of the systems is badly outdated, and basic data are stored in different systems. This creates the risk of inconsistency. Information is mostly obtained by writing easytrivies and queries. The problem has been tackled in the Renewal program. Progress has been made with respect to enterprise architecture, working under architecture, Basis Administration Person, and improved portals for the education institutions and the students. IAG should pay attention to the realization of flexible information provision in the new systems for study financing».¹¹⁰

But after the improvements, what is the auditors' judgment about the present state of affairs? What remains to be done?

IAG explains the rescheduling. (The presentation of 31 March 2009).

Although the roar of the waterfall could already be heard for a long time, nobody in IAG and the ministry wanted to acknowledge that the main progress was in the direction of the abyss. In 2009 the fall could no longer be averted. The crash was marked by three presentations of IAG, dated 31/3, 22/6, and 23/9.¹¹¹

¹⁰⁹ And probably only called preparatory by hindsight. The first mention of a preparatory year was found in the 8-months report 2006 IAG, dated 26/10/06. In the directory Renewal, under 20061026.

¹¹⁰ The report of the audit department can be found in the directory Renewal, under 20090309.

¹¹¹ All three can be found in the directory Renewal, under 20090331, 20090622 and 20090923.

On 31/3/09 IAG still seems to be thinking that it can keep or regain control of the program. On that day the rescheduling was explicated.¹¹² Rescheduling had been decided in December 2008. It meant spreading the (remaining) work over the years 2009–2012 instead of 2009–2010 (inclusive). In addition, the scope was limited to study financing. One of the sheets explains the reasons for the rescheduling as follows:¹¹³

- «The required capacity would preclude other development work;
- All development activities in IAG make use of the same scarce resources;
- An unacceptably high ratio internal/external personnel: costs and safeguarding know how;
- Other activities need much management attention (problems with production, Taskforce, fusion etc.);
- Specification of the migration showed that problems will arise in the middle of 2009;
- Introduction of new techniques cost more time and money than planned;
- 2008 was the year of milestones, 2009 the year of the heart of the service: quality first;
- More balance needed! Together with change managers an alternative scenario was formulated».

Why had nothing of this been said in the progress reports? The rescheduling operation shows that the progress reports were unreliable, that they reported selectively at best. Why then should we believe this new report?

Changes in goals. (The presentation of 22 June 2009).

The presentation of 22/6/09 is not or not only about rescheduling, but also about changes in the goals and scope of the Renewal program.¹¹⁴ Mention is made of a request of the SG: “[to] investigate reduction of scope in relation to reduction of risks”. The presentation presupposes problems, and the problems seem to be very serious. Beside options “Continue”, “Pause”, and “Partial pause”, there is even an option “Stop”.

Sheet 4 is titled “Analysis”. The sheet has the following text:

«What are the causes?

- Growing stacked complexity of old systems and new parts;
- Pressure by Policy and Going concern in the field of study financing gives extra complexity;
- Inadequate decomposition of plans and activities;
- Inadequate management (program leaders removed to other priorities);
- Too much dependence on external co-workers.

=> drop in productivity (products come later and cost more) => adjustment of plans => even more complexity => present form of renewal plan has insufficient chances of success (PwC)).

The points are supposed to be causes, but it is not explained of what. The state of affairs of the program is not described, and the development that led up to this state even less. Obviously, the points should at least be the causes of the need to reschedule and rescope. And therefore be similar if not identical to those listed in the previous section. Which evidently is not true. In other words: the exact weaknesses of the implementation of the program and of IAG remain uncertain.

The presentation chooses the middle option: “Partial pause”. It proposes to use the coming three months to elaborate manageable alternatives for the Renewal program,¹¹⁵ and in the meantime to continue with some parts of the program.

Informal discussion of the situation at the ministry (10 September 2009).

The following is a report by the author written to an acquaintance, one or two days after the

¹¹² Using the presentation dated 20090331. The quote is from sheet 3.

¹¹³ Unexplained examples which don't seem necessary for understanding have been skipped.

¹¹⁴ The presentation can be found in the directory Renewal, under 20090622.

¹¹⁵ Note that if the causes are identified correctly, the management has failed, and the Renewal plan may be manageable as it is. It probably isn't, for a reason which has not been mentioned: IAG wanted to do too much simultaneously. Of course, for a successful program more is needed than good management.

event.¹¹⁶

«Around midday 10/9/09 there was an informal meeting about the Renewal program. The participants were: Jacob Smit (IAG, account manager ministry), an investigator of Ernst & Young, and some of the co-workers of the ministry who had IAG or the Renewal program in their portfolio: Fons Cammaert (contact for IAG of the section Study financing of HE), Ben Salah, Slooff, Barbara Solleveld (manager of Cammaert), Haring, and the present author. Haring was late. Entering he said: "As you know, when I'm late, I have to leave early". Haring had been involved in Renewal from the beginning, in 2005; Cammaert and Solleveld for about a year. By the people of his section Haring was seen as the man who knew everything about the program.

The meeting took place because in a week or a few weeks IAG would send proposals to the ministry for a follow up. The proposals would include alternative options. MTM and SG would have to choose and decide. The participants of the meeting would have to advise them.

[...]

Smit and the investigator noted that IAG has the required knowledge and know how at the level of specific parts, but not at the level of aggregates.¹¹⁷

In his introduction, the investigator had repeatedly used the word "alternatives", without explanation. I asked what he meant. I noted that I had always been surprised by the absence of a long term plan for system maintenance and renewal, and a strategy for that. There seemed to me to be a big difference between making all changes in a single operation and making them gradually, as normal part of the business. The investigator shared this surprise, and showed serious doubts about the ability of IAG to design and implement a major overhaul of its systems in a relatively short time. It is very doubtful whether IAG has the knowledge and know how required for such an operation. In the field of management as well. It is clear in any case that up to now the program exceeds IAG's abilities.

In this meeting several things were said which help explain how things could run out of control. Slooff said that he had often seen progress reports which he didn't understand, but had accepted because he thought: "They are the experts". Actually they were not, and they were not reliable either. Of course I reacted: "As long as you don't understand, you simply say 'no'!".

Ben Salah supported Slooff by saying that one should work on the basis of trust.¹¹⁸ Which sounds nice, except that the meeting had been convened because IAG had shown that it could not be trusted.¹¹⁹ Ben Salah furthermore thought that problems should be solved by talking and good agreements, and by monitoring and discussing the follow up of the agreements. I reacted by noting that the present meeting is held because promises had not been kept, and that the question is: what to do then? New agreements generate a vicious circle. Instead, one should look for the causes, and try to fix them.

At a given moment, the investigator noted that a progress report which starts with red lights at the bottom of the hierarchy has a tendency to reach the top with green lights only.

Some of the people of the ministry said to have difficulties with their role and responsibility. They feel that they have insufficient expertise in the field of ICT, and find that they shouldn't want to know details. Haring thought that decisions about system development and choices of the best alternative should be made by IAG autonomously. I reacted with: "Maybe I feel the same, but it is an irrelevant opinion. Fact is that the ministry gets proposals from IAG, that SG will choose and approve, that our DG will advise him, and that we will be asked to advise our DG. We cannot say: 'IAG should decide for itself'. That would not be accepted. A decision will be made anyhow. So we have to advise, whether we like it or not. The only relevant question is: how?" Everybody agreed. I explained how I dealt with this kind of problem myself. That IAG has to convince me with understandable answers to critical questions. By asking questions I try to find out whether IAG can be trusted. If its answers are

¹¹⁶ The original can be found in the directory Renewal, under 20090914. No (official) minutes were made.

¹¹⁷ The same was said of IFC by Van Loon in connection with the policy portal project in personal communication with the author. In other words: there were no people who understood the coherence and could coordinate.

¹¹⁸ In other words: she preaches blind faith, and the opposite of a critical attitude. But a controller like Slooff has a duty to check. His function forbids him to simply believe. Ben Salah furthermore uses the argument selectively. With respect to most of her colleagues in the ministry she showed no trust at all: see the preceding two chapters for many examples. The remark is a trick to cover whatever you do, and to duck responsibility.

¹¹⁹ The assumption of Ben Salah had been shown to be incorrect.

unsatisfactory, I feel compelled to enter into details. Not because I want to know everything, but because I want to find out whether IAG understands, and can communicate about it. If they cannot communicate with us, am I to believe they can communicate among themselves?»

The evaluation by Ernst & Young. (The presentation of 23 September 2009).

Neither rescheduling nor rescoping could stop the fall. The presentation of 23/9/09 asserts that the Renewal program has “got stuck”.¹²⁰ Ernst & Young had been hired to find out what went wrong. Its report could not be found, but the presentation is clear. According to sheets 8-10, the following aspects are the “essence of the jamming”:¹²¹

1) Management (external/internal):

- «The relation between ministry and IAG is insufficiently clear:
 - IAG doesn’t know how to handle it;
 - The management by the ministry is dispersed;
 - The ministry comes with (stacked) changes in regulation, and expects that IAG can implement them properly.
- Decision making is often partial, and not always well-considered and consistent (under pressure);
- Too much management on process and method instead of contents. Use of knowledge is insufficiently enabled and assured;
- Too much room for individual interpretation (large distance between senior management and execution, insufficiently clear course of the program, archipelago of 1000 project islands);
- Instability of the course: ideas about the course, goals and scope changed permanently, in the course of time the center of attention in the Renewal plan shifted from changes in organization and work processes to system renewal;
- Insufficient management with respect to the coherence of the changes;
- The approach was too much activity driven.

2) Ambition in relation with adulthood of the IAG organization:

- Too much simultaneously in addition to policy implementation;
- Overestimation of adulthood/ know how/ abilities;
- The type of change/renewal doesn’t fit the operational character of the organization;
- Insufficient use of creativity of the organization/ fear of making mistakes;
- Some types of vital knowledge are scarce and used inefficiently.

3) Culture:

- Acting on the basis of dogmas, and also of stray shouts;
- Insufficient transparency (not willing or able to say no);
- Causing differences about problems in and outside IAG;
- Radical renewal: not directed at results/ lack of confidence in own abilities/ local power to act;
- Especially in the going concern, sometimes with negative effect on the whole;
- Law of conservation of complexity = conservation of work;
- Underestimation of resistance of the organization against change, so that much of the old was kept. Conservative forces often won from renewal, and corrective management was insufficient.

4) Management former (top) management:

- Division in management and lack of continuity affected organization and Renewal plan;
- Management of Renewal plan was influenced too much by divide and conquer policy;

¹²⁰ The presentation is in the directory Renewal, under 20090923.

¹²¹ Ambiguities have not been/ could not be resolved.

- There was insufficient communication about problems and results;
- Too much energy was spent on solution of symptoms, instead of tackling the real causes (external program managers were set aside)».

The next sheet, sheet 11, summarizes as follows:

- «Both internal (IAG) and external (ministry) management was too dispersed. As a consequence, the management of the Renewal plan was insufficiently stable and unambiguous, and left too much room for individual interpretation;
- The ambition of the plan was too high in relation to the adulthood and capacity of the IAG organization. The management of contents and the application of know how and business were insufficient;
- The unruly culture of IAG in combination with the complexity of the domain of study financing caused a deadlock in which small steps required steadily increasing amounts of energy;
- The management by the top did not contribute to a constructive work climate, and disabled appropriate reaction to images and facts».

Note that all inquiries and audits should have mentioned the same defects, problems and other causes of failure. Note furthermore that it is quite plausible that the aspects listed cause failure, but that this doesn't prove that the analysis is correct, nor that the points listed are the most important causes. In fact, not all "aspects" are true (or formulated correctly). The consequences of defective management are much more extensive than suggested in the last or other points. The (top) management and only the top management is responsible for the start of Renewal plan and its utterly unrealistic ambitions. The dispersal of the management by the ministry is nonsense. Substantiation is missing. IAG never complained, and knew very well that the ministry is a hierarchical organization, and that uSG is the only person or body speaking with real authority. On the other hand, the ministry and Supervisory council should not have approved the Renewal plan in the first place. They should have asked much better reporting,¹²² and should and could have pulled the brakes years earlier. None of which is said by Ernst & Young.

Informal meeting about advice for the sequel (September 23, 2009).

The file with the presentation of 23/9/09 was sent to the participants of a follow up meeting of the meeting of 10/9/09 reported above.¹²³ The following informal report of the follow up meeting was written by Van Velsen within a few days of the meeting:

«On 23/9/09 from 11:00-12:30 there was a meeting about a sequel of the Renewal plan. Present were Ans Gottenbos (head of the section Study financing of HE), Cammaert, Ben Salah (a quarter too late), Slooff, Onno van Zutphen ((u)SG control), Gakeer, Havinga, Smit, the representative of Ernst & Young, and Van Velsen.

After a long self portrait Gottenbos outlined the perspective of budget cuts, and the possibility that the law of study financing will be changed substantially.¹²⁴ Van Velsen added that Ernst & Young had concluded that IAG cannot deal with projects of a more complex nature, that it recommends talks IAG-ministry about simplification of the law, and that for these reasons NEA should participate in the talks about the implementation of budget cuts. This met with unanimous approval.

The discussion was hampered by Gottenbos and Smit taking much more time than necessary to say what they had to say. Maybe they were killing time on purpose.¹²⁵ In so doing they showed how these

¹²² In addition: why were the reports unreliable and misleading? This is not only a question of technical abilities, but also of integrity.

¹²³ The presentation discussed at 23/9/09 is dated 23/9/09, but was not given at that date.

¹²⁴ Budget cuts are made as a consequence of the financial crises, to be discussed in chapter 7..

¹²⁵ And not for a good purpose. Gottenbos had been head of the section Study financing for many years. She therefore bears a large part of the responsibility for the failures of IAG. There cannot have been any real cleverness in the time-killing. It seems much more probable that it was caused by infatuation and/or escapism.

discussions and processes can go wrong: important matters are not discussed due to waste of time on less important matters. In the meantime I got the impression that I was the only one who had read the report (the sheets). Nobody referred to it, or to specific conclusions.

The discussion showed that “development of people and organization” was conditional for any successful sequel.¹²⁶ So this should get the highest priority. Therefore Van Velsen asked why it was mentioned last in the list of proposals on sheet 52.¹²⁷ He asked for a development plan.¹²⁸

The proposals on the sheets were not from Ernst & Young but from IAG. They were not from the top, but from the bottom. This followed from an explanation by Smit of the absence of a time schedule, and the absence of thinking in terms of a plan for number of years.¹²⁹

The last minutes of the meeting were wasted by a squabble of Gottenbos and Ben Salah about the number of sheets of the presentation which had to be prepared for the SG. 10 or 12? When they didn’t stop, Van Velsen proposed 11.¹³⁰ This was accepted. In reality the number became 17.

The main conclusions of Ernst & Young or of Ernst & Young and IAG together seem to be the following:

- People and organization failed; they put too many irons in the fire.¹³¹
- A major renewal operation is not necessary. The existing system is adequate for at least several years to come.

On the basis of the discussion the following remarks can be made about the proposal:

- It was formulated by the existing organization (which had failed utterly, and had not been open about its difficulties);
- The question whether the short term proposals are a good start of the long term approach has not been answered;
- There is no long term plan for gradual development (even the idea is missing);
- Its first phase should consist of the development of people and organization. It should result in an organization which can adjust and correct itself, and work permanently on more effective and efficient production;
- The timing and priorities of the other phases or activities should be properly argued;
- The analysis of Ernst & Young shows, but the proposals do not, that the internal communication and the communication with the ministry should be improved. Because of the costs for the taxpayer and the political risks, NEA should be able to communicate about plans and investments in a way that is understandable for the ministry, so that the ministry can properly account for its approval or refusal thereof;
- The ministry should not approve anything it does not understand, and never accept silence or mystifying language for an answer».¹³²

HE's recommendations for the SG.

On 29/9/09 Cammaert sent the following remarks to Ben Salah on behalf of HE.¹³³ The remarks were to be used to prepare the SG for the discussion about the presentation by IAG:

- «It is sensible that IAG renounces major system changes in the short run, and wants to

¹²⁶ Also in the light of the failure of the previous project Redesign.

¹²⁷ No meaningful answer was given.

¹²⁸ It never came. The reports of NEA show that it has never been implemented, that only lip-service was paid.

¹²⁹ The sheets distinguish short and long term, but don't define these concepts, en nowhere mention years. Van Velsen feared that the vagueness foreshadowed indefinite delay, in other words that once more insufficient improvements would be realized.

¹³⁰ He knew from experience that any agreement would probably not be kept. The squabble was meaningless.

¹³¹ There is no reason to assume that sufficient improvement has already taken place. On the contrary: the new proposals show defects of the “old” organization, and failure to learn.

¹³² The original of this informal report of the meeting is part of the file with the correspondence about the IBG PC2009.

¹³³ The text can be found in the file under 20090929 in the directory Renewal.

- temporize them;
- It is sensible that in the future IAG wants to adopt ambitions for change only if it is ready for them. Therefore IAG should give high priority to assembling sufficient knowledge and know how in the organization. The organization culture and the relation with the ministry should be sufficiently grown up to support the changes;
- Because of possible changes in regulation due to budget cuts it is good that at this stage no energy is spent on major changes of [hard and software] systems which may have to be changed in the near future to accommodate changes in regulation;
- It is good that IAG proposes to look forward at the consequences of possible changes in regulation together with the ministry;
- In the coming 5-7 years IAG will remain using the present systems. They should be optimized to be able to accommodate new policies and regulation. Without optimization the system changes for new policies and regulation will become ever more costly;
- IAG announced that in the coming 2 years new functionalities will be added to the present systems. It is important to indicate that new functionalities should only be added if they are 1) manageable; 2) compatible with expected changes in regulation.

In a general sense we can note (contribution Van Velsen):

1. The proposed 3-track approach is OK.¹³⁴
2. The tracks should be elaborated in long term plans.
3. The plans should be evaluated by external experts, such as from Ernst & Young. The experts should report to the ministry.
4. The implementation of the plans should be evaluated yearly by the same experts.
5. With respect to the organization development: NEA should learn to communicate better with the ministry¹³⁵ about plans and investments, in a way which is understandable for its partners. The ministry should be able to understand what it approves».

At least 3 and 4 were ignored.

Note that the assertion that a Renewal plan was/ is not necessary, and that IAG can go on working with the present systems for years to come is not compatible with the arguments used to substantiate the budget of 45-55 M€ in 2005-2006, and with the observation of 2009 of the audit department that “The present systems of IAG are not very well suited for flexible and fast information retrieval. The architecture of the systems is badly outdated, and basic data are stored in different systems. This creates the risk of inconsistency. Information is mostly obtained by writing easytrieves and queries. The problem has been tackled in the Renewal program”.¹³⁶

The three-track approach (30 September 2009).

The presentation of IAG for the SG on 30/9/09 proposes the following 3-track approach:¹³⁷

«Track 1: Safeguard the continuity of the present production processes;

Track 2: Together (ministry and NEA) towards a new political/ regulatory system for study financing. [Outline of the new system, to be implemented 1/1/13].

Track 3: In the short term, 1-2 years, work on ordering conditions for successful innovation, coupled to merger trajectory NEA».

¹³⁴ For a specification of the 3-track approach see the following section.

¹³⁵ Formally, since NEA has formally become part of the ministry: the complement of NEA in the ministry.

¹³⁶ Of course, it would be unwise to believe the audit department blindly. The chapters 2-5 contain too many examples of its unreliability. Furthermore, it is highly improbable that a renewal program of 55 M€ is necessary to solve this problem.

¹³⁷ The presentation can be found in the directory Renewal, under 20090930. The three tracks are described on sheets 13-15.

The last should include “people and organization”.

No report or minutes of the meeting of 30/9/09 could be found. The sequel implies that it was decided to write a memorandum for the MTM of 26/10/09.

Memorandum for decision making by MTM.

The (extensive¹³⁸) memorandum is entitled “Together towards a new perspective for study financing”.¹³⁹ It has the following table of contents:

1. Executive summary
2. Motivation and terms of reference
3. What are the results of the Renewal plan up to now?
4. How the Renewal plan got stuck: an analysis
5. Developments in context
6. Boundary conditions
7. Approach and timelines.

The contents looks similar to that of the presentation of IAG at 30/9/09. The following is from the executive summary:

«1.1 Introduction

In 2006 IAG began with a major renewal program to improve the processes of study financing. In April 2009 the SG has asked IAG to study further possibilities of downsizing the scope of the program in order to reduce risks. On the basis of an analysis it was decided in June to pause the part of the program concerning study financing. There was insufficient perspective of realization of the original goals within the framework of the available time and money. In July-September IAG made a deeper analysis and developed the outline of a plan for a sequel of the renewal plan.

1.2 Most important results of the analysis

[...] The analysis confirmed the picture of the memorandum *Realistic renewal* of the management team NEA of June 2009.¹⁴⁰ The most important conclusion is that at this moment, IAG is not able to execute a sizable renewal program of study financing successfully simultaneously with the regular processes for study financing. Conditions regarding management, culture, know how and cooperation are not fulfilled. In addition there was a lack of acuity and real cooperation of ministry and IAG along the axis of development and implementation of new regulation and management of complexity. Finally it turned out that the present system landscape is good enough for another 5-7 years if some technical and functional improvements are made timely. With the understanding that the present system landscape cannot cope with new major changes in the regulatory regime».

The conclusion that “at this moment, IAG is not able to execute a sizable renewal program” is the same as that drawn by minister Hermans 9 years before, and quoted in the beginning of this chapter:¹⁴¹ «Experience has shown that the alternative [to gradual system renewal], simultaneous replacement of existing systems by an integral new system is not feasible». Clearly, the promise of gradual renewal has not been kept. Instead, IAG and ministry repeated the history of the failed Redesign project. Parliamentary, DGAO and other forms of control were non existent or did not work, and the taxpayer has been swindled.

The following is said about organization development:

«*Track 3: Organization development NEA*

In the short term an effort will be made to satisfy the conditions for successful innovation, coupled

¹³⁸ 15 pages, 5800 words.

¹³⁹ It can be found in the directory Renewal, under 20091026.

¹⁴⁰ It can be found in the directory Renewal, under 20090617.

¹⁴¹ Hermans’ letter was dated 20/12/00. The earlier quotes can be found by searching for “hermans”.

with the fusion trajectory NEA. This track therefore supports tracks 1 and 2. Important fields of attention are organization development (culture, management, people) and creating new élan. The development will expressly build further on the changes in the cooperation ministry-NEA and the management of NEA by the ministry which are already set in motion.

The three tracks will be implemented simultaneously and coherently».

After a summary of the 3-track approach the minutes of the discussion of the memorandum in the MTM conclude as follows:

«One of the most important observations is that the present system landscape cannot cope with new sizable regulatory system changes. It is important that minister and policy departments are aware of this. For the investments which are necessary to ensure that the system landscape remains fit for a number of years of use a plan will be submitted to the SG [...]»

MTM will monitor progress on the three tracks in the NEA block».

Intermezzo: ConQuestor on inadequate management of IFC.

To show that not only IAG needs organization development, but IFC as well, some quotes are given from a ConQuestor report “Inquiry of the quality of the production processes of IFC” of 15/5/09.¹⁴²

In the paragraph “Observations” of section 4.5, “Culture”, one reads:

«In addition we note that it happens that the willingness of co-workers to actively cooperate depends on the person with whom they have to cooperate.¹⁴³

By failing to implement the O&F report¹⁴⁴ consequently and by leaving this situation unchanged, it is tacitly implied that an agreement need not be an agreement, that lack of clarity is permitted, and that management is not self-evident».

Section 5, “Conclusions”, includes the following:

«The education departments HE and PAE are vulnerable as regards personnel.¹⁴⁵ Often there are [only] one or few persons with the knowledge necessary for correct financing of the educational institutions. In addition the chain management in these sectors is less visible than in components.

The fields needing attention of IFC are:

- Limited chain management in IFC;
- Defective planning and control of the primary process;
- Absence of the ability to prove internal control;
- Defective sharing and safeguarding of knowledge;
- Insufficiently professional cooperation between contract management, the line, and ministry;
- The internal cooperation in the financing department».

On 17/8/09 the report was discussed in the MTM. The following is the relevant part of the minutes of this discussion:

«DGHPSE notes that a very important part of the budget [of the ministry] goes to the executive agencies, and that excellent quality control is therefore essential. If this requires deviation from government-wide norms, then that should be possible. uSG stresses that reflection on the regulatory framework of the agencies only makes sense if undertaken government-wide».

The top management of the ministry has spoken. And decided/ done nothing.

It is evident that in the merger of IAG and IFC, IFC cannot serve as an example for IAG.

¹⁴² It can be found in the directory Renewal, under 20090515.

¹⁴³ The original Dutch is just as cumbersome.

¹⁴⁴ This refers to an earlier report on a redesign of organization and formation.

¹⁴⁵ The report does not explicitly say that this refers to IFC-departments. If the remarks concern the departments of the ministry, that should have been said explicitly, since the review concerns IFC, and not the ministry.

The management agreement Ministry-IAG 2010.

On 17/12/09 SG Van der Steenhoven and DGNEA Kerstens signed the management agreement ministry-NEA for 2010 (MA 2010).¹⁴⁶ With respect to the sequel of the Renewal program it gives some important numbers. Apart from that it leaves much clarity to be desired.

On p. 3 one reads:

«Of course most attention has been given to continuation and improvement of the delivery of products and services. In 2009 this required sharp balancing acts for several dossiers. For example, it was decided to stop the renewal plan for study financing».

P. 59, in appendix J, presents a table “Projects permitted to begin”. Among them:

«System renewal track 1: safeguarding, part 1 10,000

Tracks 2 and 3b: system renewal, part 1 2,500».

(The numbers 10,000 and 2,500 are hours, rated at 100 € an hour).

The table “Approved and advanced projects” on p. 22 mentions 40,000 hours (4 M€) for the “Sequel renewal plan/ necessary project”. The footnote on p. 24 asserts that this capacity

«is reserved for the implementation of:

1. Track 1: Investments to safeguard and stabilize the present processes (2010-2012).
2. Track 2: Together (ministry & NEA) towards a new regulatory system for study financing (2010-2013).
3. Track 3: Organization development NEA (2010-2012)».

P. 7 specifies organization development in terms of the following components:

- «completion of the merger
- further development of the organization
- quality and efficiency of the organization
- satisfaction of the employees».

Neither in this connection nor in the elaboration in appendix E of the MA reference is made to the experiences with Redesign, Renewal, or the ConQuestor report. Nothing suggests that there is a big problem that has to be solved. To wit, the problem that NEA doesn't know what it can and can not, and lacks the ability to learn and correct itself. The MA seems to bring the problem a step closer to oblivion. And repetition of the failures of Redesign and Renewal a step closer.

Renewal not mentioned in risky-projects report for last quarter of 2009.

The report about risky projects in the last quarter of 2009 makes no mention of the Renewal program or a sequel.¹⁴⁷

2010.

An enterprise plan.

On 11/2/10 NEA submits a “definitive draft” of its enterprise plan.¹⁴⁸ Section 6.3 of the plan describes by what activities NEA will try to make sure that its strategic goals for 2015 will be realized. One of them is the

«*Strengthening of leadership, culture and communication*

¹⁴⁶ It can be found in the directory Project management, under 20091217.

¹⁴⁷ The report can be found under 20100118 in the directory Project management\Project reports.

¹⁴⁸ It can be found in the directory Renewal, under 20100211. The “enterprise plan” is something new, first mentioned in MA 2010. The name is remarkable because “enterprise” suggests independence if not private. But IAG was much more independent than NEA. NEA is just one of the directorates-general. It has no exceptional legal status (any more).

NEA starts a process of culture change. The implementation of mission, vision, and strategic policy framework in a consequent way and according to a plan requires an intensive dialogue between management and employees, and an improved system of management and control. Some of the components of the adjustment process are: reduction of the number of mechanisms for control, switching to management on the basis of performance (thinking in terms of money), professionalizing the management of ICT and project management, investing in inspiring leadership, elimination of the island culture, central management of scarce resources such as analysis and development capacity, and improvement of accounting and management information about course, focus, and frameworks».

The enterprise plan gives no explanation. There is no reference to a plan for the culture change. It is not clear therefore how the plan will be realized, and how results will be measured and evaluated.

Chapter 8 of the plan lists the following priorities for 2010 and 2011:

- «Ordering the internal administration of NEA;
- completion of the merger;
- realization of a new office building in [the city of] Groningen;
- safeguarding the production agreements made with commissioners (ministries);
- safeguarding current development agreements made with commissioners (ministries);
- creation of room in finances and personnel by staff and line;
- Improving policy and implementation abilities of HRM¹⁴⁹».

Somewhat lower on the same page it is confirmed that the Renewal program has been stopped.

For example section 8.6 mentions a program organization development, but the enterprise plan gives no specification of the program. And the actual contents of the enterprise plan, such as the priorities just quoted, is hard to reconcile with a program of organization development directed at the realization of an organization which can learn and correct itself, adjust to changing circumstances, and work permanently on more effective and efficient production.

The enterprise plan was discussed in the MTM of 15/2/10. The minutes don't say that MTM approved the plan, even though DGNEA had asked for "commitment". The atmosphere of the meeting is characterized by the following paragraph:

«The members of the MTM ask attention for the implementation trajectory of this enterprise plan, the investments it requires, and future budget reductions. DGNEA stresses that this plan is exactly meant to offer a perspective for an efficient and effective future of NEA».

The risky-projects report for the first quarter of 2010.

Among the documents for the NEA block of the MTM of 19/4/10 there is a report about the progress of the risky projects in the first quarter of 2010.¹⁵⁰ "System renewal study financing" is one of them. The state of affairs of the tracks mentioned earlier is characterized as follows:

«Track 1: Started. Parts 1 and 2 (2010) are running or will be started. Preliminary inquiries for parts 3 and 4 (2011) will be made in 2010, first of these inquiries started;

Track 2: In preparatory phase;

Track 3: In preparatory phase».

The following is reported about the progress:

«The first two parts (cleaning, processing income data internal revenue service) of track 1 have been taken in production».

This suggest that the project is a dumping place of odd jobs.

At the end of the report there is a

«Remark/advice of the departments of Information policy (IP) and Finance (of the ministry):

- Further elaboration of the costs/ investments per track is very important. According to the definition of parliament, this may be a "big project". This would imply a duty to report to

¹⁴⁹ That is: the department of human resources management.

¹⁵⁰ It can be found in the directory Project reports, under 20100414.

parliament according to their particular system. This should be taken into account from the very beginning of the project;

- The ministry does not seem to act as commissioner of the program. This is an undesirable situation, for example because of the size of the project and the capacity it requires of NEA [and the possibility of interference with going concern];
- Because of the limited background information about, and involvement with, the project, the CIO¹⁵¹ cannot at present fulfill his i-control and advisory role adequately;

IP will try to take action on the above points in collaboration with HE and NEA».

MTM discusses the NEA report for April 2010.

On 31/5/10 the monthly progress report of NEA about April 2010 is on the agenda of the MTM. Section 7 of the report describes the “Progress organization development NEA”. The following is the unabridged text of this section.¹⁵²

«7.1.1 Enterprise plan

For the realization of the enterprise plan talks are being held along different channels with the employees. The plan is explained and discussed. There are walk-in sessions with the top management, where employees can speak directly with members of the top of NEA. The talks explore the direction indicated by the enterprise plan. The top uses the output of the talks as input for the organization development trajectory. In this trajectory the goals of the enterprise plan are elaborated in development nuclei, for example.

7.1.2 Organization development NEA

The start of this trajectory is the first step in the elaboration of the enterprise plan and the implementation of the downsizing.¹⁵³ In seven development nuclei people are working on an organization which works better but also cheaper. Does more with less. The seven main areas or development nuclei of organization development are: study financing, information products, examination services, financing institutions, staff and support, basic registers, and development. In each area a team begins with a quick but thorough analysis of processes. To see where “profits” can be made. How can processes be made faster, better and cheaper? With fewer rules or procedures? Questions about digitizing or “sourcing” are discussed as well. Until the end of April work is directed at an integrated improvement plan for all development nuclei. Half May this plan will be submitted to the SG. After approval realization can begin. Organization development will then become a continuous process in NEA to realize the enterprise plan».¹⁵⁴

The causes of the crash of the Renewal program and the goal of organization development which was set in the last months of 2009 seem to be completely forgotten. There is not the least chance that the approach sketched in 7.1.2 will result in an organization which can learn and correct itself, adjust to changing circumstances, and work permanently on more effective and efficient production. The minutes of the MTM of 31/5/10 nevertheless say nothing about this section 7.

SG orders NEA to investigate how system changes can best be realized.

In a letter of 16/7/10 the SG requests DGNEA to make a preliminary inquiry for system renewal. The letter opens as follows:

«In the reconsideration report¹⁵⁵ “To study is to invest”¹⁵⁶ it is noted that the information systems of NEA for awarding study financing and collecting study debts have become vulnerable. I share this

¹⁵¹ The chief information officer, prescribed by DGAO, see chapter 3.

¹⁵² That is: of section 7. Even though the numbering may suggest otherwise.

¹⁵³ The downsizing is an operation meant to reduce the number of employees.

¹⁵⁴ The report is included in the directory Renewal, under 20100511.

¹⁵⁵ “Reconsideration” is one more word to denote measures related to budget cuts and downsizing.

¹⁵⁶ In the directory Renewal, under 20100401.

conclusion. The heart of the information systems has not changed since the eighties. As a consequence, the pressure on production is steadily increasing, service cannot keep up with the times, and the costs of the implementation of policy changes are becoming higher and higher».

This is an example of misleading by half-truths. The first sentence is remarkable and questionable: at the end of 2009 both Ernst & Young and IAG had concluded that the system can remain in use for another 5-7 years, unless regulation changes radically.¹⁵⁷ The SG does not explain the fact that the system has not been thoroughly renewed¹⁵⁸ since the eighties: that renewal has been tried twice. It failed both times, at a total cost of more than 70 M€. That the failure was due to 1001 defects in IAG, and that there is no evidence that the defects have been repaired. No mention is made of the conclusion of Ernst & Young, that NEA can only be expected to successfully complete big projects after a thorough learning and development process. In short: that even if system renewal is necessary, NEA cannot realize it.

By failing to mention two failed major upgrading programs the SG gives an uninformed reader the impression that this is the first time in almost 30 years that the idea of upgrading is raised. In this way inviting the reader to admit that it is high time to do so. And of course, to approve the spending of large amounts of money on this. The text of the SG is entirely misleading everyone who starts reading at this point.

The paragraph with the actual request (formally: order) is the following:

«Because of the importance of the project I hereby order you separately to start a preliminary phase to investigate how the system changes can best be realized. For that reason I would like to receive from you on the short term a plan sketching the preliminary inquiry, what the results of the inquiry are, and for what investment costs it is made, including substantiation. As final product of the preliminary phase I would like to receive half November 2010 a quote with an extensive project planning for the system renewal».¹⁵⁹

In this letter SG Van der Steenhoven asks NEA to do something he knows it cannot do (properly). Because of the experiences and evaluations of the past 10 years the new project must be expected to cause big losses, and much more costs than benefits. Integrity would be the first victim if it hadn't already been sacrificed long ago.

As in the PPP the past is simply ignored, “forgotten”. It isn’t mentioned any more. The documentary evidence is made to suggest that history starts with this document. The letter just quoted is a perfect example: “The heart of the information systems is not changed since the eighties”. This is how historical failures are repeated.

System renewal is said to be necessary anyway, and to cost 75 M€.

According to the report about risky projects for the second quarter of 2010 track 2 will cost approximately 75 M€¹⁶⁰. The report “To study is to invest” is mentioned as the source of this number. The letter of the SG shows that this 75 M€ cannot be more than a wild guess. This conclusion is confirmed, or rather amplified, by the observation that the reference to “To study is to invest” is a trick similar to that of Van Spijker in the history of the PPP: a reference to an “independent” external report that actually quotes one’s own opinion.¹⁶¹ In this case the 75 M€ is an “estimate” of IAG.¹⁶²

In bold type the report about risky projects claims:

«It is important to realize that system renewal is necessary, irrespective of regulatory system changes».

¹⁵⁷ Why does the SG only mention the reconsideration report, and not that of Ernst & Young?

¹⁵⁸ There actually were uncountable changes (updates): see the 4-monthly reports of IAG about the implementation of the performance contracts, under system development.

¹⁵⁹ The rambling is intentional, and part of the effort to remain as close as possible to the original. Clarification would be debatable, for example because it would require choices to resolve ambiguities.

¹⁶⁰ Seventy five million euro.

¹⁶¹ See p. 51 of “To study is to invest”.

¹⁶² 75= three times 25 for each of the years 2011, 2012 and 2013. See p. 51. A similar table was presented at the beginning of the Renewal program. See the dossier.

The sentence preceding this bold one, «During the formation of a new cabinet it will become clear how much money has been made available for the operation», suggests that what is going on is an effort to gather in (“earn”) money in the context of the formation of a new cabinet. In this context ministries are used to submit lists of niceties they would like to get extra money for.

The second part of the bold sentence, “**irrespective of regulatory system changes**”, lacks substantiation. It is incompatible with the conclusions of the end of 2009.¹⁶³

The report about risky projects was discussed in the MTM of 30/8/10. According to the minutes:

«DGHPSE expresses worries about track 2 of the project System renewal. The project is expected to cost 75 M€, and this money is not available. A scenario should be developed to solve this problem. SG and DGNEA answer that much depends on the new cabinet agreement. If the regulatory system doesn't change, it is improbable that the 75 M€ will be made available.¹⁶⁴ DGHPSE reads the bold sentence aloud. It is decided that the deficit should be put on the agenda of the constituting convention [of the new cabinet]. uSG will contact the finance department about this».

DGHPSE seems to think that the bold sentence is true. The project is supposed to have a value of 75 M€. If this is spent in three years, about 25% of the employees of IAG will be working full time on the project. External people will be hired as well, and there are material costs, but the comparison clearly says much about the relative size and impact of the project.¹⁶⁵

DGHPSE works already more than 10 years at the ministry. He knows from experience that the reports of NEA are unreliable. He knows that a similar project was shipwrecked less than a year ago. And so on. In short: he should and could know that even if system renewal is necessary, NEA cannot realize it. (Of course, SG and DGNEA could and should know even better).

Only money is taken seriously and gets real attention of the top.

One of the last documents in the dossier for this chapter is the offer sent by NEA to acting SG Roborgh in reply to the letter of the SG of 16/7/10.¹⁶⁶ (SG Van der Steenhoven had left the ministry. His place was temporarily filled by DGHPSE Roborgh). The offer gives the names of the people responsible for 8 of 9 inquiry teams. The person who is to be responsible for the team “organization and competencies” is still unknown. The offer is dated 22/9/10.

On the same day there was a meeting of Roborgh, Kerstens, Smit and others about the (new) project system renewal. The participants agreed that the project should start as soon as possible. Independent of the results of the inquiries. In particular independent of the inquiry “organization and competencies”. While it is evident that reparation of the many defects identified as causes of the failure of the Renewal program is a matter of years.

That getting and spending the 75 M€ is the top priority is confirmed by the report about the risky projects in the first quarter of 2011.¹⁶⁷ Nothing has been learnt, but the third system renewal project has begun all the same.

¹⁶³ This shows one of the mechanisms for ever increasing taxes and government expenditures, and the absence of pressure to account properly and make activities more efficient.

¹⁶⁴ Note that this shows a mechanism where the wish to increase a budget creates an interest in the change of laws.

¹⁶⁵ It is far bigger than Renewal, which had a budget of 55 M€ for 5 years...

¹⁶⁶ It can be found in the directory Renewal, under 20100922.

¹⁶⁷ The report can be found in the directory Project reports, under 20110426.

Chapter 6.

Analysis of the chapters 2-5 as regards the internal operation of hierarchical organizations.

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6. Why conventional solutions won't work.
7. Conditions for honorable government.

6.1. Introduction. Historical-methodological remark.

The first version of this chapter was written immediately after completion of chapter 5. In the summer of 2011 at the latest. The plan was to analyze the chapters 2-5 before starting a study of cases in the world outside the Dutch education ministry. Especially some well-known whistleblower cases and the financial crises. The idea was to use the other cases to test the conclusions of chapters 2-5. The other cases were also studied (and selected) in the hope that they would show more of the (political) heads of the organizations who play key roles in the cases. Apart from the case Spijkers, the other cases, including the financial crises, were studied only after the summer of 2011. Though some things about them were already superficially known from the daily news.

The analysis of this chapter was primarily made to see and show what can already be inferred from the chapters 2-5 alone. Far too often, available information is badly underused. Much time and money, and many discussions, are wasted in gathering additional information which for practical purposes is unnecessary or of very little additional value. In general, the available information shows and implies very much more than people realize. Implications simply are not seen. This can be blamed on inadequate or absent reflection and analysis. Including the failure to combine seemingly separate fragments of information, and the failure to identify and ask relevant questions. As a consequence, many more answers lie hidden in the available information than are retrieved. At great cost to humanity. In practice, it often seems easier (or more convenient) to collect more information than to conduct a more thorough analysis, or to say aloud what the facts clearly show. This applies especially when analysis is felt or feared to lead to results which may cause difficulties of one kind or another. The need to revise one's world view being among them.

To show how much can be derived from the open study of just one ministry, this chapter has been edited only slightly after the study of the other cases. No really new elements have been added. In fact, with the exception of the case of Van Buitenen, the other cases give only little explicit information about the internal operation of hierarchical organizations.¹ And what they tell about it either confirms the analyses or can just as well be dealt with in chapter 9.

On the other hand, the analyses and conclusions of this chapter play an essential role in the understanding and interpretation of all of the following cases (in the chapters 7 and 8). Most of those cases are inexplicable if important conclusions of the present chapter were substantially incorrect. That is: if the organizations concerned worked properly. In accordance with widely accepted norms and their own codes of conduct.

¹ "Explicit information": to be distinguished from implicit information, such as implied by the lack of whistleblowers in cases of gross malfunctioning, and the repetition of similar failures.

6.2. General conclusions from the chapters 2-5.

Introduction about generalization and the exception-hypothesis.

“General conclusions” are understood to be conclusions which are not case-specific. A general conclusion may be hardly more than a factual observation, inferred from a set of facts. It is not a description of a specific fact. The general conclusions include “necessary implications”: assertions which must be true to make phenomena possible or explainable. The same argument may also justify a generalization. Though obviously not all generalizations can be justified in this manner. In the present context, generalization may also be justified by variants of the following grounds:

- There is no evidence supporting the hypothesis that a phenomenon, such as shown in the policy portal project, is exceptional. On the other hand, there are sound reasons for assuming that they are representative;
- The other projects were studied in order to find out whether the policy portal is an exception. The result of the study was: no, the gross misconduct characterizing the policy portal project is not the exception but the rule.

Analysis (reflection) furthermore shows that the causal phenomena cannot be exceptions. They don't have specific or incidental but structural causes.

That not many more cases are known is easily understood. The chapters 2-5 themselves provide at least part of the explanation. These chapters and the present one show that whistleblowing produces very little or nothing positive, but may easily ruin the life of the whistleblower. Whistleblowers show that politicians resort to terrorism, and condone this kind of terrorism by their colleagues. (Or even collaborate).² This kind of terror always goes unpunished. As a consequence one needs to think twice before blowing a whistle. Indeed, the chapters 7 and 8 show many cases where a whistle could and should have been blown, but wasn't. Governmental terror is effective. That cases are easily forgotten, and therefore seen as incidental instead of structural, is explained just as easily. For it is in the nature of journalism to travel with time: to see only today, and to forget the past. That is: it is in the nature of journalism not to integrate newly acquired information in the body of knowledge already acquired. Its almost exclusive attention to the news of today is equivalent with actively making people forget what happened yesterday and before.

General conclusions from the reports in the chapters 2-5 and miscellaneous analytical remarks.

Some conclusions can be formulated rather concisely. The following is a list of phenomena which characterize the projects described in the chapters 2-5. Because of the nature of these phenomena, they must have an all-pervading influence on the organization as a whole. The listing gives priority to clarity and explicitness. Some of the points overlap, are partially equivalent, or are implied by some of the others.

1. Essential false pretensions of the top. The general nature of these pretensions is: claiming to be, or do, something one is not or can not. The cases show false pretensions in almost every field of importance. Not only in technical fields like information technology, but also in integrity, inquiry and (project) management. The false pretensions cause structural failure.
2. The false pretensions are combined with the absolute refusal to admit them (or any important error). Errors are not acknowledged but denied and/or hidden. As a consequence they are not a marginal affair, but dominate the dynamics of all cases. The false pretensions generate more misconduct if employees try to correct something.
3. Irresponsible behavior, especially of the top. For example by approving something without understanding, disregarding experience, or against better judgment.
4. Harming people of whom one knows that they do their duty, and that they refuse to collaborate with misconduct.

² As in the case of Edward Snowden.

5. Rewarding people of whom one knows that they did not do their duty, failed grossly and avoidably, are not competent to do their duty, or falsely pretend that everything goes fine.
6. Incorrect and misleading reporting, usually too rosy. Failure and causes of failure are not mentioned or lied about, making remedying difficult or impossible.
7. This also applies to inquiry institutions like the Dutch General accounting office (DGAO) and the audit department of the ministry.
8. Structural violation of the code of conduct by the management.
9. Violation of professional norms, including forgery, by employees of the audit department.
10. The top acts as if it has nothing to fear from parliament or any other form of supervision or control. Nothing in the projects described in the chapters 2-5 betrays the existence of control/audit organizations like parliament and the DGAO, or the following stipulation from the Dutch General Civil Servants Regulation : «**The civil servant should fulfill the duties which are implied by his function meticulously, and behave as is proper for a good civil servant.**»

Other conclusions need some more words and discussion.

The conduct of the top is incompatible with its words. Many employees participate more or less actively in misconduct. Almost nobody tries to fight it. If an appeal is made to integrity officers in cases where the top is actively involved, integrity officers back down, don't show up, or become ineffective in another way.

Considered separately, the “imperfections” may not seem to be very harmful. Indeed, if they are incidental and uncorrelated, “human weaknesses” or errors need not cause a lot of harm. The problem is the structural character of the “errors”- which is correlated with resistance against correction- in combination with the influence and responsibility of the positions of the officers concerned. The deficiencies add up to complete corruption. Where “corruption” is defined as any form of systematic inappropriate behavior, and/or lack of integrity. As opposed to accidental transgressions. Corruption means the subordination of norms and values necessary for the proper fulfillment of a function or duty to other, incompatible norms and values. Corruption arises if priority is given to maintaining and improving the (power) position of individuals who do not and cannot do what they claim and should do. In the present report, corruption only refers to situations where the operation of the organization is dominated by norms and values which are incompatible with the norms and values which are publicly professed. They are publicly professed because they are considered desirable and/or normal by the public, and because support of the public is considered necessary or desirable. The organization is dominated by inappropriate norms and values if the operation or products of the organization are seriously affected. Corruption need not mean that every employee is corrupted. Neither does it mean that the organization does not produce anything useful.

Both inwards and outwards the top of the ministry of education broadcasts that the ministry works according to professional and integrity norms. This can be interpreted as part of image building. The image is false however. The author has personally informed the secretary-general and the under secretary-general about the misconduct described in chapter 2, and about its structural character. The secretaries reacted with temporization tricks, and efforts at misleading, concealment and repression. Not with correction. The foremost mismanagers (liars) were even promoted. Not integrity, but dirty hands seem to be conditional for promotion. On the other hand, someone who tries too seriously to stop misconduct, and does not accept the fairy tales of the management, is sidetracked.

The whistleblower histories presented in chapter 8 clearly show how other government organizations dealt and deal with criticism of misconduct. The common denominator of the histories is: the whistleblower was right, but suffers very badly and irreparably, and nothing is done with respect to those who necessitated whistleblowing, and to those who terrorized and harmed the whistleblower. In general it even remains unclear whether anything effective has been done at all to

prevent repetition of the phenomena which gave rise to the whistleblowing. In this respect too, supervision fails completely.^{3,4}

When considered in combination with the reports of the chapters 2-5 and the analyses given in the present chapter, the whistleblower cases strongly suggest that the reprehensible phenomena seen in the education ministry are not exceptional, but representative of (at least) government organizations.

If a higher goal existed, the top of the education ministry had lots of possibilities for explaining that the observed misconduct served that higher goal. It could have indicated the higher goal. It never used these possibilities. Therefore, and because there is no indication of a higher goal whatsoever, it has to be assumed that it simply does not exist. Or that it is indefensible. Such as self-interest and/or the interest of the political establishment.

The conclusion is that the top misleads, covers misconduct, and obstructs efforts directed at correction for no defensible reason. The top is an integral part of the problem.

The misconduct of the management seriously harms relatively honorable and competent people. It harms people who want to work in accordance with norms and values which the population considers desirable or necessary. Norms and values which are publicly professed by SG and uSG and other top government officials, such as Van Es of the ministry of internal affairs.⁵

In practice however, government officials give overriding priority to keeping up appearances. They seem to think that this is the only way to keep the house of cards from falling apart. They seem to think that real respect, integrity and transparency would be fatal for the public image of themselves and their organization. Competence is of secondary importance. Obviously such an attitude is equivalent with corruption.

The cases show considerable avoidable waste of taxpayer's money. The percentage is not small. If the reports are representative, then the percentage is closer to 90% than 50%. The 90% applies in any case to the category "projects". This is not to say that the situation can be compared with a rotten tree never producing healthy fruit. The management is not the productive part of the organization, and for that reason the comparison with a fruit tree does not hold. A rotten management does not exclude the possibility of competent subordinates. Still, incompetent management inevitably affects appointments, and very much else in an organization. With an incompetent management it is logically impossible that the efficiency of any activity is high. Quality control cannot be adequate, since those responsible are neither honorable nor competent, and do not want this to be exposed. Correction, improvement and optimization require competence.

Incompetence also affects policy development. If one considers the long term,⁶ it is obvious that policy development has nothing to do with improvement.⁷ It is the product of the pretensions and self-assertion of the political heads of the ministries. They want a place in history as authors of great improvements, even if their realization requires nullifying the supposedly great improvements of their predecessors.

³ The lack of measures against those who were responsible for the misconduct discovered by the whistleblowers, and the way those responsible were (and are) treated by politicians in power is even more telling than the misconduct initially exposed. After all, such a lack can only be understood if the misconduct is not incidental but structural, and if politicians want to keep this fact hidden at all costs. If it were incidental, there would be no reason for any irritation: errors are indeed human, and can often be corrected easily (not always!).

⁴ The supervisors include (general) accounting offices. Their legal duties, mission statements, etcetera, require them to promote integrity, efficiency and true (instead of only verbal) respect for other generally accepted values in government. That is: they should make sure that government organizations work in a way that makes whistleblowing unnecessary, and allow for true transparency.

⁵ See chapter 4 on integrity in Dutch public administration.

⁶ Say 50 years or more.

⁷ Or adjustment to changed social or economic circumstances. As distinct from changes in politics. For indeed, some changes are necessary to correct harmful consequences of policy errors in the past. But efforts at correction usually introduce new undesired effects. This is what incompetence breeds in practice.

In so far as legal prescriptions and policy rules require an honorable and professional public administration, in short: if they require acting responsibly, then there is gross structural violation of legal prescriptions and policy rules.

The ministry of education is a world onto itself. The influence of the outside world on its operation and activities is strongly filtered and very limited. Parliament only communicates with the minister. Reports of the General accounting office and others are only used if they fit a preconceived mental framework. Otherwise they are not considered politically relevant, and simply ignored. Nobody calls civil servants or the organization to account. Neither the members of parliament of the coalition in power, nor those of the so-called opposition.

The conduct of the top of the education ministry clearly shows that it doesn't want its failures and violations of the code of conduct to become public. The top furthermore assumes that lies and repression of internal criticism are all that is required. It does nothing to avoid past mistakes and errors, and doesn't change its ways. There is no indication that it is afraid of having ever to account for this, or that its misconduct will be found out and made public by say the General accounting office.

How the minister and ministry of education, and parliament manage reactions to publicity about a failure is shown by the letter about the project Redesign of minister Hermans to parliament.⁸ Parliament is fobbed off with fair words and promises. Parliament accepts them. It doesn't check whether the promises are made good, and whether they have the required effects.⁹ In the case considered, the promises were no more than paper. Nothing changed. With the logical consequence that a repeat project some years later, a project similar to the Redesign project, failed completely.¹⁰

A large majority of employees conform themselves to what they suppose the management expects of them. They behave as instruments of their superiors. Obedience and adaptation are given top priority, integrity and professionalism are subordinated.

A minority nevertheless keeps on trying to work according to generally acknowledged integrity and professional norms. A smaller minority even tries to promote wider respect for these norms in the organization. None of these people has a management job however, and their success is limited at best. Maybe they prevent or retard worsening.

The inquiries into the execution of projects and the functioning of organization units by audit services and consultancy firms are almost always fatally flawed. Both with respect to integrity and method. Often the reports are misleading (in a practically relevant sense). For example by leaving important problems unmentioned, or by implicitly suggesting that problems are less serious than they really are.^{11, 12} It is as if professional codes don't exist.

As examples of methodological errors can be mentioned:

⁸ For an excerpt see chapter 5.

⁹ As in the case of many if not all other inquiry reports. See chapters 7 and 8. There is no exception. This is not particularly amazing, for if monitoring would be seen as important, it would be a routine practice.

¹⁰ Until 2015 the then ex-minister Hermans had influential roles in public administration. In 2015 however he was unmasked, and gave up his political jobs. A judge ruled that he had utterly failed his duties as supervisor of care provider Maevita. See *Hermans (VVD) stopt als senator na uitspraak rechter*, NOS.nl 2/11/15. It can be found in the dossier for this chapter under 20151102. Hermans was nevertheless expressly invited to attend the opening of the Dutch parliamentary year in September 2019.

¹¹ A good example is the report *Stand van zaken integriteitszorg Rijk 2009* (State of affairs integrity care government 2009) of the Dutch General accounting office of March 2010. It was discussed in chapter 4, and can be found in the directory Integrity. (More examples can be found in the chapters 7 and 8).

¹² There is moreover an important bias, namely that some inquiries are only made when a preliminary investigation shows that the results of a full inquiry will be reasonably positive. As a consequence of this bias the picture arising from the set of published reports is too positive. This note is based on oral communication with an employee of a consultancy firm.

- lack of clarity about the scope and limitations of the inquiry and the reach of its recommendations;¹³
- (uncritical) use of interviews as an important source of information, especially the use of interviews with persons whose functioning is to be evaluated, and who have an interest in specific outcomes;
- inconsistency, especially between the “executive summary” and the rest of the report. It may arise under the influence of discussions of the draft report with a client who only reads the executive summary.

The reports show that no positive lessons are learnt from experience and inquiry reports, and that no attention is paid to relevant knowledge about for example project management and ICT projects. Where positive lessons are defined as lessons which help prevent repetition. As opposed to negative lessons which help keeping misconduct and failure secret, or make misconduct less risky for the top. There is some marginal supervision in this respect, but the relevant reports lack insight and openness, are easily ignored, and have no positive effect.

A minister is the head of his ministry, and the only person in a ministry who can be demanded by parliament to account for whatever has been done or omitted by his ministry, its dependent agencies, and any of his employees. At the same time he is invisible in all of the projects described, and in the project management. In fact, there is no indication of any form of supervision on the operation of his ministry by the minister. At least outside the domain of policy development, and as regards policy development only as regards contents.¹⁴ The above mentioned letter of minister Hermans to parliament is a case in point. The minister may have thought that his promises would be fulfilled of their own accord. He didn't check anything.

It is unclear why, given their CV's,¹⁵ members of the government would be able to select good top managers and/or other experts, either for their ministry or for other jobs. Nothing in the CV's shows any competence in this respect.

The education ministry can only be called a professional organization if professionalism allows unthinking approval (or rather praise) of, and obedience to, the requests of the head of the organization, and the neglect of all other (professional) norms and values.

A ministry could also be called professional if its overriding goal is keeping its minister and top managers in power, and if it successfully upholds or (re)creates a positive image of its top, itself and its work. However, this would mean that the set of norms and values of a ministry is inconsistent, and a guarantee (and explanation) of inefficiency.

Possibly the most essential instruments for the preservation of the corrupt state of an organization are the selection of new employees (including managers) by the sitting managers, and the transfer of employees from one position to another. When the top lacks integrity and/or competence, the condition that employees should not be able to endanger the sitting top has important consequences. In the situation of the education ministry, and many if not most other organizations, the condition means that the combination of integrity and abilities is at most acceptable far away from the top. Of course, such a policy impairs the quality and quantity of the products and/or services of the organization, and its efficiency and reliability.

¹³ With the scope of an inquiry is meant: the phenomena or objects of investigation. The reach of recommendations indicates the consequences of implementation of the recommendations. They may solve the problem, or contribute only marginally. Not every necessary improvement or correction is sufficient to solve the problems which prevent the realization of given goals. Sometimes the recommendations solve nothing at all, and seem to be meant only as window dressing. As in the reports of the independent experts in the case Van Buitenen, see chapter 8. In general, inquiry reports say simply nothing about these questions.

¹⁴ Not or rarely as regards the process for example.

¹⁵ CV= curriculum vitae: a concise description of life & career.

It is only logical that people for whom integrity and competence is a boundary condition, are prejudiced by people who allow themselves more degrees of freedom. For example by only taking self interest and self promotion as guiding values, and allowing themselves to play-act and lie as they deem fit. Members of the last group have an interest in helping one another. This gives them an advantage.¹⁶ The reason being that integrity strongly limits the extent to which honorable people can favor one another.

To prevent exposure of misconduct, honorable people must be kept out of a corrupt management. Even the top manager who once told the author what he really thought about the policy portal project did not act accordingly. And this was the only manager who ever was somewhat honest about any of the phenomena described in the chapters 2-5. During the lifetime of these projects honorable top managers had plenty of opportunities to speak up. But they didn't. None of the cases mentioned in this work shows support for the hypothesis of the existence of honorable top managers anywhere.

An important selection mechanism is the departure of people who are disappointed by what they saw and experienced in their organization. ("Voting with one's feet"). This mechanism increases the proportion of employees who are blind or (implicitly) approve of what they see and experience. It increases the complacency of the organization (= of the people who stay).

The education ministry does not have one (single) "organization culture". There is a subculture of the top management. It is characterized by deeds which are incompatible with its (public) words. In other words: it is characterized by play-acting. But this is not the rule in all of the ministry. A majority of the employees shares the norms and values of a majority of the population. However, hierarchical relations are accepted, and objections against the course of things are rarely raised. Objections almost never have the desired effect. Which amplifies the tendency of employees to keep their mouth shut. Those who don't are transferred to functions and places where they can do no harm. Or they are rendered harmless by other tricks.

In western societies it has already been recognized for centuries that law making, executive and judicial powers have to be separate and independent. But this insight has had no effect on the way organizations are organized and regulated. In organizations the three powers are not separate but united: in the top. This also applies to organizations which are supposed to comply with codes of conduct and professional codes. As a consequence the top can use or ignore codes at will. The reports of chapters 2-5 show that the primary function of the code of conduct of the education ministry is to create the appearance of integrity. The code is an instrument for propaganda. In the practice of the organization it may play a role in localized infringements of integrity. But it certainly plays no role where the quality of management is concerned. It is violated as a matter of fact. And violations are less reason for sanctioning than for promotion.

In the education ministry not only bad news is unwanted, but anything that is perceived as being inconvenient. Neither internally nor externally the neglect of seemingly reasonable advisory reports or recommendations is accounted for (in a credible, tenable way). Obviously this is only possible due to lack of effective control.

All mechanisms indicated in these conclusions are of a more or less fundamental nature. None of them is specific for the Dutch education ministry. No reference to education had to be made at all. The general validity applies in particular to the absence of effective preventive regulation and effective control. For this reason it has to be assumed that the phenomena which they produce are general too, and occur in at least all government and similar organizations.

All this in a democratic constitutional state, after more than 2000 years of Christianity.

¹⁶ "Together we are strong". Indeed, their kind governs the world.

Because of the lack of integrity and competence witnessed by the reports in the chapters 2-5, politicians and governments cannot be expected to be able to reliably solve the principal problems confronting countries and mankind. Such as those caused by man-made changes in the environment, by the coexistence of people with mutually hostile sets of norms and values, by armaments which can wipe out all life on earth in a single day, by uncontrolled technological developments, and by a infinitesimal level of international law and order.

6.3. Explanatory analyses and remarks.

Introduction.

The following analyses try to explain the events and conduct described in the chapters 2-5. They try to identify causes. The causes include circumstances and conditions which make the events and conduct possible or rewarding. The analyses are primarily concerned with causes and circumstances which are changeable. For both practical and theoretical reasons. The study wants to show how explanatory hypotheses can be tested, and to find measures for correction.

In spite of its length, the following note is only of marginal importance. The analyses contain a few remarks of a factual nature which supplement the reports. They are compatible with the reports, but not always substantiated sufficiently. This has several reasons. Such as missing documentation. Originally the study was limited to the policy portal project. The field of view was gradually widened. As a consequence, during the analysis it sometimes turned out that a specific document was no longer available or accessible. Sometimes something could be said on the basis of personal recollection. This could not always be verified with the available documents. In a few cases more substantiation could possibly be provided. But the added value this would provide did not seem to warrant the costs in terms of time and effort. And in most cases it is obvious that the opposite of a remark is incompatible with the evidence.

Why the top doesn't solve but hide problems.

The reports show that employees of the education ministry are very hesitant in forwarding bad news to their superiors. Often they say nothing, or give too rosy a picture.¹⁷ The hesitation is seen at every hierarchical level, making the hierarchical staircase an almost impassable filter. However high heads, directors, and directors-general may say to value openness and reliability: it is not visible in daily practice. Integrity clearly is not seen as a boundary condition.

Line managers dislike bad news. If they receive it nonetheless, they rarely take action.¹⁸ The SG and the uSG are no exceptions. The reports show that they force their subordinates to assume a similar attitude. Another attitude is sanctioned. When the author informed SG and uSG about the course of the policy portal project, they adopted an extremely closed attitude. There was no openness of any kind. They did not try to find the truth. (They probably already knew). They did not take corrective action. What they did try was to mislead the complainants into believing that the top would do whatever was necessary. At the same time, and by abusing their power, they (secretly) tried to construct a record showing that the complaints were unjustified and no further action necessary.

The development of the policy portals and the renewal project were stopped before the project goals came in sight. They were not stopped by the commissioner, but because they got stuck. No action was taken to prevent similar failures in other projects. Rather the opposite: those responsible for the failure were promoted, and not to a harmless, but to higher management position. Everything possible was done to make it appear as if nothing had gone wrong.

In the education ministry the aversion against forwarding bad news can be blamed on SG and uSG. By their treatment of messengers, a general lack of attention to reliable reporting, their denial of, or silence about, failures, and their exaggerated and unfounded optimism- as in the mail of SG after his

¹⁷ Just one more example of “a glass half full” from the policy portal project, from a draft report to a director general in 2006. It said: “Solution of this problem is being discussed”. It did not remark that the talks had been going on for several months already, and that no solution was anywhere in sight.

¹⁸ Except for inventing an argument that shows that it is not their responsibility to take action.

visit to IFC- they unambiguously broadcast that they don't want to hear about problems. Even though they say the opposite. In this climate, mismanagement and waste continue unabated. While it is evident that another attitude of especially SG would work miracles. In a hierarchical organization like the education ministry, the behavior of the top serves as an example and norm. It nullifies the code of conduct. By giving reliable information and advice an employee only makes sure that he will be side tracked.

The behavior of the top of the education ministry can be explained on the basis of the hypothesis that the highest goal of the top of the ministry is keeping up the appearance that the ministry works very well, and that it continues to improve itself. Everything that endangers the rosy picture is unwanted and repressed as much as possible.

This hypothesis explains why reliable and important but unpleasant information is kept under the table as much as possible. It may not explain the complete cover up and denial however, and the repressive attitude against the messengers. The top knows that the bad news is correct. The absence of an adequate reaction cannot be based on knowledge of good project management and progress. Because of the fact of the hierarchical organization it is impossible not to hold the SG and/or uSG responsible. The state of affairs and the course of events suggest much more strongly that the SG and uSG simply are unable to manage and deal adequately with the problems arising from their own false pretensions. The top seems unable to do its duty. To manage. In the sense of: doing what is necessary to make the organization, projects, etcetera work well, in accordance with integrity and professional norms. If they wanted to have projects executed properly, they appointed the wrong project managers.¹⁹ SG and uSG seem to work according to the biblical creation model. As if they were Gods. As if uttering a command is enough to have it executed perfectly. According to the creation story in the bible, God said: "Let there be light", and there was light. SG and uSG (and many other top officials!) seem to think that an organization works like that. That they need not do anything else. They never properly supervised any of the projects for which they were (directly) responsible. If they could do better, it was in their interest to do so, and to show that they could. To protect themselves against criticism. Keeping up appearances is nice, demonstrable success is even better. Real success reduces the risk of unmasking. But SG and uSG failed even to make minor corrections and improvements.

In the given circumstances the stubborn refusal to acknowledge problems can be explained from fear for a domino effect. The top may try to keep the door hermetically closed because it is very much afraid that it will burst open as soon as the latch is only slightly loosened. When one considers the course and findings of this rather limited study, in which every step revealed new problems, then one can conclude that this fear is more than justified. Probably the top knows better than anyone that lots of things are amiss. It may be aware of its own lack of management abilities, and that the only way to stay in (apparent) control is by denial and secrecy.

It may furthermore be difficult to appreciate critical comments if you are a blind optimist, or spend much of your time broadcasting a "positive", optimistic attitude, and explaining away or repressing everything that may be interpreted as pessimism.²⁰ It is anyway clear that the top of the education ministry feels that it cannot afford to be open.

The sketch of the attitude of the top is compatible with the observation that there are no real discussions. There is no openness and no tolerance. In internal conferences people remain silent because speaking makes no sense, or because remarks that can be interpreted as criticism may have negative consequences for the speaker. The reports show that contributing to important meetings is

¹⁹ Besides the projects mentioned in the chapters 2-5, important examples are the projects "Electronic accessibility" and "Edoc". There simply was no basis for the assumption that the appointed "managers" had the required competencies. It would have been a miracle if they had succeeded. (They did not).

²⁰ In this study, "critical" is understood to refer to using one's brain and capacity for thinking and applying common sense. In the digital edition of the Merriam-Webster 2002, one finds under "critical": «*syn critical, hypercritical, faultfinding, captious, carping, censorious* mean inclined to look for and point out faults and defects. *critical* may also imply an effort to see a thing clearly and truly in order to judge it fairly».

hindered by the late distribution of relevant documents, and by overcrowded agendas. Protests never had a lasting effect.

The answer to the title question of this section seems to be that the top is unable to solve the problems, and that the only alternative it sees is to hide them. Bad news means imperfect management and an imperfect organization, and that keeping up the appearance of perfect management and a perfect organization is an inviolable priority of the top. The top lacks the abilities necessary for proper fulfillment of its duties. It is unable to solve important problems. It can only keep up appearances by denial of deficiencies, and by repression of bad news.

It should be kept in mind that in general an explanation is not an excuse.

Disagreeable advice is ignored (and most advice is considered disagreeable).

From time to time authoritative organizations publish all kinds of inquiry reports. Sometimes they contain remarks or recommendations which regard education, science or other fields of interest to a ministry, even though the ministry had nothing to do with the inquiry. The top of the education ministry handles such reports politically. Which is to say that not the contents matters, but the attention the report gets in politics and the media. If it doesn't get attention, it is ignored, unless useful for political reasons. There is no standard procedure for the processing of relevant external reports. If a report has the public attention, and makes assertions or recommendations which the minister or ministry doesn't like, the wish to refute or invalidate them evokes an energy, creativity and "professionalism" that is hard to imagine, and is never shown in any regular activity of the ministry. Which of course is only too compatible with the disregard for the duties and professional norms, and with the frequent recurrence of failures.

Upon the publication of a report with new or otherwise unwelcome ideas about education or other topics of interest to the ministry- "not invented in the ministry"- the minister and top of the ministry quite generally assume a negative attitude. They suddenly demonstrate critical abilities. They defend themselves by claiming that they have always done everything that was needed etcetera. They do as if acknowledgement of the validity of opinions differing from their own amounts to admission of errors, and as if admission of errors shows that they are to blame. They tacitly assume that they are infallible, and that it is wrong to raise doubts about their infallibility. They implicitly suggest that everyone who disagrees with them is mistaken, if not plainly wrong. Sometimes they may nevertheless be aware of the fact that their position is indefensible. In that case they try to get the item out of the public eye as soon as possible. For example by making an ally of the forgetfulness of journalists and the public, or by procrastination in the hope that more interesting news items will divert the journalists' and public's attention. Or to gain time by proposing an "independent inquiry" of specific subjects.²¹

The preceding chapters contain many examples of reports that should have evoked action, but were ignored. See especially the chapters 2 and 5. Although as regards chapter 5 on the Renewal plan it has to be admitted that there are indeed reports which are more or less inadequate, and can be ignored safely. For example because the client didn't want a critical report, and/or because the investigators were no good in the first place, and/or gave a high priority to the wishes of the client and almost none to the norms of sound inquiry. Prevention is better than the cure, and liability for inadequate inquiries is virtually non existent, irrespective of the consequences.

Last but not least: the ministry can afford to ignore even the best reports. Its experience teaches that ignoring advice or criticism is a lot easier than taking it seriously. Even if a critical report catches everyone's attention, it is for only a few days, and soon replaced by something else, and forgotten. After a few months only an irrelevant minority remembers. Only in exceptional cases will the General accounting office (DGAO) check whether anything has been done with a specific report.²² And if the answer is no, nothing happens. The DGAO has no executive or sanctioning power, and there is no other supervision. Parliament should check the proper functioning of the DGAO-system, but doesn't, or only in very exceptional cases.

²¹ By people selected by themselves. Not by for example an Academy of Sciences.

²² And as all of its reports show, the DGAO is not looking for trouble.

Management in the education ministry.

Readers of the chapters 2-5 may find it amazing that heads and directors at the ministry remain passive even when the interests of their unit are seriously threatened.²³ It took years before a responsible director looked at a policy portal. There is not the least indication that SG, uSG and DGPS ever inspected the results of the projects for which they were responsible, and for which they allocated many millions of taxpayers' money. They behaved as if they were only interested in keeping up the appearance that under their leadership NEA (and its predecessors) worked perfectly, and in hiding and repressing everything betraying the contrary. The present section explains why they do so. To a certain extent of course. In principle the explanation applies only to the phenomena described in the reports. That is, to phenomena that do not interest the political heads of the ministry. But because they involve the same people, it is clear that the management of for example policy development cannot be fundamentally different or better.²⁴ Specific empirical substantiation of this assertion would require extra space and time. According to the author this isn't worth the added value, and is therefore passed over.

In a ministry an important distinction is made between activities related to subjects of current political interest and all other activities. This distinction is especially made by the managers. Only subjects which are on the political agenda of the moment get their time and energy. Only progress on these subjects is actively managed (to certain extent). These subjects offer opportunities to please the minister, and to oblige. Other subjects don't. For other subjects it is therefore assumed that everything goes well unless problems are explicitly reported. This is sometimes called the "squeak-system": the management does nothing unless someone squeaks. The problem is that even if someone squeaks action is rarely taken. Or worse: that a manager tries to prove that there is no problem at all, possibly because he doesn't know how to solve it, doesn't want to waste his valuable time on something politically irrelevant, or doesn't want to risk losing "friends" or making enemies. This is the explanation of the passivity. It characterizes the ministry as a political organization, having the power to hide, and to pay the costs of almost any failure.

Because keeping up appearances seems to be the primary goal of the management, its culture can be called a "story telling culture". The reality of the management consists of telling stories. Of words. The top is not interested in the reality behind the words. That reality may as well not exist. They are only interested in the words as a façade. The words are meant for outsiders, to create an illusion. Of course it is crucial that the public and the media believe that the words have their ordinary, normally defined meaning, and do represent reality. This is why it is so very important that the public believes in the integrity of the government. Its words should be taken for facts.

In addition to what has been said above, heads and directors interpret their duties in a very strict sense. If something does not only concern their own unit, but others' as well, they tend not to feel themselves responsible. If they discuss a subject with a director general or (u)SG, they tend to give the answer they think is desired (gratifying). They seem to have been selected for their sensibility for, and compliance with, the opinion of superiors. To define good and bad in the workplace in terms of current office-political opinions. To refrain from saying anything that may displease the superior. They have not been selected for the presence of a gyroscope, the ability to think independently, true interest in education and science, and the detection and rejection of nonsense. But definitely for the ability to keep secrets, especially secrets that would cause a scandal when made public. They are selected for the loyalty of criminals.

The refusal to distinguish sense and nonsense, and to call nonsense just that, is made easier by believing that everything is subjective, and that the truth always lies in the middle. The problem with such niceties is that for example discussions at the ministry during the lunch break clearly showed that at home everyone without exception reasons and acts completely differently, and normally. Outside the ministry, nonsense and truth are rarely thought to be ambiguous or subjective.

²³ The term "heads and directors" is meant to denote all heads of organization units.

²⁴ An important characteristic of policy development is that subjective opinions play a dominant role. Facts often are selected and manipulated to fit opinions. This is just one more reason for making no illusions about the quality of its management.

Idealistic reasoning about competencies and feasibility as a cause of failure.

Both in- and outside a ministry people quite generally argue idealistically. That is to say: as if people or organizations with a given function or name can really do (properly) what the function requires or the name suggests, and that they actually do so. The reports however give numerous examples of people and organizations who do not and/or cannot do their duty or what they promised to do.²⁵ In addition it is often thought that everything that can be imagined can be realized. That the realization of an idea is just a technical problem (not worthy of the attention of lofty thinkers). As soon as one becomes aware of these assumptions one realizes their absurdity. In general it is simply nonsense to assume that people can do whatever they want or should. In reasoning about people and organizations one should be aware of the assumptions one makes about their competences. One should consider the consequences, the risks, of insufficiency of competences.²⁶ One should be aware of the possible necessity of a wide variety of competences. From writing minutes to the management of people who lie about the feasibility and progress of projects.

One of the conclusions that can be drawn from these observations is that one should try to avoid giving people and organizations duties or jobs of which it is doubtful whether they can fulfill them properly. The more so when it is unclear whether they are aware of, and open about, their own limitations, and whether they will report possible inabilities or failures. Duties and jobs should be evaluated much better with respect to feasibility of proper fulfillment or execution with the given human resources. Probation periods and performance appraisals should be taken much more seriously. For projects too a probation period should be introduced. The probation period should be concluded with an appraisal resulting in a “go”(with a possibly amended plan) or “no-go”. (A really independent and critical appraisal that is). Where necessary the goals (and name) of organizations should be adjusted to the true competences of its employees. Not all goals are feasible, not even when there is plenty money.

The top ignores integrity and professional norms, as well as experience.

Lack of abilities is one thing; claiming to be able to do what you cannot is something entirely different. Already in the beginning of the discussed projects fatal errors were made which only for a small part can be blamed on technical inabilities, and mostly on lack of integrity. The commissioner could and should have known that even in the recent past similar projects had miscarried. He should have doubted the ability of the contracting agency to deliver as promised. He should have ascertained that sufficient corrections and improvements had been realized to greatly reduce the risk of repeated failure. All this was omitted. In addition well substantiated warnings, and the people who gave them, were ignored systematically, without arguments or explanation. This was done both in the decision making process, the preparatory phase and during the execution of the project. The top management of the ministry acted as if money grows on trees, and as if nobody will ever call it to account. Risks were ignored, and costs and benefits were not seriously weighed. The management did as if the above quoted article 50 of the General Civil Servants Regulation, «**The civil servant should fulfill the duties which are implied by his function meticulously, and behave as is proper for a good civil servant**» does not exist or can be ignored at will.

The executing agency on the other hand seems to have been led by nothing but greed. By the desire to win as many orders as possible, or rather: promises of money. Cost what it may. It either lacks

²⁵ In fact only a small minority of the employees of ministries were educated for the jobs they actually have. This minority does not include the top. Those who have a higher education are supposed to be “generalist”: to be able to do everything. With respect to their specific jobs they have at most had courses or training programs of a very short duration. SG and uSG seem to think that it is sufficient to create a function with a nice name, to append a salary scale to it, and to appoint someone available who already has that scale. As from that moment they simply assume that the function is fulfilled as suggested by the nice name. This is what happened in the projects Electronic accessibility, Edoc, and NEA. According to the “God said” model. When you know how it works in practice, there is nothing amazing in the failure of so many projects.

²⁶ The reports show that what the education ministry calls risk analyses do not analyze risks. They are only meant to pay lip service, to keep up appearances.

sufficient self-knowledge, and/or failed to investigate reliably whether it would be able to make good on its promises. Or simply acted in bad faith, as a swindler. When during the execution it turned out that too much had been promised, it tried to maintain as long as possible that all was well and nothing the matter. Where necessary by lies, and by falsely accusing people who refused to accept useless products of obstruction and sabotage. If you do things you cannot, and nevertheless want people to believe that you are performing well, you cannot remain honorable.

After the start of a project the integrity and professionalism of the commissioner are especially called upon when the progress of the project has to be evaluated, and when problems require (re)action. Even more in the case of non-performance or misconduct of the contracting agency. This requires intervention and correction, and/or recognition of the fact that the goal was too ambitious. With respect to the problems arising in the projects of the chapters 2-5 however, the responsible managers of the commissioning ministry did nothing. They and the heads and directors concerned gave no support to their representatives. Even though the representatives frequently requested corrective action, and wanted little more than compliance with the code of conduct. Behind their backs managers of the executing agency told the managers of the ministry that everything was fine. Which was obviously incompatible with the test results and with what everyone could see on his own PC monitor. If one took the trouble of looking of course. Which the management didn't. Both commissioner and contractor demonstrated to be part of a wider problem.

In all cases considered the commissioner paid the contracting agency in spite of inadequate or non-performance. He did not declare a moratorium on all except absolutely necessary projects. He did not improve his project management in any substantial way. On the contrary: at the end of 2009 he appointed a contract manager NEA who began his new job on the basis of "I know everything better", including the assumption that everyone is equally right and wrong, except a few prejudiced quarrelers. The recommendations for the development of employees and organization which had been made in the evaluation of the Redesign project, and which were reiterated by Conquaestor and Ernst & Young in relation to a similar project, have never been implemented. They were soon forgotten. Undoubtedly in part because the management lacks the ability to understand and do something constructive with them. After all it would be very surprising to see the top manifest abilities which it had never shown before.

Refutation of the hypothesis of a publicly defensible higher interest.

When told the story of the policy portal project or the renewal project, some people thought that they can be explained in terms of goals (especially interests) or other motives that we, ordinary people low in the hierarchy, don't know about, but which nevertheless exist and may explain what happened. If the direct goal of the project cannot be the goal of the project, then there must be another goal (interest). This subsection tries to show that this hypothesis is no more than an illusion, wishful thinking.

Explanations in terms of interests or other extraneous reasons assume something like rational behavior. Behavior can be called rational if it is determined by a well defined and consistent set of conditions, desires, duties, goals, interests, norms and/or other reasons.^{27,28} In short a well-defined and consistent set of "norms and values". However, the hypothesis of rational behavior not only assumes the existence of such a set, but also that people can reason consistently about it, and about the conduct which optimizes compliance. If these assumptions were correct, explanation of human behavior would boil down to finding the relevant duties, goals and interests. Similarly for (conscious) omissions. People could refrain from certain actions because they might violate norms or harm interests.

²⁷ The "well-defined and consistent" requires specification of the relative priorities of the different goals, norms, etcetera. Sometimes this is not sufficient to decide between available alternatives. Then quantification of the relative priorities of the different goals etcetera may be necessary. Without relative priorities and, in general, quantification, no non-arbitrary decisions can be taken, or choices made.

²⁸ Note that duties and interests may easily give rise to conflicts. Doing ones duty may hurt one's interests.

In this study we are only interested in publicly defensible explanations. For this reason, only publicly defensible norms and values are accepted as a valid basis for (rational) behavior. Greed and lust for power may explain a lot of phenomena, but do not provide defensible explanations. Neither will making a boundary condition of promotion or protection of the personal interests of top managers be considered publicly defensible.

Since an explanation is only considered to be an explanation if it is logically correct (and therefore consistent), it is crucial that the set of norms and values is consistent, and that the reasoning too is logically correct. Inconsistencies create a multitude of possible “rational behaviors”, and thereby annihilate rationality. In practice inconsistencies mean that behavior can both be justified and rejected on the basis of (for example) one and the same inconsistent set of duties plus interests. Inconsistency may be difficult to conclude from a single action. But it can be simple when not a single action has to be evaluated or explained, but someone’s conduct in a variety of activities during a longer time.

The possibilities for rational action (or rational choice) are limited. People have limited knowledge, abilities and opportunities. Even if they have consistent goals and/or interests, they may still be unable to reason consistently about them. They make mistakes. Their (self) knowledge is incomplete, and often incorrect. Forecasting is already difficult with complete information,²⁹ let alone with incomplete information with unknown errors. Of course there are also limitations or even deficiencies in abilities, such as management abilities and the ability to work in accordance with codes of conduct or professional codes. People cannot always reason (see) and do what their norms and values require. Not only because of external circumstances, but in the first place because of their limited mental abilities.

The chances of irrational (publicly indefensible) behavior are increased by false pretensions. For example when insufficient self-knowledge is coupled with a lack of integrity. In themselves false pretensions are already incompatible with integrity. It becomes worse if the pretensions have practical consequences that make the incompetence and the falseness of the pretensions manifest. As when the people incriminated find it necessary to cover up and lie about them, and to silence potential whistleblowers.

With respect to the phenomena described in the chapters 2-5 it has to be concluded that the hypothesis of unknown but publicly defensible goals or interests and rational behavior is extremely unlikely. There is not the least positive indication of explanatory, publicly defensible, interests. On the contrary: if they existed and were publicly defensible, SG or uSG had an interest and plenty opportunities to communicate them. That would have spared everyone a lot of trouble. But they never did. In the discussion of 9/6/09 the SG did not even make the first beginning of an explanation of his actions and omissions, and to elicit the least appreciation of his conduct. The hypothesis of the absence of publicly defensible higher interests is moreover supported by many proofs of lack of integrity and lack of competence. Which also mean that the code of conduct cannot be part of the true norms and values of the top. Last but not least the lack of integrity and competence is more than sufficient to explain all observed phenomena.

In other words: continuing to throw away money at doomed projects, failing to learn, etcetera, most probably have no publicly defensible reasons, and serve no defensible interests. On the other hand the efforts at cover up can impossibly be accidental. They seem meant to serve personal interests at the cost of public interests. Successful execution of a project requires serious abilities. But given hierarchical relations and the power of a ministry, and the complete lack of internal or external control, it is very easy for those in power to keep up appearances.

There is no better basis for explanation than the combination of incompetence and keeping up appearances.

When one considers the totality of developments in and around the Dutch education ministry in 2005-2015 (or a longer period), then one sees nothing that can possibly justify the phenomena described in the chapters 2-5. There seems to be only one reason and goal that can explain these phenomena. Namely false pretensions coupled with the wish to keep up appearances. False

²⁹ At least of present and past!

pretensions about abilities and goals, and the appearance that all is well at the ministry. There is no indication of any better explanation for the behavior of the top management.

If things really go well, or if only mistakes are made, there is no reason for keeping up appearances, and for the denial of mistakes. Keeping up appearances is only necessary if failure is structural, and if it shows the falseness of the pretensions of the management. It is only necessary if knowledge of the truth would endanger the position of the management, and the management wants to hold on to its position at all costs. If the management of the education ministry had been honorable and competent (or only honorable), this report would not have been written.

The conclusion seems inescapable that the described phenomena have to be explained by lack of integrity and lack of competence of the top, in combination with the wish, born from self interest, to make everyone believe that it is doing fine, and that the ministry performs excellently. The delusion is possible because the top has no reason to fear sanctions in case its deceit is discovered. Effective control and regulation are absent. The political heads (members of government) always claim full responsibility for the operation of their ministry. In the unlikely event of discovery therefore, the political top is the most interested party, and will have to shield the ministry.

If the management could do better, then in spite of the only minute chance of punishment, it would still be less risky to perform really good. Successful completion of a project obviously creates less risks and difficulties than a failed project. For most of the projects mentioned there was no real necessity. As demonstrated by the fact that nothing went fatally wrong anywhere when they were aborted, or delayed by years. Most projects were just a waste of human effort and taxpayers money, and could better not have been started. The top seems to have been unable to make correct feasibility judgments, or to get reliable advice. Or failed to say "no". Often, saying "yes" must be the easiest, given the verbal pressure from the contractors on the one hand, and the absence of control and sanctions on the other. If it could have done better, the top should have done so. Proper performance would definitely serve its self-interest. But it should have done better also because the various kinds of failure create risks for the political heads of the ministry.³⁰ For example through publications like this. The reports clearly show that truly competent people could have realized much better results for far less money. Could have realized qualitatively and quantitatively better operating executive agencies, and especially better (project)management. Honorable and much more competent.

Many of the violations of integrity and professional norms in government organizations can be explained by the subordination of the organization to subjective and changing opinions of top officials and politicians, and to their personal interests (and those of their friends).³¹ For the present governments quality seems to exist only in a political sense. The yardstick for quality is the apparent political success of the political head of the ministry, the minister. What matters is not to be right, but to be put in the right. It is the image that counts, not reality. Nothing is appreciated more than successfully keeping up appearances. The successful creation of a positive image of what was done or proposed. Irrespective of true material merits.³² People who can accomplish this go far in this kind of organization and situation. Especially because there is no real opposition or control.

It is incorrect to think that the employees of a ministry serve the interests of society. They serve their superiors, and the highest superiors primarily serve themselves and their class. As long as they keep their ministries opaque, they have plenty of instruments, including spokespersons and spin doctors, and power, to make you believe that whatever they do is in the best interests of society.

For the given reasons, the observation that a ministry does not learn from its errors and failures need not mean that it learns nothing at all. It may be very successful in its image management, in keeping most of its failures secret, and in making the population underestimate and forget the failures which do get public. This is what members of government and their top officers are really good at. This is what has their priority, and what they are eager to learn more about.

Of course all this also means a complete lack of respect for people.

³⁰ Creating a risk for a political head is the mortal sin in a ministry.

³¹ And first of all of course: their false pretensions. But this is not repeated every applicable time.

³² The letter of minister Hermans to parliament about he project Redesign is an excellent example.

An important other goal is budget maximization.

Neither policy portals nor renewal plan were really necessary. But money was available. Reality is, that there is a never ending battle for the tax receipts between the different ministries. Every ministry tries to secure as much money and as large a portion as possible. This battle already rages for centuries. In combination with the complete lack of power of the population and the false pretensions of politicians, this battle can be seen as one of the main engines of the perpetual growth of tax pressure and government. It is a manifestation of a real problem, to some extent independent of the integrity and competence of ministers and their ministries. The fundamental problem is, that no objective or generally accepted- logical, scientific, or what have you- method for the distribution of the tax receipts over the ministries is known. It is no more than wishful thinking and concealment to speak of "political choices". In reality these "political choices" are nothing but the result of negotiations (battles) between ministries and/or their ministers. Either or not via the ministry/ minister of finance. The distribution has little to do with choice, and much with trickery, manipulation, and power play. And since none of the ministries wants to spend less than last year, or to have a smaller increase than other ministries, etcetera, and since it is often much easier to bleed the taxpayer than the colleagues in the cabinet, it is the taxpayer who foots the bill.

For a ministry, the high priority given to the desire to keep or increase its budget is an inexhaustible source of violations of integrity and professional norms. A ministry feels that it should always keep in mind that it has to negotiate with the other ministries every year. It needs to manage its negotiation position. Its position should not for example be undermined by a failure to exhaust the given budget. A remainder would suggest that the budget was too high, and can be reduced. Asking too much is wise if it is unknown how much money will be available next year, and what other ministries will need or ask. It is even wise irrespective of financial prospects, as part of any negotiation strategy. For this reason, it is useful to invent new items which can be used to absorb the potential extra money. Some of these items may be really useful, but others probably are a waste of money, or worse. A useless project may waste the energy of good people, who for the duration of this project can do nothing better. Anyway, these items are mostly "sold" with false pretensions. Not integrity but earning money has priority. Similar mechanisms determine the distribution of "windfalls" in government income, and budgets for special purposes. If a ministry feels slighted in the negotiations, it calls upon its minister, who calls upon his colleagues in the cabinet. And if the decision making about projects like the policy portals or system renewal by the supposedly expert ministry already is utterly inadequate, nothing is to be expected of the evaluation of the unreliable and badly specified plans submitted in budget negotiations at government level. For practical reasons, beyond a certain point, negotiators have to trust one another, even though they know that this trust is incompatible with experience.

In general furthermore it is not completely clear what integrity means or should mean in the framework of negotiations. It is certain however that maximization of the budget of a given ministry benefits from a believable amount of misleading, or tacit agreements about acceptance of appearances. Ministries know of one another that they "play games". This is accepted, even though ministries are not averse to abuse each other's mistakes.

Something similar happens inside ministries (as in other organizations). The relations between directorates-general and directorates are similar to those between ministries. With one important difference: a ministry is organized hierarchically, and (u)SG has more powers, and more relevant information than a cabinet or prime minister.

It will be clear that the fact of negotiation relations has an important influence on the integrity and professionalism of the work of the ministries. Keeping up appearances may be politically desirable anyway, but is also an instrument for budget maximization. However, the question which of the two has the highest priority is not important for this study. What is important, is that budget support requires the outside world to believe that the activities paid for with this budget are important and necessary. In other words: what the chapters 2-5 describe can be explained by the wish to keep up appearances in order to protect the budget and the power positions of those responsible.³³

³³ Of course in the context of lack of control, relatively easy access to money, and inadequate law.

Everyone who wants a more honorable (transparent, reliable) government will have to take good account of the problem of the budget distribution. In particular it has to be ensured that ministries and/or supervisors report critically and reliably about the work of the ministries, the effectiveness and efficiency of the spending of their budgets, and so on. Errors should be openly admitted, and not the ministry but those responsible should be sanctioned. Integrity can be made conditional if equality is guaranteed by a supervisor.

Nobody feels responsible.

Hierarchical relations undermine feelings of responsibility.

A minister is the head of his ministry. All its employees, including the secretary-general, are subordinated to him. From a formal, legal point of view the minister is the only one responsible, and from a practical point of view even more. This is the only true and defensible position. The reason being that the hierarchy really works as a hierarchy. That is, as a dictatorship. Nobody else has any independent authority and responsibility, and indeed, nobody else feels responsible. At least not for what he does or does not, or at most to a very limited extent. Ultimately an employee only feels responsible for the way he does what his superiors ask or expect. Not only for formal reasons, but also because one has no authority or means to act as one would when responsible, and because one knows from experience that doing otherwise is meaningless and/or risky. For practical reasons most employees simply cannot do what they would do if they were to account for their conduct personally. The following example did not fit in the reports of the chapters 2-5, but shows some of the relevant mechanisms rather explicitly.

An example: IAG refuses to incorporate a correction mechanism in a databank.

The agency IAG/NEA wanted to make a register of diplomas. The register was meant to make fraud more difficult, and to increase efficiency. The register was to be accessible through the internet. IAG thought that it already had the necessary data about the diplomas and about the people who had received them. Of course IAG wanted extra money for the development of the register. The development of the project is a story in itself. Because the added value with respect to the chapters 2-5 is very small most of that story is passed by. I only mention a few minor events which show the absence of a feeling of responsibility by some of the participants. And its consequences.

The group of future users of the register included the institutions of higher education. The content of the register, and the information which was to be accessible through web pages was therefore discussed with them. For discussions about matters of common interest there was a Joint Working group Student data (JWS). This group met every few months in the town of Utrecht. The meeting of 29/10/10 was chaired by Ron van der Meer, head of the section Finance of the directorate for higher education (HE). It was attended by the contact of HE for IAG, Van Velsen. After the meeting, back at the ministry in The Hague, Van der Meer and Van Velsen evaluated the meeting. They agreed that the performance of IAG was inadequate. On the one hand IAG claims the legal status of "basic register" for the diploma register. On the other hand it doesn't want to comply with the legal obligations this brings along. Such as the obligation to take corrective action if an error in the register is reported. In the meeting, Hans de Haan, one of the representatives of IAG, had implied several times that IAG was unwilling to incorporate the necessary service in the register as a system. Several promises which IAG had made in earlier meetings of the JWS about quality assurance remained unfulfilled. Van Velsen argued that the ministry (in practice HE) should do what is necessary to make IAG work properly, with respect to this as well as other subjects. The ministry pays, and the minister is responsible. Van der Meer denied that it was HE's duty to take an active position. It should leave IAG alone. The ship would run aground of its own.

It is rather unclear what this metaphor was supposed to mean in practical reality. In a certain sense the ship ran aground frequently, as we saw in the preceding chapters. But this clearly doesn't mean that IAG comes to a standstill. If only because the ministry quickly comes to the rescue. It covers errors and failures, and provides new money. Examples: policy portals, datawarehouse, and renewal plan. There are no counterexamples.

In the next meeting of the JWS, on 10/12/10, it turned out that IAG had not made any progress with respect to error correction, in spite of the reminder in the meeting of 29/10/10. Half a year before, IAG had been asked to inquire how other managers of basic registers handle this question. On 10/12/10 De Haan declared that the matter had been “discussed” in IAG, but without result. He couldn’t say anything more. To make matters worse the chairman of the meeting, Paul van Capelleveen, who took the place of Van der Meer, said “to sympathize with IAG”. This meant that for months at least nothing would be done. Van Capelleveen may have wanted to be kind, may have been prepared insufficiently, failed to use his brains, and/or be incompetent (or a combination of these). Knowing even a little about IAG, which Van Capelleveen certainly did, a professional would have been more careful, asked questions, and made reservations. The more since several other people in the meeting had unambiguously shown dissatisfaction about the non-performance and attitude of IAG. IAG had not given any plausible reason for not doing what it had promised and was obliged to do. The ministry took no corrective action. (Neither then nor later). The misconduct was simply condoned.

Neither Van der Meer, De Haan nor Van Capelleveen gave any sound argument for doing nothing. What they did say could be refuted easily and indisputably. None of them felt responsible. It is evident that they would behave very differently if they would have had to account in a serious manner for their (in)action towards a superior or the public.

Note that if IAG really was a professional organization and wanted to provide reliable services, it would find a good and user-friendly correction system self-evident, and waste no words and time about it.

The minister gives no sign of feeling responsible.

As far as the reports of the chapters 2-5 are concerned, the minister might as well not exist. He shows no interest, and does not check or interfere in any way. In other words: the reports are incompatible with the hypothesis that the minister feels responsible, or that in his case “feeling responsible” has any practical consequences. He probably relies on his immediate subordinates, and blindly. But he cannot know, and never tries to find out, whether trust is justified. This too would seem to be incompatible with a feeling of responsibility.

Note that here too there is no trace of any control or correction mechanism.

False pretensions cause integrity violations.

There are also causes of integrity violations that have nothing to do with budget maximization. Most of the described dishonorable conduct can be explained by false pretensions. By the wish to appear honorable and competent. In general: to appear far better than one actually is. If only due to a lack of self knowledge, and/or a distorted concept of integrity. And even though the pretensions miss any basis in reality, and can only be maintained by silencing everyone who refuses to replace truth by illusions. The reports (and the daily news!) show numerous people and organizations who/ which systematically bite off more than they can chew, promised more than they can fulfill, and as a consequence waste people’s time and money. Or worse. The reports show that those responsible deny failure, or put the blame everywhere except on their own incompetence. The reports show that the responsible employees try to keep their errors and failures hidden by other forms of misconduct, and that they systematically ignore codes of conduct and other generally accepted integrity norms. The report shows that bad easily elicits worse. That in cases where suppression of the truth turns out to be difficult, more and more people and units are requested to collaborate in covering up non-performance and misconduct. People are required to accept the side tracking of colleagues who dare complain about misconduct, and dare to ask the management to enforce the code of conduct. They are required to accept that their organization collaborates with auditors and external organizations in cover-ups.

Similar phenomena can be caused by efforts of government officials to get people accept proposals which are substantiated insufficiently, or can be shown to have harmful effects on the general welfare, and would not get a majority without such efforts. Where necessary the top officials who originated such proposals use tricks, cunning, and deceit to generate support. And they don’t stop at that. They also require silence or active support (“loyalty”) from their subordinates. Ditto in the case of

unjustified or incorrect statements about causes and effects of unwanted phenomena, and unwanted effects of regulation and policy. The government is always right. Cost what it may.

In short: false pretensions of higher ups “force” their organization to behave dishonorably, and to eliminate employees who give the norms and interests of society higher priority than the personal interests of their superiors. In this way corruption spreads and deepens.

In the described projects honorable and competent management could have prevented, or minimized, the spreading and deepening. Competent managers and commissioners don’t let themselves be cheated by nice looking presentations of castles in the air. They distinguish words and deeds, theory and practice, and take account of experience and the reliability of the speaker. They ask verifiable intermediate results and clear reporting, and don’t accept selective half truths. In the described projects we see a commissioner who orders products to be developed, pays lots of money for that, but otherwise remains passive, irrespective of (lack of) progress. We see a management that reacts to misconduct and useless products not by corrective action, but by action against its own representatives who don’t accept misconduct and useless products. It is these people who occupy the positions of power in the organization. Everyone else has to accept and adjust, or leave.

The higher in the hierarchy, the more false pretensions. False pretensions as cause of problems.

Not everyone has the illusion that he or she can accept or bear responsibility for the work of 10, 100 or even thousands of people. For making them do together what the organization is required to do, effectively and efficiently. Not everyone is willing to promise and pretend what members of governments and other politicians promise and pretend.³⁴ At one time or another you may have wondered how the suitability of candidate ministers for being head of a ministry is evaluated. The answer is that there is no indication that they are evaluated responsibly or professionally, or even evaluated at all. On the contrary. From both the absence of indications of necessary competence in CV’s of ministers and the way they do their job it can be concluded that only rarely can these competences be demonstrable. In general there is every reason to doubt their presence. It seems to be simply assumed that politicians, or people with experience in parliament, have these competences, or that these competences are not really needed, on the assumption that they are supplied by the SG (and that such a model of the job is sound). For decades the education ministry has not had a minister (head) whose previous career shows the ability to manage and lead a large organization. And indeed, at the ministry they never showed this ability. They never led in any meaningful sense of the word.³⁵

Something similar applies to most or all members of the higher management. Their abilities are far less than what they pretend and should be able to. Like the minister they may think that they can rely on their subordinates. However, like the minister, they cannot really judge the abilities of these subordinates. They must trust them blindly, or just work with them. This is obviously risky. Therefore the management relies heavily on the power of the minister and ministry, and on the loyalty within the management, to solve or cover problems. Where “solve” should be understood in the political sense: making sure that nobody talks or writes about them publicly.

It is evident that honorable people with adequate understanding and self-knowledge, who do not pretend more than they can, and who are unwilling to saddle other people with harmful consequences of their false pretensions, will not apply for jobs which make them responsible for activities nobody can vouch for. Experience shows that higher functions require more pretensions than functions lower in a hierarchy. Jobs which require the impossible, induce self selection of people who pretend too much, are willing to take risks at the cost of others, and don’t mind misleading others for what they consider a good purpose, and rolling off the costs of their inability and arrogance on innocents.

Conversely this selection mechanism can be seen as part of the explanation of many government activities which do not produce what they are officially supposed to. It explains the structural resistance against transparency and truly independent evaluation. Transparency and independent evaluation would expose the false pretensions and lack of integrity and incompetence, and unmask those responsible. The given pretentious political and government culture can be understood as being

³⁴ Including by their oath on the constitution.

³⁵ To be distinguished from both dictatorship and passivity (except perhaps in the case of a few hobbies).

caused by, or the result of, the indicated selection mechanism. It is logically inevitable that it causes widespread failure, harm, and risk.

The observation that some jobs require sheep with five legs does not justify the pretension to be such an animal. Neither does it justify using the fact of their non-existence as an excuse for the failures which the pretension causes. Let alone for trying to hide the failures and the falseness of the pretensions. It is only the acknowledgement of the problem.

The conclusion is that politics and government can only work responsibly and transparently if they become much more modest. They can only work responsibly and transparently if they match their pretensions with their abilities. Only then can they do without trickery, deceit and other forms of abuse of power.

Corruption is spread by selection.

There is not just one organization culture: there are incompatible cultures.

The reports suggest a mechanism by which the top of a hierarchical organization ensures that the power in the organization remains restricted to people with the same norms and values. The norms and values which define the subculture of the top. The mechanism is selection. People are selected by promotion, by selecting “suitable” participants for specific activities, and by deselecting people with incompatible norms and values. Of course the mechanism is appropriate if the top is honorable and competent. If not, then one can expect the phenomena described in this study. Up to and including the extinction of systems for control and correction. This is only logical. In the education ministry people who ask for using common sense, who require agreements to be kept and compliance with the code of conduct, are eliminated from processes where such an attitude may cause trouble. The silent majority interprets this as a warning, or is less critical “by selection”, or invents excuses, especially for doing nothing and not feeling responsible.

For a corrupt culture the co-optation of kindred people is necessary for survival. Those who share this culture know only too well that they cannot refute the criticism expounded in this study.³⁶ Giving positions of power to honorable and competent people would make the positions of dishonorable and incompetent people untenable.

It is important to note that the subculture of the top is not shared by the majority of the employees, and even less by the population in its entirety. It is improbable that you, reader, aspire to top positions in politics or administration. But even if you were put in a position of power it is unlikely that you would behave similarly. That you would behave similarly is no more than a hypothesis which the present top wants you to believe. Namely because it suggests that it behaves normally, and that there is no alternative. The hypothesis serves the interests of the top. What the reports show is that people differ greatly, and that people like those in the top are rare but common. They are rare not with respect to positive abilities, but with respect to their exceptional arrogance and false pretensions. Regrettably, this kind of character is rather common too: one finds them in every larger organization.

As a rule it is assumed that people differ mainly and mostly in their abilities in the various fields of human activity. And that other differences are less relevant and need not be taken into account.³⁷ In particular that differences in norms and values do not “really” exist, or are irrelevant. The reports show that these hypotheses are incorrect. Hypotheses like these make historical and social phenomena incomprehensible.

In the meantime the homogeneity of the group of top employees with corrupt norms and values precludes improvements without replacing the whole top, and their entourage, by people with defensible norms and values. Which is difficult because these people never got an opportunity to gain experience in a top position.

A consequence is that at most a significant failure can stop the merry-go-round. On a small scale this happened for example in the policy portal project and the renewal plan(s). The cases support the conclusion that this does not (cannot) lead to improvement. The corrupt system is stable.

³⁶ As demonstrated by SG Koos van der Steenhoven of the education ministry in his talk with the author in June 2009.

³⁷ “Except of course with respect to common criminals.” As if this would be a well defined and isolated group.

The conclusion is that it is understandable that there is an evolution towards a top which is not honorable and cannot do its duty properly.³⁸ Its most important competence is self defense: keeping up the appearance that everything goes well. In their self defense they are supported by power and an inexhaustible amount of taxpayers' money. The reports clearly show that the top is very well able to cover-up, but not able to really solve any (solvable) serious problems.

People do not have the same conscience.

There are neither empirical nor logical reasons to assume that people have one and the same conscience, or even a very similar conscience. The reports show that the norms and values, and therefore the consciences, of ministers and high officials differ substantially from the norms and values which are generally considered desirable or self-evident.³⁹ By definition people judge behavior by the measuring stick of their personal norms and values. In the context of judging, norms and values are called conscience. Differences in norms and values mean differences in conscience, and different value judgments. That the conscience (= norms and values) of ministers and high officials differs from the standard is therefore confirmed by the observation that they are happy about their own performance. This observation shows that they judge their performance with other norms and values than other people. In other words: that they have a different kind of conscience. A conscience that enables them to act contrary to generally accepted norms and values. Someone who thinks that this is evidence for the absence of a conscience, and calls it unprincipled, should realize that every being that has to make choices must have norms and values. For such beings the absence of norms and values, or principles, is a logical impossibility. But logic allows, and reality shows, important differences. People may have very different consciences. They should not be assumed to see or value things similarly.

How decent people become helpless.

Someone who applies for a job, or accepts a job, sometimes does not and cannot know that the job requires more or other abilities than advertised or mentioned by contact persons. Neither can one always know or even guess beforehand that in practice the management of the organization applies norms and values which differ from those professed by its public relations officers, press releases, and public image. Once part of the organization, and having seen how it works, the question arises: how to cope with the contradictions? In other words: how can one handle this unexpected and unknown situation? A situation for which one is not prepared, and which one may find troublesome, objectionable or completely unacceptable? What *can* one do? Practical answers are difficult because there seems to be no solution that does not cause personal harm.

It is seen that an incorrect picture of the necessary abilities, and insufficient abilities, can be sources of incalculable problems. The reports show that in general people are unable to solve them in an honorable way. Especially not in a way that is compatible with the code of conduct.

The above questions concern everyone. Integrity officers too. Because of the theoretical-idealistic education program and a never ending stream of misleading government information they too can impossibly be prepared for structural deceit by authorities. And indeed, the one who coached the author couldn't cope.

Why integrity violations are rarely reported.

The reports show that integrity violation in the Dutch education ministry had a structural character, and a dominating and disastrous influence on several projects. The reports show that the observed abuses were known to the management, and that the management did nothing to eliminate them. Promotion of people responsible for the abuse suggest that the top of the ministry approves misconduct. There is no indication of either formal or informal reporting about the abuses reported in this study by employees of the ministry. For example in the annual reports of the integrity officers. It

³⁸ Given power and a political establishment with common interests.

³⁹ As laid down for example in codes of conduct and integrity codes. The overwhelming majority of novels provides additional support for the text.

seems improbable that somebody else beside the author has ever reported integrity problems in any of the projects mentioned. Namely because the efficacy of reporting misconduct is greatly helped by cooperation. And the author never made a secret of his opinion and complaints.

It has to be concluded that violations of the code of conduct are rarely reported. This is not difficult to understand. There are many possible reasons. In the first place many people tend to identify what is normal in practice with what is normal in a normative sense. That is: to think that what happens in practice is the way it should be.⁴⁰ In the second place objectionable behavior is only rarely understood as violation of a code of conduct. Many people seem to have little difficulty with a double moral (= two distinct and incompatible sets of norms and values): one for home, another for work. People can get so used to what actually are integrity violations that they don't even notice them any more. And if people nevertheless realize that specific conduct is incompatible with the norms and values of an applicable code, they may still fail to realize that the code is supposed to be complied with (for good reasons!), and that violations allow for an appeal to the management. Another possible explanation is that people think they live in the best possible world, that nobody is perfect, and that parliament controls. And last but not least: most employees consider an appeal to the management to correct misconduct unrealistic or even ridiculous.

Probably there is a selection effect too. Due to various causes relatively many people may have been appointed and remained who accept the actual norms, or consider them normal or good. Relatively few people may have been appointed, and/or many left, who find the actual norms objectionable.

Finally there is the terror by governments. That is: the organized efforts by politicians and high officials to make the lives of whistleblowers as unbearable as possible, and to make this well-known. With complete disregard of the law. Governments obviously want to discourage the reporting of their misconduct. As a consequence, most employees of government organizations are very cynical. They think that whistleblowing always ends badly and changes nothing. In spite of the freedom of speech and codes of conduct, speaking remains silver, and silence gold.

Whatever its explanation, it is evident that the whistle is blown far too rarely. In all avoidable man-made disasters and other influential cases of misconduct, such as the Bhopal accident, the corrupt practices of Cresson at the EU, the Love Parade accident in Duisburg, the North-South line of the Amsterdam metro, the oil leak in the gulf of Mexico, and the subprime crisis, many people have known of malfunctioning people and/or systems. Many people must even have been legally obliged to go public. But only in extremely rare cases this is done. It follows that there must be very much that should be made known but isn't. The alarming fact is not that sometimes things go wrong. That may be inevitable, even if everybody is honorable and competent. Instead, what is alarming, is that one of the very few existing safety systems is being forcefully repressed, and not allowed to operate and have a preventive effect. In a world brimming with very large, and ever increasing risks.

The following is a pointwise summary of the causes of the silence about even dangerous misconduct, with a few variants and supplementary remarks:

- The terrorizing of whistleblowers by governments, and the absence of corrective effects of whistleblowing;
- The belief that "in our country" things are organized in the best possible way. Parliament controls the ministers, the hierarchy is therefore legitimate, and Befehl is Befehl;
- A normative interpretation of reality: the idea that things should be done as they are done in practice. In combination with the ability to live with a double moral;
- The idea that the code of conduct is only meant as an ideal, and should not be taken literally or seriously;
- The idea that reporting misconduct only has negative consequences;
- Fear of reprisal (in spite of whistleblower laws);
- The force of habit;
- Selection of people who adjust to the environment (like a chameleon);
- The idea that change is impossible ("you cannot change people");
- The idea that it is not your responsibility;

⁴⁰ Note that children unconsciously assume the same.

- The idea that it is not too bad;
- Lack of understanding and reflection;
- Closing ears and eyes for everything that might undermine one's peace of mind.

Causes of inadequate inquiries and inadequate supervision.

The reports show that present-day law and institutions do not have sufficient preventive and corrective effect. None of the studied reports of consultancy firms, supervisors or inquiry commissions gives a clear and reliable picture of the course and results of projects and processes, and of the competences and conduct of the people and organizations involved. Investigators seem very much inclined to overlook or ignore deficiencies in people and organizations, or to indicate them with understatements, metaphors and other ambiguities. They are so "good" at diplomatically describing (or rather indicating) abuse, that one may need the most suspicious reading to avoid complete misunderstanding. For example when a report asserts that "there is room for improvement" instead of "... is insufficient".⁴¹ (As a consequence) They advise superficial remedies even for major problems. Which of course is insufficient, as all cases prove. Repetition of errors and failure is the rule. Even auditors with a professional code are seen not to balk at fraud.

To a certain extent the unreliability of inquiry reports can be explained from a desire to deliver what is assumed to be requested, and/or to keep the relation between the investigators and their organization on the one hand, and the organization being investigated on the other, pleasant, or at least workable. Of course in combination with a failure to accept the code of conduct or professional code as an inviolable boundary condition.^{42, 43}

The superiors of the investigators probably don't accept openness and clarity about abuse from their subordinates. They give priority to a well-filled order portfolio, and fear the consequences of "too much" openness and clarity. The firms doing the investigations are hierarchical organizations. Superiors have to approve the reports of their subordinates. Nothing leaves a firm without a signature from the higher management. Not the codes, but the wishes of superiors are conditional for investigators. For that reason the superiors are at least co-responsible for the unreliability of inquiry reports. Not only formally, but practically too.

Just like everybody, investigators don't like repeating themselves in successive reports. For example by exposing the same abuse year after year. Also, but not only, because it shows the futility of their work. Conversely a reader who understands their difficult situation should attach great weight to observations which are repeated year after year. But the most important may be that in general the investigators see very little effects of their work. Often they have to listen meekly while those responsible for abuses push well founded but understated criticism aside with misleading tattle, and have to look on helplessly while parliament and media accept this tattle unthinkingly. Sometimes inquiry reports do raise dust. But the dust almost always settles quickly. Rarely if ever is it followed by adequate corrective action. In other words: this kind of inquiry is terribly frustrating.

But although this is only too understandable, the consequence remains that even crucial inquiry reports are unreliable, and do not comply with the applicable norms and codes. Which means that one of the few systems for control is effectively switched off.

Here too, there may be selection effects. Namely by a preference for investigators with rose-colored glasses, a "positive attitude" or "political sensitivity", "realists", and people who for whatever reason are less able or willing to take their professional code or public expectations about their role seriously. This in addition to the relatively early departure of those who are unwilling to keep their

⁴¹ "Can better" is a practically empty judgment, and should never be accepted.

⁴² The codes are almost always public, and in that case reflect what the overwhelming majority of the population considers desirable or normal. The findings of this study are compatible with the hypothesis that many or all of the codes are primarily meant to mislead the public by suggesting that the people in a given organization or profession work in agreement with these rules. Note that there is no corresponding system of supervision, enforcement, and sanctioning of non-compliance. At least nothing in the least practical and effective.

⁴³ It may be a problem that clients won't give contracts to firms which really respect the codes. This problem may be reduced by making firms liable.

eyes and mouth shut, or to soften criticism beyond recognition, and who find professional codes and the public interest more important than the short-term interests of the firm and its management.

Finally it should be remembered that investigators in general depend more or less on the cooperation of the investigated organization. Investigators should carefully manage their relations, if not for the present inquiry, then for future ones. Often this situation may seem to require compromises. Which however can easily conflict with professional requirements. The dependency creates a risk for the quality of the inquiry.

Because of the mechanisms (and other causes of failure) indicated above, expansion of supervision and inquiry is meaningless. It is utterly insufficient. It is the mechanisms which have to be neutralized or eliminated. The independence and quality of supervision, inquiry and reporting should be corrected and improved fundamentally. Maybe this isn't possible to a sufficient extent. At least some of the mechanisms seem to be an intrinsic part of inquiry and supervision by outsiders, and the client is obviously co-responsible. One can furthermore ask oneself whether supervision by outsiders can ever be as effective, let alone as efficient, as that exerted by the employees themselves.

Earlier in the study it was noted that where a choice exists, inquiries are made only if the results are expected to be publishable. In addition it is obvious that it is the most blatant abuses that will be most softened in the inquiry reports (if not kept under cover completely). The combined effect of all these mechanisms is that the public gets a positively biased picture of what is happening around them.

Politicians exclude themselves from liability, criminal law and independent administration of justice.

There is a glaring contrast between the impunity of the heads and top management of government organizations, and the punishment for integrity violations meted out to employees in the lower ranks of these organizations. Especially if one considers that the misconduct of the heads and top management causes much more damage. It causes damage along both the human, administrative and financial dimensions. Those who excuse such people by noting that they do much good too, should not only prove this, but also explain why they do not apply the same argument to employees lower in the hierarchy, and to common criminals. Neither the (Dutch) General Civil Servants Regulation, the codes of conduct, or other documents about integrity offer substantiation for this kind of apologies and discrimination. It should furthermore be explained why the proportionality principle is not applied. In other words: why the punishment is not proportional to the damage caused.

Present-day law applies arguments for punishment and liability selectively. Contrary to what is often said and believed, there is no equality before the law. In the run up to the financial crisis and in all other cases in the preceding and following chapters one sees officials operating as if they have nothing to fear from non-fulfillment of duty. It is inconceivable that the cases would have occurred if the principal persons would have had to fear liability claims or punishment (including imprisonment for life). There can be no doubt whatsoever that liability and criminalization will make incompetent people think twice before accepting a job, and everyone in public administration act much more responsibly.

Nobody openly defends the opinion that crimes should remain unpunished, and nobody says to believe that criminal behavior can or should be combated without criminal law. Why then is there no (effective) criminal law for the misconduct described in this study, or why is it almost never applied? Why should one believe that gross misconduct in government can be eliminated without criminal law and punishment, if at the same time one is expected to believe that the same is impossible for other forms of misconduct, especially the lighter forms? What is the justification for the inequality that this implies?⁴⁴

Something similar can be said with regard to unequal liability, and the obligation to recover damages caused by avoidable behavior, and/or as a consequence of failure to adequately perform a function in government or another public organization. Such as supervision, the maintenance of financial stability, and containment of systemic risk. Where it is to be understood that the costs of

⁴⁴ Textbooks on criminal law offer none. For authors and titles see the references in *Het recht van de logica*. An example of an American textbook is Wayne R LaFave, Criminal Law, Thomson West, St Paul (MN), 2003, ISBN 0-314-14997-X.

liability are not to be covered by the public administration or the Treasury, but for as large a part as possible by the responsible officials personally. Someone violating a law or code of conduct does not act on behalf of his organization, and cannot claim its protection.

The Civil Servants Regulation says that the competent authority, in a ministry the secretary-general, can deal with integrity violations by subordinates. It does not tell how integrity violations of the competent authority itself are to be dealt with. Or discrimination by the same authority, or a failure to take action. The Civil Servants Regulation seems to assume that the competent authority is honorable. As this study shows, that assumption is incorrect.

Codes of conduct and professional codes have no teeth. There is no procedure that guarantees independent evaluation and sanctioning of infringements. Whistleblower regulations do not provide for effective measures against those who were responsible for the misconduct which necessitated the whistleblowing. Not an independent judge, but coalition- and party members who depend on public authorities for their future career decide whether these authorities informed parliament and public timely, completely and correctly, or lied. In the present democratic constitutional states there are two systems for the administration of justice. One for the top of the public administration, and an entirely different system for everyone else.

It is a mistake to think that the given democratic constitutional states cannot be improved substantially.

Many discussions about law and the democratic constitutional state seem to be based more on blind faith than on experience and logical reasoning. The idea that “the democratic constitutional state” is a good or the best possible regulation for a state (or a group of people) is based on several misconceptions. In the first place “the democratic constitutional state” is not well-defined, contrary to what is suggested by the definite article “the”. There is an infinite number of ways to organize and regulate a democratic constitutional state. Reality shows many examples, and many more can be devised with little effort. The different democratic constitutional state forms differ with respect to all possible laws, including those regulating the democratic and constitutional aspects of the state.

The possibility that a certain existing democratic constitutional state is the best of all existing state forms cannot be excluded. Although it is far from clear in what sense it is “the best”. Being the best of the given systems does not however mean that is good in this sense, that a timely, completely and correctly informed population would agree voluntarily with its constitution, or has good reasons for assuming that society will benefit from it, in a logically tenable sense.⁴⁵ Assuming that the population would understand and apply the relevant information. Examples of characteristics of the existing democratic constitutional states that cannot be voluntarily accepted consistently or without losing one’s self-respect are:

- The possibility to pass the costs of damage by avoidable human activities onto people who were kept out of the decision making about the harmful activities;
- Forms of representation which practically mean that the representative gets a blank check. In other words: without the possibility of binding instructions, recall and replacement. (Note that this kind of “representation” is restricted to politics. Everywhere else in society it would be considered plain madness);
- Forms of representation which mean that one can only chose for a package of opinions;
- Decisions which cannot be turned back when it is found that the decision makers were not informed timely, completely and correctly;
- Adjudication by judges whose future depends on those they have to adjudicate;
- Adjudication of which the result depends on the financial circumstances of the parties.

All present-day “democratic constitutional states” have all of these characteristics. They could easily be precluded or eliminated by an (improved) constitution. An acceptable constitution should

⁴⁵ Majority decisions may hurt society, and do not by definition serve the general welfare. Conversely, what serves the general welfare could not only be approved by a majority, but also unanimously. This is a purely logical observation. For a simple proof see *The law of logic*.

furthermore give people a realistic opportunity to go to an independent judge if they think the constitution has been violated, and give the judge the power to enforce compliance with the constitution, and punish the violator(s). In present-day democratic constitutional states this is at most possible in part. In the USA partly, in the Netherlands not at all. Not all damage causing activities and omissions are adjudicated similarly. If public administrators or their employees ignore integrity and professional norms in spending taxpayer's money, they don't have to pay damages. Parliament allows them to fill even the biggest holes with empty tattle. The reports show that they are frequently rewarded for (or at least notwithstanding) costly misconduct. With promotion or a very well paid job in government or a government agency (which in the Netherlands include universities).

In short: the dysfunctioning observed in the reports is not an unavoidable consequence of the best possible system. It is a manifestation of inequality aimed at safeguarding those in power against liability and punishment. It is a manifestation of fundamental systemic deficiencies..

Legal inequality as an instrument to prevent whistleblowing.

Article 28 of the Dutch whistleblower regulation (law) of 1999 is unthinkable if the government really wanted to eliminate misconduct and therefore facilitate justified whistleblowing.⁴⁶ What remains of the article if legal technicalities are skipped is the following:

«If the judge declares that a whistleblower was right, the competent authority reimburses all really and reasonably made expenses of every separate procedure, with the understanding that:

- a. the reimbursement is made without application of the tariff system in the decision previously mentioned;
- b. the costs of professional juridical support by a third party is reimbursed for an amount of at most € 200 per hour, up to a total amount of at most € 5000, where both amounts are exclusive of VAT and office costs.»

In the first place it is to be noted that in practice € 5000 for legal assistance is a very small amount. It may be possible to get a good lawyer for € 200 an hour, but the better lawyers, and I presume those of the government, are much more expensive.⁴⁷ And if these amounts are adequate, why not for the government too?

The costs furthermore are only reimbursed if the judge decides in the whistleblower's favor. That is: if the whistleblower had good reason to complain. This is equivalent to saying that the top of the government organization has been warned adequately, should have corrected things themselves, and failed to do so. The top preferred litigation. It follows that top managers made important errors of judgment. In the first place because of the abuse complained about, and in the second place because of their inadequate reaction to internal reports. They did nothing, even though they had plenty of time to reflect and change their minds. This follows from the fact that the regulation prescribes a long (years) and difficult (unacceptable) internal procedure to be finished before allowing an appeal to a judge. The judge will only accept to consider a whistleblower's case if the internal procedure was completed. In spite of all this, reimbursement of costs of the whistleblower are limited, and those of the "competent authority" which was proven dishonorable and/or incompetent, is not. In other words: if the whistleblower was right, and the top of the government organization wrong, the responsible government managers can freely use taxpayers money to pay for their defense, while the whistleblower has to pay largely from his personal account. Why is the reimbursement of one party conditional and limited, and that of the other party unconditional and unlimited? Why is the procedure and regulation strongly biased in favor of the government?

The conclusion is that the regulation is a manifestation of legal inequality, and of a strong bias in favor of the top of government organizations. It is incompatible with the fundamental norm of equality before the law. The regulation virtually ensures that the whistleblower will lose an appreciable amount of money, while the responsible top has to pay nothing at all.

⁴⁶ The regulation can be found in the directory Integrity under 20091215.

⁴⁷ In 2019, a prominent criminal lawyer asked 500 € an hour, and a deposit of 50,000 €.

Reasons for punishment and criminal law.

The literature about criminal law gives the following reasons for criminal law, and for punishment according to the law:

- Damage caused by avoidable behavior of people has to be recovered;
- Crime should be reciprocated;
- Crime should not benefit the wrongdoer;
- Misconduct deserves punishment;
- The public should be protected;
- Punishment may act as a deterrent, and prevent repetition or following an example;
- Punishment may correct or improve the wrongdoer.

These arguments can also be seen as conditions to be satisfied by punishment. Or more precise: conditions for the punishment actually meted out.

The opinion that punishment should be proportional to the seriousness of the wrongdoing is widely shared.

The principle that damage caused by avoidable behavior has to be compensated is widely accepted. It is a fundamental norm of civil law. Which is not to say that it is applied generally or consequently. Neither is non-application accounted for consistently. This is especially true for politicians and the higher officials of government organizations. As a rule the damage which they cause is not compensated. They are not punished, and no preventive or protective measures are taken. Neither with respect to their organization nor with respect to the responsible persons.

So there is a gap in the law which makes it inconsequent. If the indicated reasons for punishment and criminal law are sound, then the gap can be seen as part of the explanation of the continuation of the misconduct shown in the reports. If they are sound, then one may expect that elimination of the gap will result in improvement.

Centennial.

One of the episodes of the TV-series *Centennial* illustrates some of the given analyses.⁴⁸ One of the subjects of the episode is the chasing away and indiscriminate killing of Indians by the US army. The episode shows several things:

- Not everyone thinks the same about the course followed, or agrees with it. This applies to both civilians and soldiers;⁴⁹
- (Mis)conduct required of a soldier (employee) is not described clearly or explicitly, but ambiguously, with metaphors etcetera. As in: “it seems you cannot or will not deal with the situation”;
- Pressure is exerted to make people comply with behavior that is known to be unaccountable in public. If you have difficulties with compliance, it is suggested that you are not in the right place (and can better be removed);
- In judging people, much weight is attached to kindness in personal contacts, and little to integrity and professionalism in the execution of the job. ADC John Macintosh of general Laban Asher finds it necessary to correct the negative impression his boss made on Maxwell Mercy with the remark that “he really is a good man”. Whereupon Mercy says: “So are they all... They are all honorable men”;
- It is shown implicitly that the civilians and soldiers in this part of the episode are not a representative sample of the population, but the result of selection processes.

⁴⁸ DVD 2, part 4, after ca. 25'. Identification of the DVD's: Universal 825 570-6, barcode 5 050582 557060. Film © 1978. The series is based on the book of James A. Michener with the same title.

⁴⁹ Like “employees”, “soldiers” includes officers.

This may be all too recognizable. It is only mentioned as an illustration, to help the reader connect the given analyses with his or her other experiences. In theory Michener's book and the TV-series are wholly fictional. Still, it is unlikely that Michener or the film makers want to disqualify themselves by painting an utterly unrealistic picture.

6.4. General causes of false pretensions in government.

Introduction.

This report does not try to defend the proposition that governments are good for nothing. Neither does it want to suggest that in public administration nothing goes well. It does however conclude that the pretensions of politicians and higher government officials far exceed their abilities and actual performance.⁵⁰ That they are unable to do what they pretend, and don't do what they say they do or can do. They don't respect the integrity norms which the population wants and expects them to respect, nor their own integrity codes. They fail fatally in crucial duties, and do everything in their great power to keep their misconduct, errors and failures hidden. The study concludes that the given instruments for control of government do not work.

The following tries to explain these phenomena, and show their structural character and coherence.

This is an inductive section. It is based on the chapters 2-5. But the conclusions are formulated in a generalized form: references to the original context are simply dropped.

False pretensions are profitable and affordable.

The reports of the preceding chapters show widespread lack of integrity and competence. Integrity is especially violated by efforts to deny or hide the falseness of various pretensions, and to silence people who ask for honorable and competent management. Many important assertions of top government officials are incompatible with facts, or with reliable knowledge and reasoning. Many of their assertions would be untenable in an open discussion. The point is that in modern political processes, assertions need not be true, reliable or trustworthy. Inside hierarchical organizations the power provided by a suitable hierarchical position obviates the need of sound argumentation. Outside the organization a positive vote is all that is needed, and only once every so many years. Assertions can be practically imposed with the help of selective (ab)use of information and power. In parliament it is not the arguments that count, but the votes. Which in most democratic constitutional states are assured, at least in principle, by the simple fact of majority coalition government. And if arguments and an appeal to party-loyalty fail, there still remain manipulation,⁵¹ power, and (other) tricks.

Governments have plenty money to cover costs of errors. The reports show that there is no control or supervision deserving the name. Neither of efficiency nor effectivity. The organizations meant to supervise or inquire are part of the problem.

High officials, and members of parliaments and governments, are products of selection processes that only pass candidates who find the kind of practices mentioned in the reports normal and necessary (and/or profitable!), and are able and willing to participate actively.⁵² Who are willing to make false pretensions to get a (top) job. The fact of the existence of such people can be considered one of the most important factual conclusions of this study, and an essential element in the explanation of the observed phenomena. The assumption of honorable and competent governments and top managements must be considered falsified by the facts. Especially regarding integrity, the differences between people are larger and much more important than generally thought. Without these differences the described phenomena are inexplicable.⁵³

⁵⁰ Note that they practically claim infallibility without saying so. After all, never admitting serious errors is equivalent with claiming infallibility.

⁵¹ Including trading votes for contracts or between different (unrelated) proposals.

⁵² Do you know of any high government official, or member of parliament or government, who quit for any of the given reasons, and protested publicly?

⁵³ The most important missing link in the given explanation may be the discrepancy between the requirements of many top jobs and the abilities of those who are available to fill them. In other words: the impossibility of

As causes of false pretensions can be mentioned:

- discrepancies between the requirements of a job and the abilities of those who are available to fill them. That is: errors of organization;
- lack of self-knowledge (overestimation of one's abilities);
- lack of integrity;
- the idea that one can make claims with impunity (impunity eliminating the need of critical reflection);
- the wish to eliminate opponents;
- the desire to show that one is suitable, the best, and better than any other candidate, in order to get a job or more votes than the competition, in combination with one or more of the other points;
- ambition in combination with one or more of the above;
- the wish to get a law, proposal, policy, or something else accepted.

The corrupting influence of false pretensions.

Claiming to be able to do a job for which one lacks the qualifications means false pretensions. False pretensions are an inexhaustible source of problems. Last but not least when one has to account for the failures which they inevitably give rise to. When that happens, the pretender has to choose between openness and the admission of errors on the one hand, and holding on to pretensions, and talking what is crooked seem straight on the other. Admission of errors threatens one's job and career. Therefore pretenders almost always choose the alternative. The more easily if integrity is not really among their norms, or has a low priority.

Even if false pretenders would be able to evaluate people correctly, and could find people who are able to do their job honorably, it is unlikely that they will appoint them. At least as regards management functions. The reason being that honorable people dislike and oppose false pretensions. If they are not only honorable but capable as well, they are sure to become a problem for over pretentious superiors. On the other hand the necessity to hide one another's false pretensions and ensuing errors and failures creates a common interest, and a sound basis for mutual dependence.

If the top tries to avoid appointing managers and people whom they consider to be a risk for their own position, so will every other manager. In principle this mechanism will corrupt the whole organization. It may be muted by the need to keep the façade intact, by providing at least some services of sufficient quality. Salaries must be paid, in time, and the correct amounts. Compromising may be possible because corruption is not always a matter of black and white. It may have any shade of gray. However, it is an illusion to think that external requirements with respect to output guarantee anything. Many organizations and states in past and present can serve as examples. They are simply too big and opaque, and competitors may be similar or absent.

The effect of the pursuit of budget maximization by members of government and their ministries is similar to, and supplements, the effect of false pretensions. The assertion that the given budget is necessary, or insufficient, is no more than a false pretension.⁵⁴ When there is much to hide, the war for the tax receipts with the other ministries does not permit an open and critical attitude with respect to one's own policy, projects, and agencies. The war has to be supported by a positive image of everything the minister is responsible for. Preferably infallibility. Signs of mismanagement, and everything else that harms the image of perfection, hurt one's negotiation position. The battle for money requires that everyone outside the ministry thinks that the minister and ministry perform excellently and never waste even a penny. Whatever threatens this image has to be repressed or covered-up.

adequate fulfillment. Perhaps the denial of this discrepancy by the various holders of high office should be mentioned as an element in the explanation.

⁵⁴ Only the head of a firm with only a few employees could reliably make this claim.

Politicians need false pretensions, and therefore dislike transparency and supervision.

Inside a ministry, nothing is felt of any form of control or supervision by parliament, the general accounting office or whatever. This reflects the common interest of all politicians, including the members of parliament. The legitimacy of their power position requires structural deficiencies of public administration to remain hidden. Discovery would undermine the authority of politics and government in a fundamental way. Consciously or unconsciously every politician knows that he or she can impossibly fulfill his promises and his or her job, and that it is of vital importance that he is allowed to defend himself with nebulosities, half truths and tricks. It is moreover unwise and risky to judge the sitting government more severely than you yourself want to be judged when the roles are interchanged. And what politician doesn't want to become a minister? Members of parliament have an interest in a semblance of criticism and independent opinions, to keep up the appearance of controlling government and the opposition. But they have no interest in showing that many of the pretensions of politicians are false, and that taxes are much higher than necessary to realize the desired effects. It is not in their interest that it becomes known that their "control" of government is no more than an empty pretence, and does not prevent government to dysfunction on a very large scale. Irrespective of the composition of the coalition and parliamentary majority and "opposition".

The lack of serious control of government by parliament can be partly explained by lack of integrity and competence of the members of parliament, the size of modern government, and the lack of cooperation of government with controlling institutions. But there is more. The members of parliament have a good though personal reason for complaisance with respect to the government. The reason is that they strongly depend on the government for their career. It is the government who controls thousands of convenient and well paid jobs. (Which in practice are available only for (ex-)politicians). Even members of the "opposition" cannot be open, because as regards false pretensions all politicians and political parties are the same. One cannot unmask a government without unmasking politics. This personal dependence is especially strong if one has few abilities outside politics (that is: the ability of play-act and keep a cloud of balloons with false pretensions in the sky). The given systems of representative democracy are founded on the idea that the representatives depend on reelection for their welfare. On the idea that reelection is important for them. Since many decades this is an empty illusion. The future of the "representatives" depends much less on the voters they are supposed to represent than on the government and the party bosses.⁵⁵

In systems with coalition governments it is rather illogical to expect the coalition parties in parliament to be really critical with respect to the government. And indeed, they rarely are. Instead they support and defend their government; even if to keep up appearances they sometimes seem to be critical, ask concessions and even reject proposals. Which may very well have been agreed secretly beforehand.

Nothing shows the abhorrence of politicians of openness and control as clearly as their attitude towards whistleblowers and towards the misconduct that the whistleblowers made known.⁵⁶ Again there is no significant difference between coalition and opposition parties. Only a few small parties which never participated in a government seem to treat the subject of whistleblowing more seriously. But it is very doubtful whether this is more than show. Just like almost everyone else these parties pay no attention to the impunity of the members of government and officials who were responsible for the misconduct that required whistleblowing, and who tried to keep the misconduct hidden, and to silence the whistleblower. They don't propose action against people who demonstrably and structurally violated fundamental integrity norms (human rights). How can one let such behavior go unpunished if one really wants an honorable, open and responsible government, and equality before the law?

Even those politicians who say they want better protection of whistleblowers do not propose to correct inequalities in the law. Neither do they try to fill the gaps in liability and criminal law which preclude litigation against the people responsible for the various forms of misconduct which cause, if

⁵⁵ Note that the number of political jobs has grown much more than the number of members of parliament.

⁵⁶ This and the following paragraph only uses general knowledge about whistleblower cases. They do not use specific information from chapter 8.

not require, whistleblowing. So as to make the laws which outside government are said to be necessary to prevent, correct and punish misconduct, applicable to government and government officials as well. As it is, most misconduct in government and subsidiary organizations is effectively shielded from the law.

It follows that there are understandable causes and/or reasons for the observed misconduct, and that those responsible for the misconduct need not fear the consequences.

For an organization, whistleblowing about another organization is harmful.

All organizations mentioned in this study have a practical interest in friendly mutual relations. None of them has a practical interest in exposing essential deficiencies in other organizations. There often are financial interests and a need to be able to cooperate. There always is the need to appear to be a reliable partner that will not let you down. Inquiries as by governmental accounting offices often require cooperation, preferably voluntary; even if no use is made of interviews.⁵⁷ And if an organization or employee concludes that he should talk notwithstanding these interests, then he should ask himself whether his action has a reasonable chance to cause the desired positive effects. Everybody knows that this chance is very small, to put it mildly. So again: there are good reasons for unwanted conduct. Especially for lack of openness when openness is urgently needed. On the other hand behavior in conformity with professional and integrity norms can only cause problems.⁵⁸

Experience tells us that even gross government failure does not lead to structural improvement. Politicians treat the failures as incidents which are unrelated to the political system. Where possible, they try to put the blame somewhere outside politics, as after the subprime crisis, see the next chapter. They simply say that repetition is impossible since adequate measures have been taken. If necessary a pawn is sacrificed.⁵⁹ Better protection of whistleblowers will not cause structural improvement. Because it does not substantially change the causes. Better protection of whistleblowers does not or hardly change the situation of responsible politicians and their accomplices in the civil service.⁶⁰ The observed legal inequalities nonetheless mean that substantial improvement is possible. Even with real people. Although, because of their anti-social norms and values, not with the given political and administrative top. Replacement of dishonorable incompetent office holders by honorable competent people can only yield a durable effect after effective extension of liability and criminal law to political office holders.

6.5. Pointwise explanation of the observations.

This section summarizes and rephrases the preceding analyses. It adds conclusions and remarks which did not fit naturally in the above texts. It also adds causes in the field of education.

The top of public administration and false pretensions.

⁵⁷ Interviews require preliminary negotiations.

⁵⁸ Note that this paragraph argued in terms of interests. This is fundamentally incomplete and may easily yield incorrect conclusions. Not all norms and values are covered by the concept of interest. Such as openness, reliability and honesty. The paragraph moreover mentions only the “personal” interests of the organizations which are directly concerned, and not the interests of the society which finances them and for which they work.

⁵⁹ For example in the Jamby-affair and the glossy Gerda the pawn was a high official of the ministry concerned. This kind of discharge is dubious because the minister must have approved. Either on the basis of adequate information, or not. In the first case the discharge was not justified. The second case can be a consequence of a failure of the minister to manage his ministry properly. In that case too not the official but the minister himself should leave. As long as society and parliament cannot (has no right to) look inside a ministry, at least the minister should leave, and possibly the official(s) involved. If only because malicious intent and absence of oral agreements are hard to prove.

⁶⁰ In the meantime, and as shown earlier, it may be doubted if the professed improvement of the protection of whistleblowers is real, or just one more untrue and misleading political assertion.

- The heads of public administration have created a system that brings and keeps people in the top of public administration who fancy themselves far too much, are insufficiently competent for their duties, and make nothing of misleading the public.
 - Democratic political systems are characterized by competition and a permanent battle between politicians and parties (without voters' rights to full information). Chances of winning are improved by making as good an impression as possible on the people who have to choose between them.
 - The image people have of politicians and top officials is largely determined by what they, or their spokespeople or press releases say. Not by their accomplishments.
 - People do not only differ in disposition. They also have different norms and values, and different consciences. They do not only differ in unimportant respects, but also in important ones. Often the differences are larger and more important than commonly thought. On the one hand there are people who fancy that their abilities far exceed what they really can, and on the other people who underestimate themselves. There are people who think that everything is permitted to realize a certain goal, and that integrity is something of the simple minded. There are others who think that one should respect everyone's opinion and rights. There are people who think that misleading by play-acting and selective (dys)information is necessary and permitted, and other people who think that people should be informed timely, completely and correctly about what concerns them.
 - As a rule, members of government and top managers of government organizations:
 - Claim that they and their organization operate honorably;
 - Claim that they are sufficiently competent to let their organization operate effectively and efficiently;
 - Assert and promise much more than they can realize.
- Their pretensions concern both their personal functioning and their ability to realize given goals and let government operate efficiently.
- This report and innumerable other studies show that these pretensions are utterly false. None of the top managers figuring in any of the cases mentioned in this report is seen to be honorable and/or competent.
 - To keep their jobs, and to defend the given political system, politicians and the heads of government organizations must give outsiders the impression that their pretensions are justified. This is only possible by keeping honorable and competent people at a distance, and by surrounding themselves with their peers. That is: with people whose career depends just as much on keeping up appearances as their own.
 - This selection process creates an upper layer with norms and values which differ from those which the majority of the population wants and assumes them to respect. The most important values of the top layer are: a good salary and power position for themselves, and keeping up the appearance of an honorable and competent government. Integrity and respect for people play no role.
 - The mechanisms described in the preceding points imply that people who are truly honorable and more competent are kept out of the higher levels of public administration.
 - The lack of integrity and competence of the top of public administration means that governmental duties are not fulfilled properly, and that very much talent, time and money is wasted.
 - The governmental reactions against whistleblowers who reveal serious misconduct is excessive. The terroristic nature of these reactions is only understandable if the misconduct is not incidental but structural.

Budgetdefense is a source of corruption and tax increases.

- In the absence of objective norms or an authoritative arbiter the need to distribute tax receipts among government organizations has a corrupting influence. The organizations compete for money. They try to maximize their budget, and tend to claim more money than necessary. To support their claims they invent nice looking projects, make false claims about them, and hide failures and misconduct.

- The influence of the tax payer on this process is nil. He has no power. He is not really represented. As a consequence, distribution problems are “solved” at his cost: by creating budget deficits, and by creating the need of tax increases.⁶¹ Due to inadequate representation and control there is no effective counterbalance.
- Parliament stimulates this development by asking government to assume new duties as if they cost nothing, without considering the question of cost-effectiveness (and even effectiveness), and without asking themselves whether the population would still like the niceties if they would be coupled to a reliably specified tax increase. Only in exceptional cases does parliament say what expenditures should be reduced to make room for the new ones within the given budget. Moreover, costs of new duties are often if not always underestimated; not in the last place to get the proposal accepted.⁶²
- The public and the media promote a culture of false pretensions by doing as if government can be asked everything that a century ago was asked God. Again, without considering feasibility, costs and possible alternatives.

Supervision/ control is actively obstructed.

- The power of modern governments is immense. Governments redistribute and pay about half of the incomes of the population. This means that many persons and organizations depend for a smaller or larger part of their income on the government. As a consequence, many must feel that they should be careful in their criticism of government.
- The increased power of governments also means that they control the appointments for a large part of the most important, more or less public, functions in society.⁶³
- For their career perspective members of parliament depend far stronger on the political and party top than on preferences of voters.
- When governments represent a majority coalition, parliament in principle supports instead of controls government.
- This explains why parliament controls at most marginally, and why parliamentary inquiries have only very limited results, if positive.
- This conclusion is supported by the fact that virtually none of the cases in this study was discovered (and dealt with) by parliament.
- In practice parliament acts as the only judge of all important political matters. It judges all aspects of the functioning of members of government. Where no distinction is made between subjective political choices and objective questions about lying and withholding information. It is impossible to arraign a member of government for fraud.
- Investigations of organizations are often commissioned by themselves. As a rule, they control both the inquiry and the reporting of the results.
- Inquiries which are (partly) based on interviews need the cooperation (and integrity) of the organization and people involved. This precludes reliability and openness.
- The inquiries mentioned in this study were rarely if ever independent.⁶⁴
- Selection of investigators (including members of inquiry commissions) can ensure “formally independent” to actually mean a strong bias in favor of established interests (which are to be investigated). For example by choosing people who have shown this bias before.
- Because of their responsibility, top managers bear at least part of the responsibility for failings exposed by investigations of hierarchical organizations. Since publication of the report needs the signature of the top, this causes underreporting of abuses. It follows that as a group, inquiry reports give a too rosy picture. It is not known however by how much.

⁶¹ N.B. This was written before the outbreak of the second financial crisis, the (government) debt crisis.

⁶² Another mechanism for budget deficits and tax increases.

⁶³ In the Netherlands, the articles 1 and 3 of the constitution state that most of the functions meant here should be open to everyone. Practice shows systematic violation of these articles. But the Dutch constitution does not provide means to assure compliance.

⁶⁴ Causes were mentioned earlier.

- Mutual dependencies between the investigating and investigated organizations cause silences which can easily prevent necessary improvement and correction.
- Internal systems of control are not independent but part of the hierarchy. The top can use the system to better keep up appearances, since outsiders tend to trust the integrity and professionalism of for example auditors. Whistleblower regulation is utterly inadequate, and is not accompanied by rules for the adjudication of those who are responsible for the abuse which justified whistleblowing, and for the need to litigate. The cost of the abuse and the cost of the defense of the abusive managers are paid from the tax receipts.

The law practically safeguards government officers from liability and punishment.

- There are no practically meaningful instruments for bringing dishonorable and incompetent members of government and principal officers of governmental organizations to justice, to get them judged by an independent judge, and where applicable to hold them liable and get them punished.
- The subordination of the prosecutor's office to the minister of justice is part of the deficiencies of the legal system. It facilitates foregoing prosecution, and prosecution for appearance's sake.
- This is amplified by the absence of a duty of the public prosecutor to account at least annually for its policy and for what it did and did not.
- There is no organization with the duty to find and prosecute abuse in and by government organizations, or any other organized effort with this purpose.
- Members of government can only be held to account by coalition members, and top officials of government organizations only by their minister. In both cases the two parties cooperate(d) on a regular basis, and depend on one another for their careers.
- The more incompetent a minister, the stronger his or her dependency on the ministry, and on the loyalty of the top of the ministry. Ministers have very good reasons to protect the subordinates in the ministry with whom they communicate regularly.
- It follows that there are two kinds of justice. People are liable for damage caused by activities outside the (semi) governmental sphere, and punished for crimes and misdemeanors in the same area. They are judged by an independent judge. Damage caused by employees of public administration or related organizations is not recovered by those responsible, but by the taxpayer. Misconduct of members of government and their top officers is punished only very rarely. They are judged within the political system, in principle by parliament.
- Note that the law was made by the people who are protected. The given situation can therefore be interpreted as a successful effort at self-protection.

Education gives an incorrect picture of reality, and offers an inadequate basis for understanding and discussion of government, and participation in public choice.

- Education about man and society is theoretical and idealistic: it shows how it should be, not how it is. Because the social climate suggests that we live in the best of all possible worlds, because to young people the theory seems self-evident, and because nobody gives a coherent description of reality, education suggests that reality agrees with the ideal.
- As a preparation for reality, education is insufficient. It does not give the knowledge and does not develop the abilities needed to be able to survive working honorably and competently in large (hierarchical) organizations.⁶⁵
- Education prepares insufficiently for participation in a society with a government which spends about half of the sum of the incomes of its population.
- The education of the members of government and the top of government organizations is just as deficient.
- That of journalists too. They lack knowledge, understanding and know how which is essential to function properly as a journalist. In addition they are or make themselves dependent on the people and organizations they want to write (critically!?) about.

⁶⁵ Supposing this to be possible. In a criminal organization it is definitely impossible for example.

- Most people are not aware of what could be regulated differently. Many people wrongly believe that society cannot be organized better. They don't realize that already something as simple as extension of the law for ordinary people to government officials would greatly reduce misconduct as described in this study.
- Important gaps in education are: knowledge about the reality of the internal functioning of organizations like a ministry, the laws that are of interest to everyone,⁶⁶ and the science of decision making.
- Information and learning cost time. Therefore it is difficult to make up for gaps in education after leaving school. This causes an almost vicious circle.
- The above explains why insufficient accounting is requested of politicians and government officials, and that the account given is not judged competently.

The conclusion is that there are many systemic properties, circumstances etcetera which cause and maintain corruption of the top layers of public administration. There are no significant counterforces. Present law makes repression of potential counterforces easy. The corrupt system is therefore stable. As recent history shows, it can even withstand the larger shocks caused by wars and financial crises.

6.6. Why conventional solutions won't work.

Introduction.

Someone who read the chapters 2-5, and knows that the work of subordinates in a ministry is strongly conditioned by their superiors, will conclude that an active attitude of the secretary-general is conditional to realize compliance with a code of conduct. Of course, this is one of his formal duties. He has the authority to fulfill this duty effectively. Although not even a reminder should be necessary for an honorable and competent SG, some people will recommend that one should speak with him. On the basis of the (falsified) axiom/ norm: everything is solvable by talking, and/or should be resolved by talking. The following section shows that talking with people with characteristics and histories like this SG is worse than meaningless. It is a recipe for losing valuable time, energy and money.

Talking always costs time, but does not always yield solutions.

In many circumstances, talking and discussion are useful, necessary and efficient. But in the cases presented in this report it is simply unreasonable to expect anything positive from them. Both the reports and the analyses prove that talks with the given top officers is just a waste of time and energy, and may easily elicit repression and cover up. In 2007 the SG was informed about the course of the policy portal project. He was asked to uphold the code of conduct of the ministry. In the following two years he, the uSG, and the education DG's were kept informed, and were asked repeatedly to straighten matters out. But although their words seemed to indicate a helpful attitude, they did nothing to stop the misconduct, and constructed a web of lies to prove that nothing was amiss. They did not explain their (mis)conduct or anything else. For a long time they claimed that further investigation was necessary before they could act. Apart from that they just denied any wrongdoing. They were authoritarian, and never discussed anything in an open way. In short: the appeal to the appropriate authorities was worse than useless: it only caused more misconduct. A cooperative attitude and patience were simply abused. This and other experience shows that the management of the education ministry considers the code of conduct not as a set of norms and values to be complied with, but as a public relations instrument. As an instrument to mislead ignorant outsiders into believing that the ministry can be trusted to work according to appropriate norms and values.

Talking makes sense if the interlocutors are (truly) well meaning and honorable, and have the required competences. The reports show that the top of the education ministry and other top managers do not satisfy these conditions. They consciously and intentionally violate their own code of conduct. The reports show various efforts to cover up misconduct, and to silence those who report misconduct

⁶⁶ Such as the constitution, civil law, and criminal law.

and ask for correction. They show no efforts to end the misconduct. The reports are as many warnings against talks on the basis of trust.

The possibilities and failure of integrity officers.

This section presents conclusions of the time the author was still thinking in terms of recommendations, and in terms of solution with the help of integrity officers. Further study led to the conclusion that more fundamental systemic changes are necessary, and that systemic changes cannot be realized by integrity officers. The integrity officers nevertheless could have done much more than they actually did. This section shows what and how, and that their negligence and false pretensions made them part of the problem. Their existence wrongly suggests the existence of a system that actively protects the integrity of the organization.

In the first place it is important to note that integrity officers have access to the top of the ministry. They can request to talk with it. They publish an annual report in which they can say what they want, at least to a certain extent. To a certain extent only, because it may be assumed that they do not want to spoil their good relations with the top. And I suppose they can only publish the annual report after approval by the SG.

An SG may gain time by making promises. He can propose “independent” investigations. As long as such proposals are accepted by the integrity officers, he has nothing to fear. Moreover: if the integrity officers are unwilling to draw conclusions from what they know (and unwilling to trust those who appealed to them), they may be willing to be kept on a string indefinitely. With a good probability of gradually losing interest. The management will gratefully use such opportunities.

Integrity officers could confront the SG with facts selected from the reports. They could ask whether he wants to deny them, defend them, or whatever. The SG may be expected to reply that nothing is seriously wrong (any more), and that if something went wrong in the past, he has already taken adequate measures. He will point to the fusion of IAG and IFC and other organizational changes (which he will call “improvements”). The integrity officers may object that the changes are clearly visible, but that the improvements are not. They can give as their judgment that the following facts are incompatible with the hypothesis that everything is already going as it should:

- The people responsible for misconduct and failures kept their functions, were promoted, or got another responsible function;
- The management has never explained the course of events, and justified its actions and omissions to those who reported the misconduct, and have suffered from it;
- It has not even acknowledged that the conduct was not in agreement with the code of conduct of the ministry. Not towards those directly involved, and not towards the ministry, IAG and IFC. It is therefore unclear how people can know that the old abuses will not be tolerated any more. It isn't clear either what consequences misconduct will have in the future. Nothing has happened that removes the impression that supposedly unwanted behavior is rewarded, and complaints about it will result in one form of repression or another.

In the annual report the integrity officers can declare that in their opinion this is contrary to the code of conduct of the ministry and the integrity policy of the government.

The points are of fundamental importance because they give the reasons why employees of the ministry have the idea that the code only exists because there has to be a code, and to keep up appearances; but that in actual fact ignoring integrity and professional norms is rewarded by the top. Both the code and the OPIPA documents require the top to set an example.⁶⁷ They do, but they set the wrong example.⁶⁸

The integrity officers can tell the SG that they will discuss matters in their annual report. In the annual report they can describe the most important types of integrity violation, give examples, and observe that as far as they can see no corrective action has been taken. They can conclude that the violations seem to have a structural character. They can say that in their opinion the violations have

⁶⁷ OPIPA= Office for the promotion of integrity in public administration. See chapter 4.

⁶⁸ «The managers have a specific role. They are expected to show good exemplary behavior. Managers should be aware of this, and be open towards their subordinates about the ways in which they act in certain situations». Which they obviously don't do at all.

important harmful implications for the organization. Both with respect to the work climate, human resources policy, and accountability of expenditure.

In their annual report the integrity officers can propose the SG to supplement the code of conduct with examples taken from practice as described in the chapters 2-5. For example about the meaning of “respect”:

- Send documents which are to be discussed or used in a meeting well in time to the participants. Say at least a week in advance. If the meeting has to be prepared by subordinates of the participants, or if topics have to be discussed in the organization units of the participants, they should be given even more time;
- If you request contributions for something, inform the contributors about their use. For example by means of the minutes. And if this cannot be sent in a reasonable time, by other means.

Of course these points can also be classified under “responsible practices”. For what the points request is also necessary for an adequate material preparation. As a matter of professional conduct.

“Respect” is only one example. For other examples the reports and the conditions to be mentioned below can be used as a source of inspiration.

The integrity officers may conclude that they have insufficient instruments to effectively correct the misconduct discovered. They could try to develop proposals for more effective duties and authority for themselves, and for improvements and supplements of the code of conduct. They could discuss the duties and authority of integrity officers, and the lack of integrity of the top of ministries, in an interministerial framework.

In a general way, the annual report could note that false pretensions are incompatible with integrity and professionalism, and that they are a source of various other threats to integrity and professionalism. For that reason it could request persons, especially politicians and top managers of government organizations, to be more modest in their goals and about their competences.

The code of conduct should pay attention to honorable and professional handling of risks. Especially to, and because of, the risk of project failure and accountability with respect to the tax payers. The code should make recommendations about the responsible handling of risks. More often than not, a problem with risk management is the absence of mechanisms which make it attractive for decision makers to weigh pros and cons objectively, and to take not only all possible benefits into account, but also all possible costs (including risks). Both false pretensions and the absence of personal liability invariably cause costs and risks to be ignored, or underestimated far too much.

Underestimating costs and risks can be seen as part of the policy of budget maximization. To prevent it, no risks should be taken which cannot and will not be paid out of the structural budget. The integrity officers could recommend the formulation of rules for the honorable management of risks. Because of the great and general interest of “risk”, this topic should be discussed government-wide. Of course the rules should be accompanied by proposals for checks. For example in the form of liability, sanctioning, and/or supervision.

As in other jobs which one starts without prior experience, the job of an integrity officer may turn out to be more difficult than one has been told and expected. It may exceed one’s abilities. When this applies, the honorable reaction is to admit it, to resign, and to explain why this is done.⁶⁹

It is pointless to ask people to change themselves radically.

⁶⁹ The argument that your job will be taken over by somebody else, and that you may actually be relatively good at it, is a fallacy because unproven, can be used by everyone, and can be seen as a primary cause of the phenomena described in this study. Giving in to the argument creates a society in which people systematically do things they can not properly do, and in which they maintain a system which they cannot maintain in a proper way. It creates (created!) a society in which there is a structural discrepancy between abilities and duties. What was called “as good as possible” has too often been found to be insufficient.

Apart from other reasons, when you reflect on what talks should produce, it quickly becomes clear why they make no sense. The SG and his close associates are almost perfect models of contradictory words and deeds. The facts show that the SG very well knows what is expected of him, but acts as if he doesn't. He would have to change himself radically, and change his character too. He would have to acknowledge that he made many important "mistakes", structurally, during a long period of time. To become credible he should specify the mistakes. He would have to acknowledge that the top of the ministry has not reacted properly to misconduct, but instead tried to cover it up. He would have to admit having given auditors orders which required them to violate their professional code. The SG would have to take credible and drastic visible action. Also with regard to the management. For as long as mismanagers keep their positions, and he himself remains SG, his declarations will meet with justified cynicism. Nobody will believe that anything will change. The employees of the ministry (of any ministry, if not any organization) have seen "improvement programs" before.

There is not the least ground for the assumption that people like the SG and uSG are able to radically and sufficiently change behavior that they have shown for years. Neither theoretical nor empirical. The necessary changes in behavior have never been seen anywhere before. They could easily be physically and/or psychically impossible. A minimum of equal rights moreover requires that the top does not get better opportunities than any other lawbreaker, let alone people without any criminal record. So as far as we know, the necessary change probably is impossible. And even if it were possible, consistency and credibility require removal of such people from public administration.

It is illogical to expect self-correction of a ministry.

In the policy portal project, the SG and uSG were told that an integrity officer was kept informed of the course of events. From other people too SG and uSG knew that several projects and activities did not run as well as the IFC managers reported. SG and uSG could have seen and tried the policy portal on their own PC, and easily. In the summer of 2007 the author told the SG that he preferred the ministry to correct itself, without external interference, instead of filing a formal complaint. In the following years, the SG and uSG have shown that his hope was vain. They showed that they are part of the problem, and the most responsible part. They have shown that they think they have nothing to fear from integrity officers, and much from revelations about their misconduct.

It is furthermore clear that the DG's responsible for the projects had been kept informed just as well. But it seems that they took the SG as an example. They shared or adopted the norms of their superiors, ignoring everything else.

On the basis of the analyses it has to be concluded that replacement of the top by kindred people cannot bring improvement. The system doesn't create the wrong people, but selects them. It rejects honorable and competent people, and retains the unsuitable ones. Replacing an individual by someone similar doesn't change the mechanisms. The results of the analyses are supported by the empirical evidence. Which tells us that replacement does indeed bring change, but no significant improvement.⁷⁰ (Self)Correction would require explanation and openness, and bring to light that the top is insufficiently competent for its job. This is contrary to the top priority of the top: keeping up the appearance of perfection, and of course its personal interest.

Conclusion.

Since control and correction of organizations are conditioned and regulated by laws which apply generally, and since the most important institutions which supervise public administration organizations have a duty with regard to many or all government organizations, it would be a miracle, if not logically impossible, that phenomena as described in the chapters 2-5 are limited to the (Dutch) education ministry.

Because of the general nature of the causes identified in the analyses, they must be present in most or all government organizations. A conclusion for which support is easily found. At the time of writing

⁷⁰ This has the same reasons as the phenomenon noted by Tolstoy in the first sentence of *Anna Karenina*: happy families are all alike; every unhappy family is unhappy in its own way. At best there are only few options to do things right, and there is an infinite number of things one can do wrong.

the disastrous failure of the risk management of the North-South metro line project of Amsterdam and the subprime crisis may be the best known examples. But the most telling support comes from the excessive government reactions to whistleblowing. Of which the excessiveness can only be explained by their reasons not being incidental but structural.

On the basis of the phenomena and analyses described and given above it has therefore to be concluded that correction of public administration is impossible without vigorous intervention by the outside world. If it is to have the desired results, it should be based on a reliable picture of the true state of affairs in a ministry like the Dutch education ministry. This is necessary in order to eradicate illusions which prevent solution of the problems. But though such knowledge is necessary, it is not sufficient. Better knowledge of the facts is only meaningful if it is known how structural misconduct can be terminated structurally. It should be kept in mind that most people in power can only keep their position by dishonorable means. They have a great interest in the failure of efforts at structural improvement. This underlines the importance of a blueprint for legislation with a preventive effect with respect to unwanted conduct in government and politics.

In the following section the analyses given above are translated in conditions for a more honorable and competent public administration. They are called conditions and not recommendations or proposals for a reason. The reason being that failure to satisfy the conditions is equivalent with approval of dishonorable or otherwise unprofessional behavior. Failure to satisfy the conditions is contrary to generally accepted principles of law, or their premises. An honorable government tries to formulate and promulgate honorable laws. Such laws require consistency and consequence. Especially in liability and criminal law, and in the administration of justice. Finally they are called conditions for a logical reason: they are supposed to be part of “if..., then...”-propositions. Recommendations and proposals are not.

6.7. Conditions for honorable government.

Introduction.

The reports and analyses show that integrity violations do not have a marginal but dominating negative influence on the operation of the organizations concerned. The existing systems for control and correction are utterly ineffective.⁷¹ The reports do not only give a picture of the operation of the education ministry, IAG and IFC, but of other organizations too. They show that none of the top managers appearing in any report considers integrity (respect, honesty and openness) as a boundary condition. All inquiry reports which passed in review gave an incorrect and too rosy picture. None of the top managers ever protested against misconduct, or spoke openly about it. Which shows that replacement by kindred people makes no sense. Solutions have to be found in very different directions.

The conditions to be mentioned below are based on comparison of information of two kinds. On the one hand information about the actual treatment of misconduct in politics and government. On the other hand information from (other) areas of social activity and law. The comparison is supported by evaluation of the reasonings underpinning the relevant laws.

In general the conditions are self-evident. There are logical relations between them. Some conditions need to be satisfied in order to be able to satisfy others. It will be obvious that failure to satisfy a given condition is incompatible with integrity and professionalism. In other words: that a correction program is only credible if it adopts the complete set of conditions. To the author, the probability of incompleteness of the presented set seems much greater than the probability that conditions can be dropped without causing risk or harm. As long as there are meshes there will be fish slipping through. Where it should be realized that in this case the fishes that escape are not the fry, but the biggest and most harmful ones. In almost all cases, rejection of conditions means choosing in favor of dishonorable and dangerous conduct. It may nevertheless be useful to distinguish between:

- Necessary and logically sufficient;

⁷¹ So much so, that one wonders whether they were instituted only for appearances sake. Like codes of conduct.

- Useful and necessary, but insufficient.

If only as a warning. The insufficiency of the second class is argued as a preparation against political blah-blah suggesting that they are sufficient.

Conditions which are necessary and possibly sufficient.

The main idea is very simple, namely equalizing the treatment of behavior which causes similar harm. Irrespective of the context of the behavior, and irrespective of the function of the actor (or omittor).⁷² As noted earlier, at present there are two separate systems of law and adjudication. The one of politicians judging politicians and their subordinates, and the other of judges judging other people and organizations. This dual system should be replaced by a system with equal treatment of all norm violations which cause avoidable harm for other people. In other words: "the political exception" is to be abolished. To some extent, consequent law obviates the need of external supervision. But not completely, since there is no certainty about the preventive effect of the law. Prevention is of paramount importance when consequences of misconduct or errors are irreparable and large. The only known solution is supervision. Obviously supervision too must be liable and punishable. It should do what it is meant to do. There should not be responsibility without liability and punishability.

By definition, misconduct is avoidable behavior that is incompatible with norms of integrity and professionalism, and/or causes harm.

The conditions are the following:

1. Everybody is personally liable for harm caused by his avoidable activities or omissions, or which are incompatible with one's duty, with integrity, or applicable professional norms. The actions and omissions include reactions to signals.
Rejection of this condition implies permission to roll off costs on people who may expect functioning in accordance with duty, integrity and professional norms, and who had no part in the decision making.
2. In so far as an actor cannot properly repair or compensate the damage he has caused, his misconduct is punishable.
3. Behavior which is incompatible with duty, integrity and professional norms is punishable if it causes the risk of irreparable damage or damage that cannot be compensated by the actor(s). This also means that public declarations may make one liable and punishable.⁷³
4. Misconduct may show unsuitability for functions in public administration. Where this is the case, punishment should therefore include exclusion from public offices.
5. Information about the operation of governmental organizations is public unless publication would cause disproportionate unjustified harm to innocent people. Which is to be proven by the organization concerned.
At present the prosecution and punishment of leaking is utterly disproportional to the virtual impunity of untimely, incomplete and/or incorrect information in the framework of public decision making. The disproportionality undermines the legitimacy of a democratic constitutional state because democracy presupposes timely, complete and correct information of the voters about everything regarding public administration that may affect their voting behavior.
6. All this to be judged by an independent honorable and competent judge. Judges should have (had) no relation with politics whatsoever. In particular they should not be selected and/ or appointed, directly nor indirectly, by or through politicians or any government related organization.⁷⁴
7. When a hierarchical organization has to pay damages as a consequence of misconduct, everyone in the responsible hierarchical lines has to contribute an appropriate share. For the sizes of the shares a distribution default and/ or general rules should be developed and published. A default

⁷² An omittor is someone who omits to do what his or her duty requires.

⁷³ The freedoms of a citizen may differ from those of an official who has a function which brings duties.

⁷⁴ To avoid misunderstanding: this also applies to the highest judges.

- rule might be: an equal share for everyone in a given hierarchical line, from the lowest level involved to the very top.⁷⁵ The sharing reflects the character of a hierarchical organization.
8. Agreement in group decision making means sharing liability. Agreement with the group decision is presumed unless disagreement is proven. The distribution default and general rules are applied unless someone proves that this means a disproportional assessment.
 9. Misconduct causes all kinds of unwanted risks, if not direct harm. Therefore reporting misconduct is obligatory. In the first place internally. If no effective action is taken within a month, anyone knowing of the misconduct is obliged to report to a judge. Non-reporting is punishable.⁷⁶
 10. Not reporting misconduct one should know about makes liable and is punishable. This gives employees an interest in working honorably and professionally, and to report misconduct. It makes misplaced loyalty risky (and therefore costly).
 11. Legal assistance of parties should always be equivalent. This may require one party to support another, or to employ cheaper lawyers.
 12. In litigation of government against whistleblowers it is presumed until proven otherwise that both parties may be representing the public administration. The financial support of both by the public treasury should therefore be equal.
 13. If the judge declares that the whistleblower is right, this should lead to correction, and to payment of damages by, and punishment of, those convicted for misconduct (costs should not be paid by the public treasury);
 14. In the first place, punishment should be effective as regards its goals. In the second place it should be proportional. The reference frame for proportionality should be published and easily accessible;
 15. Because of the potentially very large consequences of government activities and omissions, misconduct regarding decision making about public affairs has to be punished so severely that it may be assumed to be sufficiently preventive.
 16. Members of inquiry commissions and investigators are personally liable and punishable for the consequences of misleading or incorrect reports. Such as payment of the costs of continuation of a project that should have been terminated.
 17. Investigations of the functioning of parts of public administration should accept integrity and applicable professional norms as (inviolable) boundary conditions. The same applies to the reports of the investigations. In case of noncompliance, a corrected report should be published, and the old report replaced free at request, at the cost of those responsible for the norm violation(s);
 18. Every citizen is entitled to all information about the operation of the government that may be of importance for deciding his vote. The information should be timely, complete and correct. A complaint about incorrect or misleading information can be submitted to a judge. If the complaint is found to be justified, further distribution of the information is forbidden. Those responsible are obliged to produce a corrected version, to publish it in the same way as the rejected version, and to accompany the new version with a description of the changes. They are liable for the costs, and punishable.
 19. Similarly for information that is relevant for decision making about public affairs.
 20. People and organizations respect integrity (also) when reporting about their abilities. Which often means that they will be much more modest.^{77, 78} They make no false pretensions. Their subordinates cannot be honorable and professional if superiors request the impossible, and want everyone to keep up the appearance of success, irrespective of reality.
 21. All participants in public administration accept integrity (as defined at the beginning of chapter 4) as an inviolable boundary condition. This also means openness about costs (including risks) and

⁷⁵ An equal share may mean: an equal percentage of income. (How could such punishment not be legitimate if taxation is?)

⁷⁶ In a hierarchical organization this is not an empty obligation, since it is well known what positions people had in a given period. Moreover, superiors must be presumed to know what their subordinates do, unless they can prove otherwise, and unless they show that they need not have known. Not knowing is no excuse. No one should accept an impossible job.

⁷⁷ And do not pretend to be able to select the manager of an ICT or inquiry project if they don't know anything about ICT or research and science.

⁷⁸ Modesty and risk aversion are two different things.

benefits. Policy papers do not one-sidedly stress supposed benefits, but openly discuss costs, risks and potential negative effects as well. Criticism is taken and treated seriously and professionally. In general, justified criticism has consequences. Failure and success differ: a failed project was not successful. The infallibility of members of government has ended. Government officials do not only defend their pre-occupied positions, but listen, reflect, and improve or correct (change!) their ideas.

It will be clear that the measures implied by these conditions will have a preventive effect, and that it may be expected that after some time people have adjusted, some people were replaced, and the number of lawsuits against measures becomes negligible.

Useful and necessary, but insufficient due to lack of incentives.

The following recommendations are necessary but insufficient. Still, they contribute to the realization of the goal of an honorable and competent government.

1. Appoint only people of proven integrity in functions in government organizations (including members of government).
2. Give people only functions for which it can be assumed with good reason that they have the required abilities. Qualifications like “better than all other candidates”, or “as good as possible”, are insufficient.
3. Managers should be able to judge whether subordinates can do what they are required to do. People who lack this ability should be given jobs for which they do have the necessary abilities.
4. People should be stimulated to improve their self-knowledge: the knowledge of their character, abilities, limitations, and weaknesses, such as pretending more than they can realize.
5. Managers should keep in touch, and manage actively when things don’t seem to go well of their own accord.
6. Improve the independence, possibilities and authority of those who supervise compliance with integrity and professional norms in government organizations. They should not be headed by (ex) politicians. Supervisors should be given the additional duty to track down integrity violations and other unprofessional conduct. Their findings should be made public.
7. Project plans should include plans for reactions to problems arising in the course of time. Including financial problems. There should be an exit strategy, offering an alternative for keeping up appearances. Continuing an impossible or badly underestimated project should be less attractive than stopping.
8. A new activity or project should be preceded by a reliable⁷⁹ feasibility study and risk analysis. Feasibility has a practical and theoretical dimension. A practical question is: do we have the necessary people, money and time?
9. Admit as soon as possible that a goal was too ambitious. Where applicable, explain why the problems or their size could not have been foreseen, or only as a risk. If meaningful submit an amended plan, or propose discontinuation.
10. Acknowledge errors. If incidental, show why. Show what has been done to prevent repetition, or to reduce their probability. Show why the measures are credible. Of course, if the errors were manifestations of incompetence, other conclusions have to be drawn.

Realization of these recommendations would mean an important step forwards. Major shortcomings are the lack of provisions for compensating harm inflicted, and the lack of permanent incentives for really doing what is required, including lack of adequate supervision and sanctioning of non-compliance. The reports show that it is easy to comply on paper, without really doing what is

⁷⁹ Those in the Dutch education ministry were not reliable at all. Underlining the remark that these measures are insufficient. It should be made impossible (very costly) to pay no more than lip service to these measures.

required, and without the least positive effect.⁸⁰ Keeping up appearances by trickery only makes things worse.

All of the above points are well-known. If they were ignored structurally for more than 10 years, why should one expect them to be respected as from now? Just because they are mentioned one more time?

What may help, but will not produce any fundamental improvement.

1. Promote open discussion of everything discussed in this study.
2. Promote awareness of the meaning and importance of integrity in work and organizations.
3. Promote self-knowledge, of (limited) abilities, and weaknesses, such as pretending more than one can realize.
4. Promote awareness of threats to integrity. Such as arise from overestimation of ones abilities, and from underestimation of the tendency to please superiors, even if they act dishonorably or unprofessionally (misplaced loyalty).
5. Promote integrity as an inviolable boundary condition. Instead of a luxury to be respected “as much as possible”.⁸¹

These points are referred to as recommendations.

Credible implementation of these recommendations requires integrity and abilities. Credibility requires for example that the values presumed by the recommendations play an essential role in performance appraisals. Declarations claiming a desire of fundamental improvement are not credible if people who structurally acted contrary to these values are left in place. The reports of the chapters 2-5 clearly show that at least in the years 2005-2010 everyone in the top of the education ministry failed to pass the test, and even actively obstructed compliance.

The example and common sense indicate that implementation of the recommendations will cause serious tensions. Mainly because the whole top of public administration and politics is corrupt: dishonorable and incompetent. Their false pretensions are an integral part of their “personality”. Without false pretensions they never would have obtained their actual positions. Given their character, it must be assumed that they will oppose durable improvement by all possible means.

And don’t forget that the law is made to allow a corrupt top to stay in power. Durable improvement is impossible and incredible without fundamental and far reaching adjustments of the law.

Radical improvement of education.

Education should be supplemented by:

1. Knowledge of those parts of the law which are of importance for everyone.
2. Explanation of the ways the law tries to limit certain kinds of misconduct and to reduce its harmful consequences.
3. Discussion of the motivation for the law: explanation of why it is as it is, and not otherwise.
4. Description of important differences between the laws of different countries, and explanation of these differences.
5. An outline of the history of the law, here and in other countries.
6. Discussion of possibilities, limitations and criticism of the law.
7. Information about practically relevant differences between people, and of the danger of the assumptions that everyone is reasonable, has a similar conscience, and “ultimately” thinks alike (or the same).
8. Discussion of the social consequences of the properties of people, and of the spectrum of

⁸⁰ A clear and simple example is the formal instruction of uSG to adopt Prince2 (a method for project management). She herself immediately started making important exceptions. Nobody took the instruction seriously, and uSG did not supervise implementation.

⁸¹ To be honorable it is not sufficient to have the best intentions, or to do ones utmost. One is only honorable if one satisfies the integrity requirements listed in section 4.3. Not partly, but fully.

- properties, on important events in the course of history, such as wars and crises.
9. Training in information management. Including evaluation of information. Making aware of the fact that kindness displayed at teatime says nothing at all about people's integrity and competence on the job, and that our image of the state of the world is strongly colored by large and permanent streams of one-sided government "information" (propaganda) which dwarfs all other information taken together, and makes it very hard to get a reliable and well-balanced picture.⁸²
 10. Teaching to distinguish between different kinds of statements and texts, for example, fact, opinion, news, explanatory analysis, implication, and summary.
 11. Showing and explaining that independent analysis is rare, while self-censorship and unthinking acceptance of whatever is the norm in one's environment are common. Showing how the dangers this poses can be reduced.

Where necessary to create space or time, outdated or overweight parts of the curriculum should be dropped. Efficiency can be promoted by the combination of (new) subjects with language education, and concurrent pruning of less relevant "literature".

Some useless measures.

There are also "measures" which are no more than efforts to suggest the best of intentions, while actually meant to leave things as they are. They are mentioned because they will undoubtedly be proposed by people who don't want to go "that far" (as in the lists above). That is: by people who don't want to go as far as necessary to be effective. These measures are even softer than those in the third set given above, under the heading "What may help". If implemented effectively, they may have a positive effect. But without accompanying measures ensuring effectiveness, this is no more than falsified wishful thinking.

1. Improvement of existing integrity and/or professional codes of conduct. This will not help, because in hierarchical organizations there is no separation of powers, and because codes are noncommittal. There was little wrong with the codes in the first place. Compliance is judged by people who are responsible for the conduct to be judged. They are not independent, and have an interest, but not in compliance. Judgment by the top furthermore presumes integrity. The chapters 2-5 show that this presumption is unreasonable: the top has too many reasons to shun openness, honesty and other forms of integrity. Codes would substantially restrict its freedom of action. Summarizing: the problem with the codes was not their content, but the lack of supervision of compliance, and of sanctioning of violation.⁸³
2. Improvement of whistleblower regulations. Indeed, at least the Dutch regulation offers ample room for improvement. And Edward Snowden is living proof of the absence of meaningful whistleblower protection in the USA. Dutch regulation offers very incomplete protection, causing litigation to remain highly unattractive for the whistleblower. The regulation is heavily biased in favor of the management. The management does not run any risk of personal costs. The whistleblower does. Therefore, the management need not fear litigation. Moreover, litigation can only start after an internal procedure of years, adding to the bias ("man against organization"). In other words: the regulation discourages whistleblowing, and has no preventive effect against misconduct in the organization. It presumes the innocence of the management, and says nothing about the consequences to be connected to the verdict that this presumption was incorrect. So improvement is possible and might help. And the credibility of proposed improvements can be judged with the help of the points mentioned here and earlier.

The reports show that the codes and regulations utterly failed their (pretended) purpose. Not just a little, but completely. As regards the codes, the reason is only too simple: there is no independent

⁸² As will be seen in chapter 9, this should be supplemented by biased journalism and the legal bias due to libel laws and the like. There being no restrictions on "positive" information.

⁸³ Of course, creation of a really independent and effective judgment system- outside the organization- could mean real improvement. And will therefore meet with much more resistance.

system for tracking down violations, and for prosecuting and judging violators. Violators are not punished. In short: the codes are no more than paper. As regards whistleblower regulations: they are biased to such an extent as to make them useless (or harmful!) in most important cases. Therefore, there is no reason to believe that minor improvements will be of any use.

If substantial positive effects are wanted, fundamental improvements are necessary. The equality and safeguarding principles, and consequent law, all require general applicability of liability and criminal law.^{84, 85} If this is done properly, codes can be done away with. Society still needs to encourage whistleblowing however, as an early warning system. Nobody can see and understand better what happens in organizations than insiders, and organizations can easily cause harm that cannot be repaired or compensated by the people who are responsible for it. Which makes early warning a necessity, even an obligation. Even more than chapters 2-5, the cases presented in the chapters 7 and 8 show that the importance of true openness of (public) organizations cannot be overestimated. And if prevention is more important than reparation, it is crucial that people in organizations are made personally and effectively liable and punishable.

Why the transformation to an honorable organization should not be managed by the sitting top.

One might suppose that part of the measures or recommendations can be implemented by the given management. It can not. The facts are, that the management knew what was wrong and what should be done, and that it had years to realize improvements without any loss of face. But it didn't, and actively obstructed efforts of others. It found it more important to keep up the appearance that everything was already perfect as it was. That it made no mistake. It proved that it is insufficiently honorable and competent. Nobody in the management has ever shown "deviant" (= honorable and competent) behavior. In other words: these people have shown beyond any doubt that they are unfit for their job.

A project for the gradual development towards better government organizations directed by the given management is therefore incredible, to put it mildly. It is impossible that such a project will have the desired effect. The experience of many years has shown that promises of the given managers cannot be taken seriously. They had plenty opportunities to prove their integrity and competence. But refused to when they were free to choose. Should one believe their seriousness when failure to make promises can cost them their job?

But allowing these people to keep top positions is not only stupid. It would also be completely contrary to what are generally considered sound and normal selection criteria. It is good practice to require proof of integrity and competence. But in this case people would be kept notwithstanding proof of unsuitability. This is no less than gross injustice towards everyone who never got the chances the sitting management got (took).⁸⁶ So the project not only lacks credibility, but is also unjust. It implies a lack of just punishment, and extremely unequal treatment as compared all other crimes. What is really needed is the complete removal of all responsible managers from public administration.

As regards an organization like the Dutch education ministry: a clear and radical break with the past is an absolute necessity to convince the employees that the future will be really different. They have been exposed to too many empty promises already. The top management should be removed, and all other managers at least demoted, with corresponding loss of salary. They could not what they pretended, and failed to act honorably (and/or in accordance with their own code of conduct). They should have known, and concluded as much from the events. The reports show that the following persons were not only formally responsible, but actively contributed to continuation and spreading of misconduct: Koos van der Steenhoven, Simone Roos, Rob Kerstens, Ineke van Oldeniel, Steven van Spijker, Frank van Loon, Lex de Lange, Femke Aarts, and Ed Smid. They actively tried to silence and sidetrack people who protested the misconduct. Retaining such people shows that integrity and competence, and by implication accountability, are considered unimportant. And that violations have no serious consequences.

⁸⁴ For the safeguarding principle see part B of chapter 7.

⁸⁵ And procedural law that has the same boundary conditions: no costs for innocents.

⁸⁶ In fact, the analyses suggest that the sitting management may be supposed to have blocked access of honorable and competent people to management functions.

Because of the generally available evidence about whistleblowers in public administration, the absence of whistleblowers in many cases where they should have given a warning signal, the silence about practices as described in the reports, and the general nature of the causes found in the analyses, it can be hypothesized that the above is true for all government organizations. Chapters 7 and 8 were meant to test this hypothesis. From the evidence and analyses presented there it can be safely concluded that the hypothesis stands.

Postscript.

Later analysis has shown that one crucial condition is missing in the above. Unless this condition is fulfilled, some of the other conditions cannot be realized properly. The missing condition has been hinted at (unawares). Section 6.7 has nevertheless been left as it was, to show the difficulty of the inquiry. At least of the inductive part. At this point in the report, identification of the missing condition is left as an exercise to the reader. Of course, the answer can be found in chapter 9.

Governed by Lies

Book 2

The financial crises of 2007-2013

Chapter 7. The financial crises of 2007-2013.

Introduction.

The title of this chapter, “The financial crises of 2007-2013”, plural, refers to the subprime or liquidity crisis of 2007-2008, and the crisis of the government debts of Greece and other EU countries beginning at the end of 2009.

The financial crises are studied because they provide information and insight which previous cases provide hardly or not, and because the new information and insight are needed to get a more complete picture and understanding of the phenomena studied in this book. In contrast to the previous cases, most information provided by the financial crises concerns the top functionaries, most of them politicians. There are more reasons:

1. The fact that the crises had enormous consequences: almost everybody in at least the western countries has experienced substantial harmful consequences from the crises;
2. The clarity about many important facts, thanks to good documentation and its availability;
3. The large amount of documentary information about the conduct of the principal actors in the (pre)history of the crises, and about the way they accounted for their conduct;
4. The clarity the information provides about the integrity and competence of the principal actors;
5. The previous cases show more than they explain. The picture they give of the functioning of the political top is implicit. Study of the financial crises gives explicit information.

Where it is to be understood that the information covers not only the years 2007 and later, but also the prehistory of the crises, here defined as the history of the years 1994-2006.¹ For the reasons given, everyone can check everything that is said in this chapter for her- or himself. This makes the financial crisis one of the most revealing and convincing cases of this book.

It turns out that the first financial crisis, the subprime crisis, provides enough information to answer all important questions which remain after the investigations reported in the preceding chapters. The second crisis, the debt crisis, is much easier to understand. At least with the help of the results of the study of the first. For these reasons only the first crisis will be studied in some detail. Of the second only the main facts will be discussed.

To get the facts ordered neatly, and to avoid interference between facts and analysis as much as possible, this chapter is split in two parts: a Chronicle with a report of the most relevant events, and an Analysis. The Chronicle was written first, but adjusted (mainly supplemented) during the analysis.

The chapter is supplemented by a rather voluminous series of appendices. The appendices were mostly written in an early stage of the study of the subprime crisis. They are part of the study of individual actors and subjects. They are mainly based on contemporary sources. That is: sources from the years 1994-2006. They were written before the corresponding parts of the chronicle and analysis. Not all of the material of the appendices fits smoothly in either chronicle or analysis. In general the most important findings are summarized in the main text. All of the appendices probably played a role in the writing of the main text, at least subconsciously. They contain much relevant information, and may be used as a guide to the dossier.

In the Chronicle it has been tried to sketch or indicate all those events and phenomena which are necessary to explain and understand the origin and course of the financial crises. It sketches events and phenomena which show the incorrectness of some of the common explanations. To enable verification or falsification, it has been tried to discover and describe all possibly relevant phenomena. Complete-

¹ This period is chosen because one of the most important reports in the context of the subprime crisis dates from 1994, and because this period turns out to be sufficient for the purposes of this work.

ness in another sense has not been pursued. As little attention as possible is given to matters which are not essential for the explanation of the crises or the refutation of incorrect explanations. Such as details of “new” financial products.²

In the first instance the purpose of the Chronicle is to get an overview of the relevant facts. In the second instance it must provide the material necessary for an analysis. For an analysis aimed at explanation and finding measures for the prevention of similar phenomena. In particular to prevent innocent people from being harmed by avoidable behavior of other people of which they never approved. To realize this ultimate goal, the history need not be told in every detail. Neither need all aspects of every financial instrument and process be understood. As regards the ultimate goal it will be sufficient to show that the measures are necessary and sufficient to prevent crises like those of 2007-2013.

Part 2 of the chapter is called Analysis. It represents an effort to understand the history and prehistory of the crises, and to find sufficient measures to prevent repetition. The Chronicle is written to be as much self-explanatory as possible. But the Chronicle would no longer be a chronicle if it were frequently interrupted by too much background information, and by analyses of the possible relations between background information and the events and phenomena described in the Chronicle. By discussing separately what can be discussed separately one avoids the risk of losing track and mixing things up. There is no need to do everything at once. Therefore the analytic part of this study of the financial crises has been kept separate from the chronicle.

As regards the content of the Analysis, it is noted that in order to understand the past and learn what can be learnt from it, it is often not sufficient to know what happened. What people do and do not is not only determined by historical events, but also by their personal characteristics, including their education and other personal circumstances and experiences. It is affected by boundary conditions like the law, the organization of society, and the state of knowledge. In so far as possible and relevant, these topics will be studied in the Analysis.³

In another sense too, it is not sufficient to know what has happened. It may be just as important to know what could and should have happened, but did not happen. More specifically: it may be just as important to know what could and should have been done, but was not done. The present work shows that understanding of what did not happen is of crucial importance to avoid crises, wars and other disasters. Both the subprime crisis and World War 2 would not have happened if there had not been enterprising actors. But the actors would not have had any chance of success if responsible authorities had not knowingly allowed the risk to grow out of control, but done their legal duty.

The hypothesis about the importance of omissions is strongly supported by the subprime and governmental debt crises. Study of what happened and did not happen in the prehistory of the crises, and of the duties of the relevant people and organizations, reveals that the crises could have been avoided if legal duties had been fulfilled appropriately. Instead, governments recklessly fostered the growth of the risks. They had, and still have, no risk management whatsoever. Like their governments, supervisors had the duty to protect the population. But they remained passive, at the same time falsely proclaiming that the financial system was safe and sound, and that they did everything possible and necessary to keep it so. Obviously, establishing and understanding the irresponsible behavior of the relevant officials is essential for finding measures to prevent repetition, and to prevent other disasters.

No reliable explanation can ignore important facts, or leave important questions unanswered. One important fact is that the government and supervisory organizations responsible for the safe and sound operation of the financial system had (and have) tens of thousands highly educated employees.

Another important fact is that well-argued crisis scenarios had been outlined by authoritative

² The “new” is written between quotation marks because the products were often called “new” in the hearings of inquiry commissions immediately following the subprime crisis, even though the products existed already around 1994. See the GAO 1994 report specified below. The products can only have been called “new” to mislead the audience by suggesting “we couldn’t know yet”, and thereby exculpate the speaker.

³ An example. When in certain respects the members of a well-defined group of people show similar behavior, the differences in personal histories of these people cannot be very significant. Therefore personal histories need not be studied. (At least not extensively).

organizations long before the subprime crisis actually took place. How can these two facts be reconciled? To answer this and similar questions the Analysis pays ample attention to the functioning of those parts of public administration which had legal duties with respect to the safety and soundness of the financial system.

Part A. Chronicle.

Table of contents of this Part A.

1. The chronicle in a nutshell.
2. Chronicle. (1938-2011, subdivided as seemed convenient).

7A.1. The chronicle in a nutshell.

Modern banking is characterized by leverage. Banks are allowed to lend an amount that is a multiple of their capital (assets). The multiple is called leverage. Uncertainty about borrowers' ability to pay what is due means that more leverage increases the risk of bankruptcy. In the period considered, the leverage ratio is often more than 10, sometimes more than 20. In 1988 the Basel Committee on Banking Supervision (BCBS), composed of representatives of central banks and supervisors, published Basel I, a set of recommendations for capital requirements for financial institutions. The recommendations were widely accepted and implemented. However, the recommendations accomplished the opposite of its supposed intentions. Instead of decreasing, leverage increased. Thereby increasing the instability of the financial system.

In a period including 1990-2008 the governments of most countries with a relatively high GDP per capita implemented deregulation.⁴ With minor exceptions, governments, supervisors and private enterprises claimed that the general welfare is served by less regulation and supervision. The financial system was said to have sufficient interest in adequate self regulation and responsible behavior to prevent harmful accidents. Governments, supervisors and private enterprises resisted everything that seemed to imply more rules or interference.

Since 1992 or earlier, law and policy in the USA were directed at increasing home ownership, especially of people with moderate and lower incomes. Reduction of mortgage requirements was one of the means to realize this goal. The US government gradually increased the pressure on the financial system to provide mortgages even for people who could not afford it. Availability of loans was promoted by allowing government sponsored (mortgage) enterprises, GSEs, to loan much against exceptional little capital, and by suggesting that the value of mortgage backed securities (MBS) sold by GSEs was guaranteed by the government of the USA.

Law and policy were successful in this sense, that home ownership of people with moderate and lower incomes increased substantially. At least until 2006. But they also substantially increased the percentage of more risky mortgages (vulnerable mortgagors).

At no time did the US government consider the risks of its policy.

Mortgages were included in various kinds of securities. The performance, and therefore market value, of these securities depended on the performance of the underlying mortgages. They were spread all over the financial system, and beyond. In the years 1992-2001, securities incorporating mortgages came to form a significant part of the assets of banks.⁵

In the USA, the interest rate on mortgages reached a maximum of 18% (per year) in 1982. From

⁴ GDP= gross domestic product. GDP is expressed in currency units such as USD, euros, etc. In a first approximation, the GDP is the sum of the incomes of persons and enterprises. For further explanation of the concept and of related concepts the reader can consult an economics textbook or try the internet.

⁵ Statistics are given in the OFHEO report on systemic risk. They are quoted below, under 2003, or search for "role of OFHEO".

then on it decreased more or less gradually to about 5% in 2010.

In 1991-2006 home prices approximately doubled.

In 2004 the BCBS made recommendations for changes in the capital requirements of Basel I. The new set of norms is called Basel II.

In the period under consideration, all main financial supervisors always gave an optimistic picture of the state of the financial system. They never gave a realistic picture of the risks. They never said that specific measures or actions were really necessary, and that doing nothing would mean disaster. If not now, then in the near future. The US Fed gave no attention at all to systemic risk.⁶ Some supervisors did see some risks, and did warn for them. But not all of these risks had anything to do with causes of a crisis. The warnings were moreover presented in such a way as to give policy makers an easy excuse for not bothering. Supervisors never communicated a sense of urgency. Consequences of risks were never explained. Often, supervisors arrogantly and complacently claimed that due to their hard working expert staff everyone's money was safe and secure.

Only in exceptional cases have government organizations detailed systemic risks, and made recommendations to reduce or eliminate them. The exceptions are the GAO reports of 1994 and 1999, and to a lesser extent the BIS CGFS report of 2003 (and similar sequels).⁷ The GAO reports explicitly sketch crash scenario's, and warn for the risks which actually precipitated the financial crisis of 2007-2008. The report of 1999 had the unambiguous title: *LTCM: Regulators Need to Focus Greater Attention on Systemic Risk*. In response, the financial supervisors and (ir)responsible government officials argued that they already did what was needed. In other words: they ignored the report and its recommendations.

It has been asserted that the ratings of the rating agencies underestimated the risks. The documentary evidence for this assertion is inconclusive. It seems certain however that the ratings have been interpreted incorrectly (stupidly), and that after the fact something impossible was asked from the rating agencies. In this connection, but also quite generally, a small risk was generally thought to mean no risk. Which is dangerous nonsense.

In April 2006 home prices in the USA reached a maximum. In other words: from then on they decreased. It is this phenomenon that determined the time schedule of the first financial crisis. As from this moment, risks begin to be realized.

In the years 2000-2003 the cumulative default rate for mortgages originated in a given year decreased slowly. In the following years, until (& including) 2007, it increased strongly. In 2007 the default rate in the first months after origination was more than 10 times the rate in 2000-2003.

In the first half of 2007, confidence in MBS and similar securities rapidly deteriorates. Markets expect related prices and indexes to decrease. Borrowing becomes more difficult.

In the first months of 2007 the ABX indices⁸ BBB en BBB⁻ for mortgage related securities fall from 100 to about 65. In July the AA index is still almost 100, while that for BBB⁻ has fallen to 55. Around the turn of the year 2007-2008 it is 20.

July 2007. Rating agency Moody's downgrades recent MBS on a wide scale. Because of problems with its MBS portfolio, the German bank IKB is taken over by KfW Bankengruppe. Downgrades also cause serious difficulties for Bear Stearns and BNP Paribas.

The financial supervisors continue to underestimate risks and potential consequences.

⁶ Fed= Federal Reserve Bank. The Fed is the US central bank and supervisor. For information see the Fed publication *Purposes and Functions* in the directory USA\Fed.

⁷ GAO= General Accounting Office (1921-2004), and Government Accountability Office (as from 2004). BIS= (International) Bank of International Settlements, and CGFS= Committee on the Global Financial System. For explanation see any BIS annual report in the directory BIS\Annual reports.

⁸ For MBS related securities. See the main text, search for "Lehman Live".

August 2007. Countrywide, the USA's largest mortgage lender at the time, is unable to extend its loans at the repo market, a vital part of its operations.⁹ It fails to find the billions of dollars it needs to remain in business. The Fed refuses help. Bank of America comes to the rescue, and in October takes over Countrywide.

In the second half of 2007 the financial world sees devaluations of more than 10% along a wide front, uncompensated by gains elsewhere. At the end of 2007 many large financial institutions have to write off substantial amounts. The Fed reacts with a relatively large decrease of the discount rate. However, this does not or hardly affect the willingness of financial institutions to provide loans (i.e. to pass on loans they got from the Fed).

March 2008. The Fed purchases B\$ 30 of Bear Stearns's assets, and helps its take over by J P Morgan Chase.¹⁰

September 2008 is the month of one big bankruptcy after another. It is the month of the crash of the financial system. Milestones are:

- 7 Fannie and Freddie are placed under conservatorship of the US government;
 - 15 Bankruptcy of Lehman Brothers;
 - 15 Bank of America takes over Merrill Lynch;
 - 16 In exchange for a share of 80%, the Fed loans AIG B\$ 85;
 - 20 Treasury secretary Paulson sends a proposal of three pages for a Troubled Asset Relief Program to Congress, with a request for a budget of 700 B\$.
 - 25 Washington Mutual is "seized" by OTS, and "placed into the receivership" of FDIC.
- (All dates are in September).

The US Fed and Treasury take far reaching measures to prevent bankruptcy of most of the remaining financial institutions and total collapse of the financial system. Borrowing from the Fed is facilitated in virtually all possible legal ways. By numerous programs, hundreds of billions of dollars are made available to prevent the system to come to a standstill.

Although the USA was the source of the problems, risk management and supervision were fatally insufficient almost everywhere. As a consequence, the financial system was like a series of dominoes. Once the USA fell, all other countries were bound to follow. Everywhere central banks reduce the discount rate, and facilitate borrowing by banks. Everywhere governments implement programs to help ailing institutions, to bail out and nationalize banks etcetera.

After September 2008, solution of specific problems is replaced by general measures and programs. Which are applicable or can be used by all financial institutions (of a given type). But this does not end the deterioration of the economic situation. Unemployment increases by several percentage points (representing many millions of people), and will not start to decrease until after 2012. Many countries enter a recession (negative economic growth) which will last for years. Although it should be noted that developments in 2010 and later are only partially caused by the subprime crisis, and for the other part by the euro debt crisis.

20/5/09. The Financial Crisis Inquiry Commission (FCIC) is created by Congress to «examine the causes of the current financial and economic crisis in the United States.»^{11, 12}

⁹ Repo= repurchase agreement. This refers to a method of lending where the borrower sells securities to the lender as collateral and agrees to repurchase them at a higher price within a short period, often within one day. From the glossary of the FCIC report, p. 543/571.

¹⁰ In this report, \$ means USD unless specified otherwise.

¹¹ FCIC report p. xi.

¹² In this book, Congress always means US Congress.

23/6/09. The Temporary Commission Inquiry Financial System (= Commission De Wit, CDW) is created by the Second Chamber of the Dutch parliament. It is asked to answer the following questions: «What are the causes of the recent turbulent developments in the financial system, and what recommendations can be made on the basis of the findings of the inquiry for a more adequate operation of the financial system?»¹³

In the last year of the Second World War, government debts had risen to about 90% of gross domestic product (GDP). After the war they decreased to about 25% in 1975. The average debt of the OECD countries subsequently rose by fits and starts to 81% in 2008. In 2009-2012 it rose further, to 108% in 2012.¹⁴

Decision making about the euro took place mainly in 1990-2001. It had an authoritarian and propagandistic character. On 1/1/01 Greece was admitted to the euro, even though it did not satisfy the (rather weak) Maastricht convergence criteria by far. Europe and the euro were musts. Benefits were measured out widely, costs and risks were said to be negligible. The benefits were no more than wishful thinking. Doubts were not refuted with arguments, but rejected out of hand, as efforts at obstruction, and anti Europe. Politicians may have perceived no other option: the EU is far too unwieldy to be able to correct mistakes.

In October 2009 Greece gets a new government. In December it announces that the Greek government debt was much larger than the previous government, with Kostas Karamanlis as prime minister, had told. For 2009 it was 130% of GDP. As a consequence, the interest on new Greek government debt rises to heights which make markets doubt whether Greece will ever be able to redeem its debts.

In April 2010 the Greek government asks EU for a loan of B€ 60. In the beginning of May the EU and IMF approve a loan to Greece of B€ 100 for 3 years.¹⁵ On the major part of the loan Greece has to pay 5% interest. The loan is conditional. Greece is required to cut its government budget drastically. The measures taken by the Greek government to comply with this condition cause widespread long term unemployment of about 25%, and other misery.

In the EU, no government created as much relative debt as Greek governments. But several other countries were not far behind, and most of them, including euro-countries, have debts far exceeding the agreed debt ceiling of 60% GDP. Some are confronted with interest rates explosions like that of Greece earlier. In 2010 and 2011, under the pretext of a supposed need to prevent serious devaluation of the euro, stronger euro countries provide large loans to Ireland and Portugal under conditions similar to those for Greece. In 2011 the European Central Bank starts buying Italian and Spanish government bonds, with the same effect.

As a consequence of these events, the period 2010-2015 is characterized by economic uncertainty and muddling through. Including uncertainty about the future of the financial system and the EU. Events suggest important differences in government conduct, “culture”, between the north and south of the EU. Obviously serious policy errors had been made regarding euro, budgets and debts. In the EU, the same people were responsible for insufficient supervision of the financial system and insufficient supervision of compliance with the agreed deficit and debt criteria.

7A.2. Chronicle.

Introduction: the GSEs 1938-1981.

Understanding the chronicle requires a minimal acquaintance with the mortgage market and the concept of GSE. This section should suffice to start with.

One of the key indicators for the state of the mortgage market is the percentage of defaulting

¹³ First report of the CDW (= CDW1) p. 29/25. The report has the title “Lost credit”.

¹⁴ OECD *Economic Outlook* 2012-1, annex table 32.

¹⁵ These loans are kept off balance: they are not counted in the calculation of government debt...

mortgages. In the USA and before 2004, this percentage had been constant for many years. Between 2004 and 2007 it increased substantially. It was this increase that started the avalanche that grew into a financial crisis. For this reason it is crucial to get an idea of the development of the US markets for mortgages and houses, and of the actors affecting that market.

The biggest and most important actors were two government-sponsored enterprises, abbreviated GSEs. Namely the Federal National Mortgage Association, mostly called Fannie Mae, and the Federal Home Loan Mortgage Corporation, mostly called Freddie Mac. They were instituted and regulated by law, and were instruments of government housing policy. The Wikipedia describes their history as follows:

«The Federal National Mortgage Association (FNMA), colloquially known as Fannie Mae, was established in 1938 by amendments to the National Housing Act after the Great Depression as part of Franklin Delano Roosevelt's New Deal. Fannie Mae was established to provide local banks with federal money to finance home mortgages in an attempt to raise levels of home ownership and the availability of affordable housing. Fannie Mae created a liquid secondary mortgage market and thereby made it possible for banks and other loan originators to issue more housing loans, primarily by buying Federal Housing Administration (FHA) insured mortgages. For the first thirty years following its inception, Fannie Mae held a monopoly over the secondary mortgage market.

It was acquired by the Housing and Home Finance Agency from the Federal Loan Agency as a constituent unit in 1950. In 1954, an amendment known as the Federal National Mortgage Association Charter Act made Fannie Mae into "mixed-ownership corporation" meaning that federal government held the preferred stock while private investors held the common stock; in 1968 it converted to a privately held corporation, to remove its activity and debt from the federal budget. In the 1968 change, arising from the Housing and Urban Development Act of 1968, Fannie Mae's predecessor (also called Fannie Mae) was split into the current Fannie Mae and the Government National Mortgage Association ("Ginnie Mae").

Ginnie Mae, which remained a government organization, supports FHA-insured mortgages as well as Veterans Administration (VA) and Farmers Home Administration (FmHA) insured mortgages. As such Ginnie Mae is the only home-loan agency explicitly backed by the full faith and credit of the United States government.

In 1970, the federal government authorized Fannie Mae to purchase private mortgages, i.e. those not insured by the FHA, VA, or FmHA, and created the Federal Home Loan Mortgage Corporation (FHLMC), colloquially known as Freddie Mac, to compete with Fannie Mae and thus facilitate a more robust and efficient secondary mortgage market.

In 1981, Fannie Mae issued its first mortgage passthrough and called it a mortgage-backed security. The Fannie Mae laws did not require the Banks to hand out subprime loans in any way.¹⁶ Ginnie Mae had guaranteed the first mortgage passthrough security of an approved lender in 1968 and in 1971 Freddie Mac issued its first mortgage passthrough, called a participation certificate, composed primarily of private mortgages.»¹⁷

In its Annual report 2006 Fannie Mae presents itself as follows:

«Overview.

Fannie Mae's activities enhance the liquidity and stability of the mortgage market and contribute to making housing in the United States more affordable and more available to low-, moderate- and middle-income Americans. These activities include providing funds to mortgage lenders through our purchases of mortgage assets, and issuing and guaranteeing mortgage-related securities that facilitate the flow of additional funds into the mortgage market. We also make other investments that increase the supply of affordable housing.

We are a government-sponsored enterprise ("GSE") chartered by the U.S. Congress under the name "Federal National Mortgage Association" and are aligned with national policies to support

¹⁶ Formally this may be true, but materially it is not. See the requirements of the GSE Act, outlined under 1992.

¹⁷ "Fannie Mae", Wikipedia, 14/5/12. Another source is the FCIC staff study *Government sponsored enterprises and the financial crisis*. It can be found in the directory FCIC.

expanded access to housing and increased opportunities for homeownership. We are subject to government oversight and regulation. Our regulators include the Office of Federal Housing Enterprise Oversight (“OFHEO”), the Department of Housing and Urban Development (“HUD”), the SEC, and the Department of the Treasury.

Although we are a corporation chartered by the U.S. Congress, the U.S. government does not guarantee, directly or indirectly, our securities or other obligations. We are a stockholder-owned corporation, and our business is self-sustaining and funded exclusively with private capital. Our common stock is listed on the New York Stock Exchange (“NYSE”), and traded under the symbol “FNM.” Our debt securities are actively traded in the over-the-counter market.¹⁸ [...]

Our customers.

Our principal customers are lenders that operate within the primary mortgage market where mortgage loans are originated and funds are loaned to borrowers. Our customers include mortgage banking companies, investment banks, savings and loan associations, savings banks, commercial banks, credit unions, community banks, and state and local housing finance agencies. Lenders originating mortgages in the primary mortgage market often sell them in the secondary mortgage market in the form of loans or in the form of mortgage related securities.

Our lender customers supply mortgage loans both for securitization into Fannie Mae MBS¹⁹ and for purchase for our mortgage portfolio. During 2006, over 1,000 lenders delivered mortgage loans to us, either for securitization or for purchase. We acquire a significant portion of our single-family mortgage loans from several large mortgage lenders. During 2006, our top five lender customers, in the aggregate, accounted for approximately 51% of our single-family business volume compared with 49% in 2005. Our top customer, Countrywide Financial Corporation (through its subsidiaries), accounted for approximately 26% of our single family business volume in 2006 compared with 25% in 2005. Due to increasing consolidation within the mortgage industry, we, as well as our competitors, seek business from a decreasing number of large mortgage lenders.»²⁰

In its Annual report 2006, Freddie Mac presents itself as follows:

«Overview.

Freddie Mac is a stockholder-owned company chartered by Congress in 1970 to stabilize the nation's residential mortgage markets and expand opportunities for homeownership and affordable rental housing. Our mission is to provide liquidity, stability and affordability to the U.S. housing market. We fulfill our mission by purchasing residential mortgages and mortgage-related securities in the secondary mortgage market. We are one of the largest purchasers of mortgage loans in the U.S. We purchase mortgages and bundle them into mortgage-related securities that can be sold to investors. We can use the proceeds to purchase additional mortgages from primary market mortgage lenders, thus providing them with a continuous flow of funds. We also purchase mortgage loans and mortgage-related securities for our investments portfolio. We finance our purchases for our investments portfolio and manage associated interest-rate and other market risks primarily by issuing a variety of debt instruments and entering into derivative contracts in the capital markets.

Though we are chartered by Congress, our business is funded completely with private capital. We are responsible for making payments on our securities. Neither the U.S. government nor any other agency or instrumentality of the U.S. government is obligated to fund our mortgage purchase or financing activities or to guarantee our securities and other obligations.

Our Charter and Mission.

The Federal Home Loan Mortgage Corporation Act, which we refer to as our charter, forms the framework for our business activities, shapes the products we bring to market and drives the services

¹⁸ Fannie Mae Annual Report 2006 p. 1/16. The notation “p. 1/16” means: p. 1 according to the paging in the document itself, and (this corresponds with) p. 16 of the pdf-file. “Annual report” may henceforth be abbreviated “AR”.

¹⁹ MBS = mortgage backed securities.

²⁰ Fannie Mae Annual Report 2006 p. 4/19.

we provide to the nation's residential housing and mortgage industries. Our charter also determines the types of mortgage loans that we are permitted to purchase [...].

Our mission is defined in our charter:

- to provide stability in the secondary market for residential mortgages;
- to respond appropriately to the private capital market;
- to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- to promote access to mortgage credit throughout the U.S. (including central cities, rural areas and other underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

To facilitate our mission, our charter provides us with special attributes including:

- exemption from the registration and reporting requirements of the Securities Act of 1933, or the Securities Act, and the Securities Exchange Act of 1934, or the Exchange Act. We are, however, subject to the general antifraud provisions of the federal securities laws and have committed to the voluntary registration of our common stock with the Securities and Exchange Commission under the Exchange Act;
- favorable treatment of our securities under various investment laws and other regulations;²¹
- discretionary authority of the Secretary of the Treasury to purchase up to \$2.25 billion of our securities; and
- exemption from state and local taxes, except for taxes on real property that we own.

Our activities in the secondary mortgage market benefit consumers by providing lenders a steady flow of low-cost mortgage funding. This flow of funds helps moderate cyclical swings in the housing market, equalizes the flow of mortgage funds regionally throughout the U.S. and makes mortgage funds available in a variety of economic conditions. In addition, the supply of cash made available to lenders through this process reduces mortgage rates on loans within the dollar limits set in accordance with our charter. These lower rates help make home ownership affordable for more families and individuals than would be possible without our participation in the secondary mortgage market.»²²

The following shows a mechanism by which GSEs create added value:

«The GSEs did a large part of their business securitizing mortgages into MBS and guaranteeing these mortgages against default risk. These transactions were usually "swap" transactions, where the mortgages were never held on the GSEs' balance sheets. When a GSE issues and guarantees MBS, the GSE bears the credit risk (and the associated management and operations risk) but shifts the interest rate risk, and the associated returns, to investors in the MBS. An MBS represents an undivided interest in a pool of mortgage loans. A lender that held a portfolio of mortgages would obtain a GSE guarantee for the mortgages and thus convert them to MBS. The GSE guarantee assumed the credit risk of that pool of mortgages, which increased the market value of the pool. As a result of the GSE guarantee, the institution holding the MBS faced lower capital requirements. [...] For example, under Basel I total capital required for an agency MBS was 1.6%, versus 4% on whole loans.»²³

For more information about GSEs the reader is referred to the sources mentioned in the footnotes, and to the preliminary FCIC staff study *GSEs and the financial crisis*.²⁴

Now we can turn to the chronicle.

²¹ Such as Basel I. See the next quote. The favorable treatment also applies to Fannie Mae.

²² Freddie Mac, Annual Report 2006 pp. 1-2/13-4.

²³ *GSEs and the financial crisis* (FCIC Preliminary staff study) p. 11 (incl. footnote 23).

²⁴ Several preliminary staff studies are collected in the directory FCIC/Studies/Staff-studies.

1957.²⁵

The Treaty of Rome is signed by Belgium, France, West Germany, Italy, Luxemburg, Netherlands, and UK. They form the European Economic Community (EEC). Its objective was to create a "common market" to increase economic prosperity and contribute towards "an ever closer union among the peoples of Europe". The treaty makes no mention of economic and monetary union and a single currency.

Denmark, Ireland, and the United Kingdom join the EEC in 1973, Greece in 1981, and Portugal and Spain in 1986. Former East Germany is admitted as part of reunified Germany in 1990. Greenland, a dependent state of Denmark that entered the EC when under full Danish rule, withdrew in 1985.

1962.

The paper *Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study* by Edward J. Pinto gives a chronicle of events in the field of housing policy which influenced the development of the crisis.²⁶ Pinto's chronicle starts with 1962-1991.²⁷ Pinto shows that in this period "community groups", acting as lobbyists, exerted political pressure to get mortgage conditions lightened, so that people with low and moderate incomes could obtain a mortgage ("own a home") more easily. The most important policy instruments in this period are the Federal Housing Administration (FHA), and the Community Reinvestment Act (CRA).

With respect to 1962 Pinto notes:

«Since it was established in 1934, FHA has been reliant on low down payments and long-term fixed rate mortgages. It initially insured fixed rate loans with a maximum LTV²⁸ of 80% (up from 50%-60% by non-government lenders) and a loan term of 20 years (up from a maximum of 12 years by non-government). By 1962 it would be insuring LTVs up to 95% and loan terms of 30 years.

Along with LTVs and loan terms, FHA's foreclosure²⁹ rate has also been increasing, a trend that would continue for the next 58 years. In 1956 FHA's annual foreclosure start rate was up to 0.37% per year. By 1961 FHA was experiencing a tripling of its foreclosure start rate to 1.00% per year.»

1967-1979.³⁰

1967. The EEC merged with the European Coal and Steel Community and the European Atomic Energy Community to form the European Communities, or EC (the plural was dropped from the name in the 1980s).

1969. The heads of the EC governments set up a working group under the direction of Luxembourg Prime Minister Pierre Werner to report on how a European Monetary Union (EMU) can be achieved by 1980.

1970. The Werner group submits its report in October. It set out a three-stage process to achieve an EMU within a 10-year period. The final objective would be irrevocably convertible currencies, free movement of capital, and the permanent locking of exchange rates, or a single currency. Monetary

²⁵ Encyclopedia Britannica 2002 article *European Union*, and *A brief history of the euro* on the website of the Belgian central bank (nbb.be). The brief history is part of the file *Histories of the euro* in the directory EU/Euro.

²⁶ The report can be found in the directory FCIC/Studies, under 20100814.

²⁷ Pp. 31-45.

²⁸ LTV = loan to value. That is: the ratio of the value of the loan to the value of the object purchased with the loan. For example: the ratio (value of mortgage)/(value of house), in general expressed as a percentage.

²⁹ Foreclosure= a legal proceeding that bars or extinguishes a mortgagor's right of redeeming a mortgaged estate (Merriam Webster 2002).

³⁰ *A brief history of the euro* on the website of the Belgian central bank (nbb.be) and *One currency for one Europe- the road to the euro*, EU publications office, DOI 10.2765/65860 (2014). Both can be found in the directory EU/Euro.

turbulence and the end of the Bretton Woods agreements³¹ prevent the project from being carried out.

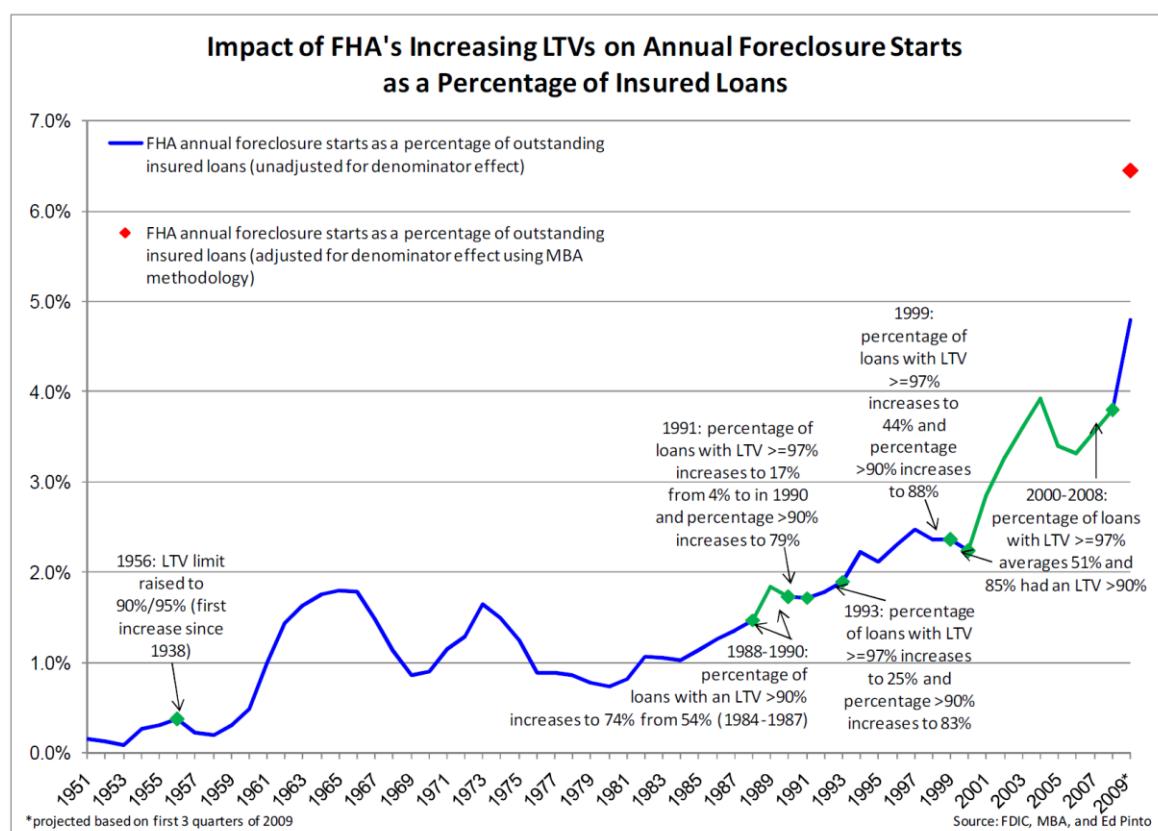
1979. In March 1979 the European Monetary System (EMS) is created, to stabilize exchange rates and counter inflation. It also created the European Monetary Cooperation Fund (EMCF).

The EMS was built on the concept of stable but adjustable exchange rates defined in relation to the ECU, the European currency unit. The ECU was a “basket” currency based on a weighted average of EMS currencies. Within the EMS, currency fluctuations were controlled through the exchange rate mechanism (ERM) and kept within $\pm 2.25\%$ of the central rates, with the exception of the Italian lira, which was allowed to fluctuate by $\pm 6\%$. While the EMS’s primary purpose was to reduce exchange-rate instability which was seen as damaging to trade, investment and economic growth, its creation was undoubtedly helped by a new consensus among EEC countries that controlling and reducing inflation had to become an economic priority.

The EMS was a radical new departure because exchange rates could only be changed by mutual agreement of participating EU countries and the Commission, an unprecedented transfer of monetary autonomy.

1980-1985.

In the years 1980-1991 the percentage FHA-mortgages with an LTV > 95% increased from less than 20% to 45%.³² For some details see the following graph. The graph shows that in the same period the foreclosure start rate approximately doubled.



With respect to the effect of the Community Reinvestment Act (CRA) on lending and lobby groups

³¹ The Bretton Woods agreements provided an international framework for currency stability with gold and the US dollar as the predominant monetary standards. For details see for example an encyclopaedia or the Wikipedia.

³² Pinto, chart 19 on p. 35.

Pinto notes and quotes the following:

«Most [people] agree that CRA had very little impact in its early years. Announced CRA commitments over CRA's first 15 years from 1977 to 1991 totaled less than \$9 billion, with almost half of this total announced in 1990 and 1991. This was likely due to the fact that many industry participants were reluctant to weaken underwriting standards. Also until 1995 CRA was based on the effort put forth by a bank, not [on] results as measured by actual loan volume. Finally, regulators had minimal ability to penalize a bank for any perceived CRA shortcomings. While announced CRA commitments did not represent all CRA activity and CRA activity did not represent all low- and moderate-income lending, community groups viewed these CRA volume levels as small compared to overall origination volume (total originations were running about \$500 billion/year in 1990 and 1991).»

By the mid-1980s, these groups concluded that Fannie and Freddie's underwriting requirements were to blame for the perceived low level of CRA volume. In about 1986, National People's Action (NPA), a consumer advocacy group, began to meet separately with Fannie and Freddie in an effort to get them to adopt more flexible underwriting standards in an effort to expand CRA lending. While agreeing to a number of pilot programs, Fannie and Freddie were dubious about many of the requested flexibilities. NPA, ACORN and other groups were dissatisfied with the perceived pace of change and were concerned that Fannie, Freddie, and lenders "still viewed them as 'special programs' and have not incorporated them into standard underwriting practices."»³³

«"During the 1980 to 1985 period we witnessed the emergence of Fannie Mae and Freddie Mac as significant players in the secondary mortgage market. There was a substantial increase in the average loan size because of inflation and greater willingness to lend larger amounts secured by liens on real estate. Mortgage pricing became more closely tied to national rates. The market shifted from thrifths originating loans and holding them in portfolio funded by saving accounts to tradable securities held by banks, insurance companies, mutual funds and others. We also saw the debut of wholesale mortgage companies that bought mortgages from smaller firms and turned them into securities."»³⁴

Under 1985 Pinto notes:

«While Fannie and Freddie both have conservative underwriting guidelines, FHA has loosened its guidelines»

In this year, 40% of the loans insured by FHA have an LTV > 96%.³⁵

In 1982 the mortgage (interest) rate in the US reached a maximum of 18%. As from that year until 2010 it decreased more or less gradually to 5%.³⁶

In 1985 one of the GSEs, the Farm Credit System, gets liquidity problems and help from the US government:

«While GSEs lacked a full-faith-and-credit government guarantee, their obligations generally traded at narrow spreads above Treasuries and below the level of AAA-rated securities. The government had reinforced a perception of an implicit federal guarantee when it acted to support another GSE, the Farm Credit System, when this GSE declared in 1985 that it could not meet its obligations. The federal government stepped in and provided funding through an organization called the Farm Credit System Financial Assistance Corporation. Similarly, the government arranged for support of the Financing Corporation, an organization that issued obligations with the attributes of GSE obligations, when its viability was in doubt in 1996.»³⁷

³³ Pinto pp. 34-5.

³⁴ Pinto p. 79. Pinto quotes from Thomas LaMalfa and David Olson, "Market efficiencies and nonconforming lending", Mortgage Banking, April 1, 1996. Note that the quote is from 1996.

³⁵ Pinto p. 37.

³⁶ See Figure 6.1 on p. 86/114 of the FCIC-report. The figure shows graphs for the 30-year conventional mortgage rate and for the effective federal funds rate. The figure also shows that the mortgage rate changed much more smoothly than the effective federal funds rate.

³⁷ GSEs and the financial crisis (FCIC Preliminary staff study) p. 9.

1986.

In February 1986 the Single European Act formalized political co-operation within the EC including competency in monetary policy.³⁸

1988.

In Basel, Switzerland, the national supervisors of the financial system approved an agreement about capital requirements for banks:

«[...] the Basel Committee [on Banking Supervision] (BCBS) in Basel, Switzerland, published a set of minimum capital requirements for banks. [...] Assets of banks were [...] grouped in five categories according to credit risk, carrying risk weights of zero (for example home country sovereign debt), ten, twenty, fifty, and up to one hundred percent (this category has, as an example, most corporate debt). Banks with international presence are required to hold capital equal to 8% of the risk-weighted assets.»³⁹

This agreement would later be referred to as Basel I.

The BCBS does not have the authority to prescribe rules or norms. It can only advise and recommend. Its recommendations can be adopted by national or (for example) EC supervisors.⁴⁰ Governments can translate them into laws or other binding rules, changed or unchanged as they deem fit. In the G-10, Basel I was given force of law in 1992.^{41, 42}

The effect of Basel I was the opposite of what it is supposed to have intended. Financial institutions held less instead of more capital (relatively). Their leverage increased.⁴³

The norms of Basel I didn't provide, let alone guarantee, safety. It wasn't a safety net.⁴⁴ Translated for a home owner it means that he may borrow up to at least 12 times the value of his house. The rule is similar to, or rather: supplements, limitation of liability of enterprises. Both rules mean that the larger risks are borne by society as a whole. While citizens remain fully liable.

The following quote shows what Basel I meant for MBS:

«A risk based capital weight of 20% was set for bank holders of Fannie and Freddie MBS. Private “AAA” and “AA” MBS were set at 100% and remained at this level until changed to 20% in 2001. Residential mortgages were set at a 50% level. These percentages were then applied to the base capital level of 8%. This yields the following risk based capital levels:

- Fannie and Freddie MBS: 1.6% capital (8% base capital requirement x 20% risk weight)
- Residential mortgages: 4% capital (8% base capital requirement x 50% risk weight)
- Private “AAA” and “AA” MBS: 8% capital [8% base capital requirement x 100% risk weight].»^{45, 46}

³⁸ See the file History of the euro_Wiki_20140622.

³⁹ Wikipedia 26/3/12. For more information see the appendix *The Basel agreements* or the file about the Basel Accords dated 20120326.

⁴⁰ EC= European Commission. This is more or less the board of directors of the European Union (EU).

⁴¹ See the file about the Basel Accords dated 20120326.

⁴² The G-10 is made up of eleven industrialized countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States, which consult and cooperate on economic, monetary and financial matters. The G-10 central banks also include the European Central Bank. Source of this information: the Financial Stability Report 2006 of the Swiss National (= central) Bank. (Most publications which use the concept G-10 do not specify it. Not even when statistical information is presented).

⁴³ According to Van Wijnbergen in his discussion with the Inquiry Commission De Wit: «Consequences were for example much lower capital requirements for positions which banks took when trading at their own risk. Through this gap bankers drove with a truck.» p. 25, Gespreksverslagen Commissie De Wit. Apart from this it is plausible that Basel I required less capital from US banks than hitherto applicable US regulation: 5,5% of total assets. Plausible also for political reasons (including abuse of power). See the book of Balthazar, quoted in the appendix on the Basel agreements.

⁴⁴ There was, and is, no safety net.

⁴⁵ P. 40 of Pinto. Slightly edited for the purpose of clarity.

The year 1988 provides a telltale example of the functioning of the CRA:

«In 1988 the holding company for Union National Bank, a large bank headquartered in Pittsburgh, requested approval from the Federal Reserve for its merger with Pennbancorp.... Through flexible loan underwriting, [Union National's CRA lending] agreement created an affordable conventional home-purchase product for homeownership in [Pittsburgh Community Reinvestment Group] neighborhoods. Union National Bank reduced the interest rate on these loans by at least one half of one percent below their rates, waived points, mortgage insurance, and minimum loan amounts, and increased the loan-to-value and qualifying debt-to-income ratios. To avoid the conservative underwriting preferred by secondary market investors, Union National agreed to keep these mortgages in portfolio.”⁴⁷

The last sentence means that for example the GSEs didn't want to insure or buy these mortgages. According to Pinto the example shows that “community groups were not really looking for equal treatment by banks; they wanted the private sector to provide subsidized loans”.⁴⁸

In October 1988 US presidential candidate Dukakis presented a plan to facilitate home ownership of people with low and moderate incomes by, among other things, “relaxed criteria for mortgages insured by the Federal Housing Administration”.⁴⁹

Wallison, member of the Financial Crisis Inquiry Commission, and author of one of its two minority reports, gives the following characterization of the mortgage market of the eighties as compared with its later development:

«Until the 1990s, these NTMs [= non-traditional mortgages] were never more than a fraction of the total number of mortgages outstanding. The reason that low underwriting standards were not generally used is simple. Low standards would result in large losses when these mortgages defaulted, and very few lenders wanted to hold such mortgages. In addition, Fannie and Freddie were the buyers for most middle class mortgages in the United States, and they were conservative in their approach. Unless an originator made a traditional mortgage it was unlikely that Fannie or Freddie or another secondary market buyer could be found for it.»⁵⁰

1989.

A European Council summit in Hannover on 14 June 1988 began to outline monetary co-operation. It set up the Committee for the Study of Economic and Monetary Union. The Committee was chaired by the then President of the Commission, Jacques Delors, and included all EC central bank governors. Their unanimous report, submitted in April 1989, defined the monetary union objective as a complete liberalization of capital movements, full integration of financial markets, irreversible convertibility of currencies, irrevocable fixing of exchange rates and the possible replacement of national currencies with a single currency.

The report indicated that this could be achieved in three stages, moving from closer economic and monetary coordination to a single currency with an independent European Central Bank and rules to govern the size and financing of national budget deficits.

⁴⁶ This is what the FCIC says about this: «Fatefully, the Basel rules made capital requirements for mortgages and mortgage-backed securities looser than for all other assets related to corporate and consumer loans. Indeed, capital requirements for banks' holdings of Fannie's and Freddie's securities were less than for all other assets except those explicitly backed by the U.S. government. These international capital standards accommodated the shift to increased leverage.» FCIC-report p. 49/77.

⁴⁷ Stanley A. Lowe and John T. Metzger, “A Citywide Strategy: The Pittsburgh Community Reinvestment Group”, Chapter 6, page 89 of *Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions*, 2003, Gregory Squires, editor. Quoted by Pinto on p. 38. The quote is unchanged (as always, unless mentioned otherwise): the rectangular brackets are in the original. For more explanation see the FCIC minority report of Wallison, in particular section III. 6 on p. 524/552.

⁴⁸ Still from p. 38 of Pinto.

⁴⁹ Pinto p. 40.

⁵⁰ FCIC report, minority report of Wallison (shortly : FCIC Wallison report), p. 486/514.

The proposed stages were:

1. Complete the internal market and remove restrictions on further financial integration (1990-94);
2. Establish the European Monetary Institute to strengthen central bank cooperation and prepare for the European System of Central Banks (ESCB). Plan the transition to the euro. Define the future governance of the euro area. Achieve economic convergence between the EC countries (1994-1999);
3. Fix final exchange rates and transition to the euro. The ECB and ESCB are responsible for independent monetary policy-making. Implement binding budgetary rules in the EC countries (1999-).

On the basis of the Delors Report, the Madrid European Council of June 1989 decided to proceed to the first stage of EMU in July 1990, and the 1989 Strasbourg European Council called for an intergovernmental conference to determine the Treaty revisions that would be needed to move to the second and third stages and implement EMU.⁵¹

1990.

On 31/5/90 secretary Jack Kemp of the US ministry of Housing and Urban Development (HUD) set up an Advisory Commission on Regulatory Barriers to Affordable Housing. The following is the unabridged "Mandate to the Commission":

«When she visited the United States, the Russian human rights "activist" Yelena Bonner said to the American people: The people of the world do not want war, they want to own a house. They want to own a home. They want the decency and dignity that goes along with their own home.

The American dream is a universal dream. But all too often this dream of ownership, of decent and affordable housing, is being denied to first-time homebuyers and low-and moderate-income families. Government rules and red tape are regulating the dream out of existence. The challenge to this Commission is to discover and to tell us how to remove those regulatory barriers.»⁵²

1991.

On 8/7/91 the Advisory Commission on Regulatory Barriers to Affordable Housing submitted its report *Not in my backyard- Removing barriers to affordable housing* to president Bush and secretary Kemp of HUD. The report asserted for example:

«Fannie Mae's and Freddie Mac's underwriting standards are oriented towards "plain vanilla" mortgages. The standards encourage lending in suburban, growing, homogenous, and higher income areas, where housing and zoning requirements result in the production of "cookie cutter" new homes in uniformly single-family neighborhoods. These standards work against more diverse building types and mixed-use neighborhoods, which are more difficult to assess and to underwrite.»⁵³

The report does not mention or discuss mortgage conditions, at least not explicitly. The reader has to make do with the vanilla metaphor and the conclusion of the commission.

Regarding the influence of the GSEs, the commission notes that:

«The market influence of Fannie Mae and Freddie Mac extends well beyond the number of loans they buy or securitize; their underwriting standards for primary loans are widely adopted and amount to national underwriting standards for a substantial fraction of all mortgage loans.»⁵⁴

The report pays no attention to the question how many people could in principle afford to buy and maintain their own home, and why. It does not propose to try and answer this question. The most relevant remark it makes about this question is the following:

«Regulatory barriers are not the only factors affecting housing affordability, and removing regulatory barriers will not resolve all the housing affordability problems in the United States.

⁵¹ *The road to the euro*, pp. 5-6.

⁵² P. 5 of the pdf-file of *Not in my backyard- Removing barriers to affordable housing*, in the directory USA, under 19910708. Henceforth the report will be called NIMBY.

⁵³ NIMBY p. 3-13/65.

⁵⁴ NIMBY p. 5-3/81.

Significant and substantial problems would remain for the poorest families in society. At the same time, however, the regulatory barriers that now exist are exacerbating the problems of the poor. The Commission believes that a serious effort to reduce regulatory barriers is an essential component of an overall strategy to promote housing affordability.»⁵⁵

According to Pinto, around this time:

«Congress was becoming interested in addressing what it perceived as overly conservative underwriting standards.

“Lenders will respond to the most conservative standards unless [Fannie Mae and Freddie Mac] are aggressive and convincing in their efforts to expand historically narrow underwriting.” This point was reinforced over and over again by other [community advocacy] witnesses.” (U.S. Senate Committee on Banking, Housing, and Urban Affairs 1991)

This statement provides a clear indication as to Congress’ intent when it passed the GSE Act of 1992 the following year. Rather than being viewed as prudent, the GSEs’ standards were attacked for being inflexible and too conservative. Ignored was the fact that these standards were designed to originate sustainable loans in a safe and sound manner. They were based on the “Three Cs of Mortgage Credit”.⁵⁶ As noted previously, Fannie’s underwriting standards had undergone a thorough risk based review in 1985 to address the substantial losses it had incurred on high LTV and highly leveraged loans in the early 1980s.»⁵⁷

Before the arrival of the new GSE law in 1992, three non-overlapping mortgage markets could be distinguished:

- «The prime market generally served borrowers with low to medium LTVs (however first time home buyers have a substantially higher usage of high LTV financing), excellent credit, and moderate debt ratios.
- The FHA market served borrowers (particularly home purchase and first time homebuyers) with high LTVs, approximately half with impaired credit (a FICO⁵⁸ below 660), and high debt ratios (similar to subprime).
- The subprime market primarily served borrowers getting cash out refinances with medium to low LTVs, most with impaired credit, and with high debt ratios.

Not only were these markets quite separate and distinct, prime originators did not originate subprime loans and vice versa and a loan qualifying for FHA rarely met prime loan standards. All of this would change in 1992 with the passage of the GSE Act. Post 1992 the GSEs would be required to substantially increase their acquisitions of low- and moderate-income borrowers—the same customer bases relied on by FHA and subprime. To accomplish this they would need to depart from the investment quality credit standards that distinguished “A” lending from FHA and subprime.»⁵⁹

In December 1991 the Treaty on European Union was approved by the Heads of State or Government at the European Council at Maastricht. It was decided that Europe should have a strong and stable single currency by the end of the century. The EU Treaty, also called the Maastricht Treaty, replaced the Treaty of Rome.

For the economic and monetary union to provide a framework for more jobs and growth, and to avoid disruption, it was necessary for the member state economies to achieve a high degree of convergence before introducing the single currency. Therefore, the Treaty on European Union set the ‘Maastricht convergence criteria’ that EU countries have to meet in order to adopt the euro. They are shown in the following table. In addition, EU countries would have to achieve convergence of the national laws and rules governing their national central banks and monetary issues.⁶⁰

⁵⁵ NIMBY p. 5-10/88.

⁵⁶ According to footnote 39 on p. 22 of Pinto, the three C’s are: collateral, character, and capacity.

⁵⁷ Pinto p. 46-7.

⁵⁸ «FICO score: A measure of a borrower’s creditworthiness based on the borrower’s credit data; developed by the Fair Isaac Corporation.» FCIC, Glossary, p. 541/569.

⁵⁹ Pinto pp. 44-5, with rectangular brackets from the original, but list format (the dots) added by JFCvV.

⁶⁰ Text and table: *The road to the euro* p. 6. For the table also: nbb.be, 22/6/14.

What is measured	How it is measured	Convergence criteria
Price stability	Harmonised consumer price inflation rate	In the year before admission to euro not more than 1.5 percentage points above the rate of the three best performing EU countries
Sound public finances	Government deficit as % of GDP	Reference value: not more than 3 %, unless approaching this value at satisfactory pace
Sustainable public finances	Government debt as % of GDP	Reference value: not more than 60 %, unless approaching this value at satisfactory pace
Durability of convergence	Long-term interest rate	In the year before admission to euro not more than 2 percentage points above the rate of the three best performing EU countries in terms of price stability
Exchange rate stability	Deviation from a central rate	Participation in ERM ⁶¹ for 2 years without severe tensions

1992.

«The Federal Reserve Bank of Boston released a statistical analysis of the 1990 and 1991 HMDA [= Home Mortgage Disclosure Act] data that attempted to control for all objective indicators of applicant risk. The conclusion was that minorities were 56% more likely to be rejected than whites, down from the Federal Reserve's 1991 report of a rejection rate that was roughly double for minorities»⁶²

According to William Neilson, speaker at the Symposium on the Mortgage Discrimination Controversy in 1998, the analysis had a great impact on media and policy makers.⁶³ It is said to have been used “to support a wholesale abandonment of traditional underwriting standards”.⁶⁴ However, in 1993 it was found that there were fatal errors in the analysis of the Boston Fed.⁶⁵ Other research showed that the “default rates for black borrowers are higher than those for white borrowers”.⁶⁶ Invalidating the hypothesis that the selection was (only) based on discrimination instead of objective judgment of financial capacity.

«In 1992, Congress enacted Title XIII of the Housing and Community Development Act of 1992 (the GSE Act), legislation intended to give low and moderate income borrowers better access to mortgage credit through Fannie Mae and Freddie Mac.»⁶⁷

«Among the requirements imposed by the GSEs' charters were requirements to serve the market for low- and moderate-income people and underserved markets. When Fannie Mae became a GSE in 1968 its charter authorized HUD to set affordable housing requirements as a portion of the company's mortgage purchases, “but with reasonable economic return to the corporation.” The 1992 Federal Housing Enterprises Financial Safety and Soundness Act authorized the HUD Secretary to set affordable housing goals for Fannie Mae and Freddie Mac “involving a reasonable economic return that may be less than the return earned on other activities.” Both Freddie Mac and especially Fannie Mae publicly promoted policies to increase the homeownership rate in the United States.

The 1992 Act established three housing goals [affordable housing goals, abbreviated AH-goals],

⁶¹ ERM= exchange rate mechanism.

⁶² Pinto p. 52, 1992-A.

⁶³ Pinto p. 52, 1992-A.

⁶⁴ Pinto p. 64, 1993-D.

⁶⁵ The Boston Fed is the Federal Reserve Bank at Boston. It is part of the US Federal Reserve System.

⁶⁶ “all other characteristics being equal”. Pinto p. 64, 1993-D.

⁶⁷ FCIC Wallison report pp. 453-4/81-2. This is confirmed by the following quote and the annual reports of the GSEs.

1. The Low- and Moderate-Income Housing Goal: loans to borrowers with incomes at or below the median income for the market area in which they live;
2. The Special Affordable Goal: loans to very low-income borrowers (those with incomes at or below 60 percent of the area median income), or to low-income borrowers living in low-income areas (borrowers with incomes at or below 80 percent of the area median income, living in census tracts in which the median income of households is at or below 80 percent of the area median income);
3. The Underserved Areas Goal: loans to borrowers living in low-income census tracts (tracts in which the median income of residents is at or below 90 percent of the area median income) or high-minority tracts (tracts in which minorities comprise at least 30 percent of residents, and the median income of residents in the tract does not exceed 120 percent of the area median income).»⁶⁸

The law empowered HUD to specify quantitative goals for the GSE's. The following quotes and graph show the use HUD made of its authority.

«Over the next 15 years, HUD consistently enhanced and enlarged the AH goals. In the GSE Act, Congress had initially specified that 30 percent of the GSEs' mortgage purchases meet the AH goals. This was increased to 42 percent in 1995, and 50 percent in 2000. By 2008, the main LMI [low and moderate income] goal was 56 percent, and a special affordable subgoal had been added requiring that 27 percent of the loans acquired by the GSEs be made to borrowers who were at or below 80 percent of area median income (AMI).

Table 10, page 510[538⁶⁹], shows that [the GSEs] Fannie and Freddie met the goals in almost every year between 1996 and 2008.»⁷⁰

«Congress also made clear in the act that its intention was to call into question the high quality underwriting guidelines of the time. It did so by directing Fannie and Freddie to “examine—

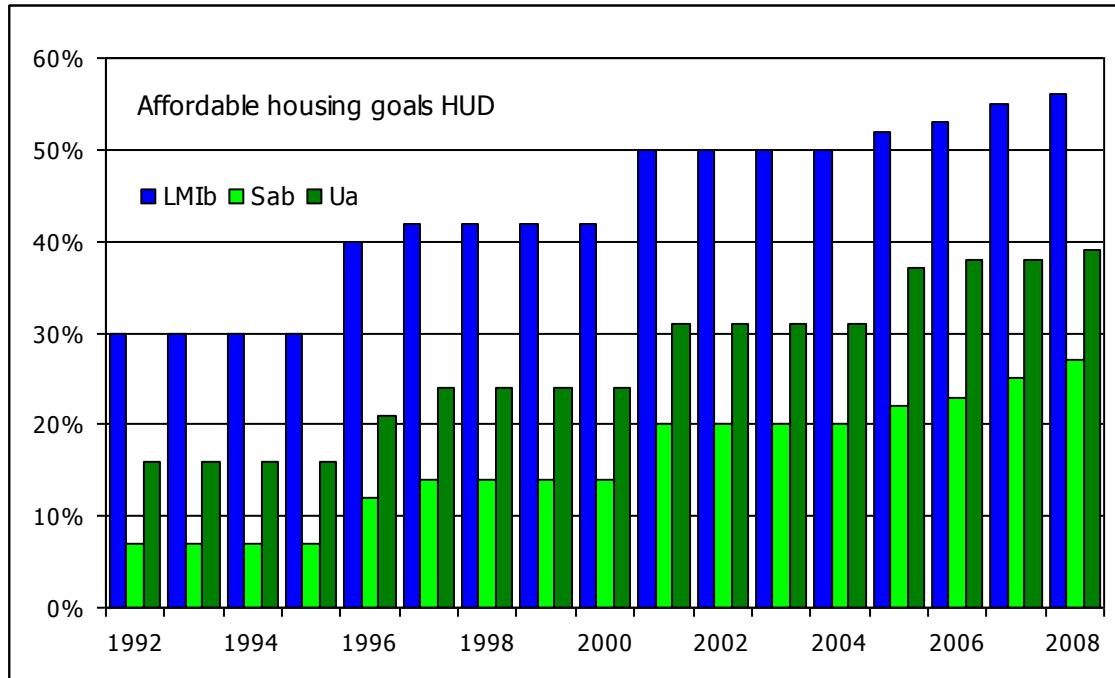
- 1) The extent to which the underwriting guidelines prevent or inhibit the purchase or securitization of mortgages for houses in mixed-use, urban center, and predominantly minority neighborhoods and for housing for low-and moderate income families;
- 2) The standards employed by private mortgage insurers and the extent to which such standards inhibit the purchase and securitization by the enterprises of mortgages described in paragraph (1); and
- 3) The implications of implementing underwriting standards that-
 - (A) establish a downpayment requirement for mortgagors of 5 percent or less;
 - (B) allow the use of cash on hand as a source of downpayments; and
 - (C) approve borrowers who have a credit history of delinquencies if the borrower can demonstrate a satisfactory credit history for at least the 12-month period ending on the date of the application for the mortgage.”».⁷¹

⁶⁸ *GSEs and the financial crisis* (FCIC Preliminary staff study) p. 6.

⁶⁹ This table corresponds with Figure 4 on p. 8 of *GSEs and the financial crisis*. Figure 4 is a graph of the GSE low and moderate income goal performance 1996-2009.

⁷⁰ FCIC Wallison report pp. 454/82.

⁷¹ FCIC Wallison report pp. 490-1/518-9.



Pinto gives the following explanation for the above stipulations in the new GSE law:

«In 1992 the interests of Fannie, community groups, and Congress converged resulting in passage of the “The Federal Housing Enterprises Financial Safety and Soundness Act of 1992” (GSE Act). Fannie got its wish as the GSE Act formalized its strategy of using affordable housing to protect its key charter privileges— protection that would last until 2008, two months before it and Freddie would be forced into conservatorship. The community groups got their wish now that Fannie and Freddie were now required to loosen underwriting standards in support of CRA. Congress got its wish by moving the affordable housing mission largely off-budget and at the same time, placing itself in a position to take credit for the affordable housing activities of Fannie and Freddie.»⁷²

The FHA was “on-budget”: it was on the budget of the federal government, and cost taxpayers’ money. This limited the possibilities to increase home ownership by means of FHA. The GSEs could (further) tap the private market.

In the sources no indication could be found for a study of the possibilities and risks of imposing affordable housing (AH) goals as mentioned, as part of the preparation of the GSE law. Estimates of side effects are not mentioned either. Neither before nor after the introduction of the law. (Periodic) evaluations of the operation and effects of the law were not prescribed or made.

In 1992 George H.W. Bush was president of the USA. The AH policy was continued by his successor, Bill Clinton, president in 1993-2001:

«In 1995, President Bill Clinton announced an initiative to boost homeownership from 65.1% to 67.5[%] of families by 2000, and one component raised the affordable housing goals at the GSEs. Between 1993 and 1995, almost 2.8 million households entered the ranks of homeowners, nearly twice as many as in the previous two years. “But we have to do a lot better,” Clinton said. “This is the new way home for the American middle class. We have got to raise incomes in this country. We have got to increase security for people who are doing the right thing, and we have got to make people believe that they can have some permanence and stability in their lives even as they deal with all the changing forces that are out there in this global economy.”»⁷³

Clinton’s successor George W. Bush followed in the footsteps of his predecessors. In the speech in

⁷² Pinto p. 51.

⁷³ FCIC p. 41/69. A memorable text!

which he accepted the nomination of the Republican party for the presidency of the USA- his second term- he said the following:

«Another priority for a new term is to build an ownership society, because ownership brings security, and dignity, and independence.

Thanks to our policies, homeownership in America is at an all-time high. Tonight we set a new goal: seven million more affordable homes in the next 10 years so more American families will be able to open the door and say welcome to my home.»⁷⁴

The quotes show that it was the policy of successive US governments to increase home (and mortgage) ownership of Americans with lower incomes. It was the policy of both republican and democratic governments. The quotes show that it was the policy of the president, and that this fact was broadcast as widely as possible.

As noted under 1980-1985, from 1982-2010 the interest rate steadily decreased. Lower interest rates make mortgages cheaper, and even apart from this the new GSE Act made it easier for larger groups of people to get a mortgage. However, mortgage buyers and/or mortgage sellers did not always think realistically about the possibility or difficulty of meeting accepted mortgage obligations in the long run. For example in the case that the interest rate increases, or house prices go down.

The decreasing interest rate caused an increase in the demand for houses and in house prices.

«From 2000 to the peak of originations in 2003, mortgage activity increased rapidly, and it continued at an elevated pace through 2006 and into 2007. By 2008, originations had fallen back to historical levels.»⁷⁵

In the peak period, the number of mortgages sold was 2 to 3 times the average historical level of 1990-2000. The levels of 1990-1995 probably were the result of the earlier mortgage conditions.⁷⁶

«FHA's annual foreclosure start rate hits 1.79%; almost double the 1% level in 1961. Notwithstanding this troubling foreclosure trend, government housing policies were being put in place that mandated loosened underwriting standards, as part of a well-publicized effort to increase the homeownership rate, ultimately to 70% by the end of 2006.»⁷⁷

Regrettably the reports are silent about the communication HUD-GSEs.⁷⁸ However, the following quote from Form 10-K of Fannie Mae about 2003 suggests that Fannie experienced pressure:

«HUD has informed Fannie Mae that the 2003 goals will remain in force during 2004, and that during the year HUD will issue new goals for 2005 and beyond. During 2001 through 2003, HUD provided incentive points for serving small multifamily and owner-occupied rental housing. These incentive points are no longer available in 2004, making the same goal levels more difficult to achieve. A unit may be counted in more than one category of goals. If HUD determines that Fannie Mae has failed to meet its housing goals and that achievement of the goals was feasible, taking into account market and economic conditions and Fannie Mae's financial condition, Fannie Mae must submit a housing plan to HUD describing the actions it will take to meet the goal in the next calendar year. If HUD determines that Fannie Mae has failed to submit a housing plan or failed to make a good faith effort to comply with the plan, HUD may take certain administrative actions.»⁷⁹

In the years $\leq 1991 - \geq 2007$ there was a political climate of deregulation and "self regulation" by for

⁷⁴ Acceptance speech given by George W. Bush to the Republican National Convention in Madison Square Garden in New York City, from 10 pm on September 2, 2004. The speech can be found in the directory USA, under 20040902. Thanks are due to the Inquiry Commission De Wit for mentioning this speech. On p. 43/39 of its first report.

⁷⁵ The mortgage crisis (FCIC staff study) p. 4, figure 1.

⁷⁶ See note 20 on p. 458/ 486 of the FCIC Wallison report, and pp. 75-6 of Pinto, *Government housing policies in the leadup to the financial crisis*.

⁷⁷ Pinto p. 58, 1992-F.

⁷⁸ Most notably the FCIC report.

⁷⁹ Form 10-K of Fannie Mae for 2003, p. 15/18. The document can be found in the directory Fannie, under 20040315.

example the financial institutions.⁸⁰ The following gives an impression of the substantiation:

«More and more, regulators looked to financial institutions to police themselves—“deregulation” was the label. Former Fed chairman Alan Greenspan put it this way: “The market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures.”»⁸¹

«Fed Chairman Greenspan and many other regulators and legislators supported and encouraged this shift toward deregulated financial markets. They argued that financial institutions had strong incentives to protect their shareholders and would therefore regulate themselves through improved risk management.»⁸²

The policy was implemented in regulation which gave companies more freedom:

«In 1991, the Treasury Department issued an extensive study calling for the elimination of the old regulatory framework for banks, including removal of all geographic restrictions on banking and repeal of the Glass-Steagall Act. [...] The report contended that its proposals would let banks embrace innovation and produce a “stronger, more diversified financial system that will provide important benefits to the consumer and important protections to the taxpayer.”»^{83, 84}

Consequences were: more growth, more concentration, and more leverage.

1993.

Pressure was kept on mortgage originators to ease conditions:

«Banks were in a quandary. Unless they could prove that their standard credit guidelines relating to downpayment, credit, and income did not have a disparate impact on minorities, they had to replace them with “innovative or flexible” guidelines.»⁸⁵

1994.

«CEO Jim Johnson [of Fannie Mae] announces Fannie’s Trillion Dollar Commitment to low- and moderate income housing. Just 3 years before Johnson had announced a \$10 billion commitment, but the passage of the GSE Act of 1992 necessitated a much larger commitment—100 times as large. While the sum of a trillion dollars has become commonplace today (largely thanks to the financial crisis brought on by the mortgage meltdown), this is the first time such a massive sum came into common parlance to describe a government related housing finance initiative. The total capital that would support this commitment was less than \$15 billion. Ultimately, Fannie and Freddie would announce a total of \$5 trillion in such commitments—most being highly leveraged and benefiting from loosened lending and all representing the off-budget “free lunch” so desired by Congress and HUD. These acquisitions were leveraged by the GSEs at about 60:1.»⁸⁶

Fannie also introduced a 97% LTV mortgage. In pursuance of these actions, Pinto presents empirical evidence showing the relationship between default rates and LTV. Fannie itself had done an experiment, with disastrous results.⁸⁷ Pinto concludes:

⁸⁰ “≤1991 - ≥2007” means: the years between 1991 or earlier, and 2007 or a later year. It could mean for example the period 1985-2010.

⁸¹ FCIC report p. 28/56. According to p. 558/86 the source of the quote is: Alan Greenspan, “The Evolution of Banking in a Market Economy,” remarks at the Annual Conference of the Association of Private Enterprise Education, Arlington, Virginia, April 12, 1997.

⁸² FCIC report p. 35/62.

⁸³ FCIC report p. 36/64.

⁸⁴ The following is quoted from the glossary on p. 541/69 of the FCIC report: «Glass-Steagall Act: Banking Act of 1933 creating the FDIC to insure bank deposits; prohibited commercial banks from underwriting or dealing in most types of securities, barred banks from affiliating with securities firms, and introduced other banking reforms. In 1999, the Gramm-Leach-Bliley Act repealed the provisions of the Glass-Steagall Act that prohibited affiliations between banks and securities firms.»

⁸⁵ Pinto p. 66, 1993-F.

⁸⁶ Pinto p. 66, 1994 A.

⁸⁷ Pinto p. 67, 1994 B.

«Two lessons should have been learned. First, high LTV lending suffers disproportionately high default rates when home prices come under stress. Second, FHA lending with its broader use of loosened lending standards, experiences an even higher default rate.»⁸⁸

Pinto shows that Fannie walks in the vanguard of easing mortgage requirements.

Events showed the inadequacy of self regulation. In pursuance of big losses and litigation caused by misleading information,⁸⁹ the US Government Accounting Office (GAO) published a report *Financial derivatives- Actions Needed to Protect the Financial System*.⁹⁰ GAO warns of the risks of financial derivatives. It draws attention to the difficulty (impossibility) of summing (aggregating) risks of a collection of activities and securities:

«Because of the numerous combinations of products and types of risks, no single measure exists that reflects the actual amount at risk from derivatives activities.»⁹¹

The following quotes from the GAO report show that the events of 2007-2008 cannot have come as a surprise to someone who had done his homework, or had done what he had to do because of his role in the financial system. The quotes show that the assertion that nobody could have foreseen or predict these events is both incorrect theoretically and as a matter of fact.

The GAO demonstrates the existence of a real systemic risk:

«Derivatives activities are rapidly expanding and increasingly affected by the globalization of commerce and financial markets. Much OTC derivatives activity in the United States is concentrated among 15 major U.S. dealers that are extensively linked to one another, end-users, and the exchange-traded markets. This combination of global involvement, concentration, and linkages means that the sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole. Although the federal government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, the federal government would be likely to intervene to keep the financial system functioning in cases of severe financial stress. While federal regulators have often been able to keep financial disruptions from becoming crises, in some cases intervention has and could result in industry loans or a financial bailout paid for by taxpayers.»^{92, 93}

The GAO has evaluated applicable regulation, and found it to be insufficient:

«GAO believes that innovation and creativity are strengths of the U.S. financial services industry and that these strengths should not be eroded by excessive regulation. However, GAO also believes the regulatory gaps and weaknesses that presently exist must be addressed, especially considering the rapid growth in derivatives activity. The issue is one of striking a proper balance between

- (1) allowing the U.S. financial services industry to grow and innovate and
- (2) protecting the safety and soundness of the nation's financial system.

⁸⁸ Pinto p. 67, 1994-B.

⁸⁹ See p. 4/6 of the GAO report *Financial derivatives- Actions needed to protect the financial system*, and pp. 46-7/74-5 of the FCIC report. This GAO report will henceforth be referred to as GAO 1994.

⁹⁰ It can be found in the directory USA/GAO, under 19940531. Study of this report is recommended strongly. According to the title page of the report, it is a report to "Congressional Requesters".

⁹¹ GAO 1994, p. 4/6

⁹² OTC= over the counter. On p. 46/74 of its report, the FCIC gives the following information: «The derivatives markets are organized as exchanges or as over-the-counter (OTC) markets, although some recent electronic trading facilities blur the distinctions. The oldest U.S. exchange is the Chicago Board of Trade, where futures and options are traded. Such exchanges are regulated by federal law and play a useful role in price discovery—that is, in revealing the market's view on prices of commodities or rates underlying futures and options. OTC derivatives are traded by large financial institutions—traditionally, bank holding companies and investment banks—which act as derivatives dealers, buying and selling contracts with customers. Unlike the futures and options exchanges, the OTC market is neither centralized nor regulated. Nor is it transparent, and thus price discovery is limited. No matter the measurement—trading volume, dollar volume, risk exposure—derivatives represent a very significant sector of the U.S. financial system.»

⁹³ GAO 1994 p. 7/9.

Achieving this balance will require unprecedented cooperation among U.S. and foreign regulators, market participants, and members of the accounting profession. GAO makes recommendations designed to help Congress, the regulators, and the industry address this issue.»⁹⁴

The report has recommendations for Congress, supervisors and FASB.^{95, 96} Together with the remarks already quoted, the report shows that an authoritative institution warned already in 1994 on solid grounds for a scenario like that of September 2008. It shows that an authoritative institution made recommendations which, if implemented, would have prevented the crisis. Because of their importance and to make this book more or less self-sufficient they are quoted in full.

«Recommendations to Congress.

Given the weaknesses and gaps that impede regulatory preparedness for dealing with a crisis associated with derivatives, we recommend that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. Regulators should attempt to prevent financial disruptions from turning into crises and resolve crises to minimize risks to the financial system. Thus, firms that become insolvent should be allowed to fail but to do so in an orderly fashion.

The immediate need is for Congress to bring the currently unregulated OTC derivatives activities of securities firm and insurance company affiliates under the purview of one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies. This could be done in several ways. For example, one legislative proposal would accomplish this goal by assigning the responsibility for the unregulated entities to SEC and creating an interagency commission to establish principles and standards for each federal financial regulator to use in supervising derivatives activities. Another approach could be based on the concept that underlies the arrangement established for government securities dealers. Under this concept, lead responsibility for setting principles and standards applicable to all major U.S. derivatives dealers would be divided among existing agencies on the basis of their expertise and mission. Extensive consultation with all of the agencies supervising derivatives activities would be required before any principles or standards were adopted.

We also recommend that Congress begin systematically addressing the need to revamp and modernize the entire US. financial regulatory system. Gaps and weaknesses in OTC derivatives regulation clearly demonstrate that the existing regulatory structure has not kept pace with the dramatic and rapid changes in the domestic and global financial markets. Banking, securities, futures, and insurance are no longer separate and distinct industries that can be well regulated by the existing patchwork quilt of federal and state agencies. Many issues need to be debated and decided, including the appropriate uses of federally insured deposits and the extent to which they should be used to finance activities, such as large-scale proprietary trading in derivatives or other financial instruments. One of the first issues that needs to be addressed is how the U.S. regulatory system should be restructured to better reflect the realities of today's rapidly evolving global financial markets. We recommend that the committees of jurisdiction work together on this issue. In addition, these committees should hold hearings, at least annually, on developments that affect the safety, soundness, and stability of the U.S. financial system.»

«Recommendations to Financial Regulators.

We recommend that the appropriate regulatory authorities take the following actions to improve their capability to oversee OTC derivatives activities and to anticipate and respond to any financial crisis involving derivatives. Developing specific solutions should involve working closely with industry representatives to:

- Develop and maintain accurate, current, and centralized information, that is accessible to all regulators, including information on the extent of major OTC dealers' counterparty concentrations and the sources and amounts of their derivatives earnings.

⁹⁴ GAO 1994 pp. 8-9/10-11.

⁹⁵ FASB= Financial Accounting Standards Board.

⁹⁶ The recommendations can be found on pp. 14-16/16-18 of the GAO 1994 report.

- Develop and adopt a consistent set of capital standards for OTC derivatives dealers sufficient to ensure that all of the major risks associated with derivatives as well as legally enforceable netting agreements are reflected in capital.
- Establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers. Internal control reporting by boards of directors, managers, and external auditors should include assessments of derivatives risk-management systems.
- Perform comprehensive, annual examinations of the adequacy of major OTC derivatives dealers' risk-management systems, using a consistent set of standards established for this purpose and including consideration of the internal control assessments performed by boards of directors, management, and auditors.
- Provide leadership in working with industry representatives and regulators from other major countries to harmonize disclosure; capital, legal requirements including netting enforceability; and examination and accounting standards for derivatives.»

«Recommendations to FASB.

We recommend that FASB:

- Proceed expeditiously to issue the existing exposure draft on disclosures of derivatives and fair value of financial instruments.
- Proceed expeditiously to develop and issue an exposure draft that provides comprehensive, consistent accounting rules for derivative products, including expanded disclosure requirements that provide additional needed information about derivatives activities.
- Consider adopting a market value accounting model for all financial instruments, including derivative products.»

«Recommendations to SEC.

We recommend that SEC:

- Ensure that SEC registrants that are major end-users of complex derivative products establish and implement corporate requirements for independent, knowledgeable audit committees and public reporting on internal controls. Internal control reporting by boards of directors, managers, and external auditors should include assessments of derivatives risk-management systems.
- Ensure that FASB proceeds expeditiously to develop and adopt comprehensive, consistent accounting rules and disclosure requirements for derivative products.»

Note that most recommendations do not concern only the USA, but for example also governments, supervisors and accountants in other countries. Note furthermore that BIS, IMF and every international organization having a responsibility with respect to the stability of the financial system could and should have acted on (at least) the last recommendation for the financial regulators.

Under 1996 the reader will find a summary of the report of the GAO about the implementation of its recommendations.

In 1994 HUD begins to sign "best practices" agreements with lenders:

«Since 1994, HUD has signed Fair Lending Best Practices (FLBP) Agreements with lenders across the nation that are individually tailored to public-private partnerships that are considered on the leading edge. The Agreements not only offer an opportunity to increase low-income and minority lending but they incorporate fair housing and equal opportunity principles into mortgage lending standards. These banks and mortgage lenders, as represented by Countrywide Home Loans, Inc., serve as industry leaders in their communities by demonstrating a commitment to affirmatively further fair lending.»⁹⁷

⁹⁷ Footnote 175 of 1994-D on p. 68 of Pinto.

«HUD’s Best Practices Initiative was agreed to by the Mortgage Bankers Association of America and undertaken by HUD in 1994 after HUD threatened to go to Congress to get CRA broadened to apply to mortgage bankers.»⁹⁸

«Countrywide [...] would ultimately announce \$1 trillion in Best Practices commitments.»⁹⁹

These observations are also of interest in connection with the following two assertions of the FCIC:

- 1) that the GSEs followed Wall Street, and
- 2) that the easing of mortgage requirements was motivated mostly or only by the pursuit of gain.¹⁰⁰

1995.

«CRA regulations are revised to be more quantitative and outcome based. A bank’s performance was [to be] compared to its market competitors. Banks were [to be] measured on their use of “innovative and flexible” lending standards. [...] Large banks desiring an “outstanding” rating needed to outperform their competitors. [This competition principle] helps explain the dramatic growth of CRA commitments over the next 12 years. Announced CRA commitments totaled \$4.5 trillion over the 1995-2006, 75 times the commitment volume for the 18 year period 1977-1994. [...]

CRA helps promote “too big to fail institutions” by rewarding banks that loosened their underwriting standards with the ability to consummate mergers. Ninety-four percent of the \$4.5 trillion in post-1995 CRA commitments reported by the National Community Reinvestment Coalition related to just 4 banks and banks they merged with. This demonstrates that bankers chose loosened underwriting in order to facilitate mergers. The four banks were Bank of America, Citibank, JP Morgan Chase, and Wells Fargo.»¹⁰¹

«In 1995 HUD announced HUD’s “National Homeownership Strategy [- Partners in the American Dream]¹⁰²”. HUD announced that it had “forged a nationwide partnership that will draw on the resources and creativity of lenders, builders, real estate professionals, community-based nonprofit organizations, consumer groups, State and local governments and housing finance agencies, and many others in a cooperative, multifaceted campaign to create ownership opportunities and reduce the barriers facing underserved populations and communities.” The goal was to make “financing more available, affordable, and flexible”.»¹⁰³

«The Strategy was prepared by HUD, “under the direction of Secretary Henry G. Cisneros, in response to a request from President Clinton.” The first paragraph of Chapter 1 stated: “The purpose of the National Homeownership Strategy is to achieve an all-time high level of homeownership in America within the next 6 years through an unprecedented collaboration of public and private housing industry organizations.”»¹⁰⁴

According to HUD:

«Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer downpayment requirements. [...] The amount of borrower equity is an important factor in assessing mortgage loan quality. However, many low-income families do not have access to sufficient funds for a downpayment. While members of the partnership have already made significant strides in reducing this barrier to home purchase, more must be done. In 1989 only 7 percent of home mortgages were made with less than 10 percent

⁹⁸ Pinto p. 68, 1994-D.

⁹⁹ Pinto p. 68, 1994-D.

¹⁰⁰ Of course, the GSE law of 1992 and the quotes from speeches of US presidents have already shown that politics is at least involved.

¹⁰¹ Pinto 1995-A pp. 69-70.

¹⁰² *National Homeownership Strategy- Partners in the American Dream* seems to be the full name of the program. See for example note 191 on p. 73 of Pinto.

¹⁰³ Footnote 192 on p. 73 of Pinto.

¹⁰⁴ FCIC Wallison report pp. 491-2/519-20.

downpayment. By August 1994, low downpayment mortgage loans had increased to 29 percent.»¹⁰⁵

Pinto concludes that in 1992-1995 HUD succeeded to change the mortgage market radically. According to him, its success was made possible by the following four factors:

1. «The GSEs' affordable housing mission was under HUD's regulatory control pursuant to the GSE Act;
2. Banks' CRA activities were under the control of their safety and soundness regulators, who announced new CRA performance based regulations in 1995;
3. Mortgage bankers had voluntarily agreed to HUD's Best Practices initiative in late-1994; and
4. FHA was, of course, a part of HUD.»¹⁰⁶

The Madrid EU summit approves a plan for the transition to a single currency. It agrees on the name of the new currency: the euro. The transition will take place in three stages. The third and last will begin 1/1/99.

1996.

«In January 1996, the Community Reinvestment Act (CRA) regulation, revised to reward performance, not process, became effective for thousands of community banks in the United States.»¹⁰⁷

«Eighty-seven percent of the increase in low- and moderate-income goals from 1996 to 2007 was due to increases in the Special Affordable goals (low- and very low-income group).»¹⁰⁸

The deregulation policy continues unabatedly. This year, an Economic Growth and Regulatory Paperwork Reduction Act comes into force. It prescribes regulators «to review their rules every decade and solicit comments on “outdated, unnecessary, or unduly burdensome” rules.»¹⁰⁹

In November the GAO reports about the implementation of the recommendations of its report *Financial derivatives* of May 1994. The following is quoted from the Executive Summary:

«A number of actions have been taken or proposed since 1994 that are consistent with the recommendations that GAO made in its 1994 report. However, GAO notes that its key recommendations to improve corporate governance and internal controls for major derivatives dealers and end-users, close regulatory gaps, establish comprehensive and consistent accounting standards, and harmonize regulatory and accounting standards internationally have yet to be fully implemented. While GAO is making no new recommendations in this report, it believes that regulators, accounting standards-setters, and others need to continue to take actions necessary to completely respond to the intent of its prior recommendations.»¹¹⁰

The implementation of the recommendations for Congress is summarized as follows:

«Six derivatives-related bills were introduced in Congress in 1994. These bills included proposals to

- regulate derivatives activity and promote uniformity of such regulation;
- require increased disclosure about derivatives activity;

¹⁰⁵ Quote from HUD's *National Homeownership Strategy- Partners in the American Dream*. Pinto pp. 73-4, 1995-E.

¹⁰⁶ Pinto p. 74, 1995-E.

¹⁰⁷ Pinto 1996-C op p. 82.

¹⁰⁸ Pinto 1997-A op p. 85.

¹⁰⁹ FCIC report p. 53/81.

¹¹⁰ GAO 1996 report p. 15/17.

- require that GAO study the speculative uses of derivatives and the feasibility of imposing taxes and margin requirements on speculative derivatives activity;
- establish principles and standards related to accounting, customer suitability, and risk management;
- require derivatives dealers to register with SEC; and
- prohibit depository institutions from using derivatives for speculation.

None of these bills were passed.

As of June 30, 1996, four new derivatives-related bills were introduced. These bills included proposals to

- establish a federal derivatives commission to set principles and standards for the supervision of derivatives activities;
- authorize the Federal Reserve to create a self-regulatory organization whose members would include derivatives dealers not under the direct regulation of SEC or CFTC;
- require regulatory agencies to jointly establish principles and standards relating to capital, accounting, disclosure, customer suitability, and risk management;
- require financial institutions to have a management plan that ensures appropriate management oversight;
- establish prudent standards for managing risk and provide a framework for internal controls;
- require that all derivatives dealers register and be subject to SEC regulation; and
- prohibit depository institutions and credit unions from engaging in certain derivatives activities.

As of July 1996, all four of the bills had been referred to committee with no further action taken.»¹¹¹

In 2010, the FCIC explains this with the following observation:

«While Congress then [= after the publication of the GAO 1994 report] held hearings on the OTC derivatives market, the adoption of regulatory legislation failed amid intense lobbying by the OTC derivatives dealers and opposition by Fed Chairman Greenspan.»¹¹²

A Market Risk Amendment to Basel I stimulated the use of derivatives:

«In 1996, large banks sought more favorable capital treatment for their trading, and the Basel Committee on Banking Supervision adopted the Market Risk Amendment to Basel I. This provided that if banks hedged their credit or market risks using derivatives, they could hold less capital against their exposures from trading and other activities.»¹¹³

1997.

«HUD commissioned the Urban Institute in 1997 to study Fannie and Freddie's credit guidelines. It advised: [...]

“Informants did express concerns about some of the GSEs' practices. The GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities.”

Translation—do away with the Three Cs of Mortgage Credit entirely and mortgage lending practices would be greatly improved. By 2000 the GSEs had done away with downpayments, had raised debt

¹¹¹ GAO 1996 report pp. 31-2/33-4.

¹¹² FCIC report p. 47/75.

¹¹³ FCIC report p. 49/77. The discussion about the accommodation of market risk had already started in 1991. See chapter 2 of Balthazar. His book can be found in the directory BIS/Basel, under 20061231.

ratios, entered the “A-minus” and “B” subprime market and re-entered the low doc/no doc market.»¹¹⁴,
¹¹⁵

On 17/6/97 the Amsterdam EU summit approves a Stability and Growth Pact (SGP). The SGP is an agreement among the EU member states to facilitate and maintain the stability of the Economic and Monetary Union (EMU). It is intended to ensure that the EU member states maintain budgetary discipline after the single currency has been introduced. It is based primarily on Articles 121 and 126 of the Treaty on the Functioning of the European Union. Art. 121 outlines the preventive part of the SGP. Art. 126 forms the basis for the corrective part and the “Excessive Deficit Procedure” (EDP). Protocol 12 defines the reference values of 3% of GDP for public deficit and 60% of GDP for government debt. It provides for monitoring of government finances of member states by the European Commission and the Council of Ministers, and the issuing of a yearly recommendation for policy actions to ensure full compliance with the SGP also in the medium-term. If a member state breaches the SGP's limits for government deficit and debt, the surveillance and request for corrective action will intensify through the declaration of an EDP. If in spite of multiple warnings corrective actions are not taken, member state can ultimately be issued economic sanctions.^{116, 117}

1998.

«The goals of HUD’s best Practices Initiative (now encompassing over 117 mortgage bankers) was described [by HUD] as follows:

“The companies and associations that sign “Best Practices” Agreements not only commit to meeting the responsibilities under the Fair Housing Act, but also make a concerted effort to exceed those requirements. In general, the signatories agree to administer a review process for loan applications to ensure that all applicants have every opportunity to qualify for a mortgage. They also assent to making loans of any size so that all borrowers may be served and to provide information on all loan programs for which an applicant qualifies.... The results of the initiative are promising. As lenders discover new, untapped markets, their minority and low-income loans applications and originations have risen. Consequently, the homeownership rate for low-income and minority groups has increased throughout the nation. However a near 30% gap currently exists between the homeownership rate of white Americans and their African-American and Hispanic counterparts. In an effort to reduce this disparity, HUD signed “Best Practices” Agreements with an additional 7 lending institutions in FY 1998. Furthermore, 10 expired agreements were resigned.”»¹¹⁸

The Annual report 2007 of the National Community Reinvestment Coalition (NCRC) gives the following information about 1998:

«1998 was a year of mega-mergers that included the Bank of America and Nations Bank merger as well as Citigroup’s acquisition of Travelers; CRA pledges totaled \$812 billion as a result.»¹¹⁹

T. Day en S. Liebowitz, working at the University of Texas at Dallas, have doubts about the soundness of the policy of HUD, and point out the risks it causes for its beneficiaries:

«After the warm and fuzzy glow of ‘flexible underwriting standards’ has worn off, we may discover that they are nothing more than standards that led to bad loans. Certainly, a careful investigation of these underwriting standards is in order. If the ‘traditional’ bank lending processes

¹¹⁴ “low doc/ no doc” refers to the requirement to provide documentation when applying for a mortgage. “low doc/ no doc” means that this requirement is partly or wholly waived.

¹¹⁵ Pinto pp. 86-7, 1997-B.

¹¹⁶ The text of the pact could not be found. The paragraph is based on descriptions or (supposed) summaries, http://ec.europa.eu/economy_finance/economic_governance/sgp, the Wikipedia page *Stability and Growth Pact* of 27/6/14, and Public finances in EMU 2009 _EC.pdf. The available files can be found in the directory EU/Euro.

¹¹⁷ Note that sanctions will probably increase both deficit and debt, contrary to its supposed purpose.

¹¹⁸ Pinto p. 90, 1998-A. The quote comes from HUD’s *Building Communities and New Markets for the 21st Century*, FY 1998 Report, p. 75.

¹¹⁹ Quoted by Pinto on p. 90, in 1998-B.

were rational, we are likely to find, with the adoption of flexible underwriting standards, that we are merely encouraging banks to make unsound loans. If this is the case, current policy will not have helped its intended beneficiaries if in future years they are dispossessed from their homes due to an inability to make their mortgage payments. It will be ironic and unfortunate if minority applicants wind up paying a very heavy price for a misguided policy based on badly mangled data.»¹²⁰

«Bear Stearns begins packaging CRA loans into Fannie, Freddie and private securities. It reported the average CRA portfolio has:

- at least 30 percent loans with 5% down or less;
- a high percentage of loans with less than a 660 FICO score (20-25%). A disproportionately large percentage can be below a 620 FICO score; and
- a high percentage of loans with “favorable” (flexible) underwriting standards.

Banks were advised:

- “Forget about FICO scores and high LTV levels. Almost everyone evaluating your portfolio assumes that the scores will be low (many 660 and less) and LTVs will be high (90 percent and greater);” and
- “Mortgage insurance is a "nice to have" amenity, but not a "need to have;" credit enhancements can be added later through subordinated securities.”

Notwithstanding FHA’s poor experience over decades with respect to similar loans, Bear Stearns, the GSEs, and others adopted the view espoused by community groups:

“To many lower-income homeowners and CRA borrowers, being able to own a home is a near-sacred obligation.”»¹²¹

In May 1998 the Commodity Futures Trading Commission (CFTC), one of the principal financial supervisors of the USA, tried to initiate a process aimed at improving the regulation of the OTC market.¹²² The initiative was killed by a combination of the federal government, including Congress, and the heads of the two most important US financial supervisors: the Fed and SEC. The following is the story as told by the FCIC:

«In 1996, Japan’s Sumitomo Corporation lost \$2.6 billion on copper derivatives traded on a London exchange. The CFTC charged the company with using derivatives to manipulate copper prices, including using OTC derivatives contracts to disguise the speculation and to finance the scheme. Sumitomo settled for \$150 million in penalties and restitution. The CFTC also charged Merrill Lynch with knowingly and intentionally aiding, abetting, and assisting the manipulation of copper prices; it settled for a fine of \$15 million.

Debate intensified in 1998. In May, the CFTC under Chairperson Brooksley Born said the agency would reexamine the way it regulated the OTC derivatives market, given the market’s rapid evolution and the string of major losses since 1993. The CFTC requested comments. It got them.

Some came from other regulators, who took the unusual step of publicly criticizing the CFTC. On the day that the CFTC issued a concept release, Treasury Secretary Robert Rubin, Greenspan, and SEC Chairman Arthur Levitt issued a joint statement denouncing the CFTC’s move: “We have grave concerns about this action and its possible consequences. . . . We are very concerned about reports that the CFTC’s action may increase the legal uncertainty concerning certain types of OTC derivatives.” They proposed a moratorium on the CFTC’s ability to regulate OTC derivatives.

For months, Rubin, Greenspan, Levitt, and Deputy Treasury Secretary Lawrence Summers opposed the CFTC’s efforts in testimony to Congress and in other public pronouncements. As Alan Greenspan said: “Aside from safety and soundness regulation of derivatives dealers under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals

¹²⁰ Quoted by Pinto in 1998-G on p. 91. Note that this is more a logically-correct common sense argument than a (political) opinion.

¹²¹ Pinto p. 92, 1998-H. The quotes are from a paper by D. Westoff dated 1/5/98.

¹²² For explanation of “OTC” please see the OTC-note under 1994.

is unnecessary.”»¹²³

September 1998 was the month of the LTCM near-crisis.¹²⁴ Between January and September 1998, LTCM, one of the largest US hedge funds, lost almost 90 percent of its capital.¹²⁵ The main events of the mini-crisis can be summarized as follows:

January	LTCM’s net asset value is \$4.67 billion. LTCM’s 16 partners’ investment in the fund is valued at about \$1.6 billion.
February-August	Due to various events, LTCM’s net asset value declines to \$2.3 billion.
Early September	LTCM partners contact Federal Reserve officials to notify them of their difficulties and their discussion with investment houses about plans to raise new capital.
September 19	The President of the NY Fed advises the Chairman of the Fed that the LTCM situation appears to be deteriorating and that efforts to raise capital had failed. The Chairman agrees that a team should visit LTCM to get a better understanding of the situation.
September 20	Federal Reserve led team visited Greenwich (CT) for LTCM’s presentation.
September 21	Federal Reserve Bank of New York contacted Goldman Sachs, Merrill Lynch, and J.P. Morgan officials (LTCM’s major creditors). LTCM experiences a single-day trading loss of \$500 million. Bear Stearns, LTCM’s clearing agent, sets a new condition that requires LTCM to collateralize potential settlement exposures.
September 22	Goldman Sachs, Merrill Lynch, J.P. Morgan, and UBS (the “core group”) dispatch two working groups to Greenwich to consider lifting the fixed-income and equity positions out of LTCM. A third group meets at one of the firms in New York to develop a “Consortium approach”. Later that evening, Federal Reserve officials contact additional LTCM creditors. That night, in addition to the core group, a meeting of a larger group involving 13 additional firms begins. Members of the core group contact LTCM about the conditions of the Consortium approach.
September 23	Federal Reserve officials call various foreign central bank officials to inform them about LTCM. Federal Reserve officials suspend the effort to proceed with the Consortium approach until an alternative offer can be considered. At 12:30 p.m., officials find out that the alternative offer was not accepted nor will the offer be extended. Treasury notifies CFTC about LTCM’s problems. CFTC sends an audit staff to LTCM as well as to Bear Stearns and Merrill Lynch to inspect LTCM’s accounts. The staff of the President’s Working Group holds a telephone conference to discuss LTCM. The 14 members of the Consortium agree to the terms of the agreement and LTCM accepts the offer.
September 28	Closing date on the agreement reached among the Fund, the Investment Vehicles, LTCM and its affiliates, and the 14 members of the Consortium. Consortium members infuse \$3.6 billion into the fund. One condition of the agreement is that the Management Company agrees to provide management investment services to the Consortium’s Investment Vehicle on the basis of a 1 percent per annum management fee and a 15 percent incentive fee for increases in net asset value over a Libor hurdle rate. Representatives of the Consortium meet and formally constitute themselves as the Board of Directors of “Oversight Partner I LLC.”

¹²³ FCIC report pp. 46-7/74-5. The film (documentary) *Inside job* provides valuable additional information. Brooksley Born was phoned by undersecretary Summers, and pressured to withdraw her proposal. The film also shows fragments of the discussion in Congress. *Inside Job* was produced by Audrey Marrs and Charles Ferguson, and directed by Charles Ferguson.

¹²⁴ LTCM= Long term capital management. LTCM was a hedge fund.

¹²⁵ GAO 1999 report, p. 2/3.

November Stake of the 16 original partners valued at \$30 million (as against \$1.6 billion at the beginning of the year).
(All dates refer to 1998).

The above summary is based on the Chronology of Events on pp. 39-40/41-2 of the GAO report *LTCM: Regulators Need to Focus Greater Attention on Systemic Risk*.¹²⁶ It is given also to show how the crisis is “solved”.

The report gives the following explanation and evaluation of the events:

«LTCM was able to establish leveraged trading positions of a size that posed potential systemic risk, primarily because the banks and securities and futures firms that were its creditors and counterparties failed to enforce their own risk management standards. Other market participants and federal regulators relied upon these large banks and securities and futures firms to follow sound risk management practices in providing LTCM credit. However, weaknesses in the risk management practices of these creditors and counterparties allowed LTCM’s size and use of leverage to grow unrestrained. According to federal financial regulators, these weaknesses, at least in part, resulted from overreliance on the reputations of LTCM’s principals, the relaxing of credit standards that typically occurs during periods of sustained economic prosperity, and competition between banks and securities and futures firms for hedge fund business.

The effects of these weaknesses became apparent during the unsettled market conditions that occurred in the summer of 1998. LTCM began to lose large amounts of money—\$1.8 billion in August alone—in various trading positions worldwide and by mid-September was on the verge of failure. The Federal Reserve facilitated a private sector recapitalization of LTCM because of concerns that a rapid liquidation of LTCM’s trading positions and related positions of other market participants in already highly volatile markets might cause extreme price movements and cause some markets to temporarily cease functioning. Following the LTCM crisis, a group of major financial firms prepared a report that addressed risk management issues and recommended improvements to financial firms’ existing counterparty risk practices.¹²⁷

Federal financial regulators did not identify the extent of weaknesses in banks’ and securities and futures firms’ risk management practices until after LTCM’s near-collapse. Although regulators were aware of the potential systemic risk that hedge funds can pose to markets and the perils of declining credit standards, until LTCM’s near-collapse, they said they believed that creditors and counterparties were appropriately constraining hedge funds’ leverage and risk-taking. However, examinations done after LTCM’s near-collapse revealed weaknesses in credit risk management by banks and broker-dealers that allowed LTCM to become too large and leveraged. The existing regulatory approach, which focuses on the condition of individual institutions, did not sufficiently consider systemic threats that can arise from nonregulated entities, such as LTCM. Similarly, information periodically received from LTCM and its creditors and counterparties did not reveal the potential threat posed by LTCM.»¹²⁸

The end of 1998 is the beginning of stage 3 of the plan for the EU Economic and Monetary Union agreed to at the Madrid summit of 1995:

«On 31 December 1998, the conversion rates between the euro and the currencies of the participating EU countries were irrevocably fixed. On 1 January 1999, the euro was introduced and the Eurosystem, composed of the ECB and the national central banks (NCBs) of the euro area countries, took over responsibility for monetary policy in the new euro area. This was the beginning of a transitional period that was to last three years and end [on 1/1/2002] with the introduction of euro banknotes and coins and the withdrawal of national banknotes and coins.»¹²⁹

Henceforth the euro is legal tender. Until 1/1/2002 the euro can be used only for cashless payments

¹²⁶ The report can be found in the directory USA/GAO, under 19991031. For clarification see especially pp. 44-5/46-7.

¹²⁷ This was the Counterparty Risk Management Policy Group (CRMPG), which we will meet again. Its report can be found under 19990621 in the dossier. (The date is adopted from the GAO LTCM report).

¹²⁸ Pp. 2-3/4-5 of the GAO 1999 report.

¹²⁹ *The road to the euro*, p. 8.

(cheques, transfers, bank cards). Payments to tax and social security authorities can be made in national currency or euros: there is no prohibition and no compulsion regarding the use of the single currency.¹³⁰ Financial markets changed immediately.¹³¹

1999.

«FHA doubles its percentage of loans with a downpayment of <5% in one year, from 23% in 1998 to 44% in 1999 and increases its home purchase share from 12% to 15%.»¹³²

The following table shows that in 1999-2007 the share of LTVs > 95% in mortgages acquired by Fannie and Freddie increased by a factor of about 5.¹³³

Chart 29 - Affordable Housing Goals and Fannie and Freddie's Acquisition of Loans with LTVs >95% (Green highlight indicates richer in goals contribution relative to low- and moderate-income goal):

LTVs >95%	1999	2000	2001	2002	2003	2004	2005	2006	2007
Fannie									
% of all home purchases	4.1%	4.3%	7.1%	7.7%	11.5%	12.9%	14.8%	19.4%	25.9%
% of low and mod	7.1%	7.4%	12.7%	12.7%	19.3%	21.7%	23.4%	31.0%	40.7%
% of geograph. targeted	6.9%	7.2%	12.4%	12.4%	18.9%	21.0%	22.9%	28.5%	37.1%
% of special affordable	7.2%	8.4%	15.7%	14.7%	22.9%	25.3%	30.9%	39.6%	50.9%
Freddie									
% of all home purchases	5.1%	5.9%	5.3%	7.9%	10.3%	6.5%	8.0%	9.8%	19.3%
% of low and mod	6.2%	10.1%	10.7%	8.5%	12.7%	9.0%	13.2%	15.0%	33.2%
% of geograph. targeted	5.6%	9.4%	10.1%	7.5%	12.2%	8.5%	12.8%	14.2%	29.3%
% of special affordable	7.2%	12.6%	15.5%	9.7%	15.4%	11.5%	18.2%	20.3%	39.4%

«On July 29, 1999, HUD issued a press release with the heading “Cuomo Announces Action to Provide \$2.4 trillion in Mortgages for Affordable Housing for 28.1 Million Families.” The release began: “Housing and Urban Development Secretary Andrew Cuomo today announced a policy to require the nation's two largest housing finance companies to buy \$2.4 trillion in mortgages over the next 10 years to provide affordable housing for about 28.1 million low- and moderate-income families.”

“Cuomo said the historic action by HUD raises the required percentage of mortgage loans for low- and moderate-income families that finance companies Fannie Mae and Freddie Mac must buy from the current 42 percent of their total purchases to a new high of 50 percent- a 19 percent increase- in the year 2001. The percentage will first increase to 48 percent in 2000 [while the planned 2000 increase was not promulgated, both Fannie and Freddie exceeded the planned increase with a 50% attainment].”

“Commenting on the action, President Clinton said: ‘During the last six and a half years, my Administration has put tremendous emphasis on promoting homeowners and making housing more affordable for all Americans. Our housing programs and institutions have been a success. Today, the homeownership rate is at an all-time high, with more than 66 percent of all American families owning their homes. Today, we take another significant step. Raising the GSEs goals will help us generate increased momentum in addressing the nation's housing needs.’”

¹³⁰ A brief history of the euro, from the website of the Belgian National Bank, nbb.be.

¹³¹ The road to the euro, p. 8.

¹³² Pinto p. 93,1999-A, based on the FHA study of 2009.

¹³³ Pinto p. 94, 1999-B.

“Under the higher goals, Fannie Mae and Freddie Mac will buy an additional \$488.3 billion in mortgages that will be used to provide affordable housing for 7 million more low- and moderate-income families over the next 10 years. Those new mortgages and families are over and above the \$1.9 trillion in mortgages for 21.1 million families that would have been generated if the current goals had been retained.”

“Fannie Mae Chairman Franklin D. Raines joined Cuomo at the news conference in which Cuomo announced the HUD action. Raines committed Fannie Mae to reaching HUD's increased Affordable Housing Goals.”»¹³⁴

In April 1999 the President's Working Group on Financial Markets (PWG) published a report *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*. The side letter¹³⁵ to the chairpersons of Senate and House contains the following paragraphs:

«The principal policy issue arising out of the events surrounding the near collapse of LTCM is how to constrain excessive leverage. By increasing the chance that problems at one financial institution could be transmitted to other institutions, excessive leverage can increase the likelihood of a general breakdown in the functioning of financial markets. This issue is not limited to hedge funds; other financial institutions are often larger and more highly leveraged than most hedge funds.

In view of our findings, the Working Group recommends a number of measures designed to constrain excessive leverage. These measures are designed to improve transparency in the system, enhance private sector risk management practices, develop more risk-sensitive approaches to capital adequacy, support financial contract netting in the event of bankruptcy, and encourage offshore financial centers to comply with international standards.»¹³⁶

The following is the operational part of the executive summary of the report:

«Our market-based economy relies primarily on market discipline to constrain leverage. But market discipline can break down. In the case of LTCM, its investors, creditors, and counterparties did not provide an effective check on its overall activities. Moreover, some of the same market and credit risk management weaknesses that permitted LTCM to achieve its extraordinary leverage were evident in other market participants. In the immediate aftermath of LTCM's near collapse, credit risk management practices vis-a-vis highly leveraged institutions were tightened. But market history indicates that even painful lessons recede from memory with time.

Therefore, the Working Group recommends the following measures:

- More frequent and meaningful information on hedge funds should be made public.
- Public companies, including financial institutions, should publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds.
- Financial institutions should enhance their practices for counterparty risk management.
- Regulators should encourage improvements in the risk-management systems of regulated entities.
- Regulators should promote the development of more risk-sensitive but prudent approaches to capital adequacy.
- Regulators need expanded risk assessment authority for the unregulated affiliates of broker-dealers and futures commission merchants.
- The Congress should enact the provisions proposed by the President's Working Group to support financial contract netting.
- Regulators should consider stronger incentives to encourage offshore financial centers to comply with international standards.

¹³⁴ This is a combination of FCIC Wallison report p. 495/523 and Pinto p. 94-5, 1999-C. Pinto quotes a press release by HUD of 29/7/99. The rectangular brackets are in Pinto.

¹³⁵ Signed by Rubin (Treasury), Levitt (SEC), Greenspan (Fed) and Born (CFTC).

¹³⁶ The report can be found in the directory USA/Fed, under 19990430. (The downloaded file has not been reformatted). The analysis of the PWG is seriously incomplete, if not incorrect. For explanation see Part 2 of this chapter.

The Working Group will be monitoring and assessing the effectiveness of the measures outlined above. If further evidence emerges that indirect regulation of currently unregulated market participants is not effective in constraining excessive leverage, there are several matters that could be given further consideration; however, the Working Group is not recommending any of them at this time.

Concerns have been expressed about the activities of highly leveraged institutions with respect to their impact on market dynamics generally and vulnerable economies in particular. Such activity can affect markets in some circumstances and for limited periods although, as a number of independent studies that have been undertaken so far have suggested, the activities of highly leveraged institutions do not appear to have played a significant role in precipitating the financial market crises of the past few years. Further study of this issue will be undertaken by the Financial Stability Forum, recently established by the G-7.»

Note that the PWG asserts that leverage is the single most important factor, and that it completely ignores the analysis of the GAO of 1994. And don't forget that at the time of writing the LTCM report, the members of the PWG, except of course the CFTC, refuse to even discuss regulating OTC.

No reports of the "monitoring and assessing the effectiveness of the measures" have been found.

Various later documents show that nothing meaningful was done with the recommendations.

«Under heavy pressure from the financial lobby, legislation prohibiting regulation of derivatives by Born's agency [= CFTC] was passed by the Congress. [Chairperson Brooksley] Born resigned on June 1, 1999.»¹³⁷

In October 1999 the report *LTCM: Regulators Need to Focus Greater Attention on Systemic Risk* of the GAO is published. It is addressed to the Congressional Requesters. It is the report of an inquiry into the near-collapse of LTCM and some of the broader issues it raised. The title of the report leaves no room for misunderstanding. The message can only be missed if the report is missed. The FCIC report mentions the GAO 1999 report twice. But only in the endnotes.¹³⁸

The report gives clear and indisputable analyses of the relevant events and phenomena. It would be difficult to make it more convincing. Its content is not only important as such, but also because it proves that an open analysis of the facts shows what may happen (and did happen), and what can be done to prevent a disaster. The report gives a thoroughly substantiated warning for almost everything that caused the financial crisis of 2007-2008.

The titles of the sections of the side-letter of the report compose its shortest summary:

1. «Lapses in Market Discipline Enabled LTCM to Have Large, Leveraged Trading Positions, Creating Potential Systemic Risk;
2. Market Discipline Did Not Constrain LTCM's Leverage and Risk-taking;
3. The LTCM Crisis Illustrated that Potential Systemic Risk Can Exist in Large Trading Positions;
4. After the Crisis, Major Financial Firms Proposed Improved Risk Standards;
5. Regulatory Oversight Did Not Identify Lapses in Risk Management Practices and the Threat Posed by LTCM;
6. Federal Regulators Had Expressed General Concerns About Hedge Funds for Years;
7. Regulators Did Not Identify Weaknesses in Firms' Risk Management Practices Until After the Crisis;
8. Offsite Monitoring Did Not Reveal the Potential Systemic Threat Posed by LTCM;
9. Regulators and Industry Adopted and Recommended Improved Oversight and Practices;
10. Existing Coordination Could be Improved to Enhance Regulators' Ability to Identify Risks Across Industries and Markets;
11. Gap in SEC's and CFTC's Regulatory Authority Limits Their Ability to Identify and Mitigate Systemic Risk;
12. SEC and CFTC Lack Authority to Regulate Affiliates of Broker-Dealers and FCMs;¹³⁹

¹³⁷ Wikipedia, page Brooksley Born, 10/12/12. In the subdirectory USA/CFTC.

¹³⁸ Search the FCIC report for "focus greater attention".

¹³⁹ FCM= futures commission merchant.

13. Regulators Recommended Limited Expansion of SEC and CFTC Authority Over Activities of Affiliates of Broker-Dealers and FCMs, but Regulatory Gap Would Remain;
14. Expanding SEC and CFTC Authority Over Affiliates Would Raise Controversial Issues.»

The following paragraph of the report draws attention to dangerous negligence of regulators:

«Because of the blurring in recent years of traditional lines that separate the businesses of banks and securities and futures firms, it is more important than ever for regulators to assess information that cuts across these lines. **Regulators for each industry have generally continued to focus on individual firms and markets, the risks they face, and the soundness of their practices, but they have failed to address interrelationships across each industry.** The risks posed by LTCM crossed traditional regulatory and industry boundaries, and the regulators would have needed to coordinate their activities to have had a chance of identifying these risks. Although regulators have recommended improvements to information reporting requirements, they have not recommended ways to better identify risks across markets and industries. We are recommending that federal financial regulators develop ways to better coordinate oversight activities that cross traditional regulatory and industry boundaries.»¹⁴⁰

Or in slightly different words in the conclusions on p. 30:

«LTCM's crisis showed that the traditional focus of federal financial regulators on individual institutions and markets is not adequate to identify potential systemic threats that cross these institutions and markets. Developing ways to enhance coordination of activities related to identifying risks that cross traditional boundaries could better position these regulators to address potential systemic risk before it reaches crisis proportions.»¹⁴¹

The observation in boldface is confirmed by the annual reports of all financial regulators and supervisors. Including those of 2006-2008.¹⁴² On the understanding that the “continued to focus on” is interpreted as a diplomatic way of saying that they gave no attention at all to interrelationships. In other words: the truth would have been served better if “continued to focus on” had been replaced by “failed to look beyond”.

Another clear warning is the following:

«Gaps in SEC's and CFTC's regulatory authority impede their ability to observe and assess activities in securities and futures firms' affiliates that might give rise to systemic risk. Although the Federal Reserve's consolidated oversight of bank holding companies did not reveal banks' risk management weaknesses related to LTCM, recommended or already implemented improvements in examination focus and in information gathered may give bank regulators a better opportunity to identify future problems that might pose systemic risk. **Without similar authority over the consolidated activities of securities and futures firms, SEC and CFTC cannot contribute effectively to regulatory oversight of potential systemic risk, because a large and growing proportion of those firms' risk taking is in their unregulated affiliates.** The affiliates may have large positions in markets such as OTC derivatives and can be major providers of leverage in the markets, as they were in the LTCM case. How they manage their own risks, as well as their provision of leverage to counterparties, can affect the financial system.»¹⁴³

The report contains facsimile copies of the reactions of the regulators (supervisors) on the draft of the report. Because they illustrate the attitude and conduct of the regulators, and because their failure to respond properly and appropriately is essential for the explanation of the crisis of 2007-2008, the substantial parts of their reactions are reproduced below.

¹⁴⁰ GAO 1999 report p. 3/5. The boldface is by JFCvV.

¹⁴¹ GAO 1999 report p. 30/32.

¹⁴² These can all be found as pdf-file on their websites. Except that of OTS of 2006 (and earlier). They can also be found in their subdirectory in the directory USA. Excerpts can be found in the appendices bearing their names.

¹⁴³ GAO 1999 report pp. 30-1/32-3. The boldface is by JFCvV.

CFTC.¹⁴⁴

«As the draft report indicates, the President's Working Group on Financial Markets (PWG) recently issued a report that made several recommendations in light of this episode. These recommendations include action to promote greater disclosure of information- both disclosure by hedge funds about their own risk exposures and disclosure by financial institutions and other publicly-held companies about their dealings with hedge funds. This disclosure will increase market transparency and thus will enhance the ability of creditors, counterparties, investors, and other market participants to monitor, and to discipline, leverage and risk taking by hedge funds.

CFTC is working to implement those recommendations which are within its authority and has already begun working with other members of the PWG to address issues raised by the LTCM situation. Specifically, CFTC staff have developed possible models for disclosure of risk information by institutions whose size and leverage render them capable of posing potential systemic risk threats. These models would call for disclosure in a format that would be shared with other federal financial regulators and the public. CFTC is consulting with other members of the PWG concerning these models of disclosure. The goal is to reduce the likelihood of systemic risk by increasing transparency, thereby strengthening market discipline.»

The evaluation of the GAO of the CFTC reaction is concluded by the following sentences:

«As pointed out in our report, although market discipline is the primary mechanism for controlling risk-taking, LTCM's creditors and counterparties failed to apply it in LTCM's case. Thus, we continue to believe that market discipline should be supplemented by regulatory offsite monitoring and on-site examinations to help ensure the prompt identification and correction of weaknesses in risk management practices.»¹⁴⁵

Fed.¹⁴⁶

«The report recommends that the Federal Reserve and other federal financial regulators develop ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries. As you know, the President's Working Group was reinvigorated in 1994, in part to address coordination concerns, and the Board is committed to making the Working Group function effectively. The Board believes that the structure for coordinating currently is adequate. Although in certain cases there may be statutory limitations on the agencies' ability to share some information, legislative proposals under consideration would address any such limitations that may apply to the Board.

Broadly, the report's recommendation suggests that the federal financial regulators focus on developing data that might reveal potential systemic risks and then coordinate on the assessment of that risk. Identifying the particular types of data that might reveal potential systemic risk is a particularly challenging task, in no small measure because systemic crises tend to embody unique features that are hard to anticipate in advance.¹⁴⁷ Various working groups under the auspices of the Committee on the Global Financial System of the Group of Ten Central Banks and the Financial Stability Forum are struggling with trying to identify the types of data that might improve our understanding of the risks being taken in financial markets. We do not want to prejudge the results of such efforts, but the task is an extremely difficult one. In the final analysis, our ability to perceive systemic crises in data is likely to be limited. We, thus, fall back to our longstanding position, that the soundest course for financial regulators is to ensure that the institutions they supervise can withstand the shocks that inevitably occur in markets. To this end, federal financial regulators are working to strengthen further the risk management practices at the institutions they supervise.»

The last sentence of the evaluation of this reaction by the GAO is the following:

¹⁴⁴ The CFTC reaction is dated 14/10/99, and signed by William J. Rainer.

¹⁴⁵ GAO 1999 report pp. 31-2/33-4.

¹⁴⁶ The Fed reaction is dated 20/10/99, and signed by Alan Greenspan.

¹⁴⁷ This assertion is falsified by the GAO report of 1994.

«However, such oversight is not currently applied to all financial institutions that can originate or transmit risk and does not include effective ways to monitor and assess risks that cut across markets.»¹⁴⁸

SEC.¹⁴⁹

«As the scope of trading and credit activities conducted outside the regulated broker-dealer has expanded, the Securities and Exchange Commission ("SEC") has found it increasingly difficult to closely monitor the systemic risks posed by unregulated broker-dealer affiliates. Therefore, I believe the Draft Report accurately concludes that the SEC requires additional risk assessment authority over these unregulated affiliates. The finding also is consistent with the recommendations recently made in the report prepared by the President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*.

In addition to our general comments on the conclusions reached in the Draft Report, we have the following three specific concerns:

First, the Draft Report compares, but does not distinguish, the leverage ratios of LTCM and several large securities firms. Though some securities firms had simple balance sheet leverage ratios (assets/equity capital) in the same range as LTCM, the assets carried by the securities firms were less volatile than the assets earned by LTCM. Moreover, securities firms are subject to regulatory capital requirements. Therefore, a general comparison of simple leverage ratios without further explanation may cause the misimpression that securities firms posed as much risk as LTCM.

Second, the Draft Report claims there is an inability of existing coordination methods to monitor risks across industry and market lines. I believe that productive avenues for sharing important information exist today. For example, the President's Working Group on Financial Markets provides an ongoing forum for the primary financial regulators to discuss issues cutting across jurisdictional boundaries. While the exchange of information between regulators can be improved to facilitate better cooperation and coordination, in my view the focus should be on public dissemination of information regarding hedge funds. The President's Working Group report therefore recommended that hedge funds should be required to publicly disclose information in the form of quarterly financial reports that include comprehensive measures of market risk. The SEC's staff also is working on a rule proposal to require public companies to disclose their direct material exposures to significantly leveraged financial institutions.

Third, the Draft Report claims that because of current limitations on the SEC's regulatory authority over broker-dealer affiliates, the SEC cannot fully assess the risk exposures of broker-dealers. The SEC, however, has sufficient information to assess and evaluate the risks incurred at the broker-dealer level. It is at the broader, broker-dealer holding structure level, which encompasses unregulated broker-dealer affiliates, that the SEC encounters difficulty in assessing risk.

In closing, while rigorous market discipline is an effective deterrent against market excesses and disruptions, the LTCM episode demonstrated that financial regulators need better tools to identify intermarket risks, especially those stemming from lapses in private market discipline. Thank you again for this opportunity to provide comments to the GAO as it prepares its final draft of the report.»

In its evaluation of this reaction the GAO notes among other things:

«Although we agree that hedge fund disclosures could be of some use, we believe that efforts should be made to improve regulatory coordination because future systemic problems may not involve hedge funds. Thus, we continue to support our recommendation that financial regulators find ways to better coordinate the assessment of risks that cross traditional regulatory and industry boundaries.

Finally, as to SEC's third issue, we continue to be concerned that SEC may be unable to fully assess risks to the broker-dealers because of its inability to oversee holding companies (and unregulated affiliates) of broker-dealers. For example, when broker-dealers are part of holding company structures, whose risk management function is located at the holding company level, SEC is unable to review that broker-dealers risk management system unless the holding company provides the

¹⁴⁸ GAO 1999 report p. 33/35.

¹⁴⁹ The SEC reaction is dated 18/10/99, and signed by Annette L. Nazareth.

information voluntarily.»¹⁵⁰

Treasury.¹⁵¹

«The draft report recommends that the Treasury, the Federal Reserve Board, the SEC, and the CFTC "develop ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries." We believe that such coordination is already occurring in the President's Working Group. The members of the Working Group meet on a regular basis- at both the principal and staff levels- and have developed a productive and candid multilateral environment for exchanging information on significant market developments. The process works well and our working relationships continue to grow and develop over time. While the Working Group is not itself a regulatory body, it serves as an important forum for federal financial regulators that better enables them to respond to market events in effective and appropriate ways.

Thank you again for this opportunity to review and comment on the draft report. We find that its factual presentation is in general agreement with our understanding of the events related to the LTCM episode.»

The second half of the evaluation of this reaction by the GAO is the following:

«As we stated previously, we agree that the President's Working Group serves as an important forum that better enables regulators to respond to market events, although primarily after the fact, but existing coordination efforts failed to allow regulators to identify the cross-industry risks that LTCM posed. Therefore, we continue to support our recommendation that the financial regulators develop better ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries.»¹⁵²

2000.

«In order to protect its market share, FHA increases the percentage of its loans with FICO scores below 660 from 42% in 1994 to 71% in 2000 and increases the percentage of its loans with an LTV \geq 97% from 14% in 1992 to 52% in 2000. This allows it to maintain its share at about 9% over 1993-2000, the same as its average share for 1990-1992.»¹⁵³

In January FHA publishes a press release about “Quicken [housing] loans”, in which it presents itself as an institution with easy mortgage requirements, and as being easier than other mortgage providers.¹⁵⁴

«FHA was setting the loosened underwriting standard with its greatly expanded reliance on minimal downpayments, raised the total debt-to-income bar to 41% and beyond on very low downpayment loans and it had no minimum FICO score. The GSEs and the private MBS sectors would not only emulate and expand upon FHA in these three regards, they would add their own loosened standards. For example, Fannie and Freddie would come to dominate the Alt-A- low doc/no doc market. The private MBS market would add ARMs¹⁵⁵ to the mix (the GSEs and FHA had the funding/pricing advantage on 30 years fixed rate, fixed payment loans).»¹⁵⁶

The result is that FHA begins to lose market share. In 1998-2000 its share varied between 10 and

¹⁵⁰ 1999 GAO rapport pp. 33-4/35-6.

¹⁵¹ The reaction of the Treasury is dated 25/10/99, and signed by Under Secretary (Domestic Finance) Gary Gensler.

¹⁵² GAO 1999 report p. 34/36.

¹⁵³ FHA's actuarial report 2009, quoted by Pinto on p. 99, in 2000-A.

¹⁵⁴ On p. 100, in 2000-B, Pinto quotes extensively from the press release.

¹⁵⁵ ARM= adjustable rate mortgage. Meaning a variable interest rate.

¹⁵⁶ Pinto 2000-B, pp. 100-1. Table 2 on p. 18 of the FCIC-staff report *GSEs and the financial crisis* gives an impression of the size of some categories of non-traditional mortgages (NTM). At Fanny, acquired “non-full doc” for example, grows from 2004 until (and including) 2007 from B\$ 101 to B\$ 199. In other words: it almost doubles in size.

15%, from 2000-2006 it falls from 15 to 2%.¹⁵⁷

«On 19 June 2000 during the summit in Santa Maria da Feira the ECOFIN Council confirmed that Greece had fulfilled the necessary conditions to adopt the single currency as of 1 January 2001. The Council based its decision on the Convergence Reports prepared by the ECB and the European Commission, the opinion of the European Parliament and a proposal from the European Commission.»¹⁵⁸

Like the quote, the following table is from the ECB annual report 2000. It shows that the decision cannot have been based on fulfillment of the Maastricht convergence criteria (given above, search for “Maastricht”) or the economic health of Greece. Note in particular the data about exports, unemployment and gross debt.¹⁵⁹

Macroeconomic indicators for Greece

(annual percentage changes, unless otherwise indicated)

	1994	1995	1996	1997	1998	1999	2000	2000 Q1	2000 Q2	2000 Q3	2000 Q4
Real GDP	2.0	2.1	2.4	3.5	3.1	3.4	4.1
<i>Contribution to real GDP growth:¹⁾</i>											
Real domestic demand including stocks	1.1	3.7	3.5	3.9	5.1	3.2	4.7
Net exports	0.9	-1.6	-1.1	-0.4	-2.0	0.2	-0.6
HICP	10.3	8.8	7.9	5.4	4.5	2.1	2.9	2.6	2.3	2.8	3.8
Compensation per employee	10.8	12.2	8.8	13.5	6.0	4.8	4.5
Unit labour costs, whole economy	10.7	11.6	5.9	9.3	6.4	0.6	1.5
Import deflator (goods and services)	5.6	7.5	5.0	2.7	4.2	1.2	6.1
Current plus new capital account (% of GDP) ²⁾	-0.1	-2.5	-3.7	-4.0	-3.0	-4.1	-6.9
Total employment	1.9	0.9	-0.4	-0.3	3.4	-0.7	1.2
Unemployment rate (% of labour force) ³⁾	8.9	9.1	9.8	9.7	11.2	12.0	11.3
Fiscal balance (% of GDP) ^{4),5)}	-10.0	-10.2	-7.4	-4.0	-2.5	-1.8	-0.9
Consolidated gross debt (% of GDP) ⁴⁾	109.3	108.7	111.3	108.3	105.5	104.6	103.9
Three-month interest rate (% per annum) ⁶⁾	26.7	16.4	13.8	12.9	13.9	10.3	7.9	8.9	8.5	7.9	6.2
Ten-year government bond yield (% per annum) ⁶⁾	.	.	.	9.8	8.5	6.3	6.1	6.4	6.1	6.1	5.8
Exchange rate against the ECU or euro ^{6),7)}	288	303	306	309	331	326	337	333	336	338	340

Sources: Eurostat, European Commission, national data and ECB calculations. Note: National accounts are according to the ESA 95.

1) Percentage points.

2) Bank of Greece data (settlement basis); data for 2000 are provisional.

3) ESA 95 basis.

4) Consistent with the Maastricht Treaty definition.

5) General government surplus (+) / deficit (-).

6) Average of period values.

7) Units of national currency per ECU until the end of 1998; thereafter, per euro.

«In 2000, Fannie Mae met its "Trillion Dollar Commitment" to help finance over 10 million homes for families and communities most in need during the seven years from 1994 through 2000. On March 15, 2000, Fannie Mae announced its "American Dream CommitmentSM" - a pledge to invest \$2 trillion over the next ten years to help finance housing for 18 million home buyers and renters and join with housing partners to reverse decay in inner cities and older suburbs and expand the availability of livable, affordable rental housing. The new plan will focus on

¹⁵⁷ Pinto p. 101, 2000-B. The 9% mentioned earlier probably refers to a market share which is defined in a slightly different way. P. 101 concerns “market share of home purchase mortgages”.

¹⁵⁸ ECB Annual report 2000 p. 76. The table is from p. 77. The ECOFIN council is the EU council of ministers of economic affairs and finance.

¹⁵⁹ Note the table-space wasted on irrelevant quarterly data.

- (i) promoting mortgage consumer rights, including broader, more equal access to lowest-cost mortgage credit;
- (ii) fighting mortgage discrimination and leading the housing market in serving minority families, including a pledge to provide \$420 billion in financing for 3 million minority households;
- (iii) addressing the unique housing needs of women-headed households, young families, new immigrants, seniors, and urban and rural dwellers;
- (iv) strengthening inner city and older suburban areas through new capital investments and expanded Partnership Offices;
- (v) providing new technologies to mortgage lenders and consumers in order to lower the costs of mortgage financing; and
- (vi) increasing the supply of affordable rental housing.»¹⁶⁰

In 2000-2001 there was a financial crisis, the so called dot.com crisis. The crisis consisted in a deep fall of the values of especially ICT-shares: a “crash” of the stock exchanges, and the consequences of this.

«Some companies, such as Pets.com, failed completely. Others lost a large portion of their market capitalization but remained stable and profitable, e.g., Cisco, whose stock declined by 86%. Some later recovered and surpassed their dot-com-bubble peaks, e.g., Amazon.com, whose stock went from 107 to 7 dollars per share, but a decade later exceeded 200.»¹⁶¹

The fall ended a decade of growth of ICT companies and of their valuation. The nineties were the years of the rise of the internet. Part of the growth of the valuations was caused by real growth of internet and related ICT companies. For another part it was based on expected future growth. But since the internet was entirely new, there was no reliable basis for predictions of its future and that of the industry it had spawned or fertilized. It was nevertheless evident that the sector and its valuation could not grow indefinitely. But nobody knew how to predict its ultimate size, when the growth would slow or stop, and when the stock valuations would start to decline.

The Fed reacted to the crash by relatively strong cuts in the discount rate.¹⁶² From half 2003- half 2004 the rate was 1%. From then on it grew to 5% in 2006-2007. In the following two years of crisis it was lowered to almost 0%.

The summary of the “Issue Brief” of December 2000 of HUD is the following:

«The homeownership rate has been eclipsing record after record for the last several years. This resurgence follows declines in the eighties with stagnate and unchanging rates through the mid-nineties. Improved overall economic conditions with the record long recovery contributed heavily to this homeownership increase. But administration and HUD efforts have also contributed to the improved access to homeownership. These efforts include a revitalized FHA, more demanding goals for the GSEs, renewed emphasis on CRA and equal opportunity enforcement, and numerous other activities such as the Million Homes initiative. While this homeownership progress is widely shared across racial, ethnic and locational groups, gaps remain. Maintaining the overall progress and closing these racial and ethnic gaps are the work remaining.»¹⁶³

How the message and pressure is passed on is implicitly explained in a speech by Fannie’s Vice Chair, Jamie Gorelick, to an American Bankers Association conference on 30/10/00, a short time after HUD had published increased affordable housing goals for the GSEs:

¹⁶⁰ Fannie Mae information statement of March 30, 2001 p. 8. The statement can be found in the directory USA/Fannie under 20010330.

¹⁶¹ Wikipedia “Dot-com bubble”, 28/5/12.

¹⁶² For the meaning of “discount rate” and many other financial terms see the glossary on p. 107 and following of *The Federal Reserve System- Purposes & Functions* in the directory USA/Fed. The concept “discount rate” is described as: «Officially the primary credit rate, it is the interest rate at which an eligible depository institution may borrow funds, typically for a short period, directly from a Federal Reserve Bank. The law requires that the board of directors of each Reserve Bank establish the discount rate every fourteen days, subject to review and determination by the Board of Governors.»

¹⁶³ P. 7 of the Issue Brief. The Issue Brief can be found in the directory USA/HUD under 20001231.

«Your CRA business is very important to us. Since 1997, we have done nearly \$7 billion in specially targeted CRA business—all with depositories like yours. But that is just the beginning. Before the decade is over, Fannie Mae is committed to finance over \$20 billion in specially targeted CRA business and over \$500 billion in CRA business altogether...»

We want your CRA loans because they help us meet our housing goals... We will buy them from your portfolios, or package them into securities... We will also purchase CRA mortgages you make right at the point of origination... You can originate CRA loans for our purchase with one of our CRA-friendly products, like our 3 percent down Fannie 97. Or we have special community lending products with flexible underwriting and special financing... Our approach is “CRA your way”.»¹⁶⁴

In 2000 the Fed published the report of an inquiry into *The Performance and Profitability of CRA-Related Lending*. The report «confirmed an earlier 1996 study by the Federal Reserve Bank of Kansas City, which found that 76% of CRA loans were less profitable, substantially less profitable, or not profitable. This report also documented a litany of loan subsidies and loosened credit undertaken by banks in order to facilitate CRA lending.»¹⁶⁵

The NCRC reported in a misleading or incorrect way about the results of the Fed report:

«The survey found that the great majority of banks reported CRA loans made to low and moderate-income borrowers to be as profitable as their overall lending. In addition, the CRA loans did not exhibit higher foreclosure rates.”»¹⁶⁶

2001.

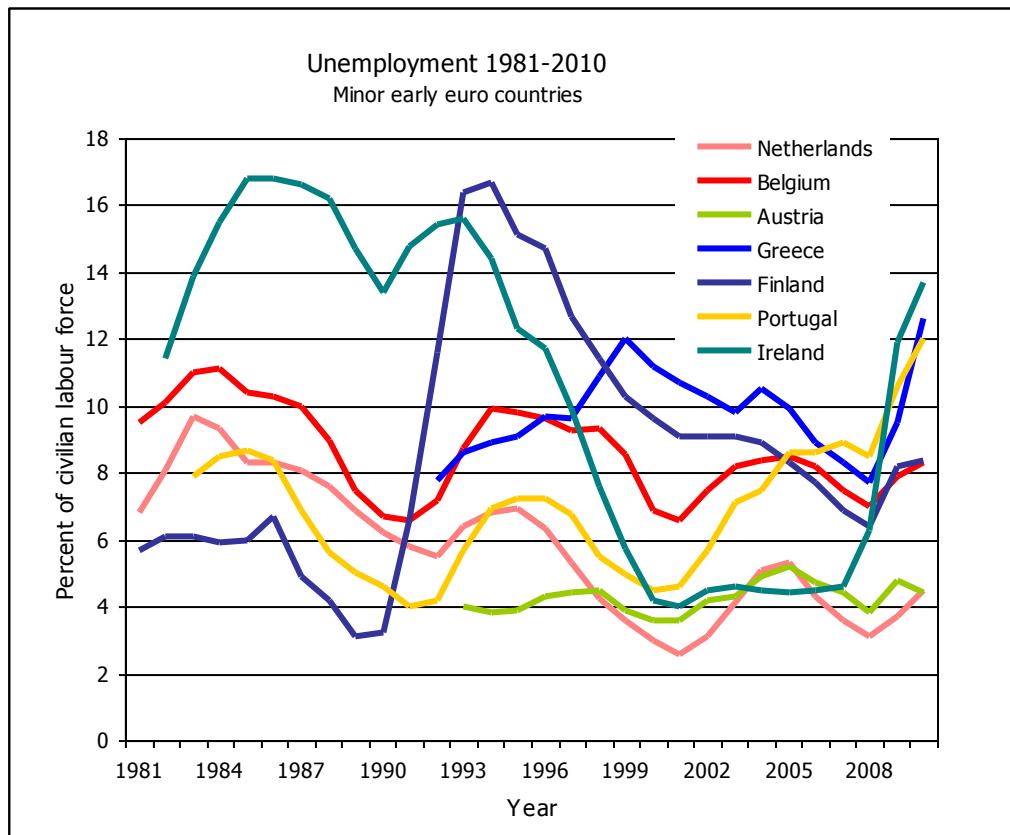
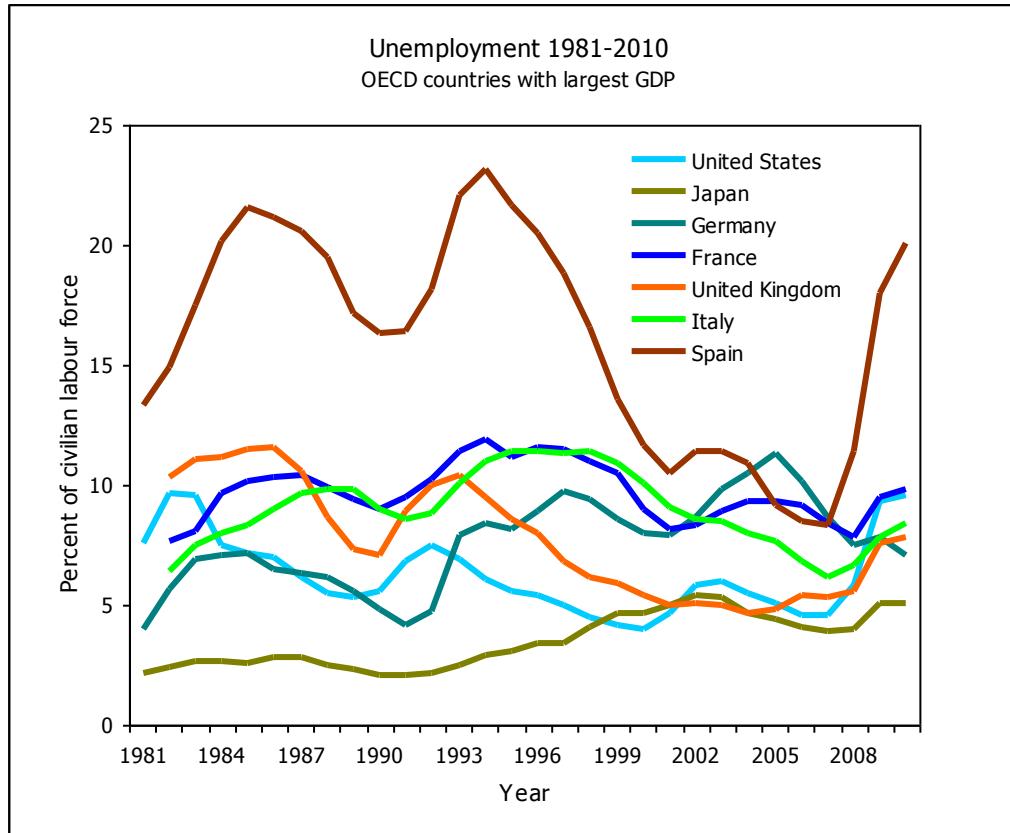
The repercussions of the dot.com crisis were aggravated by “9/11” (11/9/01) and the unparalleled fraud at Enron and Worldcom. Which made many innocent victims. The relative size of some of the consequences of these phenomena can be illustrated by graphs of long time series of unemployment data and the Standard and Poors 500 index. Graphs of the unemployment rate are given here;¹⁶⁷ the graph of the S&P 500 will be given at the end of 2008.

¹⁶⁴ FCIC Wallison report pp. 496-7/524-5.

¹⁶⁵ Pinto p. 102, in 2000-D.

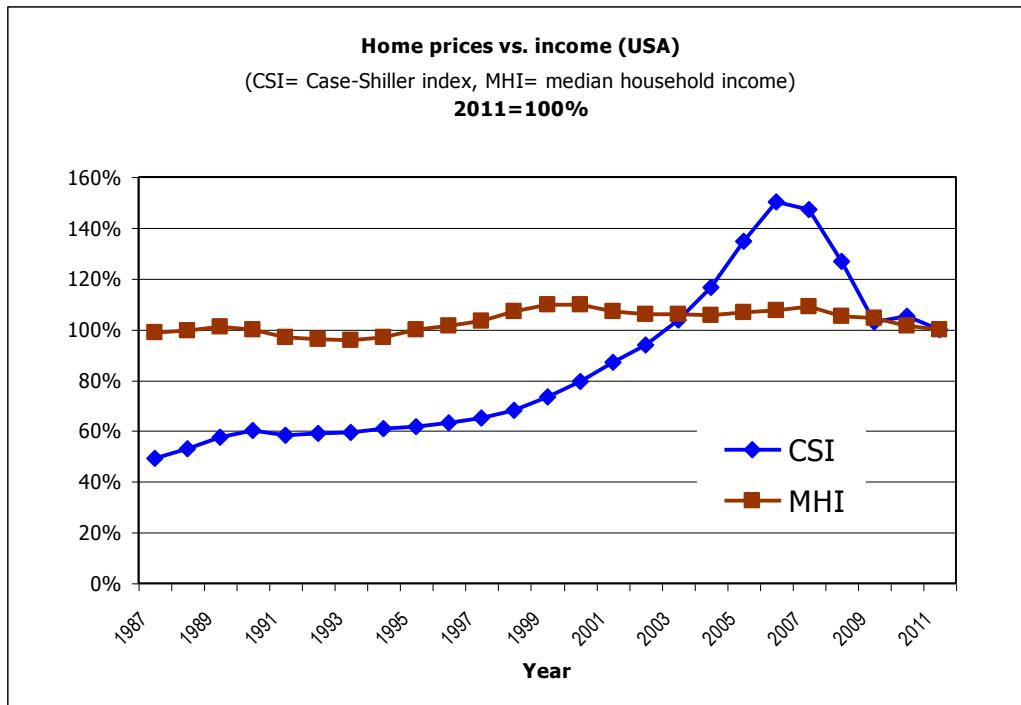
¹⁶⁶ Pinto p. 102, in 2000-D.

¹⁶⁷ The graphs were made using Annex table 22 of OECD *Economic Outlook* 2000-1 and Annex table 14 of OECD *Economic Outlook* 2012-1. The data for the overlapping years were “averaged” with linearly increasing weights.



For several reasons, such as direct or indirect governmental (HUD) pressure, profits, and market share, financial institutions tried to sell as many mortgages as possible. As from 2000 the home prices

increased (much) faster than incomes. See the following graph.¹⁶⁸ Homes became less affordable. It is moreover plausible that parts of the mortgage market became saturated, and that it was impossible to sell more mortgages under the “old” conditions. So these were (additional) reasons for mortgage originators to lower mortgage requirements (even more). They seemed not to bother about the greater risks. Perhaps because of the unfounded and unrealistic assumption that the interest rate would continue to decrease and incomes keep increasing. Or because they planned to pass the risk on by packaging the mortgages and selling them as MBS or as part of other securities.



Not everyone toaded to the government. On p. 498/526 of the FCIC report Wallison quotes an article “Housing in the New Millennium: A Home Without Equity is Just a Rental With Debt,” of Josh Rosner of June 2001:

«Over the past decade Fannie Mae and Freddie Mac have reduced required down payments on loans that they purchase in the secondary market. Those requirements have declined from 10% to 5% to 3% and in the past few months Fannie Mae announced that it would follow Freddie Mac’s recent move into the 0% down payment mortgage market. Although they are buying low down payment loans, those loans must be insured with ‘private mortgage insurance’ (PMI). On homes with PMI, even the closing costs can now be borrowed through unsecured loans, gifts or subsidies. This means that not only can the buyer put zero dollars down to purchase a new house but also that the mortgage can finance the closing costs....

[I]t appears a large portion of the housing sector’s growth in the 1990’s came from the easing of the credit underwriting process....The virtuous cycle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures.».

¹⁶⁸ The income data are from Table H-8, Median Household Income by State: 1984 to 2011, U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements. The Table includes income expressed in dollars of 2011.

The Standard & Poor's Case-Shiller Home Price Index (CSI) is a constant-quality house price index for the USA. The index reflects prices in real terms. They are corrected for inflation. The CSI in the graph is for the first quarter (Q1) of the given year. The data were taken on 4/6/13 from the Wikipedia page about the index. For more information about the CSI the reader is referred to this Wiki-page. It can be found in the directory Statistics.

On 30/3/01 Fannie Mae published an Information statement. For the year 2000 Fannie doesn't have an annual report or a 10K form. The Information statement seems to be meant as a substitute.¹⁶⁹ On p. 46 of the statement Fannie reports that it has been able to exceed the HUD goals for 1999 and 2000 by several percentage points. About the future it says:

«In October 2000, HUD issued a final rule with new housing goals that are effective in 2001 and represent significant increases over current goals. [...] The new goals represent a significant increase above Fannie Mae's historic level of performance, yet management has made a commitment to meet these goals in 2001.»

Freddie Mac does have an annual report for the year 2000.¹⁷⁰ On the pages 46-7/48-9 there is a section about housing goals. It says that Freddie has realized the HUD goals for 1999 and 2000. The section concludes:

«Management views the purchase of mortgages benefiting low- and moderate-income families and neighborhoods as an integral part of Freddie Mac's mission and business, and remains committed to fulfilling the needs of underserved borrowers and markets. Accordingly, Freddie Mac expects that it will continue to purchase the majority of the single-family and multifamily mortgages counted toward its performance under the housing goals through its standard purchase programs.»

Fannie and Freddy do not seem to expect problems with the higher goals.

In its explication of the increase of the goals, HUD said (in 2000):

«Because the GSEs have a funding advantage over other market participants, they have the ability to under price their competitors and increase their market share. This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a significant role in the subprime market. As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market. Since, as explained earlier in this chapter, one could define a prime loan as one that the GSEs will purchase, the difference between the prime and subprime markets will become less clear.»¹⁷¹

Pinto concludes: «HUD's regulatory regime drove a race to the bottom». ¹⁷² Or rather: the abyss.

2002.

«On 1 January 2002, the greatest cash changeover in history took place. It was a challenge of unprecedented dimensions that involved the banking sector, cash-in-transit companies, retailers, the cash-operated machine industry, and the general public. Around €144 billion in euro cash was provided early by the national central banks to banks (frontloading) and by these banks to retailers (sub-frontloading) to avoid bottlenecks in the supply chain. This meant that euro cash was widely available in all sectors in the first days of 2002. By 3 January 2002, 96% of all automated teller machines (ATMs) in the euro area were dispensing euro banknotes. And already one week after the introduction more than half of all cash transactions were being conducted in euro. [...] National banknotes and coins ceased to be legal tender by the end of February 2002 at the latest, [...].»¹⁷³

«In April, Fannie's Chairman Franklin Raines described the competitive landscape for public funding for housing:

“As a result of both congressionally mandated lending requirements and its own \$2 trillion American Dream Commitment, Fannie Mae has not-so-quietly become the largest single provider of mortgage funds to minority and low-income families, its chairman declared last week.”

“Not only is Fannie Mae 'by far' the largest supplier of mortgage money in the private sector,

¹⁶⁹ It can be found in the directory USA/Fannie, under 20010330.

¹⁷⁰ It can be found in the directory USA/Freddie.

¹⁷¹ Pinto p. 104, in 2000-E.

¹⁷² Pinto p. 106, in 2000-E.

¹⁷³ p. 8, *One currency for one Europe- the road to the euro*. EC 2014.

Franklin Raines proclaimed, the federally-chartered corporation is running 'neck and neck' with the Federal Housing Administration as the chief source of public funding for housing."

"The government is our only competitor," Mr. Raines said.

The absurdity of a government sponsored enterprise viewing the government as its competitor was lost on Mr. Raines. [According to Pinto] Congress intended this competition in passing the GSE Act of 1992.»¹⁷⁴

In the section *Regulation and Governmental Relationships* on p. 15/24 of its Annual report 2002 Freddie Mac says:

«We seek to purchase most single-family and multifamily mortgages in support of affordable housing through our standard mortgage purchase programs and under the same credit standards as our other mortgage purchases. We met each of the affordable housing goals in 2001 and 2002.»

The first assertion is confirmed on p. 110/119, in the section *Other regulatory matters*. Freddie does not seem to perceive the higher goals as a problem.

In the Annual report 2002 of Fanny Mae "housing goals" is missing. "Affordable housing" is mentioned, but Fannie makes no statement like that of Freddie just quoted, at least not in this annual report. Neither does the "proxy statement" of Fannie for 2002 provide useful information about this subject.¹⁷⁵

As of 2002 subprime ARMs outnumber fixed rate mortgages.¹⁷⁶

2003.

«That HUD's AH goals were the reason Fannie increased its high LTV (low downpayment) lending is clearly described in a Fannie presentation to HUD assistant secretary Albert Trevino on January 10, 2003: "Analyses of the market demonstrate the greatest barrier to home ownership for most renters are related to wealth—the lack of money for a downpayment... our low-downpayment lending—negligible until 1994—has grown considerably. It is a key part of our strategy to serve low-income and minority borrowers." The figure that accompanied that statement showed that Fannie's home purchase loans over 95 percent LTV had increased from one percent in 1994 to 7.9 percent in 2001.»¹⁷⁷

«Countrywide's CEO, Angelo Mozilo, gives the prestigious Dunlop Lecture sponsored by Harvard's Joint Center for Housing Policy. This annual address is made "by a housing leader to highlight the importance of housing as a policy and research area at the university and in business." Mozilo stated:

"One of the more obvious resolutions to the 'Money Gap' is the elimination of down-payment requirements for low-income and minority borrowers. Current downpayments of 10% or less add absolutely no value to the quality of the loan. It is the willingness [credit history] and the ability of the borrower to make monthly payments that are the determinants of loan quality."

"From my point of view, if 80% of the sub-prime borrowers are managing to make ends meet and make the mortgage payments on time, then, shouldn't we as a Nation, be justifiably proud that we are dramatically increasing homeownership opportunities for those who have been traditionally left behind."

The significance of Mozilo's 80% comment is that 20% of borrowers are not paying. A 20% default rate with a 50% severity (the percentage of the loss relative to the mortgage balance) results in a 10% loss rate. Losses of this magnitude require an annual default risk premium of 2.5%-3%. This default incidence is unsustainable at the family level – loosened underwriting sets up many home

¹⁷⁴ Pinto p. 118, in 2002-A.

¹⁷⁵ For the annual reports of Fannie and Freddie see the directories USA/Fannie and USA/Freddie respectively.

¹⁷⁶ Pinto p. 125, in 2003-E.

¹⁷⁷ FCIC Wallison report p. 493/521. "Loans over 95 percent LTV" probably means: "loans with an LTV of more than 95 percent".

owners for failure. It is unsustainable at the neighborhood level – as foreclosures spread they destroy neighborhoods.

In 2003 Countrywide was the nation's 8th largest subprime lender with a 6% market share. By 2006 it was #3 with a 6.8% share of a subprime market that was twice the size in 2003.»¹⁷⁸

Some states of the US did see the dangers (risks) of the reduction of mortgage requirements. They tried to prevent further reductions. However, their efforts were thwarted in 2003 and 2004 by the federal supervisors OCC and OTS. These asserted that (their) federal regulation pre-empted state lending laws. In other words: state and (other) local governments were shoved aside. «Once OCC and OTS pre-emption was in place, the two federal agencies were the only regulators with the power to prohibit abusive lending practices by national banks and thrifts and their direct subsidiaries.»¹⁷⁹

In the financial world, the Bank for International Settlements (BIS), domiciled at Basel, is one of the most important international financial institutions.¹⁸⁰ BIS is the home of the BCBS (mentioned under 1988) and of the Committee on the Global Financial System (CGFS). In January 2003 the CGFS published a report entitled *Credit Risk Transfer*.¹⁸¹ In the transfer of credit risk important roles are played by securitization and various derivatives. In other words: the subjects of the CGFS report are similar to those of the GAO 1994 report. Like the GAO 1994 report, the CGFS report shows large risks. It shows that since 1994 almost nothing has been done about the risks pointed out by the GAO. Regulation still lags far behind practical developments (to put it mildly). Like the GAO, CGFS fears harmful consequences of concentration:

«Concentration

As pointed out in Section IV.2, some parts of the CRT¹⁸² market are concentrated in a few institutions. In particular, intermediation of CDSs¹⁸³ is dominated by a handful of large universal banks and securities dealers; and risk taking on the most senior (“super senior”) unfunded tranches of CDOs is limited to the monolines and a few banks.

Although most intermediaries claim to have balanced books or only small structural positions, concentration in the intermediation of credit risk could itself be a problem. Even with a matched book- and achieving full matching may be difficult for a variety of reasons- institutions are still exposed to basis risks if contractual terms are not identical. It is, moreover, questionable whether a large number of contracts is effective in diversifying such risk.¹⁸⁴ Market risks can also be difficult to hedge in this area given patchy market liquidity. If intermediation remains highly concentrated, operational failings in dominant firms could disrupt markets. Any deterioration in the creditworthiness of large intermediaries- for example, as reflected in rating downgrades- could also reduce market liquidity by making counterparties less willing to trade without collateralization. It is hard to know whether the current concentration in intermediation reflects temporary first-mover effects or whether economies of scale imply that this degree of concentration will be maintained in the longer run. But it is worth recalling that consolidation and concentration seem to have become widespread features of financial markets.»¹⁸⁵

What happened in 2008 is one of the bad case scenarios suggested by this analysis. However, as in the years 1994-2003 (after the GAO 1994 report), nothing substantial was done about regulation or supervision. Not in the US, not anywhere else.

The quote is given to show that the risk and danger were well known, and that those responsible

¹⁷⁸ Pinto pp. 123-4, in 2003-D.

¹⁷⁹ Section 7.3 of the FCIC report, on pp. 111/139 and following. The quote is from p. 112.

¹⁸⁰ It was already known to the author in 1999 at the latest, at a time when he had only a minor interest in financial-economic matters.

¹⁸¹ The report, also called cgfs20, can be found in the directory BIS, under 20030129.

¹⁸² CRT= credit risk transfer.

¹⁸³ CDS= credit default swap, a security. For explanation see for example the FCIC staff study *Overview on derivatives*, pp. 17-8.

¹⁸⁴ A large number only reduces risk in the absence of correlation.

¹⁸⁵ This quote is from p. 27/31 of the CGFS report filed under 20030129.

have no excuse for ignorance and inaction.¹⁸⁶

Note that the quote implicitly shows an essential lack of information/ transparency, and that this lack makes the supervisors half blind or worse. CGFS understands that large risks exist, but due to lack of information it cannot see them clearly.

In the first days of February 2003, according to OFHEO head Falcon, Raines, head of Fannie, tried to prevent publication of the OFHEO systemic risk report mentioned below. Raines put pressure on Falcon, and tried to mobilize agencies and the Treasury department to do the same. Falcon did not budge. On the day of the release of the report, the White House announced Falcon's replacement. «The next day's news emphasized coverage of the personnel change and gave very scant coverage to the findings of the systemic risk report.»¹⁸⁷

On February 4, OFHEO published a report with the title *Systemic Risk: Fannie Mae, Freddie Mac And the Role of OFHEO*.¹⁸⁸ In this report, Fannie and Freddie are called “Enterprises”. The report studies three scenarios. They are defined as follows:

- «Scenario #1: In a Period of Reduced Liquidity, the Enterprises Help to Mitigate Systemic Risk.
- Scenario #2: One Enterprise Develops Serious Solvency Problems But Remains Liquid, There are Few Adverse Economic Effects, and No Systemic Event Occurs.
- Scenario #3: One Enterprise Suffers Large Losses and Becomes Illiquid and a Systemic Event Results.»¹⁸⁹

Footnote 360 on p. 100 of the report reads as follows:

«Those estimates were calculated from data from the Federal Deposit Insurance Corporation, and reflect OFHEO’s estimates that at year-end 2001 over 4,800 commercial banks—over sixty percent of the institutions in the banking industry—held GSE debt in excess of 50 percent of their equity capital. Nearly sixty percent of those banks have less than \$100 million in assets; over ninety-seven percent have assets of less than \$1 billion. Of banks with assets of more than \$1 billion, 123 institutions—over 30 percent of banks of that size—owned GSE debt in excess of 50 percent of their equity capital.»

So unless the GSEs have perfect risk management (not in the customary sense, but that of the present author, see the Analysis), they obviously cause significant systemic risk.

The following is excerpted from the section *Conclusions Implied by the Scenarios*:

«Scenario #3 illustrates how a severe deterioration in the solvency of Fannie Mae or Freddie Mac could heighten uncertainty about the viability of that Enterprise, the potential for credit losses to investors in their debt and MBS, and the liquidity of those securities. As a study of the financial sector written for the Department of the Treasury observed, “[t]he accumulation of uncertainty over time is a major, if not the major, element of systemic risk.” Scenario #3 also illustrates how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities. Such illiquidity could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system, potentially leading to a systemic event that could impose large economic losses.

Scenario #3 would not have been possible a decade or two ago, when the failure of Fannie Mae or Freddie Mac would have posed a much smaller systemic threat to the U.S. economy. If Fannie Mae had failed at year-end 1981, when the Enterprise was insolvent on a mark-to-market basis and had less than \$60 billion in outstanding debt and \$3 billion in guaranteed MBS, that failure would have imposed losses on investors, mortgage lenders, and related firms but probably would not have seriously threatened a collapse of the housing finance system or a disruption of financial markets

¹⁸⁶ The more so since they should have been able to reproduce the analyses of GAO and CGFS independently, without any help from GAO or CGFS. That is what it means to be competent.

¹⁸⁷ The next day was February 5, 2003. The source of this paragraph is the transcript of the FCIC hearing of 9/4/10. The relevant part is reproduced in the last section of the OFHEO appendix.

¹⁸⁸ OFHEO= Office of Federal Housing Enterprise Oversight. In 2008 it was replaced by the FHFA, the Federal Housing Finance Agency.

¹⁸⁹ Systemic risk report pp. 93/96 and following. Points added by the present author.

generally. At the time the Federal Housing Enterprises Safety and Soundness Enhancement Act of 1992 was enacted, the outstanding debt of Fannie Mae was about one-fifth, and that of Freddie Mac was about one-twentieth, of the levels at year-end 2001. In addition, the Enterprises' debt and MBS were much less important in financial markets, and Fannie Mae and Freddie Mac were just beginning to use financial derivatives. Although OFHEO regulation of the Enterprises has reduced the likelihood of an Enterprise failure, the potential for such a failure, if it occurred, to contribute to disruptions in the housing market and financial system is much greater now than it was then.»¹⁹⁰

The annual reports of 2003 and later years of the Dutch central bank DNB,¹⁹¹ the Dutch Fed, make no mention of the reports of the GAO or CGFS.¹⁹² But if you search these reports with relevant keywords you find interesting things. The Annual report 2003 shows that DNB did discern risks in the use of securitization and derivatives. On p. 93/87 it makes the following observation:

«The improvement of risk management of individual institutions goes together with increasing use of instruments like securitization and credit derivatives. These enable banks to transform risks, or to transfer them. In this way risks are spread better across the system, improving stability.¹⁹³ A drawback of these instruments is that they reduce the transparency of the system, and therefore the manageability in crisis situations.¹⁹⁴ For this reason many policy initiatives are aimed at improving transparency (see section 4.5.4).»

Section 4.5.4 shows that the last sentence may refer to (unpublished) DNB-policy. It does not however refer to initiatives of the government, or in the field of law and regulation:

«Supervisors furthermore emphatically paid attention to cross sectoral developments, such as the transfer of risks within and between (not always regulated) sectors. In particular the transfer of credit risk with instruments like credit derivatives and securitization takes a high flight. Matters of concern are that it is not clear where the credit risks end up ultimately, and whether the risk management of the institution accepting the risk is adapted to it.¹⁹⁵ Both in Basel and European context one therefore tries to get a better view of risk transfer activities, for example by interviews with banks. The first results will be published in the middle of 2004.»¹⁹⁶

“Attention” and interviews, but no action. This is what DNB means by “many policy initiatives”.

Of course it is very peculiar that DNB makes no mention of the CGFS report about this subject, which was after all published in 2003. Or of the earlier GAO reports (of 1994 and 1999). Shouldn’t a professional organization mention and use relevant work in its field? The reports of GAO and CGFS are clear and well-substantiated, and explicitly ask action of the responsible authorities. The text of the annual reports of DNB shows that DNB doesn’t really worry much. There is no sense of urgency. It is clear that even improvement of transparency will take years (at least).

DNB asserts that it needs more insight. But it does not explain what is missing or wrong in the reports of GAO and CGFS to invalidate their conclusions, and to ignore or reject their recommendations. The quotes suggest an unbusinesslike culture of talkers, lacking necessary depth and energy. Why doesn’t DNB translate its observations and worries in recommendations for the institutions whom it may concern? Why are there no more concrete plans for follow up activities? The law makes DNB guardian of financial stability.¹⁹⁷ Can a guardian suffice with observation?

¹⁹⁰ Systemic risk report p. 105/108.

¹⁹¹ DNB= De Nederlandsche Bank. For more information see the appendix DNB and the appendix devoted to its president from 1/7/97-30/6/11, Nout Wellink.

¹⁹² Neither did earlier DNB annual reports.

¹⁹³ Stability is only improved conditionally. For example if total risk remains the same. Not if more risks are taken because they end up in another institution. Spreading risks moreover also implies the possibility of widespread contamination. In any case it would have been more factual and objective, and less normative, if “spread better” had been replaced by “spread more widely”.

¹⁹⁴ Note that the prevention of crises is not mentioned.

¹⁹⁵ DNB does not explain how to manage the risk of inability to fulfill obligations of credit default swaps. In other words: how to take account of the fact that a CDS is not an insurance. Risks are not only spread but also created or amplified.

¹⁹⁶ DNB AR 2003 p. 96/90.

¹⁹⁷ Hence the text on the front cover of an informative brochure, in the directory DNB, under 20081231: “Guardian of financial stability”. The text almost fills the cover.

A search for “risicotran” and “deriva” in DNB’s Annual report 2004 gives no results. There is no report about the “first results” promised in the last quote. But in the Annual report 2005 a search for “deriva” yields interesting results. They are presented and discussed in the appendix DNB.

One of the most remarkable facts of the history of the financial crises is that

- authoritative and well-substantiated warnings have been given;
- the warnings were ignored by those who could and should act upon them;
- the warnings were denied after the fact by those responsible;
- the official inquiry commissions covered the denials, thereby falsifying history.

For example section 4.4, *Mistaken risk estimates*, of the first report of the Dutch parliamentary inquiry commission De Wit suggests that important facts only became known or understood after the precipitous events of September 2008.¹⁹⁸ The above shows that this is incorrect. “Errors” like these can be explained- to a certain extent- by erroneous methods of inquiry.¹⁹⁹ The CDW did not study contemporary documents. It gave a dominating role to interviews- held in 2010: “after the fact”- with people who had responsibilities in the events under investigation.

Section 4.4 of CDW1 opens as follows:

«Afterwards it turned out that it had not been known how the risks were distributed over the different products and actors. As a consequence not only the financial institutions underestimated risks, but the supervisors as well.»²⁰⁰

And a few pages farther on:

«When after the collapse of the credit markets it was realized that the risks had been much greater than thought, it also became clear how far securitization in combination with shadow banking had made the system opaque.»²⁰¹

The quotes from GAO reports show that it had been known for many years that the system was dangerously opaque, and that certain product types, distributions, and concentrations cause system risks which upon realization endanger the operation of the financial system as a coherent whole. This can be concluded without knowing “how the risks were distributed over the different products and actors”. The “As a consequence” of the second sentence in the first quote is logically incorrect. The annual report 2003 of DNB shows that at that time (at the latest) DNB was aware of risks. The recommendations of GAO and CGFS have nevertheless been ignored. By all central banks and finance ministers. Even though the central banks have the legal duty to maintain the stability of the financial system. And even though Wouter Bos in his interview with CDW claimed that as minister of finance he was responsible for the financial system.²⁰² None of these responsible institutions did anything to resolve the opaqueness and reduce the risks.

The main problem was not a lack of information, but the failure to use what was known. The problem was the incompetence and the lack of a sense of responsibility of those responsible. A quote from the hearing of president Wellink of DNB by the Dutch parliamentary inquiry of the (first) financial crisis demonstrates this attitude. Wellink starts by quoting Greenspan:

«As supervisors we are only interested in the tail risks; can you give us some more erudite knowledge about tail risks?» In my [= Wellink’s] opinion this was a great moment. The answer was: No, because it never happens.²⁰³ They went back to the US, and the following week a tail risk was realized, and LTCM failed. This is what I mean by risks we haven’t seen. We knew that the system

¹⁹⁸ The name of the commission is abbreviated CDW, that of its first report CDW1.

¹⁹⁹ Supposing they are errors, and not expressly intended to mislead and/or cover those responsible and/or avoid effective, far reaching, measures. As noted before, and as the GAO report of 1994 shows, any expert should have been able to reproduce the analysis of GAO, and drawn the same conclusions. In other words: the reasoning of CDW is false.

²⁰⁰ First report CDW p. 56/53. The report can be found in the directory CDW, under 20100510. The first sentence is of course true, but a typical political assertion: formally true, but misleading and a cover for deceit. The “As a consequence” in the second sentence on the other hand is untrue.

²⁰¹ First report CDW p. 60/56. There are many more incorrect or misleading assertions in this section.

²⁰² See the appendix Bos, or the Report of the hearings of the CDW.

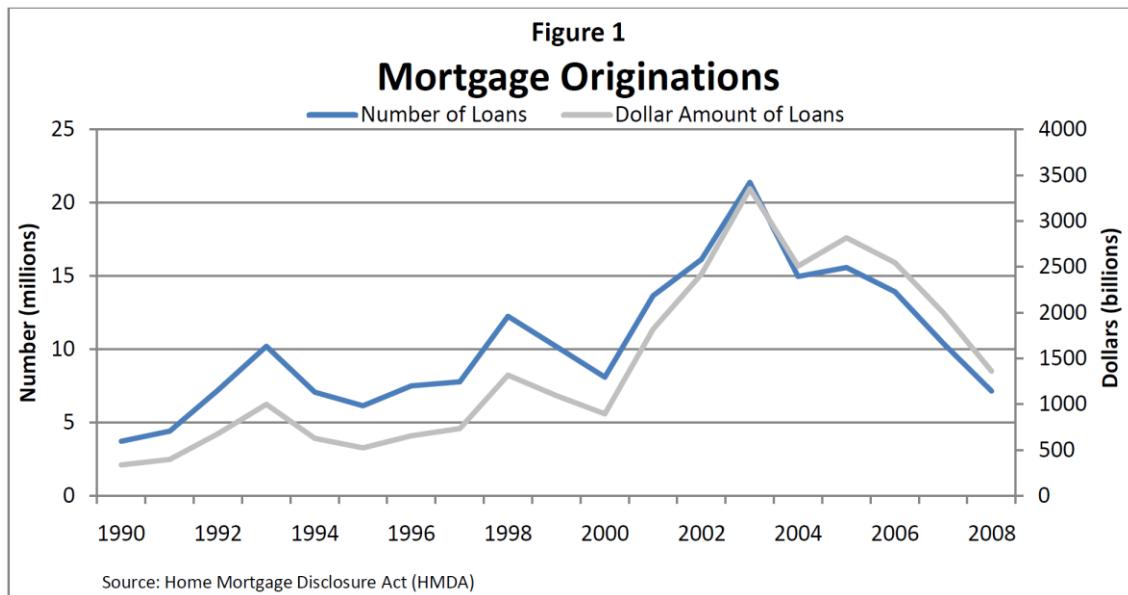
²⁰³ Is this quote correct? The answer could have been: No, because it never happened. Even this is not correct: one could for example extrapolate from known risks.

contained risks, but didn't know their size, we didn't know where the tail started, and didn't know what the tail looked like.»

But you will never know, and need not know. If you think you need to know everything you are not suitable for your function.²⁰⁴ What matters is to know the causal phenomena, and to arrange matters in such a way that innocent people and organizations will not be harmed. If Wellink and the rest of DNB had done their duty, they would have known more than enough. But they simply did nothing.²⁰⁵

Although the CGFS report was mentioned by W.R. White in his hearing by the CDW on 3/2/10, the inquiry commission has done nothing with either the CGFS report or those of the GAO.²⁰⁶

In 2003 the number of mortgages sold reached a maximum. This was partly due to refinancing of existing mortgages. Which in its turn was caused by the relatively low interest rate. The following graphs illustrate the developments. They are copied from pp. 4 and 5 of the FCIC staff study *The Mortgage Crisis*. They also show that the number of new mortgages reached a maximum in 2005.

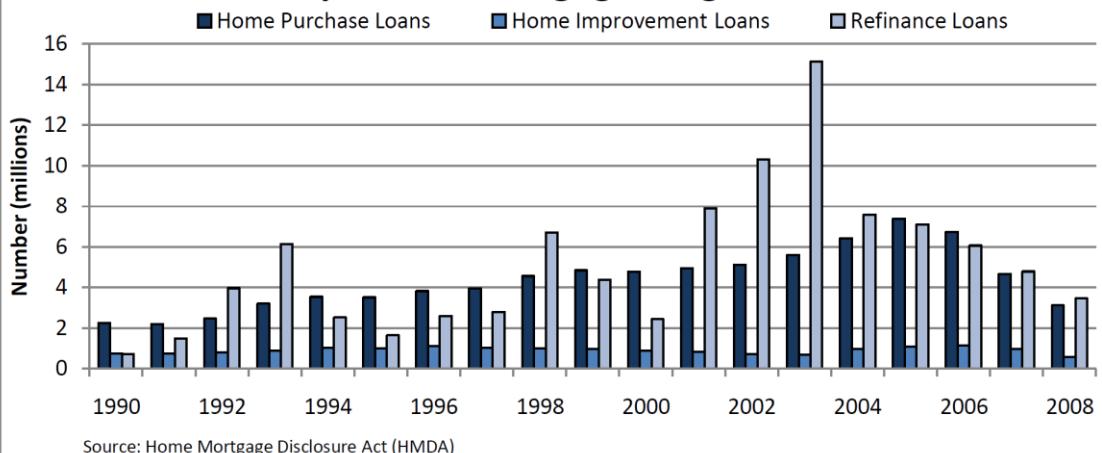


²⁰⁴ The inquiry commission and parliament should have noted this, and drawn the one and only possible conclusion: Wellink must go. By the way, why "only interested in tail risks"? Another reason for dismissal!

²⁰⁵ Actually this applies to all or almost all supervisors. In the first place the US Fed. More on this can be found in Part 2, Analysis.

²⁰⁶ The GAO-report is not mentioned. The GAO is referred to by Muis. He sketches some positive distinguishing characteristics of the Office. The report of the hearing of mr. White can be found in 20100510_Gespreksverslagen Cie De Wit_TK 31980.pdf, in the directory Commission De Wit.

Figure 2
Purpose of Mortgage Originations



As from 2003 the 10K forms of Fanny Mae unambiguously note that the affordable housing goals of HUD can only be realized by reduction of the mortgage requirements, and by taking larger risks. HUD did not react with downward adjustments of the goals, but with increases.

«In order to be able to meet these housing goals, the Charter Act permits Fannie Mae to undertake "activities . . . involving a reasonable economic return that may be less than the return earned on other activities." Accordingly, we may agree to less favorable economic terms or offer other incentives to obtain business that contributes toward meeting our housing goals. Because the housing goals are generally expressed as a percentage of the total number of dwelling units financed during the period, meeting the goals can be more challenging during a time of high refinancing volume, such as 2003 when interest rates remained at historically low levels, because a large portion of the refinance business does not materially contribute to our housing goals. We were able to meet HUD's goals during 2003, but in order to do so we entered into transactions that were meaningful to our own housing goals but had less favorable economic terms and provided other incentives. This practice is consistent with our Charter Act and may be necessary to meet our housing goals. These transactions in 2003 did not, in the aggregate, materially adversely affect our financial performance in 2003.»²⁰⁷

The Annual report 2003 of Freddie Mac points out that the increased affordable housing goals will cause greater risks and a smaller yield:

«On May 3, 2004, HUD published for public notice and comment a proposed rule that would establish higher affordable housing mortgage purchase goals for us and Fannie Mae for calendar years 2005 through 2008. The proposed rule would also establish new subgoals for purchase-money mortgages. On July 16, 2004, we filed comments with HUD on the proposed housing goals.

We believe that the adoption of the rule as proposed, or certain market conditions, could adversely affect our results of operations in future years. See also "BUSINESS- Mortgage Purchase and Guarantee Activity- Credit Guarantee" for more information regarding these factors. If a final rule were to be adopted substantially as proposed, we would take measures to reduce or eliminate material adverse business impacts; however, there could be no assurance that any such measures would be fully successful. At the conclusion of the rulemaking process, HUD may promulgate a final rule that differs from, or is the same as, the proposed rule based upon the comments that it receives, or HUD may withdraw the proposed rule entirely. Consequently, we are unable to predict with certainty the future impact of any final rule on our business operations, financial condition or results of operations.»²⁰⁸

This annual report does not notice that realization of the AH-goals necessitates lowering the mortgage requirements. At least not explicitly.

One may assume that Freddie's comments were in line with the opinions expressed in its annual

²⁰⁷ Form 10-K of Fannie Mae about 2003, p. 15. The form can be found in the directory USA/Fannie.

²⁰⁸ Freddie Mac AR 2003 p. 20/35. The pdf-file of this annual report was created on 21/9/04.

report. HUD ignored them. Though none of the documents in the dossier of this chapter shows any counterarguments.²⁰⁹

The following tables show the decline of the profitability of Fannie and Freddie in 2003-2007. The amounts are in B\$. For the notes please see the original publication.

Fannie Mae²¹⁰

EARNINGS PERFORMANCE:	2003	2004	2005	2006	2007
Net Income (\$)	8.1	5.0	6.3	4.1	-2.1
Net Interest Income (\$)	19.5	18.1	11.5	6.8	4.6
Guarantee Fees (\$)	3.4	3.8	4.0	4.3	5.1
Net Interest Margin (%) ²	2.12	1.86	1.31	0.85	0.57
Average Guarantee Fee (bps) ³	21.9	21.8	22.3	22.2	23.7
Return on Common Equity (%) ⁴	27.6	16.6	19.5	11.3	-8.3
Dividend Payout Ratio (%) ⁵	20.8	42.1	17.2	32.4	N/M

Freddie Mac²¹¹

EARNINGS PERFORMANCE:	2003	2004	2005	2006	2007
Net Income (\$)	4.8	2.9	2.1	2.3	-3.1
Net Interest Income (\$)	9.5	9.1	4.6	3.4	3.1
Guarantee Fees (\$)	1.7	1.4	2.1	2.4	2.6
Net Interest Margin (%) ²	1.27	1.24	0.66	0.47	0.44
Average Guarantee Fee (bps) ³	23.3	17.5	16.6	17.1	16.6
Return on Common Equity (%) ⁴	17.7	9.4	8.1	9.8	-21.0
Dividend Payout Ratio (%) ⁵	15.6	34.9	56.9	63.9	N/M

«By the end of 2003, 58% of all outstanding single family mortgages were less than a year old and each had an appraisal justifying the loan amount based on the latest boom-driven market value.»²¹²

The annual report 2004 of the supervisor OFHEO of the GSEs includes a FREDDIE MAC 2003 SUPERVISORY REPORT OF CONDITION.²¹³ The section *Management* of this report begins as follows:

«OFHEO conducted a special examination of the events leading to the public announcement on June 9, 2003, of the termination, resignation, and retirement of the three principal executive officers of Freddie Mac. The special examination was ordered to supplement an ongoing OFHEO examination of the financial condition of the Enterprise and the decision of Freddie Mac to restate its financial reports for 2000, 2001, and 2002. OFHEO released a report on the special examination detailing a pattern of inappropriate conduct and improper management of earnings that led to the restatement and management restructuring by the company.

Freddie Mac agreed to implement corrective measures and pay a civil money penalty of \$125 million as part of a consent order with OFHEO. The order sets forth specific actions for the Enterprise to implement that relate to:

- The Board of Directors and Senior Management

²⁰⁹ Actually I have never seen any counterargument anywhere. Note of 2019.

²¹⁰ *Mortgage markets and the enterprises in 2007*, original publication July 2008, revised February 2009, FHFA, p. 33/40.

²¹¹ *Mortgage markets and the enterprises in 2007*, original publication July 2008, revised February 2009, FHFA, p. 34/41.

²¹² Pinto p. 148.

²¹³ OFHEO's 2004 annual report concerns 2003.

- Internal Controls
- Internal Audit
- Internal Accounting
- Risk Management Transactions
- Oversight and Reporting

The Board of Directors of Freddie Mac has elected a new chairman and hired a number of senior executives as its new management team.»²¹⁴

At Fannie a special examination is still under way. Its findings will be reported below, under 2005.

2004.

In January Fannie Mae announces the next stage of the T\$ 2 of its American Dream Commitment®:

«Fannie Mae Launches Major Initiative to Tackle America's Toughest Housing Problems; Pledges to Help Raise Minority Homeownership Rate to 55 Percent over Next Ten Years. [...]»

The pledge boosts the company's commitment to President George W. Bush's Minority Home-ownership Initiative and will help raise the minority homeownership rate from 49 percent currently to 55 percent, with the ultimate goal of closing the gaps between minority homeownership rates and non-minority homeownership rates entirely.

Fannie Mae's new commitment to first-time home buyers is part of the next stage of the company's "American Dream Commitment," a plan announced in [the year] 2000 to provide \$2 trillion in private capital for 18 million minority and underserved Americans to own or rent a home by the end of the decade. Having met the \$2 trillion goal and the company's previous Trillion Dollar Commitment launched in 1994, Fannie Mae, along with many others [...] has now provided over \$3 trillion in funds for over 28 million underserved families in 10 years.»²¹⁵

On February 10 the GAO publishes a report *GOVERNMENT SPONSORED ENTERPRISES- A Framework for Strengthening GSE Governance and Oversight*. The following is the second of the two paragraphs of the section *What are the Risks of the GSEs?*

«The GSEs also pose potential risks to the stability of the U.S. financial system. In particular, if Fannie Mae, Freddie Mac, or the FHLBank System were unable to meet their financial obligations, other financial market participants depending on payments from these GSEs, may in turn become unable to meet their financial obligations. This risk, called systemic risk, is often associated with the housing GSEs because of the sheer size of their financial obligations. For example, as discussed in OFHEO's 2003 report on systemic risk, if either Fannie Mae or Freddie Mac were to become insolvent, financial institutions holding the enterprise's MBS could be put into a situation where they could no longer rely on those securities as a ready source of liquidity. Depending on the response of the federal government, the financial health of the banking segment of the financial services industry could decline rapidly, possibly leading to a decline in economic activity. As another example, derivatives counterparties holding contracts with a financially troubled GSE could realize large losses if the GSE were no longer able to meet its obligations. If such a hypothetical event were to occur, widespread defaults could occur in derivatives markets.»²¹⁶

²¹⁴ OFHEO AR 2004 pp. 43-4/49-50.

²¹⁵ Pinto 20100814 p. 137. Pinto doesn't mention a source. The style suggests a press release. The correctness is confirmed by a statement on p. 1 of Fannie's Form 10-K for 2003: «Fannie Mae expands equal housing access and opportunity in America by helping our lender customers reach the nation's underserved families and communities. In 1994, we launched our Trillion Dollar Commitment to provide \$1 trillion in home financing for 10 million families traditionally underserved by mainstream mortgage finance. After achieving that goal ahead of plan, in 2000 Fannie Mae announced a new, redoubled affordable housing plan, our \$2 trillion American Dream Commitment®, to serve 18 million underserved families by 2010. Having met that goal, Fannie Mae announced in January 2004 the next stage of the American Dream Commitment.»

²¹⁶ GOVERNMENT SPONSORED ENTERPRISES- A Framework for Strengthening GSE Governance and Oversight, GAO 2004, p. 6.

In June Basel II was published. Basel II is the agreement of the BCBS about a revised framework for capital measurement and capital standards; “revised” with respect to Basel I. The US Financial Crisis Inquiry Commission (FCIC) says the following about the motives for Basel II, and about its significance:

«Banks had complained for years that the original 1988 Basel standards did not allow them sufficient latitude to base their capital on the riskiness of particular assets. After years of negotiations, international regulators, with strong support from the Fed, introduced the Basel II capital regime in June 2004, which would allow banks to lower their capital charges if they could show they had sophisticated internal models for estimating the riskiness of their assets. While no U.S. bank fully implemented the more sophisticated approaches that it allowed, Basel II reflected and reinforced the supervisors’ risk-focused approach. Spillenkothen [the Fed’s director of Banking Supervision and Regulation from 2002 to 2006] said that one of the regulators’ biggest mistakes was their “acceptance of Basel II premises,” which he described as displaying “an excessive faith in internal bank risk models, an infatuation with the specious accuracy of complex quantitative risk measurement techniques, and a willingness (at least in the early days of Basel II) to tolerate a reduction in regulatory capital in return for the prospect of better risk management and greater risk-sensitivity.”»²¹⁷

The Wikipedia page about Basel II asserts that the positive effect of Basel II is controversial. An OECD study from 2011 suggest that the principal effect of agreements like Basel II is that financial institutions start looking for gaps and alternatives (that is: ways of escape).²¹⁸ The facts clearly show that Basel II was insufficient.

«By 2004, Fannie and Freddie were sufficiently in need of subprime loans to meet the AH goals that their CEOs, as the following account shows, went to a meeting of mortgage bankers to ask for more subprime loan production:

The top executives of Freddie Mac and Fannie Mae [Richard Syron and Franklin Raines] made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders. ...Fannie Mae Chairman and [CEO] Franklin Raines told mortgage bankers in San Francisco that his company’s lender-customers ‘need to learn the best from the subprime market and bring the best from the prime market into [the subprime market].’ He offered praise for nonprime lenders that, he said, ‘are some of the best marketers in financial services.’ ... ‘We have to push products and opportunities to people who have lesser credit quality,’ he said.»²¹⁹

The following quote from an internal mail of Freddie Mac of 6/10/04 clearly shows the volume and significance of Alt-A MBS:

«The Alt-A business makes a contribution to our HUD goals. This year [2004] the Alt-A bulk [whole loan] transactions contribute 2 basis points towards achieving our Low/Mod goals, 5 basis points to our Special/ Affordable goals, and 40 basis points to our underserved GSE goals. During 2003, the Alt-A bulk business contributed 10 basis points to our Low/Mod and Special/Affordable goals. However, the NINA [no income/no assets] business by themselves have a negative impact to goals due to the fact that borrower income is not disclosed.»²²⁰

«Acting under authority of the 1992 Act, HUD issued an affordable housing goal regulation in 2004 that for the first time added subgoals and required that a fraction of each goal be met with home-purchase mortgages, as distinguished from refinancings. The 1992 Act calls on HUD to consider a number of factors in setting the goals, including "the need to maintain the sound financial condition of

²¹⁷ FCIC report p. 171/99.

²¹⁸ The file with the paper can be found in the directory OECD. The filename is: 20120217_Systemically Important Banks and Capital Regulations Challenges_Slovik_OECD.

²¹⁹ FCIC Wallison report p. 499/527 quotes from Neil Morse, “Looking for New Customers,” *Mortgage Banking*, December 1, 2004. The rectangular brackets are from the original.

²²⁰ Pinto p. 120, 2002-A. The rectangular brackets are copied from Pinto. As his source Pinto mentions: internal Freddie Mac email from Mike May to [CEO, JvV] Dick Syron, dated October 6, 2004 FMAC0013695 (contained in materials disclosed to the House Oversight and Government Reform Committee). See pp. 18 and 19 of *GSEs and the financial crisis* for numbers for 2004-2008, and a picture of the proportions.

the enterprises."»²²¹

On 1/11/04 HUD issues a press release about higher housing goals for the GSEs for the coming years:

«These new affordable housing goals will help the GSEs achieve the standard that Congress intended- leading the mortgage finance industry in helping low- and moderate income families afford decent housing," said HUD Secretary Alphonso Jackson. "These new goals will push the GSEs to genuinely lead the market.»²²²

In the document with the "Final Rule" one reads:

«Millions of Americans with less than perfect credit or who cannot meet some of the tougher underwriting requirements of the prime market for reasons such as inadequate income documentation, limited downpayment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allow, rely on subprime lenders for access to mortgage financing. If the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that greater stability and standardization create.»²²³

The leadership-terminology is not incidental:

«While the GSEs can choose any strategy for leading the market, this leadership role can likely be accomplished by building on the many initiatives and programs that the enterprises have already started, including [follow 6 methods]»²²⁴

In 2004 Freddie Mac concluded, apparently in agreement with HUD,²²⁵ that the new goals could only be realized if the mortgage requirements were lowered:

«We are making significant efforts to meet the new goals and subgoals through adjustments to our mortgage sourcing and purchase strategies, including changes to our underwriting guidelines and expanded and targeted initiatives to reach underserved populations. Our strategies to meet the new goals and subgoals may result in the purchase of loans that offer lower expected returns on our investment and are likely to increase our exposure to potential credit losses. Increasing the concentration of our purchases of goal-eligible loans also may require us to forego other purchase opportunities that we would expect to be more profitable. If our current efforts to meet the new goals and subgoals prove to be insufficient, we may need to take additional steps that could lead to a significant reduction of service to portions of the conventional conforming mortgage market, and also a reduction in our profitability.»²²⁶

«Total CRA commitment volume for the year 2004 was \$1.631 trillion.»²²⁷

2005.

In March the report of The Joint Forum [on] Credit Risk Transfer of BCBS is published. It was written by a working group consisting of representatives of supervisors. Such as the Fed, NYFed, SEC, OCC, FDIC²²⁸ and DNB. The 17 recommendations, some consisting of two parts, can be

²²¹ FCIC staff study *GSEs and the financial crisis* p. 6.

²²² Pinto 2004-B op pp. 128-9.

²²³ Pinto 2004-B op pp. 128-9.

²²⁴ HUD's Final Rule, quoted on p. 133 of Pinto, in 2004-B. The leadership terminology is noteworthy because the FCIC asserted in 2011 that Wall Street was leading, and not the GSEs. No wonder that FCIC didn't prove its assertion.

²²⁵ This may be assumed because Freddie had communicated its problem to HUD through its comment on the HUD proposals for higher AH-goals, and the fact that HUD didn't adjust its proposals. Because of the text of the annual reports of Freddie en various HUD-quotes in the reports of Wallison and Pinto it is not plausible that HUD reacted to Freddie's comment with an alternative for lower mortgage requirements. On the contrary: the quotes suggest that lowering of mortgage requirements was precisely what HUD wanted.

²²⁶ Freddie Mac Annual report 2004 p. 11/23. (The pdf-file of the report is dated 13/6/05).

²²⁷ NCRC AR 2007, quoted by Pinto on p. 91, in 1998-B. For a table with CRA-commitments per institution until (& including) 1998 and as from 1999 see Pinto pp. 98-9.

²²⁸ FDIC= federal deposit insurance corporation.

interpreted as just as many risks and warnings. The first 13 are addressed to market participants, the last 4 to supervisors:

«Recommendation 14: Aggregate information

The efforts of the Committee on the Global Financial System to develop mechanisms that better identify aggregate information on credit risk should be strongly supported by supervisory authorities and market participants.

Recommendation 15: Supervisory Efforts

Supervisory authorities should undertake the steps necessary to enhance their understanding of evolving market developments in relation to CRT transactions. This includes the need to attract and retain qualified staff and to implement procedures, such as training programs, to improve staff knowledge and understanding on an ongoing basis. Supervisors would benefit from periodic discussions with market participants regarding developments in this area.

Recommendation 16: Supervisory and Regulatory Review

Supervisory authorities should periodically review regulations, supervisory guidance and reporting mechanisms that are pertinent to CRT transactions. In many cases, supervisory guidance and regulations applicable to OTC derivatives are not tailored specifically to credit derivatives transactions. While in many cases this is appropriate, there may be circumstances where the regulations, supervisory guidance or reporting mechanisms need to be adapted to some extent to better fulfill their specific objectives. Supervisors should undertake efforts to understand thoroughly the accounting treatment of CRT transactions and their implications, while also seeking to provide knowledgeable input into the development of appropriate accounting standards for CRT transactions.

Recommendation 17: Supervisory Information Sharing

Supervisory authorities should continue efforts to share information on CRT activities with the objectives of strengthening their mutual understanding of developments, promoting further improvements in risk management practices by market participants, and enhancing supervisory and regulatory approaches. In particular, supervisory authorities should share information on the regulatory approaches adopted in such areas as minimum capital and securitization to better understand the potential interactions between the different approaches and the incentives that these interactions could create for market participants.»²²⁹

In a report *Recent House Price Trends and Homeownership Affordability* of May 2005 HUD remarks:

«More liberal mortgage financing has contributed to the increase in demand for housing. During the 1990s, lenders have been encouraged by HUD and banking regulators to increase lending to low-income and minority households.²³⁰ The Community Reinvestment Act (CRA), Home Mortgage Disclosure Act (HMDA), government-sponsored enterprises (GSE) housing goals and fair lending laws have strongly encouraged mortgage brokers and lenders to market to low-income and minority borrowers. Sometimes these borrowers are higher risk, with blemished credit histories and high debt or simply little savings for a down payment.»²³¹

About the role of appraisals Pinto notes the following:

«To the extent appraisals have been considered at all, their contribution to the financial crisis has focused on fraud. The facts are much more nuanced and significant, with the major shortcoming being that the U.S. appraisal process was simply not up to the challenges of a housing boom fed by ever increasing leverage. The Collateral Risk Network, representing many of the largest financial institutions in the United States, pointed out in a white paper entitled “Reengineering the Appraisal Process”:

²²⁹ Basel Committee on Banking Supervision, Joint Forum Credit Risk Transfer, March 2005, pp. 9-10/15-6.

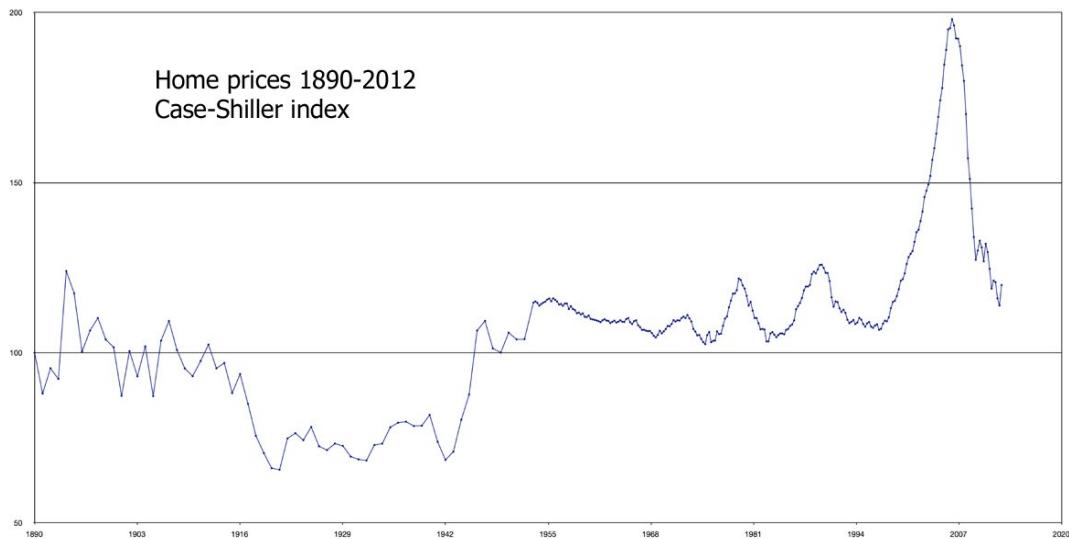
²³⁰ Note the “and bank regulators”, meaning supervisors.

²³¹ Pinto p. 156. Note the euphemism “More liberal mortgage financing”.

"[Appraisers] did help create fictitious equity and were complicit in facilitating trillions of dollars of loans that never should have been made. There are varying degrees of valuation inflation performed by appraisers. On the lighter side, there was just the grey area where appraisers hit the highest possible value as opposed to the most probable value. On the dark side, there was blatant fraud. And then, somewhere in the mix, was the failure to recognize an overheated market and report trends and risk to their clients... If we had credibly valued the underlying collateral, I would submit that there would be an active MBS market."»²³²

In Appendix D Pinto presents «a detailed description on how appraisal methods developed over the last 20 years by Fannie, Freddie, and regulators became less rigorous and resulted in property appraisers failing to recognize an overheated market and report trends and risks to their clients.»

On p. 149 Pinto gives a list of 25 «pro-cyclical/pro-leverage elements that helped drive the boom in home prices and housing finance».



«[...] some academics offered pointed analyses as they raised alarms. For example, in August 2005, the Yale professor Robert Shiller, who along with Karl Case developed the Case-Shiller Index, charted home prices to illustrate how precipitously they had climbed and how distorted the market appeared in historical terms. Shiller warned that the housing bubble would likely burst.»²³³

In continuation of the Special Examination of Freddie mentioned earlier, OFHEO in 2005 conducted a similar inquiry of Fannie. It published a separate report about the results.²³⁴ The “Letter of transmittal” to Congress in the Annual report 2006 (about 2005) gives the following summary:

«Although the Special Examination Report was not published until May 23, 2006, much of the work was done in 2005. The report concludes that Fannie Mae senior management presented an image of the Enterprise as one of the lowest-risk financial institutions in the world and as “best-in-class” in terms of risk management, financial reporting internal controls and corporate governance. The reality was that the image presented was false. The risks at Fannie Mae were greatly understated and senior management manipulated accounting and earnings. Fannie Mae also signed settlement agreements on May 23, 2006 with OFHEO and the SEC that include a \$400 million fine, growth limits and top-to-bottom remedial actions to enhance the safe and sound operation of the Enterprise going forward.

The annual examinations of both Enterprises state that progress was made in 2005, but that further work and several years are needed to fully achieve safe and sound practices. Although the Enterprises

²³² Pinto p. 148. The internal quote is from Joan N. Trice, Collateral Risk Network, “Reengineering the Appraisal Process”, 2009. Pinto mentions the website.

²³³ FCIC report p. 17/45. The years mentioned below the figure are: 1890, 1903,... 2007, 2020. In other words: the interval between the numbers given is 13 years. For more information about the Case-Shiller index see the Wiki-page with the same name in the directory Statistics.

²³⁴ Which the author could not find on the internet.

have differences, the key areas that need significant remedial attention are similar: accounting systems, internal controls, risk management, human resources, corporate governance and growth.

Due to the findings of operational inadequacies at both Fannie Mae and Freddie Mac, OFHEO required each Enterprise to hold 30 percent more capital than its minimum requirement. Capital levels are monitored weekly at both Enterprises by OFHEO's examination teams.»

2006.

«In January 2006, trading commenced in ABX.HE, an index of CDS on asset-backed securities collateralized by subprime home equity loans. The index comprises five sub-indexes created by pooling like-rated tranches with ratings of AAA, AA, A, BBB, and BBB-. Sixteen dealers participate in the CDSIndexCo consortium and vote every six months on the 20 single-names that are aggregated into each vintage of the index. These dealers also supply daily pricing to Markit, the administrator for this and other credit indices. The index notional amount adjusts as any of the reference entities amortize, prepay, default or incur write-downs or write-ups. [...]»

The ABX was an important innovation for investors who wanted a direct, relatively liquid way to take a short position in mortgage credit. Prior to the launch of the ABX in early 2006, investors who wanted to go short had to find dealers willing to sell them protection via ABCDS²³⁵, an illiquid market at that time.»²³⁶

Due to decreasing interest rates and increasing demand, international²³⁷ home prices had been increasing monotonously for about ten years.²³⁸ In 2006-2008 this development came to an end. The US led the way. US home prices reached a maximum in April 2006.²³⁹ Around this time, the interest rates on mortgages had increased from 6 to 7 %, or fluctuated between these values.²⁴⁰

²³⁵ ABCDS = asset backed credit default swap, a security. See p. 10 of the FCIC-staff study *Credit derivatives and mortgage-related credit derivatives*.

²³⁶ P. 13 of the FCIC-staff study *Credit derivatives and mortgage-related credit derivatives*. For some more explanation and graphs see below, at the transition 2006-2007.

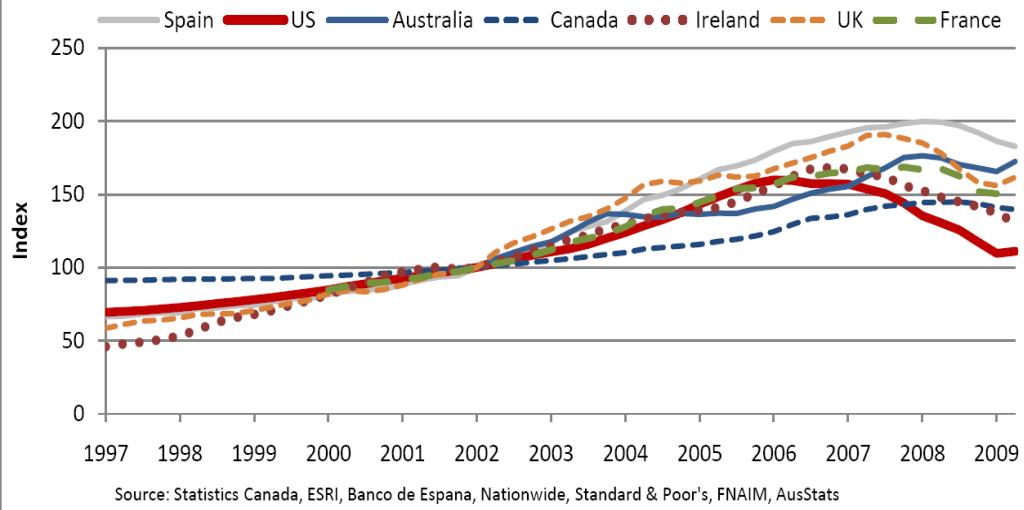
²³⁷ Figure 9 on p. 17 of the FCIC-staff study *The Mortgage crisis*. For time series starting with 1991 see FCIC document *Selected financial market & economic data* p. 8. The years 1991-1997 show a very small increase of the prices. In other words: the annual increase increases increased monotonously from 1991-2005.

²³⁸ Monotonous increase= increasing without (significant) interruption. In different time periods the increase may differ and even be zero, but it is never significantly less than zero. Similarly “monotonous decrease”.

²³⁹ FCIC report p. 87/115 and staff study *The Mortgage Crisis* p.18. For the OECD countries see table 59 on p. 293 of the statistical annex of the *Economic Outlook 2012-1* (and the corresponding table in other editions of the half yearly *Economic Outlook*).

²⁴⁰ This may be relevant information, but is mainly noted for completeness. The significance of the details of the development of the interest rate may be limited. It is clear that they cannot explain the increasing delinquency to be mentioned below.

Figure 9
International Home Prices



As long as the mortgage rate decreased and home prices increased, the consequences of inability to pay interest and amortization were relatively small. If necessary, the debt could be paid by sale of the home. If home prices decrease, sale may saddle the homeowner with a net debt.

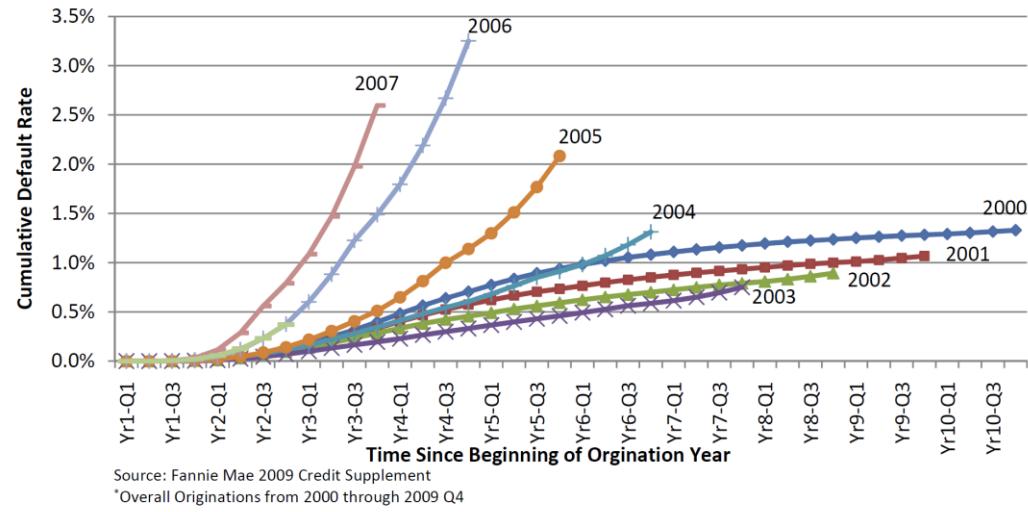
The consequences of changes in interest and/or home prices depend on the ability to bear the risks taken. In the US the risks had been underestimated relatively strongly. Especially in the years 2004-2007.

Figure 12 on p. 17 of the FCIC staff study *GSEs and the financial crisis* shows the cumulative default rate for Fannie Mae.²⁴¹ The figure is copied below. For every year of mortgage originations a line has been drawn. Figure 11.2 on p. 217/245 of the FCIC report additionally shows the difference in performance of prime, Alt A and subprime mortgages. For this graph the reader is referred to the appendix Graphs.

The figure below shows that the quality of the mortgages sold in 2000-2003 improved slowly, to drop fast from 2004 to 2007. The quality was best in 2003. In 2004 it was already worse than in each of the years since 2000. In 2008 it was back at the level of 2006.

²⁴¹ A similar graph for Freddie can be found on p. 12 of the paper *The Role of the GSEs and Housing Policy in the Financial Crisis* by D.M. Jaffee for the FCIC. The file can be found in the directory FCIC/Studies under 20100225. A similar graph can be found in CDW1: figure 3.4 on p. 46/42. This graph also shows the difference in performance of prime, Alt A and subprime.

Figure 12
Fannie Mae Single-Family Cumulative Default Rate*



In 2006 the number of people that couldn't pay the costs of their mortgage in time started to increase rather dramatically. As a consequence, the supply of houses increased, and home prices decreased further. Hampering solution of mortgage problems.²⁴² Another consequence was the devaluation of MBS.

The documentation does not show exactly when people began to think that this was not a temporary fluctuation, but a turning point, and the beginning of a slide or avalanche. Graphs like those shown here were made years after the events, and not available at the time.

It is no more than logical that it took time to see that an era had ended. Initially, what people saw could turn out to be temporary. Fluctuations, ups and downs, are normal. After a relatively short time, the old, well known trend could have been resumed. It takes time to show that times have changed for a longer time. It was clear that home prices couldn't rise indefinitely. But it was completely unclear when prices would start to fall.²⁴³

What can be observed is that at the end of 2006 and the beginning of 2007 more and more financial institutions became aware of the fact that risks are more than figments of the mind. They can be realized. The institutions became more careful with securities which depended directly or indirectly on mortgages. As a consequence the value of these securities decreased. Fearing further loss of value, more pessimistic institutions started to try and get rid of especially subprime securities, or to "insure" themselves with CDS.²⁴⁴ In efforts to sell "poisoned" securities,²⁴⁵ use was sometimes made of lack of know how on the side of the prospective buyer.²⁴⁶

According to the FCIC: «High leverage, inadequate capital, and short-term funding made many financial institutions extraordinarily vulnerable to the downturn in the market in 2007.»²⁴⁷

HUD continued its affordable housing policy as if business was as usual. And as if the implicit

²⁴² The system was and is not stable but unstable. A relatively small disturbance at least of certain types is not corrected but amplified. This is logical, and should have been known to regulators and supervisors (because of their legal duties, and because of their pretensions).

²⁴³ As far as known to the author. Perhaps the decline in sales of mortgages caused the stagnation of the price development. And the decline in sales may have been caused by the incomes in combination with interest developments. As noted earlier, market saturation may also have played a role. And it is evident that the HUD goals could not rise indefinitely either without causing something to break or burst.

²⁴⁴ FCIC report p. 234/262.

²⁴⁵ That is: securities including subprime mortgages or dependent products.

²⁴⁶ See sections 12.1 (pp. 235/263 and following) and 13.1 (pp. 246/274 a.f.) of the FCIC-report.

²⁴⁷ FCIC report p. 230/258.

warnings of the GSEs could be ignored. This while the market developments at least suggested that the remarks and warnings of the GSEs were justified. To give an example of these remarks and warnings I give two quotes from the Annual report 2006 of Freddie Mac.²⁴⁸ The first is from p. 6²⁴⁹, from the beginning of the section *Serving Our Mission* in the “Message from the Chairman” and CEO Richard F. Styron:

«As a government-sponsored enterprise (GSE), Freddie Mac faced mounting mission challenges in 2006: reduced affordability, rising concerns about credit quality and predatory lending, a housing sector losing momentum, and HUD affordable housing goals of unprecedented difficulty. Despite these challenges, we served our mission well- providing liquidity, affordability and stability to the housing finance market, and to a broader economy hoping to see a “soft landing” for housing.

I am proud that Freddie Mac’s affordable performance in 2006 was among our strongest ever. We believe we met the most demanding affordable housing goals in the company’s history, pending determination by the U.S. Department of Housing and Urban Development. Of the nearly 3.3 million homes we financed last year, almost 56 percent were affordable to low- or moderate-income families. We served 300,000 first-time homebuyers. And in another record year for our growing multifamily business, we financed almost half a million affordable apartment homes.

We also believe we achieved two of our three subgoals, although we reported to HUD that we just missed one of the extremely challenging subgoals by less than 700 loans out of more than 900,000 eligible mortgage purchases. The difficulty of this challenge was magnified by market forces affecting the entire housing sector that made the average home less affordable in 2006. It also highlighted the GSEs’ need to strike a balance between striving to achieve demanding housing goals and ensuring that we do not encourage imprudent lending.»

The second is from p. 13/25, from the section **Legal and regulatory risks**:

«We are making certain changes to our business to meet HUD’s housing goals and subgoals, which may adversely affect our profitability.

We are making significant adjustments to our mortgage sourcing and purchase strategies in an effort to meet our housing goals and subgoals, including changes to our underwriting guidelines and the expanded use of targeted initiatives to reach underserved populations. For example, we are purchasing loans and mortgage-related securities that offer lower expected returns on our investment and increase our exposure to credit losses. In addition, in order to meet future housing goals and subgoals, our purchases of goal-eligible loans need to increase as a percentage of total new mortgage purchases, which is causing us to forego other purchase opportunities that we would expect to be more profitable. If our current efforts to meet the goals and subgoals prove to be insufficient, we may need to take additional steps that could lead to a further reduction of service to portions of the conventional conforming mortgage market, and also a reduction in our profitability. In fact, for 2006, we reported to HUD that we did not meet one of the three home purchase subgoals.»

Every year OFHEO sent a report to Congress, mostly in June. The “Report to Congress 2007” concerns 2006. It states that OFHEO has the following three strategic goals:²⁵⁰

1. «Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements;
2. Provide support for statutory reforms to strengthen our regulatory powers; and
3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.»

It does not remark that the goals 1 and 3 may be inconsistent, and actually are.

The report calls attention to defects in the operation of the GSEs. The central paragraph in the press release²⁵¹ about the publication of the report is the following:

«The report concludes that both Enterprises “remain a significant supervisory concern.”

“While both Enterprises made progress in correcting their problems, especially in systems, controls and financial reporting, it has taken much more time and money to correct than the GSEs or OFHEO

²⁴⁸ For similar remarks in Fannie’s AR see the appendix Fannie or the original AR in the directory USA/Fannie.

²⁴⁹ Of the pdf-file of 3/5/07. The pages of the Message are not numbered.

²⁵⁰ On p. 4 of the pdf-file under 20071031.

²⁵¹ At the beginning of the file with the report.

expected,” said [Director] Lockhart. “A key indicator of a successful remediation will be the timely filing of annual and quarterly financial statements by each company with a clean audit opinion based on a controls-based audit. I am pleased to report that both companies are working hard to achieve this goal, but they still have much to do.”»

The defects mentioned by OFHEO do not seem to be directly (!) connected with the problems the GSEs would run into later on. And the risks they have to take to realize the affordable housing goals of HUD are not mentioned.²⁵² Even though the report has a section *Asset Quality and Credit Risk Management*.²⁵³ In this section one reads:

«Asset quality is strong due to a book of business that is mostly comprised of traditional mortgage products. Delinquencies remain low and manageable, with the serious delinquency rate at about 0.61 percent of the book and losses at about 0.016 percent. Losses due to Hurricane Katrina were low and less than originally estimated. Higher-risk products such as interest-only, sub-prime, Alt-A and negative amortization loans are growing, but are currently about 20 percent of the book of business. New initiatives target product growth in some higher-risk products.»²⁵⁴

The motivation of these new initiatives is not mentioned. Neither are HUD and the “mounting mission challenges” of the annual reports of the GSEs.

In the opinion of OFHEO, the GSEs had enough capital. See the sections *Capital* of the “Report[s] of Annual Examination” of Fannie and Freddie on pp. 29 and 43 of the AR 2006.

For 2007, the low and moderate income goal, and the special affordable goal were two percent points higher than for 2006.²⁵⁵

HUD, the GSEs and OFHEO must have had regular conferences. There must be minutes of these conferences. There is no indication that they were among the “millions of pages” reviewed by the FCIC.²⁵⁶

The volume of the securitized mortgages on the balance sheet of Dutch SPVs increased more or less monotonously from practically 0 in the year 2000 to 160 B€ in 2009.²⁵⁷

A cause may be called “active” if a phenomenon would not have occurred but for activities. Activities which for this reason are called the cause(s). Man-made disasters may have active causes. But in regulated societies there can also be passive causes, or causes by omission: people or organizations who have duties, but fail to fulfill them, and by their failure allow things to happen which would not have happened if they had acted appropriately.²⁵⁸ In the case of the financial crises, governments and supervisors had duties to ensure compliance with regulations, the safe functioning of the financial system, and the general welfare. But they remained passive. They did not do what they could and should have done. They thereby allowed the development of situations which included possibilities and risks which, if realized, could run out of control and cause immeasurable suffering and damage.

The main reason for supervision is to enable economic activities which are supposedly beneficial for the general welfare, but would supposedly not take place if normal liability would be applicable. Because the possibility of abuse of freedom is evident, the activities are allowed only conditionally. The conditions are supposed to ensure that no harm is done to outsiders. Supervision has been called

²⁵² OFHEO is an agency within HUD... (Wikipedia OFHEO 16/5/12).

²⁵³ Pp. 23 and following.

²⁵⁴ Yes indeed, sub-prime. As a reminder of the fact that this concept was not as well known in 2007 as it became through the crisis. The pdf-file was made on 6/4/07, and revised 31/10/07.

²⁵⁵ FCIC report p. 510/538. For a graph see above, under 1992.

²⁵⁶ FCIC report, at the bottom of p. xi/11.

²⁵⁷ See graph 5.8 on p. 72/68 of CDW1.

²⁵⁸ In the juridical literature this is called sine qua non causation. See *PwC must pay FDIC \$625.3 million over bank's collapse: U.S. judge*, for a report about a financial crisis case where the judge found the probability of this kind of causation more than 50%. The report can be found in the directory Liability under 20180702.

into being to make sure that those responsible for risky activities comply with the conditions and/or norms. Together the conditions and supervision more or less replace liability.²⁵⁹

In general active causes can be seen. More or less by definition. Passive causes on the other hand are easily overlooked. (And up to now most often are). Absence of something can only be noted when it is realized that there could or should have been something. A passive cause can be established when it is noted that preventive action could and should have been taken, but wasn't. In the case of the financial crisis it is even worse. The governments and supervisors not only failed to do what they could and should have done. They did act: they pretended to understand the financial system and the situation, and claimed that the system was safe and sound. They were actively keeping the public asleep, and financial institutions misinformed.

To show this I give some quotes from annual reports of important supervisors. The inaction of governments seems to be practically complete, with the tell-tale exception of a repressive action against CFTC and Born in 1999.

The quotes are taken from the annual reports about 2006. The year 2006 is chosen because even the annual reports about that year were written before the crisis became a crisis. In other words: at a time when the crisis had not yet materialized, and the supervisors could still show their true worth.

I begin with the most important supervisor/ regulator: the US Fed.²⁶⁰ On p. 5 of its Annual report 2006, the Fed gives an *Overview of the Federal Reserve*. It begins as follows:

- «As the nation's central bank, the Federal Reserve System has numerous, varied responsibilities:
- a. conducting the nation's monetary policy by influencing monetary and credit conditions in the economy;
 - b. supervising and regulating banking institutions, to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers;
 - c. maintaining the stability of the financial system and containing systemic risk that may arise in financial markets;
 - d. providing financial services to depository institutions, the U.S. government, and foreign official institutions.»²⁶¹

So “maintaining the stability of the financial system and containing systemic risk that may arise in financial markets” is one of the four duties of the Fed. Nevertheless, nothing can be found in the annual report about what the Fed has done about systemic risks.²⁶²

The annual report contains a section *Economic Projections for 2007 and 2008*. The following paragraph gives a handy summary:

«In conjunction with the FOMC²⁶³ meeting in January, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2007 and 2008. The projections indicate that the participants expect sustainable expansion of real economic activity during the next two years, assuming an appropriate course for monetary policy. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 2,5 percent to 3 percent over the four quarters of 2007 and 2,75 percent to 3 percent over the four quarters of 2008. The central tendency of their forecasts for the civilian unemployment rate is 4,5 percent to 4,75 percent in the fourth quarter both of this year and of 2008. [...] The economy is projected to expand at a moderate rate. Although the cooling of the housing market continues to damp economic activity, the drag on economic growth from declining construction

²⁵⁹ This is discussed more fully in the Analysis.

²⁶⁰ According to Fed AR 2006 p. 5 in 2006 the Fed had about 1850 employees. According to *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005, p. 4 the number was about 1400 in 2004.

²⁶¹ The original points have been replaced by a-d for ease of reference.

²⁶² Consistent with the (theoretically correct, but practically nonsensical and falsified) hypothesis that the system is safe as a system if the institutions are safe as institutions. Theoretically correct: namely if safe is a matter of either yes or no, or of either 100% or 0%. Which is nonsense. The Fed and all other supervisors moreover should have known that the risk management of most financial institutions was inadequate, and a danger for the safety of the system. More on this can be found in the Analysis.

²⁶³ FOMC= Federal Open Market Committee.

activity is expected to diminish later this year.»²⁶⁴

The other supervisors are now considered in alphabetical order.

DNB, Annual report 2006.²⁶⁵ DNB describes its mission as follows:

«DNB upholds “financial stability” and thereby actively contributes to the welfare of the Netherlands. For this purpose:

1. it dedicates itself together with other central banks to stable purchasing power of the euro (“monetary policy and implementation”);
2. it strives after smooth, reliable and efficient operation of the payment system;
3. it makes sure that financial institutions have enough capital to fulfill their obligations and are managed competently and with integrity (“prudential supervision”);
4. contributes to good national and international decision making by advising in the fields mentioned.»²⁶⁶

The annual reports of DNB do not have a summary but an overview. The Overview of AR 2006 has a section Risks. It contains the following paragraph:

«Asset prices, on securities and house markets, run the risk of shooting through. Low interest rates and insufficient risk awareness can cause too easy acceptance of financial risks and debts, by both households and investors. Subsequently, a sudden reversal of sentiment can have serious repercussions for financial markets and the real economy. Such a reversal could be caused by evaporation of trust in the dollar. Though this is not a new phenomenon, the risk for the world financial system is increasing every year, due to the long term deficit of the current account of the American balance of payments. To get a better feeling for the location of the risks, for their seriousness, and for possible remedies, stress tests are increasingly done both internationally and by DNB.»²⁶⁷

The analysis shows very incomplete and defective understanding. The action taken is utterly inadequate to manage the risks and their consequences. The stress tests are not described. For this reason, and because DNB’s understanding is at best only partial, it is not clear whether the tests cover all relevant risks. Note that DNB mentions the trade imbalance of the USA, but not the government debts. Even though DNB calls these debts “untenable” farther on in this AR. It does not do so in the section “Budget development” of the Overview, which only considers the budget deficit. Debt is discussed in section 3.3 “Government finances”:

«In spite of improvement of the budget situation further budget consolidation is required, because Dutch government finances move along an untenable path. In its study about the aging of the population of 2006 the Central Planning Office shows that demographic trends, increasing costs of care, and exhaustion of the natural gas reserves will negatively affect the EMU balance, and that, if nothing is done, the government debt will grow to untenable levels.»²⁶⁸

Why this is untenable, and what will happen if nothing is done about it, is not explained. In the Overview the debt or its growth is not mentioned as a risk. It is not mentioned in connection with other states: USA, Japan, Greece, etcetera.

The Overview concludes as follows:

«Globalization has once more put its stamp on growth and inflation in the world. But it has also affected other sectors, such as the representation in international financial institutions and fora, supervision, and the payment system. Consequences of globalization were clearly visible in the financial markets, and in the behavior of the actors in these markets, who developed innovative products on an unprecedented scale. This has made markets and institutions much more efficient, but some developments nevertheless cause anxiety. For example the ample liquidity proportions, the

²⁶⁴ Fed AR 2006 pp. 6-7/14-5. Note that only “an appropriate course for monetary policy” is mentioned as a condition for a rosy 2007 and 2008.

²⁶⁵ More information about DNB is given in the DNB appendix. In 2009 the staff of DNB was 1556 full time equivalent (equivalent to 1556 full time jobs).

²⁶⁶ DNB AR 2006 p. 133-4/131-2. On p. 125 of AR 2007 DNB calls this its mission.

²⁶⁷ DNB AR 2006 p. 19/17. N.B. The “serious repercussions” are not caused by insufficient risk awareness, but by the market mechanism of price “discovery”.

²⁶⁸ DNB AR 2006 p. 66/64

increasing debt ratio's, the low long term interest rate, and the low risk premiums. These phenomena increase the vulnerability of the financial system. Due to these circumstances monetary policy has not become simpler.

All in all 2006 was a good year. But because of many vulnerabilities and uncertainties there is no ground for euphoria and simple extrapolation of present developments.»²⁶⁹

Please don't forget that this is DNB's annual report. It is nice that it reflects upon developments. But in the first place it should report about how DNB has fulfilled its mission (duty). That is: what it has done to ensure de stability of the financial system.

The following is quoted from one of the most intriguing sections of the report:

«4.1.2. Regauging supervision strategy: more risk orientation and integrity.

Because of recent developments in the financial world and the fusion with the Pension and Insurance Chamber in 2004 DNB had regauged its supervision strategy. The new strategy lays more stress on risk orientation, integrity supervision and openness. [...]»²⁷⁰

Supervision is more emphatically applied in places with the greatest risk. Supervision is systematically coupled to the risk profile of the institutions under supervision. This requires a sharp actual picture of the risks and flexible use of the supervision capacity. In practice this means that the involvement of the supervisor is inversely proportional to the extent to which institutions have their financial and organizational matters in order. The actual risk situation of the institution determines the way DNB communicates with an institution or makes an inquiry.

Integrity supervision gets more emphasis as well. Important elements are reliability tests of policy makers and self assessments, in which institutions are asked to compare their compliance structure with a compliance standard. New furthermore is the selection of relevant themes as spearheads in supervision and communication. The themes are chosen on the basis of a risk analysis which transcends the institutions.»²⁷¹

Note that risk orientation as described requires quite a bit of prior knowledge and evaluation, and therefore adds a risk of unknown size. Salaries and bonuses are not mentioned and discussed in this annual report. As if the remuneration of employees of financial institutions is compatible with integrity. The (in)significance of the integrity paragraph is shown in for example the DSB failure (due to widespread false pretensions) and the appointments for the board of the largest Dutch pension fund, ABP.^{272, 273}

The so-called Corrigan report, *Toward Greater Financial Stability: A Private Sector Perspective* of 27/7/05,²⁷⁴ analyses parts of the financial system. The analyses are used to formulate recommendations aimed at improving the stability of the financial system. The report calls attention to numerous weak spots. It shows many new risks which are only partially known or understood. In fact, the report may give rise to the suspicion that we are living on a volcano.²⁷⁵ The report is written by the financial sector itself, and the recommendations are mostly directed at financial institutions. It asks relatively little of supervisors. But because of the risks it shows it requires a reaction and actions from anyone who is responsible for the stability of the system. In particular the supervisors. The report is mentioned in DNB AR 2005. It is not discussed, and no reaction is given. DNB AR 2006 states that DNB monitors the follow up. Findings are not mentioned and evaluated, and nothing is said about the sequel. Even though there is at least one significant information gap:

«The limited information provided by hedge funds and private equity firms hampers risk estimation

²⁶⁹ DNB AR 2006 p. 35/33.

²⁷⁰ Omitted: «(see publication 'Vision DNB supervision 2006-2010' at www.DNB.nl, under 'News and publications' and 'Publications DNB').»

²⁷¹ DNB AR 2006 p. 69/67.

²⁷² See the report Onderzoek DSB Bank of the commission Scheltema of 2010. In the dossier under 20100623. See also 20120619_Rapport oorzaken faillissement DSB_Curatoren.

²⁷³ See for example M. Pikaart, Wanbeleid- Algemeen Burgerlijk, Amsterdam University Press, Amsterdam, 2015.

²⁷⁴ In the directory CRMPG. Henceforth the report is abbreviated CRMPG II. Relevant paragraphs in DNB AR can be found by searching for "crmpg".

²⁷⁵ It seems to be very well justified to add this report to the (small) list of well-founded warnings. Like the GAO reports, it sketches a scenario for a perfect storm. Search for "perfect storm".

and management by financial institutions.»²⁷⁶

This is not followed by a report about advice or recommendations given, or actions taken or planned. While one of the few recommendations of CRMPG II directed at supervisors was addressed to exactly this and similar problems:

«CRMPG II recommends that the private sector, in close collaboration with the official sector, convene a high level discussion group to further consider the feasibility, costs and desirability of creating an effective framework of large exposure reporting at regulated financial intermediaries that would extend—directly or indirectly—to hedge funds. Using the indirect method, regulators would collect and aggregate large exposure data from traditionally regulated institutions and, through those institutions, collect data on hedge fund activity. Under the direct approach, hedge funds would, on a voluntary basis, provide large exposure data directly to the appropriate regulator.»²⁷⁷

DNB says nothing about this.

Note that the recommendation by CRMPG implies that nothing significant has been done with earlier similar recommendations.

CFTC, Annual report 2006.²⁷⁸ The following is quoted from “A Message from the Chairman”, Reuben Jeffery III, on p. 1:

«The Commodity Futures Trading Commission (CFTC or Commission) oversees the commodity futures and option markets in the United States (U.S.). These markets are the key source of commodity price discovery and are used as a tool by participants in the global economy to offset price risk. In recent years these trillion dollar markets, with massive economic force, have grown faster than almost any other asset class. The markets are expanding steadily in both volume and new users and their complexity is rapidly evolving with new technologies, globalization, product innovation, and greater competition.

The Commission accomplishes its mission through three strategic goals, each focusing on a vital area of regulatory responsibility. They are:²⁷⁹

1. to ensure the economic vitality of the commodity futures and option markets;
 2. to protect market users and the public; and
 3. to ensure market integrity in order to foster open, competitive, and financially sound markets.
- [...]

Over the last year, the Commission focused its resources: to help ensure that customers were protected when a futures brokerage firm collapsed amid an accounting fraud; to take action against an energy company in response to allegations of manipulation; and to actively address governance conflicts at publicly listed exchanges. We also addressed how best to disclose the impact of hedge funds and other speculators on our markets. Internationally, we engaged our regulatory counterparts and stakeholders on whether it is appropriate for an exchange based outside of the U.S. to be designated as a U.S. exchange.

Although these accomplishments are very significant in themselves, they are only part of the important contributions made daily by the dedicated staff of the Commission. We hope you will join us in applauding their efforts, which are highlighted in the pages to follow using data, both financial and performance, that is reliable and complete.»

P. 25 is the section *Forward Looking*. It mentions no serious problems. It mentions no risks or their growth. Nothing indicates that 2007 could be very different from 2006.

OCC, the Office of the Comptroller of the Currency, Annual report 2006.²⁸⁰ The inside of the front cover has the following text:

²⁷⁶ DNB AR 2006 p. 123/121. Note that this can only be partially true. Not doing business with companies providing insufficient information, and not buying products which are badly known or understood is risk management too, and very sound at that, but ignored by DNB.

²⁷⁷ CRMPG II p. 40/58.

²⁷⁸ In the directory USA/CFTC. The Annual report 2006 does not seem to mention the number of employees. On p. 42, the annual report of 2008 speaks of 448 fte.

²⁷⁹ Numbering and layout are by JFCvV.

²⁸⁰ In the directory USA/OCC, under 20061031.

«The mission of the Office of the Comptroller of the Currency is, and always has been, supervision. We supervise all types of banks in all parts of the country, from the smallest community banks to the trillion dollar “megabanks,” from “ag” banks to credit card banks, and from federal branches of foreign banks to one-branch banks that do their business close to home.

—Comptroller [John C] Dugan before the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 19, 2006.»

P. 3 adds:

«Protecting the rights of bank consumers is one of our agency’s fundamental obligations.»

On p. 10 the OCC AR 2006 explains:

«The OCC pursues four strategic goals to achieve its mission:

1. A safe and sound national banking system.
2. Fair access to financial services and fair treatment of bank customers.
3. A flexible legal and regulatory framework that enables the national banking system to provide a full, competitive array of financial services.
4. An expert, highly motivated, and diverse workforce that makes effective use of OCC resources.»²⁸¹

Excluding appendices and the index, the AR has 6 chapters. The first is titled “Comptroller’s Viewpoint”. This is the opening sentence:

«I am pleased to report that the national banking system not only remained strong throughout fiscal year (FY)2006, but that both the OCC and the system are well equipped to meet the challenges that lie ahead.»

But not all is well:

«Of greater concern to me was the evidence of credit trends provided by the OCC’s Survey of Credit Underwriting Practices, a detailed review of lending standards across 18 commercial and retail product lines, based on the professional judgment of examiners-in-charge at the 73 largest national banks. The 2006 survey results indicated that loan standards in both commercial and retail lending had eased for a third consecutive year under pressure from competition and optimistic expectations for loan volume, yield, and market share. The evidence included thinner pricing, reduced amortization, weaker covenants and controls, pervasive structural concessions in such terms as tenor and guarantor requirements, and increased exceptions to lending policies.»²⁸²

Therefore:

«We undertook lower-profile, but no less important, initiatives throughout the year that further strengthen risk management in the national banking system.»²⁸³

The following is quoted as an example showing that a supervisor could successfully ask for changes in the law:

«We also proposed that Congress approve legislation increasing the community development lending authority available to national banks under Part 24 of our regulations, and that measure was adopted and signed into law.»²⁸⁴

A sketch of human resources management of OCC includes a very clear sign of belief in appearances and terrible underestimation of the risks:

«We have also made great strides in assessing the agency’s skill requirements and laying plans for the training programs needed to meet them. This is an advantageous moment to be tackling these challenges. The current sound condition of the national banking system allows us to focus on our personnel needs in a measured and orderly way.»²⁸⁵

²⁸¹ OCC AR 2006 p. 10. Note that the first three are really goals, and the fourth both means and (subordinate) goal. With respect to the workforce p. 5 of the AR notes: «Our success depends on the supervisory staff that implements OCC policies: nearly 3,000 examiners, attorneys, economists, information technology experts, and other professionals and support staff. Directly or indirectly, they are responsible for the examination and supervision of the more than 1,800 national banks, federal branches of foreign banks, and uninsured national trust companies.»

²⁸² OCC AR 2006 p. 2.

²⁸³ OCC AR 2006 p. 3.

²⁸⁴ OCC AR 2006 p. 3.

²⁸⁵ OCC AR 2006 p. 5. How to explain this carelessness given the opaqueness of crucial parts of the financial system, the numerous warnings, and the complete absence- beside blind faith- of any credible refutation?

P. 10 enumerates 10 “Fiscal year 2006 highlights”. In the context of this study highlight number 8 seems the most informative:

«Fully implemented supervision by risk for both large and community national banks. Effective supervision tailored examinations to risks presented, addressing safety and soundness issues, and applicable specialty areas. There were no national bank failures and many of the problem banks at the beginning of the year returned to sound condition. Overall, the national banking system remained in safe and sound condition, with adequate capital and earnings to support future operations.»

So what does the OCC mean by “safe and sound”? And by “adequate capital”? The OCC probably means “formally adequate capital”, as required by Basel I. But is that enough for safety and soundness? There is no sound reason to assume it does.

Chapter 4, Looking ahead, counts no more than a single page. About risks it says the following:

«Risks facing the banking industry and the OCC are increasingly interdependent, cutting across traditional disciplines and business lines. Operational and compliance risks are becoming more prominent, and traditional distinctions between credit and capital markets activities and risk management tools are eroding. Corporate governance, accounting, compliance, and customer information security continue to be high-visibility issues for the banking industry and for large, publicly traded banks in particular, accentuating the need for strong corporate governance, accounting transparency, internal controls, and audit and compliance programs.

The rapid pace of financial innovation and growing concentrations—both within individual bank’s portfolios and across industry segments—pose additional challenges and require improved risk management and information systems. Quantitative risk measurement systems will continue to become more prominent in banks’ risk management processes.

The Comptroller, the Executive Committee, and other agency officials will continue to monitor these risks closely in FY 2007 and to develop and refine strategies for the agency’s workforce to address them through supervisory and regulatory programs of onsite supervision, timely examination and policy guidance, and balanced regulatory actions. The OCC also will work with other international, federal, and state supervisors to respond to the myriad of cross-cutting issues that face the financial services industry». ²⁸⁶

Note that the AR does not give its opinion about the actual state of “corporate governance, accounting transparency, internal controls, and audit and compliance programs”. It says nothing about systemic risks, and about the ways they are being managed by OCC and its sister supervisors. Furthermore the last paragraph is hard to reconcile with the fact that OCC claimed pre-emption to prevent states reducing risks.

The final quote is from the illustration opposite “Looking ahead”:

«Large national banks will remain at the leading edge of developing new banking products and services, requiring that the OCC be at the forefront of the supervisory community in developing and maintaining expertise in assessing such products and determining associated risks.»²⁸⁷

OTS, the Office of Thrift Supervision. There is no annual report for 2006. In fact, according to the *Message from the [new] Director*, John M. Reich, in AR 2007:

«This Annual Report is the first such report from the Office of Thrift Supervision in many years, just one of several “firsts” since I came on board as OTS Director in August 2005.»²⁸⁸

The annual report shows that nothing has been learnt of the events of 2007, and that for the purposes of this study we do not have to regret the absence of an AR 2006. On the contrary, its absence provides additional information. It shows that the US government, the supervisor of the supervisors, took many years to get one of its principal financial supervisors to give a (customary) yearly account of the fulfillment of its duties.

To show that OTS is not a positive exception, and to enable comparison with the other supervisors, I give some quotes from the AR 2007. The AR has the following table of contents:

- Message from the Director;
- Strategic Focal Points;

²⁸⁶ OCC AR 2006 p. 43.

²⁸⁷ OCC AR 2006 p. 42.

²⁸⁸ P. 3, OTS AR 2007, in the directory USA/OTS.

- About the OTS;
- Year in Review
- OTS Regions;
- OTS Operations.

The first of the Strategic Focal Points is:

«1 Consolidated Supervision.

The OTS utilizes a flexible and seamless approach to its supervisory oversight. Thrift holding companies and affiliates, which range from noncomplex companies with limited activities to large, internationally active conglomerates, are examined concurrently with their thrift subsidiaries. OTS examinations are supplemented by off-site monitoring. For the most complex holding company structures, we conduct continuous supervision. We also streamline our process by coordinating our examination and supervisory efforts with other bank regulatory agencies and functional regulators of related entities, such as securities firms and insurance companies.»²⁸⁹

The first paragraph of the Year in Review draws some conclusions from the market turmoil:

«Although 2007 has been a busy year, we all should have a deep sense of satisfaction that our work has made a difference for the institutions we supervise and their customers. The unprecedented turmoil in the mortgage market in 2007, and the resulting impact on our thrifts, has showcased our remarkable talent within the agency. We have more work to do, though, and 2008 will be an exciting year as we continue our hiring initiatives and expand our outreach efforts. Our goal remains to position OTS as both a premier regulatory agency and a great place to work.»²⁹⁰

The following is from the report about the OTS West Region:

«The OTS West Region supervises institutions that hold about half of all thrift assets nationwide, including the top three federally regulated thrifts in asset size: Washington Mutual Bank (WAMU), World Savings Bank, FSB, and Countrywide Bank, FSB. The region expends significant resources to supervise these and other large thrift institutions. Yet the region is also responsible for small thrifts like Del Norte Federal Bank in southern Colorado, as well as other institutions of varying sizes across the American West and as far away as Alaska, Hawaii and Guam.

The complexity of the large institutions that have pioneered new kinds of mortgages demands a regional examination staff with deep expertise in innovative products and the ability to keep pace with rapid change. Examiners frequently must find innovative approaches to supervision. Ensuring sound loan underwriting, adequate disclosures and strong risk management has been particularly challenging for OTS West Region examiners in the current competitive, aggressive financial services marketplace.

Some thrifts in the OTS West Region have been offering non-traditional mortgage products for decades, including adjustable-rate mortgages and interest-only mortgages. OTS examiners are well-versed on how institutions can manage and mitigate the risks associated with these products to keep their operations safe and sound, and provide consumers with adequate disclosure and protection.

Examiners apply this specialized knowledge to their work with smaller thrifts and growing regional institutions. Regional officials also apply this expertise to help the agency's policy-makers craft industry guidance and address emerging challenges of national significance, such as the recent interagency guidance on non-traditional mortgage products. The OTS West Region also plays a leadership role in developing and implementing new tools to improve supervision and examination processes, such as using electronic loan data to analyze risks in loan portfolios, creating enhanced financial monitoring tools and implementing electronic tools to analyze Bank Secrecy Act risks.»²⁹¹

The Operations chapter begins with a section Supervision and Consumer Protection. The first subsection characterizes the:

«Condition of the Thrift Industry.

The thrift industry performed well during fiscal 2007 and measures of financial condition remained sound, despite challenges for home lenders.»²⁹²

Next OTS notes a “weakening” since 2005. But:

²⁸⁹ OTS AR 2007 p. 5.

²⁹⁰ OTS AR 2007 p. 13.

²⁹¹ OTS AR 2007 pp. 22-3.

²⁹² OTS AR 2007 p. 25.

«Despite these pressures, earnings for the year were positive and capital levels remained strong.»²⁹³
The second subsection concerns:

«*Risk Modelling.*

[...] OTS recently completed a major enhancement to the Net Portfolio Value (NPV) Model and began producing new reports using the Enhanced NPV Model. [...] The Enhanced NPV Model solidifies OTS's position as an industry leader in the high quality measurement of interest rate risk.»²⁹⁴

The subsection only mentions (direct) interest rate risk. This is consistent with what one can read between the lines: that in the perception of OTS there are only individual institutions, and no relevant interactions. There is no sign of awareness of any influence on the OTS-institutions of phenomena in the rest of the financial world.

SEC, the Securities Exchange Commission. According to its Annual report 2006- which it calls "Performance and Accountability Report":

«The SEC is an independent federal agency established pursuant to the Securities Exchange Act of 1934. It is headed by a bipartisan five-member Commission, comprised of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate. The Chairman serves as the chief executive officer. The SEC is organized into four main divisions: Corporation Finance, Market Regulation, Investment Management, and Enforcement. It also has 19 functional offices. The Commission's headquarters are in Washington, D.C., and it has 11 regional and district offices throughout the country. In FY 2006, SEC received authorized funding of \$888 million. At September 30, 2006, the SEC had 3,590 staff, including 3,549 permanent staff and 41 temporary staff.»²⁹⁵

The pages 5 and 6 present vision, mission, values and goals:

«**Vision:**

The Securities and Exchange Commission aims to be the standard against which federal agencies are measured. The SEC's vision is to strengthen the integrity and soundness of U.S. securities markets for the benefit of investors and other market participants, and to conduct its work in a manner that is as sophisticated, flexible, and dynamic as the securities markets it regulates.

Mission:

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Values:

- Integrity
- Resourcefulness
- Accountability
- Teamwork
- Fairness
- Commitment to Excellence»²⁹⁶

«Goals:

- Enforce compliance with federal securities laws [...]
- Promote healthy capital markets through an effective and flexible regulatory environment [...]
- Foster informed investment decision making [...]
- Maximize the use of SEC resources.»²⁹⁷

²⁹³ OTS AR 2007 p. 25.

²⁹⁴ OTS AR 2007 pp. 26-7.

²⁹⁵ SEC AR 2006 p. 7/9. SEC annual reports are located in the directory USA/SEC.

²⁹⁶ SEC AR 2006 p. 5/7.

²⁹⁷ SEC AR 2006 p. 6/8, SEC AR 2008 p. 8/10.

The *Message from the chairman*, Christopher Cox, is dated November 2006. It covers two pages. It opens with the following:

«The prosperity of 300 million Americans and six billion people around the world relies on trustworthy U.S. capital markets. If you're a working American adult today, the odds are your savings are directly or indirectly invested in securities. Back in Joseph P. Kennedy's day, our first SEC Chairman could marvel that "one person in every ten" owned equities. But today, our financial markets encompass the investments, the hopes, and the dreams of half of all households. Some 57 million Americans now own stocks—and the median income for shareholders is a very middle-class \$65,000.

The U.S. Securities and Exchange Commission [= SEC] serves you by working to secure the trust in our markets that undergirds our nation's continuing prosperity in an increasingly global economy. The level of trust in our markets has enormous economic consequences—affecting everything from the affordability of food, clothing, and shelter to the creation of new jobs, increases in wages, and the protection of our retirement security. This Performance and Accountability Report helps explain how the SEC works to sustain trust in our markets.

First and foremost, the SEC is a law enforcement agency. This follows from the SEC's threefold mission to protect investors, to ensure fair and orderly markets, and to promote capital formation.²⁹⁸ These highly complementary objectives each requires a tough cop on the beat. [...]

Americans can take pride in knowing that tough, predictable enforcement is not only an essential aspect of investor protection, but also an important contributor to our nation's economic health. This past year, an unprecedented high level of collaboration with our counterpart state and federal regulators and criminal authorities ensured that our mutual efforts were even more effective, and gave America's investors even more protection for their hard earned money.»

In the AR 2006 the word fragment “derivat” is found precisely once, in the following sentences and context:

«*Cross-border exchange affiliations*.

[...] During the past several months, NASDAQ has acquired a 25 percent stake in the London Stock Exchange, and the NYSE has entered into a combination agreement with Euronext, which includes the U.K. derivatives exchange Liffe. The SEC and the College of Euronext Regulators are currently taking the necessary steps regarding the regulatory approval processes for the proposed combination of NYSE and Euronext.»

The word fragments “collater”, “subprime” en “swaps”, and the abbreviations CDO and CDS do not appear in the AR 2006.

SEC AR 2006 has three major sections:

1. Management's discussion and analysis;
2. Performance section;
3. Financial section.

The performance section is based on a set of 21 performance measures. They are defined and explained in “exhibits”. Results of their measurement are presented and analyzed (in a few sentences). The quality of the indicators is shown by the conclusions. Examples are:

«*Outcome 1.1 Potential problems or issues in the securities markets are detected early, and violations of federal securities laws are prevented.*»²⁹⁹

[...]

«*Outcome 3.1. Investors have accurate, adequate, and timely public access to disclosure materials that are useful and can be easily understood and analyzed across companies, industries, or funds.*»³⁰⁰

«*Outcome 3.2 Investors have a better understanding of the operations of the nation's securities markets.*»^{301, 302}

²⁹⁸ Take note : promote capital formation. Not : promote capital destruction.

²⁹⁹ SEC AR 2006 p. 42/44.

³⁰⁰ SEC AR 2006 p. 47/49.

³⁰¹ SEC AR 2006 p. 48/50.

³⁰² Of course, “better” need not be adequate or good.

These conclusions cannot be logically inferred from the evidence presented.³⁰³

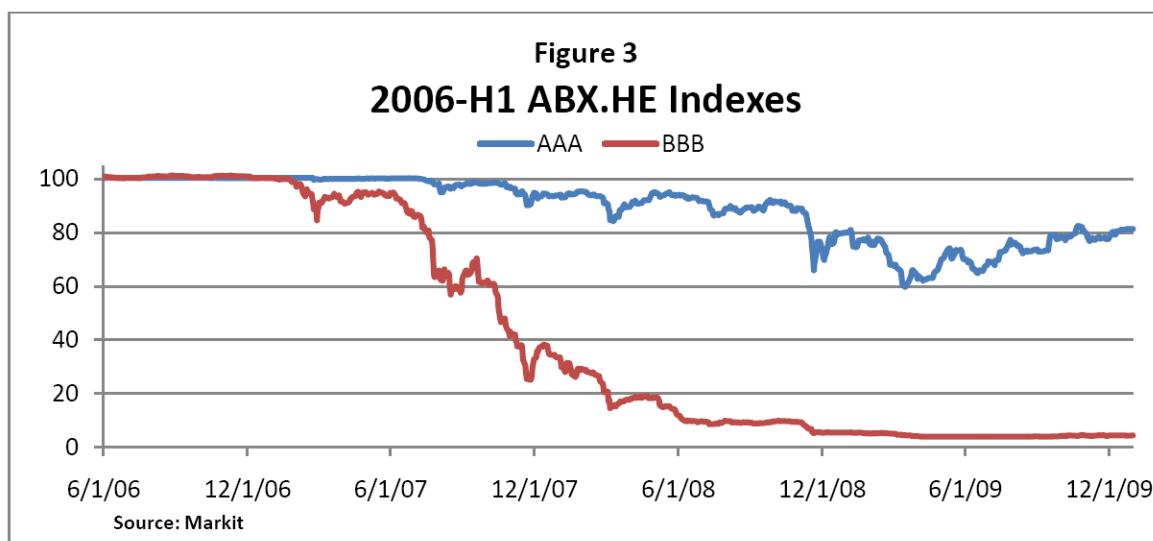
For more comprehensive analyses of supervisors, and for similar analysis of BIS, IMF and OECD, the reader is referred to the appendices.

A comparison of successive annual reports of 2006-2010 or later is very rewarding. (While reading them, ask yourself: Have any fundamental lessons been learnt?) Most of the reports can be found on the internet or in the dossier. Observations relevant in the present context can be found in the Analysis and appendices.

2007.

On 1 January, Slovenia joins the euro area.

The next two graphs can be considered as pictures of the first financial crisis along one of its crucial dimensions. The first is copied from p. 13 of the preliminary FCIC-staff study *Credit derivatives and mortgage-related credit derivatives*. The second is from LehmanLive.³⁰⁴



³⁰³ And will be contradicted (and ridiculed) by the facts.

³⁰⁴ Quoted by Markus K. Brunnermeier on p. 10 (pdf-pagenumber) of his report *Deciphering the Liquidity and Credit Crunch 2007-08* for the FCIC. It can be found in the directory FCIC/Studies, under 20100227.



Legend. «Each ABX index is based on a basket of 20 credit default swaps referencing asset-backed securities containing subprime mortgages of different ratings. An investor seeking to insure against the default of the underlying securities pays a periodic fee (spread) which- at initiation of the series- is set to guarantee an index price of 100. This is the reason why the ABX 7-1 series, initiated in January 2007, start at a price of 100. In addition, when purchasing the default insurance after initiation, the protection buyer has to pay an upfront fee of (100 - ABX price). As the price of the ABX drops, the upfront fee rises and previous sellers of Credit Default Swaps suffer losses.»³⁰⁵

Note that the indices for AAA in the two graphs do not agree. According to Markit, at the end of 2008 AAA is about 70% of its value at the end of 2006, and according to Lehman Live about 30%.³⁰⁶

At Moody's, the first time an employee used the word "crash" to characterize the housing market was in October 2006. But possibly because of uncertainty about the significance of the developments it took Moody's until 10/7/07 to announce the first large scale downgrades.³⁰⁷ On that day Moody's downgraded 399 MBS from 2006, with a value of B\$ 5.3. S&P followed suit. In October 2007 Moody's downgraded an even greater number of MBS from 2006.

Actually, in 2007 one downgrade followed the other. Not only MBS were downgraded, but (possibly) related institutions and the securities they issued just as well.³⁰⁸ Interested institutions tried to reduce the extent to which they were directly or indirectly exposed to risks, even if they had to pay a (smaller) price to reduce it. A problem was that there was great uncertainty about which institution was vulnerable for what and to what extent, and with whom one could still do business (more or less

³⁰⁵ LehmanLive, as quoted by Brunnermeier, see above.

³⁰⁶ Of course, ABX.HE and ABX 7-1 are probably different. But if this is the explanation, it would mean that the designation AAA is far less important than other characteristics.

³⁰⁷ FCIC report section 11.2 on pp. 221/249 and following.

³⁰⁸ In July-November asset backed commercial paper lost 30% of its value. See p. 274/302 of the FCIC report (in section 14.4: Federal Reserve etcetera).

safely), and with whom this was too risky. The uncertainty (opaqueness) didn't really increase, but all of a sudden it became vitally important. Bankers became increasingly more fearful of doing business with colleagues of other institutions. Of course especially with respect to relatively risky products. Which caused their value to continue falling. Trade came almost to a standstill. Due to the small number of transactions, the value of products became (even more) uncertain. After all, "no market" means: no market value. Long standing relations between institutions were severely hurt. Institutions were not trusted any more, though one more than another.

In general, securities are a kind of contract between two parties. They give rights and impose obligations. A party providing a loan often requires collateral. As in the case of a mortgage. In the subprime crisis the collateral often consisted of securities. Whose value was falling. Often contracts prescribed that in case of devaluations exceeding a certain percentage additional collateral should be provided upon request.³⁰⁹ The request is often called "margin call". In this way institutions tried to safeguard themselves against this risk. But in general both contract parties had problems. And institutions had little capital anyway. Downgrades made it ever more difficult to give additional collateral. The more so since the same phenomena made borrowing (against collateral) more difficult. Or impossible.

This description shows that a sufficiently large disturbance (devaluation) will be amplified by the (logical, rational) mechanisms which are integral parts of the financial system. Instead of being reduced or corrected. Clearly, this is the recipe for an unstable system imploding to a halt.

In early 2007 Goldman Sachs succeeded in selling the German IKB Deutsche Industriebank AG subprime MBS it wanted to get rid of. The terminology "toxic assets" turned out to be appropriate:

«In early 2007, when Goldman was looking for buyers for Abacus 2007-AC1, the synthetic CDO mentioned in part III [of the FCIC report], it looked to IKB. An employee of Paulson & Co., the hedge fund that was taking the short side of the deal, bluntly said that "real money" investors such as IKB were outgunned. "The market is not pricing the subprime [residential mortgage-backed securities] wipeout scenario," the Paulson employee wrote in an email. "In my opinion this situation is due to the fact that rating agencies, CDO managers and underwriters have all the incentives to keep the game going, while 'real money' investors have neither the analytical tools nor the institutional framework to take action before the losses that one could anticipate based [on] the 'news' available everywhere are actually realized." [Source: a law suit of 2010]. IKB subsequently purchased \$150 million of the A1 and A2 tranches of the Abacus CDO and placed them in Rhineland [an off-balance-sheet commercial paper program]³¹⁰. It would lose 100% of that investment.»³¹¹

The toxins almost killed IKB. Bankruptcy was only prevented by a takeover by its largest shareholder, KfW Bankengruppe, on 30/7/07.

This event shows that even institutions reputed to be reliable and risk avoiding can have toxic assets,³¹² and be killed by them. It added to the already existing uncertainty and risks, and reduced the willingness of institutions to do business with each other.

As the last two graphs show, the ABX index for CDS for MBS was falling since late 2006. Investment ("shadow") bank Bear Stearns had two hedge funds which were mainly collateralized with subprime mortgage-backed CDO's.³¹³ In the case of downgrading extra collateral had to be provided.³¹⁴ Investors smelt a rat, and started to sell their shares of the hedge funds. With increasing speed. In the beginning of 2007 the managers of the funds realized that this development, if continued, would be fatal. They also used illegal means to stop it. They gave investors misleading or incorrect information. This didn't help. The funds couldn't find enough money to meet their obligations. On

³⁰⁹ In the interested institutions, this obligation sometimes wasn't known to people who should have known. See FCIC report, at various pages. Search for example for "margin call".

³¹⁰ Commercial paper= short-term unsecured corporate debt. FCIC report p. 539/567 (Glossary).

³¹¹ FCIC report section 13.1 on pp. 247/275 and following.

³¹² In other words: take too much risk, do things they don't understand.

³¹³ The first part of this paragraph is based on section 12.2 of the FCIC report, on pp. 238/266 and following.

³¹⁴ This was at least the rule. For this specific case section 12.2 of the FCIC report is not explicit.

31/7/07 they filed for bankruptcy. The fund managers were criminally charged with fraud in their communication with investors. They were acquitted. The SEC filed a civil lawsuit against them.³¹⁵ On p. 127 of its fiscal year 2013 Agency Financial Report the SEC reports as following:

«In a set of cases tied to the financial crisis, the SEC, in coordination with the Federal-state Residential Mortgage-Backed Securities (RMBS) Working Group, charged J.P. Morgan Securities LLC and Credit Suisse Securities (USA) with misleading investors in RMBS offerings. The SEC charged J.P. Morgan with misstating information about the delinquency status of mortgage loans that served as collateral for an RMBS offering it underwrote. J.P. Morgan was also charged with securities laws violations rising from misconduct by Bear Stearns- with whom J.P. Morgan merged- wherein Bear Stearns failed to disclose its practice of negotiating discounted cash settlements with loan originators and keeping the proceeds without paying anything to the RMBS trusts who owned the loans. The SEC brought charges against Credit Suisse for similar activity, alleging that Credit Suisse failed to disclose its practice of retaining cash from settlements with loan originators, and for making misleading statements to investors in SEC filings about when it would repurchase mortgage loans from trusts if borrowers missed the first payment due. Both banks settled the SEC's charges, with J.P. Morgan paying \$296.9 million and Credit Suisse paying \$120 million.»³¹⁶

On 9/8/07 BNP Paribas stopped executing sales orders for three investment funds which in the two preceding weeks had lost more than 20% of their value. This is sometimes seen as the beginning of the liquidity crisis.³¹⁷

The following day, 10/8/07, the Fed announced that it would “provid[e] liquidity as necessary to facilitate the orderly functioning of financial markets”. The European Central Bank (ECB) made billions of euros available to the overnight lending markets.

On 17/8/07 the Fed facilitated borrowing for (some) financial institutions by lowering the discount rate with 50 points, from 6.25% to 5.75%. This was the first in a long series of rate cuts. The Fed moreover extended the maximal duration of discount loans from at most a few days to 30 days.

The new credit facilities were not used as intended. Institutions were afraid that use of the facilities would be interpreted as showing they were in dire straits. They preferred to borrow from the Federal Home Loans Bank. In the second half of 2007 the amount of outstanding loans of this bank increased from B\$ 235 to B\$ 875.

On the same 17/8/07 the Federal Open Market Committee of the Fed announced by means of a press release that it was aware of the worsening of the market situation, and was “prepared to act as needed to mitigate the adverse effects on the economy”.³¹⁸

In August the British bank Northern Rock got liquidity problems as a consequence of the crash of the MBS market. The MBS it produced didn't yield enough to cover its needs. For the first time in 150 years there was a bank run in the UK. In September Northern Rock requested and obtained support of the Bank of England. A search was made for a private institution that was willing and able to take over Northern Rock. In vain. The UK government thought bankruptcy and other options too harmful. It therefore nationalized the bank on 22/2/08.

In the months August-October 2007 Countrywide, the biggest mortgage bank of the US,³¹⁹ ran into fast growing problems on the repo market for overnight lending.³²⁰ Its MBS had lost too much of their

³¹⁵ The complaint and the corresponding SEC press release can be found in the SEC directory under 20121116.

³¹⁶ In principle, this report may refer to another law violation. Ambiguity being caused by somewhat different specifications. It is clear however that they concern very similar misconduct. The SEC shows that such charges may be brought successfully, and may result in reparation, if only in part.

³¹⁷ FCIC report section 13.3.

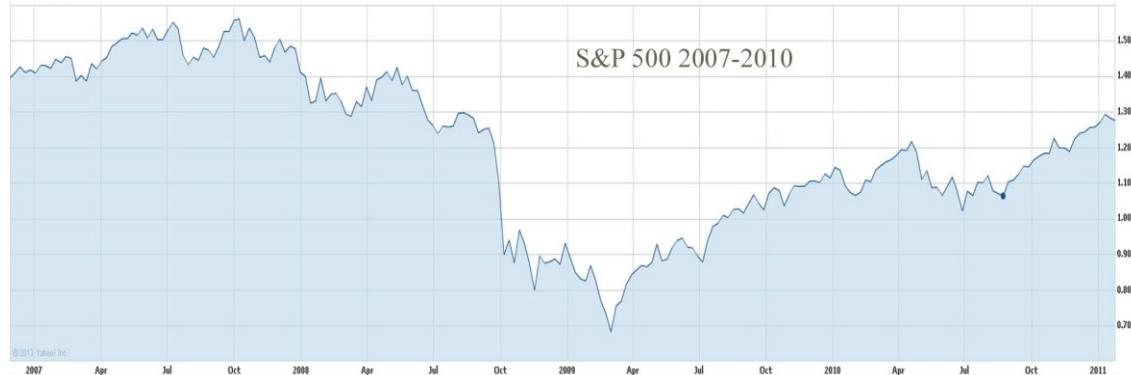
³¹⁸ FCIC report p. 252/280.

³¹⁹ «It was the biggest mortgage originator from 2004 until the market collapsed in 2007.» FCIC report p. 105/133.

³²⁰ Repo = repurchase agreement, and the repo market is a market for this kind of contract. IMF CGFS April 2008 p. 122 defines a repo contract as follows: «An agreement whereby the seller of securities agrees to buy

value to provide enough collateral. The bank needed billions, but couldn't find them. It asked the Fed for assistance, but the Fed refused. Bank of America comes to the rescue. In October it took over Countrywide.³²¹

In 2007 the Standard & Poors 500, an index for the valuation of shares, climbed by fits and starts to a maximum in October. Then it started a long slide, again by fits and starts. From March to May 2008 for example it increased 10%. This may serve as a reminder of the fact that it was not clear already in 2007 that a crisis was brewing or happening. The lowest point of the S&P 500 (in the period under consideration) would be reached only in the first half of March 2009.³²²



Monolines were companies which insured securities. Before the crisis they were thought to be 100% safe. It was supposed that they could only make profits, not losses. But monolines too turned out to be vulnerable. One of them, ACA, had a leverage of 1:100. At the end of 2007 it announced a loss of B\$ 1.7. The news went like a shock wave through the financial world. The loss was almost entirely due to CDS. In December ACA was downgraded to the status of junk. Various institutions suffered heavy losses because the “insurances” they had bought from ACA had become useless.

The monoline downgrades also affected the market for “auction-rate securities” (ARS). According to buyers, these securities had been sold to them as being completely safe and negotiable on a daily basis. When this turned out to be untrue, many of them submitted complaints against the sellers to the SEC, alleging misleading information. The complaints were declared justified, and the sellers paid B\$ 50 in damages.³²³

Partly as a consequence of the mark-to-market prescription there were accounting (“paper”) losses. At the end of 2007 many financial institutions had to write off substantial amounts.

The following quotes from the FCIC Wallison report may serve as one more part of the explication of the events of 2007-2008:

«[...] when AAA-rated PMBS³²⁴ became unmarketable they lost their value for liquidity purposes, making it difficult or impossible for many financial institutions to fund themselves using these assets as collateral for repos.»³²⁵ [...]

«Securitized assets held by financial institutions are subject to the rules of fair value accounting, and must be marked to market under certain circumstances. Thus, banks and other financial institutions that are holding securitized mortgages in the form of PMBS could be subject to large

them back at a specified time and price. The transaction is a means of borrowing cash collateralized by the securities “repo-ed” at an interest rate implied by the forward repurchase price.»

³²¹ This paragraph gives the essence of pp. 248/276 and following of the FCIC report.

³²² The graph was copied from Yahoo, on 4/6/13. Note that indexes like the Dow Jones and S&P reflect the development of the weighted average of the share prices of a chosen set of companies. From time to time the set and weights are changed. The choice has the effect of making the index grow stronger.

³²³ FCIC report p. 278/306.

³²⁴ PMBS= private MBS, as distinct from GSE-MBS. See for example FCIC report p. 542/570 (in the Glossary).

³²⁵ FCIC Wallison report p. 477/505.

accounting losses—but not necessarily cash losses—if investor sentiment were to turn against securitized mortgages and market values decline.

Accordingly, once large numbers of delinquencies and losses started showing up in the mortgage markets generally and in the mortgage pools that backed the PMBS, it was not necessary for all the losses to be realized before the PMBS lost substantial value. All that was necessary was that the market for these assets become seriously impaired. This is exactly what happened in the middle of 2007, leading immediately not only to severe adverse liquidity consequences for financial institutions that held PMBS but also to capital writedowns that made them appear unstable and possibly insolvent»³²⁶ [...]

«The inability of financial institutions to liquidate their PMBS assets at anything like earlier values had dire consequences, especially under mark-to-market accounting rules, and was the crux of the crisis. In effect, a whole class of assets—involving almost \$2 trillion—came to be called “toxic assets” in the media, and had to be written down substantially on the balance sheets of financial institutions around the world. Although this made financial institutions look weaker than they actually were, the PMBS they held, despite being unmarketable at that point, were in many cases still flowing cash at close to expected rates. Instead of a slow decline in value—which would have occurred if whole mortgages were held on bank balance sheets and gradually deteriorated in quality—the loss of marketability of these securities caused a crash in value.»³²⁷

In December 2007, Fannie sounds the tocsin:

«Finally, in a December 21, 2007, letter to Brian Montgomery, Assistant Secretary of Housing, Fannie CEO Daniel Mudd asked that, in light of the financial and economic conditions then prevailing in the country- particularly the absence of a PMBS market and the increasing number of mortgage delinquencies and defaults- HUD’s AH goals for 2007 be declared “infeasible.” He noted that HUD also has an obligation to “consider the financial condition of the enterprise when determining the feasibility of goals.” Then he continued: “Fannie Mae submits that the company took all reasonable actions to meet the subgoals that were both financially prudent and likely to contribute to the achievement of the subgoals... In 2006, Fannie Mae relaxed certain underwriting standards and purchased some higher risk mortgage loan products in an effort to meet the housing goals. The company continued to purchase higher risk loans into 2007, and believes these efforts to acquire goals-rich loans are partially responsible for increasing credit losses.”

This statement confirms two facts that are critical on the question of why Fannie (and Freddie) acquired so many high risk loans in 2006 and earlier years: first, the companies were trying to meet the AH goals established by HUD and not because these loans were profitable. It also shows that the efforts of HUD and others- including the [FCIC] Commission majority in its report- to blame the managements of Fannie and Freddie for purchasing the loans that ultimately dragged them to insolvency is misplaced.»³²⁸

The request by Mudd is also cited by the FCIC majority. The commission majority adds:

«HUD complied and allowed the GSEs to fall short without any consequences.»³²⁹

The FCIC majority quotes the letter and makes this observation to prove that GSEs could submit complaints to HUD, and that HUD listened constructively.

The following quote gives an impression of the size of the consequences of the CRA:

«In 2007, the umbrella organization for many low-income or community “advocacy groups,” the National Community Reinvestment Coalition [NCRC], published a report entitled “CRA Commitments” which recounted the substantial success of its members in using the leverage provided by the bank application process to obtain trillions of dollars in CRA lending commitments from banks that had applied to federal regulators for merger approvals. The opening section of the report states [...]:

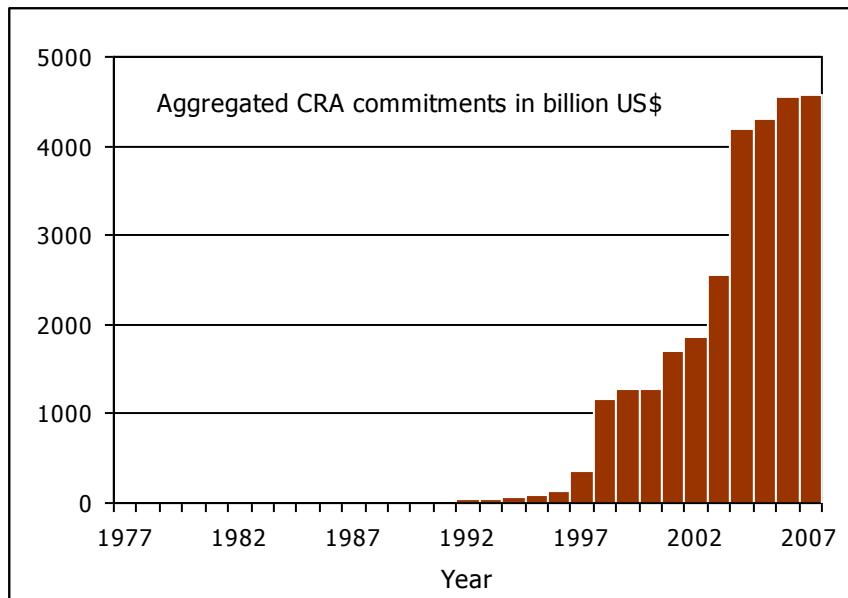
³²⁶ FCIC Wallison report p. 479/507.

³²⁷ FCIC Wallison report p. 480/508. In other words : the weak point in the system is the subjective valuation of paper. Which after all can change arbitrarily and anytime.

³²⁸ FCIC Wallison report p. 515/543.

³²⁹ FCIC report p. 185/213.

Since the passage of CRA in 1977, lenders and community organizations have signed over 446 CRA agreements totaling more than \$4.5 trillion in reinvestment dollars flowing to minority and lower income neighborhoods.»^{330, 331}



With respect to the period end 2007-beginning 2008 the FCIC majority concludes:

«The Commission concludes that some large investment banks, bank holding companies, and insurance companies, including Merrill Lynch, Citigroup, and AIG, experienced massive losses related to the subprime mortgage market because of significant failures of corporate governance, including risk management. Executive and employee compensation systems at these institutions disproportionately rewarded short-term risk taking.

The regulators- the Securities and Exchange Commission for the large investment banks and the banking supervisors for the bank holding companies and AIG- failed to adequately supervise their safety and soundness, allowing them to take inordinate risk in activities such as nonprime mortgage securitization and over-the-counter (OTC) derivatives dealing and to hold inadequate capital and liquidity.»³³²

2008.

On 1 January, Cyprus and Malta join the euro area.

Introductory remarks about the period until September 2008.

The behavior of everyone concerned in the period until September 2008 was determined to a large extent by a gradual awakening to the fact that risks are real and were being realized. Efforts were made to reduce the risks, and to limit the losses they were causing or threatened to cause.

³³⁰ FCIC Wallison report pp. 525-6/553-4. In 2012 and 2013 the documents referred to by Wallison and Pinto could not be found on the NCRC website. Neither was there any annual report. This has been checked for example on 27/5/13. The report *CRA commitments* could be found on other websites, and has been filed under 20070930. In the Acknowledgements NCRC presents itself as follows: «The National Community Reinvestment Coalition (NCRC) is the nation's trade association for economic justice whose members consist of local community based organizations. Since its inception in 1990, NCRC has spearheaded the economic justice movement. NCRC's mission is to build wealth in traditionally underserved communities and bring low- and moderate-income populations across the country into the financial mainstream.»

³³¹ The graph was made using the table on p. 8 of *CRA commitments*.

³³² FCIC conclusions from chapter 14, p. 279/307.

Chapter 16 of the FCIC report gives an impression of the situation.³³³ Most of the people involved were insufficiently prepared for the new situation. There must have been a psychic difficulty: after having worked for many years in a climate of tremendous growth and relatively easy success, people had to adjust to a climate of fear, and the possibility of losing everything. Too much had to be done in too short a time, or rather yesterday. In most organizations there must have been lack of employees fit to do the jobs required in the fundamentally changed circumstances. The new situation required other abilities (people) than the former. Employees of the organizations involved, from banks to supervisors and government, and from high to low in the organizational hierarchies, must often have lost control over their agendas and become “managed” by events. Often there must have been insufficient time and competent people to be able to take responsible decisions. Everybody may have done what he or she deemed best. But often they must have acted on the basis of inadequate know how and experience.

The Wikipedia *Subprime crisis impact timeline* begins 2008 with a paragraph “2008 in general”:

«The monoline insurance companies (AMBAC, MBIA, ACA, &c) have written vast quantities of insurance against the failure of CDO tranches. Those tranches now begin to fail by the hundreds. The credit ratings agencies downgrade the monolines from AAA, but the monolines have a unique business model. If they don't have an AAA rating, then their main line of business (bond insurance) becomes impossible for them to perform. By 2009, the monolines have all crashed.»³³⁴

March- mid September 2008.

13/3/08. «The Working Group on Financial Markets (WGF)³³⁵ released a statement with recommendations to President Bush on how to improve both the US economy along with the global economy. The objectives of the recommendations were to:

- 1) improve transparency and disclosure,
- 2) better risk awareness and management, and
- 3) stronger oversight to help mitigate systematic risk, restore investor confidence, and facilitate economic growth.

The WGF made over thirty specific recommendations which addressed:

- 1) mortgage origination,
- 2) improving investor contributions to market discipline,
- 3) reforming credit rating agencies,
- 4) strengthen global financial institutions' risk management practices,
- 5) enhance prudential regulatory policies, and
- 6) enhance the OTC derivative market infrastructure.»³³⁶

The end of Bear Stearns.

The bankruptcy of the hedge funds of Bear Stearns on 31/7/07 led to the downgrading of the parent company, and a lower quotation at the stock market. This made borrowing more expensive. In section 15.4 of its report the FCIC describes in some detail how Bear ran out of money. Thursday 13/3/08 the

³³³ But doesn't make all of the following remarks.

³³⁴ Wikipedia, the page *Subprime crisis impact timeline*, on 23/5/12. In the directory Timelines, under 20120523.

³³⁵ The Working Group on Financial Markets was created by Executive Order 12631, signed on March 18, 1988 by President Ronald Reagan. The Group was established explicitly in response to events in the financial markets surrounding October 19, 1987 ("Black Monday") to give recommendations for legislative and private sector solutions for "enhancing the integrity, efficiency, orderliness, and competitiveness of [United States] financial markets and maintaining investor confidence".

The Working Group consists of:

- The Secretary of the Treasury, or his/her designee (as Chairperson of the Working Group);
- The Chairperson of the Board of Governors of the Federal Reserve System, or his/her designee;
- The Chairperson of the Securities and Exchange Commission, or his/her designee; and
- The Chairperson of the Commodity Futures Trading Commission, or his/her designee.

This is inferred from the Wikipedia of 28/5/12, slightly shortened. According to the executive order the working group reports to the president.

³³⁶ Timeline University of Iowa. The file can be found in the directory Timelines.

bank told the SEC that it would not be able to function normally on Friday, the next business day. Sunday 16/3/08 the bank was taken over by JP Morgan, which was helped with loans and guarantees by the New York Fed. The FCIC concludes:

«The Commission concludes [that] the failure of Bear Stearns and its resulting government-assisted rescue were caused by its exposure to risky mortgage assets, its reliance on short-term funding, and its high leverage. These were a result of weak corporate governance and risk management. Its executive and employee compensation system was based largely on return on equity, creating incentives to use excessive leverage and to focus on short-term gains such as annual growth goals.

Bear experienced runs by repo lenders, hedge fund customers, and derivatives counterparties and was rescued by a government-assisted purchase by JP Morgan because the government considered it too interconnected to [allow to] fail. Bear's failure was in part a result of inadequate supervision by the Securities and Exchange Commission, which did not restrict its risky activities and which allowed undue leverage and insufficient liquidity.»³³⁷

Maybe JP Morgan would have been allowed to go broke before the take over. After the take over this was hardly possible any more.

Supervisors awake from their dreams.

The Fed began to worry. In particular about the repo market. If that would stop to operate, many of the most important financial institutions would be knocked out of business in a single blow.³³⁸ The risk of the repo market falling out was real because the downgrades of collateral made it hard or impossible to find enough acceptable collateral, and because of the downgrades of the institutions themselves.

On Sunday 16/3/08 the Fed announced that it would make available a Primary Dealer Credit Facility (PDCF), as a backup for the repo market. With suitable collateral and payment, institutions could borrow from this facility for up to 24 hours.

On 27/3/08 the Fed came with a Term Securities Lending Facility (TSLF), intended to reduce the shortage of suitable collateral. With the help of this facility institutions could borrow government loans in exchange for loans of lower quality for at most 28 days.

Both facilities were used intensively, at least in the beginning. The intensity fell fast however, for fear of reputation damage.³³⁹

Supervisors became aware of the fact that they didn't have enough information to be able to evaluate the situation. They tried to do something about it:

«On the day of Bear's demise, in an effort to get a better understanding of the investment banks, the New York Fed and the SEC sent teams to work on-site at Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley. According to Erik Sirri, director of the SEC's Division of Trading and Markets, the initial rounds of meetings covered the quality of assets, funding, and capital.

Fed Chairman Ben Bernanke would testify before a House committee that the Fed's primary role at the investment banks in 2008 was not as a regulator but as a lender through the new emergency lending facilities. Two questions guided the Fed's analyses: First, was each investment bank liquid - did it have access to the cash needed to meet its commitments? Second, was it solvent - was its net equity (the value of assets minus the value of liabilities) sufficient to cover probable losses?»³⁴⁰

In cooperation with investment banks, Fed and SEC develop stress tests to find out whether the investments banks could cope with certain types of events:

«The stress tests, under just one estimated scenario, concluded that Goldman Sachs and Morgan Stanley were relatively sound.³⁴¹ Merrill Lynch and Lehman Brothers failed: the two banks came out

³³⁷ FCIC conclusions of chapter 15, p. 291/319.

³³⁸ In other words: this was a “systemic risk”: a risk (threat) for the system as a coherent whole.

³³⁹ FCIC report p. 294/322.

³⁴⁰ FCIC report p. 297/325.

³⁴¹ Note the adverb “relatively”. And remember that the FCIC accuses the rating agencies of having given relative ratings.

\$22 billion and \$15 billion short of cash, respectively; each had only 78% of the liquidity it would need under the stress scenario.

The Fed's internal report on the stress tests criticized Merrill's "significant amount of illiquid fixed income assets" and noted that "Merrill's liquidity pool is low, a fact [the company] does not acknowledge." As for Lehman Brothers, the Fed concluded that "Lehman's weak liquidity position is driven by its relatively large exposure to overnight [commercial paper], combined with significant overnight secured [repo] funding of less liquid assets." These "less liquid assets" included mortgage-related securities- now devalued. Meanwhile, Lehman ran stress tests of its own and passed with billions in "excess cash."³⁴²

In June 2008 the total market value of the OTC derivatives which were in circulation amounted to T\$ 20. The total "notional" amount was T\$ 670.³⁴³ On August 8, 2008, an employee of the Fed wrote in an e-mail: «We still are at the early stages of assessing the potential systemic risk from close-out of OTC derivatives transactions by an investment bank's counterparties and identifying potential mitigants.»³⁴⁴ This was not an easy job. Due to many years of deregulation and blind faith, information was deficient.

Section 16.5 of the FCIC report gives examples of fatal errors of judgment of supervisors. After many years of unwarranted positive evaluations the Fed suddenly changed course by 180 degrees, and became very critical.³⁴⁵ It is quite probable that in the course of 2007 and 2008 supervisors came to realize that they had been mistaken all the time, and that they entered an internal crisis of their own making.³⁴⁶

With increasing pressure, employees of financial institutions tend to violate more behavioral norms more seriously. The history of the crisis provides numerous examples. See the FCIC report. In general the information which chief officers of institutions give the outside world is one sidedly positive. Information that might give a negative impression is left out. Sometimes information is even downright incorrect. Furthermore, in the years of the crisis, it seems to be the rule (with exceptions) that when a major bank has to report a loss, the CEO (and maybe some close associates) steps down, and receives a bonus of tens of millions of dollars.³⁴⁷

*Fannie and Freddie up to and including 7/9/08.*³⁴⁸

In 2007 and 2008 Fannie and Freddie went downhill too. Their decline is described in some detail because they were very large and influential, had their own supervisor, and because their history sheds much light on the functioning of the GSEs, the supervisor, and other interested actors. Including their functioning in the preceding years.

Fannie and Freddie always had relatively little capital, even less than other institutions.

«By the end of 2007, guaranteed and portfolio mortgages with FICO scores less than 660 exceeded reported capital at Fannie Mae by more than seven to one; Alt-A loans and securities, by more than six to one. Loans for which borrowers did not provide full documentation amounted to more than ten times reported capital.»³⁴⁹

GSEs and supervisors seem to have assumed that the risks would at most affect profitability. But due to their weak capital situation, the GSEs would not be able to sustain any serious set-back. In other

³⁴² FCIC report p. 298/326. The rectangular brackets are from the FCIC report.

³⁴³ According to p. 542/70 of the Glossary of the FCIC report, "notional amount" = «A measure of the outstanding amount of over-the-counter derivatives contracts, based on the amount of the underlying referenced assets.» It may therefore be compared with an insurance of \$ 300 for a house of \$ 250,000. The last value is the "notional amount".

³⁴⁴ FCIC report p. 298/326.

³⁴⁵ See the subsection Wachovia on pp. 304/332 and following in the FCIC report.

³⁴⁶ This is not supported by the contents of the annual reports of 2009 and later.

³⁴⁷ Search in the FCIC report for "compensation". Examples can be found on pp. 259/87, 265/93 and 273/301.

³⁴⁸ This subsection is based on chapter 17 of the FCIC report.

³⁴⁹ FCIC report p. 312/40. FICO score = A measure of a borrower's creditworthiness based on the borrower's credit data; developed by the Fair Isaac Corporation. FCIC report, Glossary, p. 541/69.

words: trouble was only a matter of time, of waiting. After all, the experience of centuries tells us that (“unexpected”) set-backs are the rule, not the exception. It is not reasonable to assume that the winds are always favorable. (And to ignore warnings).

In November 2007 Fannie and Freddie announced that they would close the year with a net loss. At the end of December it became known that losses greater than respectively 1.45 and 1.7% would mean that Fannie and Freddy were insolvent. At least, if they really had the capital they said they had. There was reason to suspect that they didn’t.³⁵⁰

In the beginning of 2008 the economy didn’t run very well. The mortgage market did poorly. Congress therefore wanted the GSEs to do what they could to keep the mortgage market going. Pressure was exerted on OFHEO and the Treasury (= ministry of finance) to reduce the operational restrictions on the GSEs. OFHEO and Treasury gave in. As a consequence, the capital requirements of the GSEs were gradually reduced. In other words: they were allowed to increase their leverage. And thereby their risks.

In May Fannie and Freddie announced an operational loss for the first quarter of 2008. OFHEO nevertheless continues lowering their capital requirements.

In July Fannie is threatened with illiquidity. The value of its collateral was insufficient to borrow on the repo market what it needed. It asked the Fed for a loan. The Fed gave the NY Fed on 13/7/08 permission to provide a loan.

«At the end of July, Congress passed the Housing and Economic Recovery Act (HERA) of 2008, giving [Treasury secretary] Paulson his bazooka- the ability to extend secured lines of credit to the GSEs, to purchase their mortgage securities, and to inject capital. The 261-page bill also strengthened regulation of the GSEs by creating FHFA, an independent federal agency, as their primary regulator, with expanded authority over Fannie’s and Freddie’s portfolios, capital levels, and compensation. In addition, the bill raised the federal debt ceiling by \$800 billion to \$10.6 trillion, providing funds to operate the GSEs if they were placed into conservatorship.»³⁵¹

The FHFA, the Federal Housing Finance Agency, replaced OFHEO. FHFA had the same director as OFHEO.

In the meantime, employees of the Fed, OCC and Morgan Stanley made an inquiry into the financial situation of the GSEs.

«The Fed and the OCC discovered that the problems were worse than their suspicions and reports from FHFA had led them to believe. According to [Timothy] Clark [of the Fed], the Fed found that the GSEs were significantly “underreserved,” with huge potential losses, and their operations were “unsafe and unsound.” The OCC rejected the forecasting methodologies on which Fannie and Freddie relied. Using its own metrics, it found insufficient reserves for future losses and identified significant problems in credit and risk management. [...]»

Nearly all of the loss projections calculated by Morgan Stanley showed that Fannie would fall below its regulatory capital requirement. Fannie’s projections did not.»³⁵²

The inquiry could only take place because the GSEs needed money. Previously GSEs nor OFHEO (!) tolerated snoopers:

«He [Clark] said that previously, “The GSEs [saw] the Fed as public enemy number one. . . . There was a battle between us and them.” Clark added, “We would deal with OFHEO, which was also very guarded. So we did not have access to info until they wanted funding from us.”»³⁵³

In the two weeks between 22/8 and 4/9 the opinion of FHFA about the GSEs changed radically. A nuanced positive judgment was replaced with a long list of serious worries and complaints. For 22/8/08 we have the following testimony:

«On August 22, FHFA informed both Mudd and Syron [CEOs of resp. Fannie and Freddie] that their firms were “adequately capitalized” under the regulations, a judgment based on financial information that was “certified and represented as true and correct by [GSE] management.” But FHFA

³⁵⁰ FCIC report p. 312/40.

³⁵¹ FCIC report p. 317/45.

³⁵² FCIC report p. 317/45.

³⁵³ FCIC report p. 317/45.

also emphasized that it was “seriously concerned about the current level of Fannie Mae’s capital” if the housing market decline continued.»³⁵⁴

It seems incomprehensible that this could be signed by somebody who knew about the inquiry of the Fed, OCC and Morgan Stanley. Was the FHFA kept in the dark? Maybe, but not necessarily. Taking account of the ever increasing AH-goals and the worries expressed in the annual reports of the GSEs, the relatively positive judgments and care-free attitude of OFHEO had already been a mystery for years.³⁵⁵ From this point of view there was at least continuity and consistency.

For 4/9 the evidence consists of letters with reports of the FHFA to the GSEs. FHFA seems to have finally seen the light (or black hole). Regarding the appendix about Fannie the FCIC notes:

«The 21-page report sent to Fannie identified sweeping concerns, including failures by the board and senior management, a significant drop in the quality of mortgages and securities owned or guaranteed by the GSE, insufficient reserves, the almost exclusive reliance on short-term funding, and the inability to raise additional capital. FHFA admonished management and the board for their “imprudent decisions” to “purchase or guarantee higher risk mortgage products.” The letter faulted Fannie for purchasing high-risk loans to “increase market share, raise revenue and meet housing goals,” and for attempting to increase market share by competing with Wall Street firms that purchased lower-quality securities. FHFA, noting “a conflict between prudent credit risk management and corporate business objectives,” found that these purchases of higher-risk loans were predicated on the relaxing of underwriting and eligibility standards. [Etcetera, etcetera]»³⁵⁶

The evaluation and conclusion for Freddie were even worse.³⁵⁷

The same turnaround can be observed in the transition from the 2008 (Annual) Report of OFHEO³⁵⁸ to the 2008 (Annual) Report of successor FHFA³⁵⁹, both to Congress. Even though James B'. Lockhart III was director of both OFHEO and FHFA. The most amazing is of course not the last judgment, but the earlier one.³⁶⁰ And the sudden turnaround. The FCIC explains neither.

CEO Daniel Mudd of Fannie told the FCIC that the letter of 4/9 came as a complete surprise:

«Mudd told the FCIC that its regulator had never before communicated the kind of criticisms leveled in the September 4 letter. He said the regulator’s “chronicling of the situation” then was “inconsistent with what you would consider better regulatory practice to be- like, first warning: fix it; second warning: fix it; third warning: you’re out of here. Instead, they went from zero to three with no warning in between.” A review of the examination reports and other documents provided by FHFA to the FCIC largely supports Mudd’s view on this specific point. While OFHEO’s examination reports noted concerns about increasing credit risk and slow remediation of deficiencies required by the May 2006 consent agreement, they do not include the sweeping criticisms contained in the September 4 letter.»³⁶¹

Treasury secretary Paulson, Fed chairman Bernanke and director Lockhart of the FHFA tried to show the boards of the GSEs that they could better accept conservatorship of FHFA than continue independently. The GSEs would only be able (be permitted) to borrow money from the government if they agreed with conservatorship. So they didn’t have a choice. The Treasury announced the conservatorship on Sunday 7/9/08.³⁶² The CEOs of the GSEs had to go.³⁶³

It was not a real takeover, but the shares of the GSEs nevertheless lost much of their value, and worsened the capital position of the shareholders. This caused downgrades and bankruptcies.

Paulson and under secretary Kashkari expected that the intervention would stabilize the market, and give a breathing space of about a month. But the market saw the intervention primarily as a sign of

³⁵⁴ FCIC report p. 318/46. As always, the FCIC report gives the source.

³⁵⁵ Unless one doubts the independence of OFHEO because it is part of HUD.

³⁵⁶ FCIC report p. 318/46.

³⁵⁷ FCIC report p. 319/47.

³⁵⁸ The pdf-file was made on 29/5/08, and last revised on 9/4/09.

³⁵⁹ The pdf-file was made on 8/4/09, and last revised on 3/9/09.

³⁶⁰ Although the surprise about the higher risk mortgages is false and treacherous. OFHEO should have warned for years, and objected against HUD’s affordable housing goals. As the next quote shows, FCIC agrees.

³⁶¹ FCIC report pp. 319-20/47-8.

³⁶² New York Times, *Credit crisis- The essentials overview*, the version “updated 10/1/11”.

³⁶³ From 2000-2008 CEO Mudd of Fannie had been paid M\$ 65. FCIC report p. 322/50.

mismangement of the GSEs and the high risk of their products.³⁶⁴

In retrospect, some of those involved offer explanations, though not of OFHEOs or their own silence of years:

«When interviewed by the FCIC, FHFA officials were very critical of Fannie's management. John Kerr, the FHFA examiner (and an OCC veteran) in charge of Fannie examinations, minced no words. He labeled Fannie “the worst-run financial institution” he had seen in his 30 years as a bank regulator. Scott Smith, who became associate director at FHFA after that agency replaced OFHEO, concurred; in his view, Fannie's forecasting capabilities were not particularly well thought out, and lacked a variety of stress scenarios. Both officials noted Fannie's weak forecasting models, which included hundreds of market simulations but scarcely any that contemplated declines in house prices. To Austin Kelly, an OFHEO examination specialist, there was no relying on Fannie's numbers, because their “processes were a bowl of spaghetti.” Kerr and a colleague said that they were struck that Fannie Mae, a multitrillion-dollar company, employed unsophisticated technology: it was less techsavvy than the average community bank.»³⁶⁵

This raises the question why the opinions of these people were ignored by their management for so long, and why these people accepted its passivity, knowing the risks and the duty of OFHEO. The observations anyway underline the systematic dysfunctioning of OFHEO, and that of the responsible secretary: that of HUD.

In anticipation of Lehman's bankruptcy.

On 14/9/08, ten of the world's largest banks agree to pool \$70 billion in a liquidity fund to mitigate the expected failure of Lehman Brothers. The ten banks involved are Bank of America, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Merrill Lynch, Morgan Stanley, and UBS. Each of the banks will be able to borrow up to one third of the fund by pledging a wide range of collateral that is not accepted for Fed loans.

The Fed also relaxed regulations and said it would allow a broader range of collateral for Fed loans and that it will also suspend the rule that prohibits deposit-taking banks from using deposits to help finance their investment banking subsidiaries until January 30, 2009.³⁶⁶

*The bankruptcy of Lehman 15/9/08.*³⁶⁷

After the fall of Bear Stearns, Lehman was the banking institution with the lowest rating. Lehman had to pay a higher premium to insure its debt than its sister institutions. Lehman contributed to its own downgrading by including debatable asset valuations in its financial reports. This made business relations and investors distrustful. The number of margin calls³⁶⁸ increased.

«As of mid-June, 62% of Lehman's liquidity was dependent on borrowing against nontraditional securities, such as illiquid mortgage-related securities- which could not be financed with the PDCF and of which investors were becoming increasingly wary.»³⁶⁹

On 10/7/08 two repo lenders of Lehman tell clearing bank J P Morgan that they don't want to do business with Lehman any more.

The Fed and Treasury had already been thinking and talking about solutions for over a month. They didn't know what to do. There was a lack of information. Information was gathered circumspectly, to avoid weakening Lehman's position unnecessarily. Only on 5/9/08 did Lehman inform the NY Fed about its OTC portfolio.

People from the banking world feared that the fall of Lehman would cause the fall of many other institutions. They therefore requested the Fed to develop a solution which included more than

³⁶⁴ Once more, Paulson and Kashkari (and their subordinates) were mistaken. Once more, since the responsibility for the healthy operation of the financial system ultimately rests with the Treasury secretary. For more on this aspect see the Analysis.

³⁶⁵ FCIC report pp. 321-2/349-50.

³⁶⁶ Credit Crisis Timeline, University of Iowa. Dated 1/7/09.

³⁶⁷ Chapter 18 of the FCIC report gives a detailed report.

³⁶⁸ Margin call= request (demand) for additional collateral. The call is based on obligations stipulated in the security (contract).

³⁶⁹ FCIC report p. 328/56.

Lehman.³⁷⁰

On 10/9/08 Lehman reported a loss of B\$ 4 for the third quarter. This further reduced confidence, and stimulated their business relations to minimize their exposure to Lehman.

On Thursday 11/9/08 J P Morgan asked Lehman to deposit B\$ 5 cash collateral before the opening of business Friday. Lehman didn't have this money. Lehman employees were treated disrespectfully by those of J P Morgan. Lehman nevertheless succeeded in coughing up the requested money.

«Early Friday evening [12/9/08], Treasury Secretary Paulson summoned the [...] CEOs of the big Wall Street firms to the New York Fed's headquarters. Paulson told them that a private-sector solution was the only option to prevent a Lehman bankruptcy. The people in the room needed to come up with a realistic set of options to help limit damage to the system. A sudden and disorderly wind-down could harm the capital markets and pose the significant risk of a precipitous drop in asset prices, resulting in collateral calls and reduced liquidity: that is, systemic risk.³⁷¹ He could not offer the prospect of containing the damage if the executives were unable to fashion an orderly resolution of the situation, as had been done in 1998 for Long-Term Capital Management.³⁷² Paulson did offer the Fed's help through regulatory approvals and access to lending facilities, but emphasized that the Fed would not provide "any form of extraordinary credit support." As New York Fed General Counsel Tom Baxter told the FCIC, Paulson made it clear there would be no government assistance, "not a penny."

H. Rodgin Cohen, a veteran Wall Street lawyer who has represented most of the major banks, including Lehman, told the FCIC that the government's "not a penny" posture was a calculated strategy: "I don't know exactly what the government was thinking, but my impression was they were playing a game of chicken or poker or whatever. It was said on more than one occasion that it would be very politically difficult to rescue Lehman. There had been a lot of blowback after Bear Stearns."³⁷³

Saturday morning it seemed as if Barclays would buy Lehman, except for B\$ 45 assets which would be taken over by a consortium.

The same Saturday morning Merrill Lynch CEO John Thain concluded that Lehman would not be saved, and that his bank would be the next in line. He therefore contacted Bank of America (BofA) CEO Ken Lewis. On Sunday the CEOs agreed that BofA would buy Merrill for \$ 29 per share.

On Sunday Barclays realized that the deal would entail an unknown but major risk, already before the acquisition would be effectuated. It wanted the Fed to assume that risk, but Paulson and the Fed refused.

On this same day the Treasury department and the Fed put pressure on Lehman to file for bankruptcy. Harvey Miller, bankruptcy counsel of Lehman, and his colleagues reported to their Board. At the request of the Board they contacted Baxter of the NY Fed to ask whether the government actually ordered them to file for bankruptcy. Of course, Baxter could not agree with such a formulation. He said that the position of the government had been made "perfectly clear" in the meeting. President McDade of Lehman told his Board that Lehman could not stay in business without government money. Thereupon the Board agreed with filing for bankruptcy. Filing took place 1:45 AM Monday morning 15/9/08.

It is clear that the Fed and the government underestimated the consequences of the bankruptcy of Lehman.³⁷⁴ Even the direct consequences were not negligible:

«As for Lehman itself, the bankruptcy affected about 8,000 subsidiaries and affiliates with \$600 billion in assets and liabilities, the firm's more than 100,000 creditors, and about 26,000 employees. Its failure triggered default clauses in derivatives contracts, allowing its counterparties to have the option of seizing its collateral and terminating the contracts. After the parent company filed, about 80 insolvency proceedings of its subsidiaries in 18 foreign countries followed. In the main bankruptcy

³⁷⁰ FCIC report p. 333/61.

³⁷¹ A responsibility of Paulson and the Fed, not of the private banks. In other words: because of their function, the attitudes of Paulson and the Fed were inadmissible.

³⁷² But note that Lehman was of the order of 100 times as big as LTCM. For LTCM figures see under 1998, for figures about Lehman see below.

³⁷³ FCIC report p. 334/62.

³⁷⁴ Even if those responsible pretend otherwise. For example Bernanke, FCIC report p. 339/367. The section "A CALAMITY" gives more instances of inconsistent utterances of Bernanke. ("Inconsistent" implies: untruthful).

proceeding, about 66,000 claims- exceeding \$873 billion- have been filed against Lehman as of September 2010.»³⁷⁵

For many years supervisors and governments had ignored analyses of relationships in the financial system, and warnings about them. In the months and days before the bankruptcy of Lehman their thinking had not changed fundamentally. Witness the following:

«As Bernanke acknowledged to the FCIC [in 2010], however, his explanation for not providing assistance to Lehman was not the explanation he offered days after the bankruptcy- at that time, he said that he believed the market was prepared for the event.»³⁷⁶

This would have been an acceptable excuse if he could not and should not have known better. But he could and should. His later explanation is that he had no choice.³⁷⁷ Because of the systematic dereliction of duty of the Fed since 1994 at the latest this can be considered as utterly misleading. Moreover, if the Fed had somehow saved Lehman he could have said the same: that he had no choice.

AIG up to and including the bailout by the Fed on 16/9/08.

“AIG” means: American International Group. It was the biggest insurance company in the USA. For the financial system it was more important than Lehman, because “every bank and dealer has exposure to them”.³⁷⁸

On 11/8/08 supervisor OTS of AIG was still thinking that AIG had no liquidity problems. The NY Fed thought otherwise. An analysis of Kevin Coffey of the NY Fed of 14/8/08 listed various red lights.³⁷⁹ They were confirmed by a report that Goldman Sachs sent to its customers on 18/8/08. It was entitled “Don’t Buy AIG: Potential Downgrades, Capital Raise on the Horizon”.

On 12/9/08 a delegation of AIG went to the NY Fed and asked what it could do to get a loan. For AIG was not eligible for the PDCF. According to the delegation, they could hold out at most a week without a loan. They expected a downgrade, and in its wake margin calls which they would not be able to answer. They didn’t have enough collateral to extend loans and borrow more, and saw no possibilities for raising capital.

The Fed tried private sector solutions. But after the bankruptcy of Lehman the private sector didn’t want to increase its risks by unknown amounts.³⁸⁰

After the closing of the market on Monday 15/9/08 AIG told the NY Fed that it didn’t have enough money to be able to operate the next day. The NY Fed decided to bail out AIG in the same way as Bear Stearns. In the first instance the NY Fed gave AIG a loan of B\$ 85 (against collateral). Ultimately the government loaned AIG a total of B\$ 182. A Congressional Oversight Panel «faulted the government for deciding to bail out AIG too hastily: “With AIG, the Federal Reserve and Treasury broke new ground. They put the U.S. taxpayer on the line for the full cost and full risk of rescuing a failing company.” The Treasury Department defended its decision, saying that the panel report “overlooks the basic fact that the global economy was on the brink of collapse and there were only hours in which to make critical decisions.”»³⁸¹

The second half of September 2008.

The bailout of AIG took place on the day after the bankruptcy of Lehman and the take over of

³⁷⁵ FCIC report pp. 339-40/67-8.

³⁷⁶ FCIC report p. 340/68. Note by the way that the remark of Bernanke is rather ambiguous. One can be prepared, even as good as possible, without being able to survive. One cannot always be prepared sufficiently for everything. Bernanke and Paulson could not and should not have assumed that one can. They themselves could and should have done things no individual institution (or group of institutions) could have done. Possibly the financial system could have been safe if and only if supervisors and government had done their duty. But they didn’t. By deregulation and enforcing affordable housing goals the government even made it more unsafe.

³⁷⁷ FCIC report p. 341/69.

³⁷⁸ FCIC report p. 347/75.

³⁷⁹ Summarised in the FCIC report on p. 346/74.

³⁸⁰ In the given situation the main problem was: are the risks we run bearable? Many actors had serious doubts about the answer. In such a situation accepting an additional risk can easily be fatal.

³⁸¹ FCIC report p. 350/78. Of course, if you wait long enough, you may have to decide in seconds. This and similar situations could have been studied years before. Scenario’s could and should have been ready.

Merrill Lynch by the Bank of America. In the eyes of the financial institutions, these events, and the acceleration in the rate at which they unfolded, confirmed the fear that they stood at the brink of the abyss, and that the same applied to the institutions they depended on. The Fed provided loans on a large scale. But this did not eliminate the uncertainty about the continuity or survival of business relations.

Investors tried to exchange debt securities of even the most renowned companies for the most reliable securities, treasury bonds. Trust had completely evaporated. People were only interested in insured securities. Insurance costs rose from 1 to 5%. On 19/9/08 the US government reacted with two new loan/ insurance programs. This probably slowed down the pace of events. Temporarily.

The OTC market came almost to a standstill. This «greatly diminished the ability of institutions to enter or unwind their contracts or to effectively hedge their business risks at a time when uncertainty in the financial system made risk management a top priority.»³⁸²

On 18/9/08 the SEC (temporarily) prohibited shortselling of securities of a large number of financial institutions. Treasury secretary Paulson started an effort to get approval of Congress for a Troubled Asset Relief Program (TARP).

For the time being the financial system continued sliding downwards:

«To protect themselves, hedge funds pulled billions of dollars in cash and other assets out of Morgan Stanley, Merrill, and Goldman in favor of prime brokers in bank holding companies, such as JP Morgan; big foreign banks, such as Deutsche Bank and Credit Suisse; and custodian banks, such as BNY Mellon and Northern Trust, which they believed were safer and more transparent.»³⁸³

Similarly, the hedge funds became victims of runs by their customers. They pulled back about 20% of their investments, with a total value of more than T\$ 2. Because of leverage effects the impact of these withdrawals was much larger:

«The hedge fund run became a \$32 billion torrent on Wednesday [17/9/08], the day after AIG was bailed out and the day that “many of our sophisticated clients started to liquefy,” as Wong [Morgan Stanley’s treasurer] put it. Many of the hedge funds now sought to exercise their contractual capability to borrow more from Morgan Stanley’s prime brokerage without needing to post collateral. Morgan Stanley borrowed \$13 billion from the Fed’s PDCF on Tuesday, \$27 billion on Wednesday, and \$35.3 billion on Friday.»³⁸⁴

Two repo clearing banks, JP Morgan en BNY Mellon, start asking more collateral:

«On Saturday [20/9/08], Morgan Stanley executives briefed the New York Fed on the situation. By this time, the firm had a total of \$35.3 billion in PDCF funding and \$32.5 billion in TSLF funding from the Fed. Morgan Stanley’s liquidity pool had dropped from \$130 billion to \$55 billion in one week. [... The] run vastly exceeded the company’s most severe scenario in stress tests administered only one month earlier.»³⁸⁵

Reality was much worse than the stress tests assumed.

Goldman had similar problems. Together with Morgan Stanley it requested the Fed on Sunday 21/9/08 permission for becoming a holding company. In cooperation with the department of Justice their request was approved with exceptional speed. Whereupon «Morgan Stanley instantly converted its \$39 billion industrial loan company into a national bank, subject to supervision by the Office of the Comptroller of the Currency (OCC), and Goldman converted its \$26 billion industrial loan company

³⁸² FCIC report p. 365/93. This sentence is highly debatable. It raises doubts about the understanding of risk management by the author of the sentence. The point being that it is the risk management of the past years that is being put to the test. In the crisis risks became and become reality. In September 2008 it should have been much less a matter of (new) risk management than executing plans made in the framework of risk management and scenario analyses in the past, in order to avoid or reduce losses. Unless every activity directed at reduction of loss is called “risk management”. The sentence says much about the way the FCIC perceives risk and risk management. It is defined and argued badly, if at all. (One can utter phrases which have no meaning. One can utter phrases without understanding what they mean).

³⁸³ FCIC report p. 360/88.

³⁸⁴ FCIC report p. 361/89.

³⁸⁵ FCIC report p. 362/90.

into a state-chartered bank that was a member of the Federal Reserve System, subject to supervision by the Fed and New York State. The Fed would begin to supervise the two new bank holding companies. The two companies gained the immediate benefit of emergency access to the discount window for terms of up to 90 days».³⁸⁶ An important side effect of the operation was that it showed other market participants that it was highly improbable that these institutions would go bankrupt. An important uncertainty had been eliminated (almost).

It was not enough to stop the slide. Washington Mutual was next in line:

«Washington Mutual, Inc. [...], abbreviated to WaMu, was a savings bank holding company and the former owner of Washington Mutual Bank, which was the United States' largest savings and loan association until its collapse in 2008.

On Thursday, September 25, 2008, the United States Office of Thrift Supervision (OTS) seized Washington Mutual Bank from Washington Mutual, Inc. and placed it into the receivership of the Federal Deposit Insurance Corporation (FDIC). The OTS took the action due to the withdrawal of \$16.7 billion in deposits during a 9-day bank run (amounting to 9% of the deposits it had held on June 30, 2008). The FDIC sold the banking subsidiaries (minus unsecured debt or equity claims) to JPMorgan Chase for \$1.9 billion, which JPMorgan Chase had been planning to acquire as part of a confidential plan internally nicknamed Project West. All WaMu branches were rebranded as Chase branches by the end of 2009. The holding company, Washington Mutual, Inc., was left with \$33 billion in assets, and \$8 billion debt, after being stripped of its banking subsidiary by the FDIC. The next day, September 26, Washington Mutual, Inc. filed for Chapter 11 voluntary bankruptcy in Delaware, where it is incorporated.

With respect to total assets under management, Washington Mutual Bank's closure and receivership is the largest bank failure in American financial history. Before the receivership action, it was the sixth-largest bank in the United States. According to Washington Mutual Inc.'s 2007 SEC filing, the holding company held assets valued at \$327.9 billion.»³⁸⁷

OTS had a responsibility because WaMu was a “thrift”.³⁸⁸ The take over had been prepared by the FDIC and J P Morgan. WaMu disagreed with the take over, and filed suit against the FDIC.³⁸⁹ The wisdom of the conduct of the supervisors was doubted by the Treasury department. The supervisors may have underestimated the disturbing effect of their intervention on the market.³⁹⁰ The partial take over could not be called a rescue operation. It caused substantial capital annihilation. Uninsured creditors lost all their money. The operation was one more warning that one could better try to save what one could. As a consequence, the conduct of OTS and FDIC made some risks greater instead of smaller.

Next came Wachovia, the fourth-largest bank holding company. It was «the largest holder of payment-option ARMs, the same product that had helped bring down WaMu and Countrywide».³⁹¹ In September it saw liquidity problems coming, and asked support from the Fed. The day after the fall of WaMu, Friday 26/9/08, there was a run on Wachovia, or an acceleration of the run. Business relations began to refuse doing business with them. Roll-over was refused.³⁹² Quotes of Wachovia related securities fell precipitously. In the evening Wachovia told the Fed that it had big problems. According to the FCIC «Government officials were not prepared to let Wachovia open for business on Monday,

³⁸⁶ FCIC report pp. 362-3/90-1.

³⁸⁷ Wikipedia, page “Washington Mutual” (19/5/12). In the quote the footnote references have been dropped.

³⁸⁸ FCIC report p. 365/93. According to Merriam-Webster (2002) a thrift is a savings bank or savings and loan association.

³⁸⁹ According to the Wikipedia, page “Washington Mutual” (19/5/12): «On March 20, 2009, Washington Mutual Inc. filed suit against the FDIC in the United States District Court for the District of Columbia, seeking damages of approximately \$13 billion for what they claim to be an unjustified seizure and an extremely low sale price to JPMorgan Chase. JPMorgan Chase promptly filed a counterclaim in the Federal Bankruptcy Court in Delaware, where the Washington Mutual bankruptcy proceedings had been continuing since the Office of Thrift Supervision's seizure of the holding company's bank subsidiaries.»

³⁹⁰ See for example the FCIC report p. 367/95, the second full paragraph, about the run on Wachovia.

³⁹¹ FCIC report p. 366/94.

³⁹² Roll-over is equivalent with prolongation of a loan, but generally refers to short term loans.

September 29, without a deal in place.»³⁹³ The Fed started looking for banks willing and able to take over Wachovia. Obstacles were: knowledge of the books, i.e. the risks, and government support, in this case from the FDIC. Wachovia itself came with a proposal for independent continuation.

The FDIC had not yet agreed with the applicability of the systemic risk exception, a formal condition for certain measures. The board of the FDIC discussed this on Monday morning 29/9/08, 6 AM. OCC, OTS and Treasury had representatives in the board. Within half an hour the board agreed to the exception. An offer of Citigroup was accepted. The board of Wachovia also accepted this offer. A short time later the more or less provisional contracts were signed.

Tuesday 30/9/08 a change took place in the tax regulation. According to the new rules losses of a company which had been taken over could be written off at once and completely instead of distributed over a number of years.

Thursday morning 2/10/08 Wells Fargo made a new offer. It offered \$ 7 per share, seven times the offer of Citigroup. It would not require government support. At 11:00 PM the board of Wachovia convened an emergency session, and accepted the offer unanimously.

The CEO of Citigroup was informed Friday 3/10/08 3:00 AM. He was surprised and disappointed. He thought he had a deal. He asked if he could take over Wachovia on the same conditions as Wells Fargo. Director Bair of the FDIC answered "No", that it was a private contract, and that the FDIC didn't have the role to help Citi in a bidding war. She furthermore doubted whether Citi could pay \$ 7 a share.

The deal was published the same Friday morning. It would come into effect midnight 31/12/08. The press release stressed that the government or government money were not involved in the contract.³⁹⁴

The following is from the Wiki page about John M. Reich, director of OTS:

«Under Director Reich, the Office of Thrift Supervision saw the failure or near-failure of at least five major institutions - IndyMac Bank, AIG, Washington Mutual, Downey Financial and Countrywide Financial. These constituted some of the largest financial failures in modern history to that point. OTS later acknowledged that in the case of AIG it failed to take regulatory actions it should appropriately have taken as early as 2004. In the case of IndyMac, after Director Reich and OTS both denied responsibility for the failure, the Office of Inspector General of the United States Treasury found that OTS both inappropriately failed to act and inappropriately and knowingly allowed regulatory misconduct.»³⁹⁵

The end of September and October 2008.

At the end of September the existing legal instruments of the Fed to provide support were exhausted. Saturday 20/9/08 Treasury secretary Paulson sent a proposal of three pages to Congress for a Troubled Asset Relief Program (TARP). It would provide «authority for the Federal Government to purchase and insure certain types of troubled [“toxic”] assets for the purposes of providing stability to and preventing disruption in the economy and financial system and protecting taxpayers»³⁹⁶ to an amount of B\$ 700. For the supervision of the program a Congressional Oversight Panel and an Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) would be installed. Monday 29/9/08 the proposal was rejected by the House of representatives. It was adjusted and expanded to 169 pages. It was approved by Congress, and signed into law by president G.W. Bush on Friday 3/10/08.

But the markets deteriorated further. «In response, on October 7, the Fed created yet another emergency program, the Commercial Paper Funding Facility, to purchase secured and unsecured

³⁹³ FCIC report p. 367/95.

³⁹⁴ FCIC report, section 20.5, pp. 366/94 and following. The preceding text in the FCIC report shows that this is at best a half truth, even in the case most advantageous for Bair. For tax measures are equivalent with support or impediment.

³⁹⁵ Wiki page of 20130207, in the directory USA/OTS.

³⁹⁶ FCIC report p. 372/400.

commercial paper directly from eligible issuers. This program, which allowed firms to roll over their debt, would be widely used by financial and nonfinancial firms.» Including foreign banks such as UBS and Dexia, and companies like Toyota and McDonald's.³⁹⁷

The misery was not restricted to the USA. In Europe too, institutions had invested in MBS. Share prices were falling everywhere. In the beginning of October they seemed to get into a free fall. They lost 20% in a single week. To slow down this development, or to reverse it, the most important central banks, the Bank of Canada, the Bank of England, the ECB, the Federal Reserve, the Swedish Riksbank and the Swiss National Bank, on 8/10/08 lowered the discount rate.

«The action prompted a worldwide stock rally, with the Dow rising 936 points, or 11 percent, on October 13. But as the prospect of a severe global recession became more evident, such gains were impossible to sustain. Just two days later, after Ben S. Bernanke, the Federal Reserve chairman, said there would be no quick economic turnaround even with the government's intervention, the Dow plunged 733 points.»³⁹⁸

It would go on like this until March 2009.

8/10/08. «The UK government launches a £400 billion rescue plan to help restore confidence in the financial markets. The three-pronged plan included:

- 1) the government investing as much as £50 billion in the banking industry,
- 2) guaranteeing as much as £250 billion of new bank debt, and
- 3) adding £100 billion to the existing Bank of England short-term loan scheme.»³⁹⁹

On 29/10/08 the US Fed lowered its discount rate from 1.5% to 1%. In November the ECB and Bank of England followed suit, and further lowered their rates as well.⁴⁰⁰

The US government was working on a proposal for support of home owners in difficulties, and of banks which were willing to reduce the monthly mortgage costs of such home owners.

The above shows that in the USA there were several or even many governmental emergency programs. On pp. 375-6/403-4 of its report the FCIC gives some numbers:

«The Fed's TSLF and PDCF programs peaked at \$483 billion and \$156 billion, respectively. Its money market funding peaked at \$350 billion in January 2009, and its Commercial Paper Funding Facility peaked at \$365 billion, also in January 2009. When it was introduced, the FDIC's program to guarantee senior debt for all FDIC-insured institutions stood ready to backstop as much as \$939 billion in bank debt. The Fed's largest program, announced in November 2008, purchased \$1.25 trillion in agency mortgage-backed securities.»

November 2008 - January 2009.

On 10/11/08 the remaining problems of AIG were solved using TARP:

«[...] the government announced that it was restructuring the New York Fed loan and, in the process, Treasury would purchase \$ 40 billion in AIG preferred stock. As was done in the Capital Purchase Program, in return for the equity provided, Treasury received stock warrants from AIG and imposed restrictions on dividends and executive compensation.»⁴⁰¹

Afterwards, the operation was criticized by the TARP-supervisor:

«In June 2010, TARP's Congressional Oversight Panel criticized the AIG bailout [by the NY Fed] for having a “poisonous” effect on capital markets. The report said the government's failure to require

³⁹⁷ FCIC report p. 374/402.

³⁹⁸ From: Credit crisis- The essentials overview, The New York Times, updated Jan. 10, 2011. This overview may henceforth be abbreviated as CCE (credit crisis essentials).

³⁹⁹ From the timeline of the University of Iowa. In de timeline of the UK House of Commons the amounts are missing. These and more timelines can be found in the directory FC/Timelines.

⁴⁰⁰ The ECB from 3,75 to 3,25%, and the BoE from 4,5 to 3%. Source: inverse timeline of Chunlin Liu.

⁴⁰¹ FCIC report p. 376/404.

“shared sacrifice” among AIG’s creditors effectively altered the relationship between the government and the markets, signaling an implicit “too big to fail” guarantee for certain firms. The report said the New York Fed should have insisted on concessions from counterparties.

Treasury and Fed officials countered that concessions would have led to an instant ratings downgrade and precipitated a run on AIG.⁴⁰² New York Fed officials told the FCIC that they had very little bargaining power with counterparties who were protected by the terms of their CDS contracts.⁴⁰³ And, after providing a \$85 billion loan, the government could not let AIG fail. “Counterparties said ‘we got the collateral, the contractual rights, you’ve been rescued by the Fed, Uncle Sam’s behind you, why would we let you out of a contract you agreed to?’”⁴⁰⁴

About the costs for the tax payer the FCIC remarks:

«In total, the Fed and Treasury had made available over \$180 billion in assistance to AIG to prevent its failure. As of September 30, 2010, the total outstanding assistance has been reduced to \$124.8 billion, primarily through the sale of AIG business units»⁴⁰⁵

After the failure of the Wachovia deal, the price of Citigroup shares had fallen 60%. It asked the Fed for more loans. The Fed refused because it feared that the money would vanish as soon as provided. Instead «Treasury agreed [Sunday 23/11/08] to provide Citigroup with an additional \$20 billion in TARP funds in exchange for preferred stock with an 8% dividend. This injection of cash brought the company’s TARP tab to \$45 billion. The bank also received \$19.5 billion in capital benefits related to its issuance of preferred stock and the government’s guarantee of certain assets.»⁴⁰⁶

At a meeting of the FDIC board the same Sunday 10:00 PM OTS director John Reich expressed doubts about the consistency of the intervention(s). Were similar remedies applied in similar cases? Were the same norms applied to decide if there was a systemic risk? Whatever the answers, the FDIC approved the proposal.

About the follow up the FCIC reports: [In] «December 2009 [...] Citigroup terminated the government guarantee in tandem with repaying \$20 billion in TARP funds. In December 2010, Treasury announced the sale of its final shares of Citigroup’s common stock.»⁴⁰⁷

Bank of America was seen as the next domino. In October 2007 it had taken over Countrywide. On 15/9/08 it had announced that it would take over Merrill Lynch. But only per 1/1/09, and after approval by supervisors and shareholders. The Fed approved the take over on 26/11/08, the shareholders on 5/12/08.

But BofA started to get doubts because the losses of Merrill “accelerated pretty dramatically”, in the words of CEO Ken Lewis of BofA. He said they had known the assets, but had not expected their value to drop so fast.

«Merrill’s [CEO] Thain contests that version of events. He told the FCIC that Merrill provided daily profit and loss reports to Bank of America and that bank executives should have known about losses as they occurred. The SEC later brought an enforcement action against Bank of America, charging the company with failing to disclose about \$9.5 billion of known and expected Merrill Lynch losses before the December 5 shareholder vote. According to the SEC’s complaint, these insufficient disclosures deprived shareholders of material information that was critical to their ability to fairly evaluate the merger. In February 2010, Bank of America would pay \$150 million to settle the SEC’s action».⁴⁰⁸

On 15/12/08 Lewis told Paulson that he wanted to invoke the “material adverse change” clause in the agreement which permitted exit or renegotiation. Paulson and Bernanke asked time to consider. They concluded that everyone concerned would be hurt by putting the clause into effect, and that it would cause a systemic risk. They furthermore thought that legal action would fail. Sunday 21/12/08

⁴⁰² At great costs to the counterparties. So the argument is weak at best.

⁴⁰³ This too is debatable: Non-existing money cannot be paid.

⁴⁰⁴ FCIC report p. 378/406.

⁴⁰⁵ FCIC report, section 20.7.

⁴⁰⁶ FCIC report p. 381/409.

⁴⁰⁷ FCIC report p. 382/410.

⁴⁰⁸ FCIC report p. 383/411. Note that this money goes to the SEC, not to the shareholders.

Paulson informed Lewis. He also told him «that the Fed, as its [= BofA's] regulator, had the legal authority to replace Bank of America's management and board if they embarked on a “destructive” strategy that had “no reasonable legal basis.”»⁴⁰⁹

In spite of the support already given, the risks for BofA remained significant. Every night BofA rolled over more than B\$ 500. Downgrades and relatively small collateral calls could easily cause liquidity problems. Treasury, Fed and FDIC therefore decided upon an arrangement similar to that for Citigroup. Once again the FDIC invoked the systemic risk exception. Namely on 15/1/09, in time for BofA's announcement of a net loss of B\$ 15.3 by Merrill due to real estate related write-downs en charges. The government arrangement was announced at the same time. The price of BofA shares nevertheless dropped 14%.

On 6/5/09 BofA requested termination of the “ring fence (protection) deal”, which was part of the arrangement. This was granted, conditional upon payment of M\$ 425 «for the benefits it had received from the market's perception that the government would insure its assets.»⁴¹⁰

9/11/08. «China announced a £373bn [B\$ 586] economic stimulus package to boost its economy». ⁴¹¹

On 16/12/08 the Fed lowered its discount rate from 1% to a range of 0-0.25%.⁴¹²

In 2008 unemployment in the USA increased to 7.2%. Before the crisis it was 4.4%.⁴¹³

In 2008 the S&P 500 lost 41% (in 1931 47%), the Nikkei 225 42%, and the FTSE Eurofirst 300 45%.⁴¹⁴

S&P 500 1990- 2013.⁴¹⁵



2009.

On 1 January 2009, Slovakia joins the euro area.

⁴⁰⁹ FCIC report p. 384/412.

⁴¹⁰ FCIC report p. 386/414.

⁴¹¹ Timeline UK House of Commons.

⁴¹² According to the timeline of the UK House of Commons. Chunlin Liu gives the date of 17/1/08. Can the difference be due to a difference in time zones?

⁴¹³ The most convenient source for this kind of data are the Annex tables of the OECD publications Economic Outlook. They are published twice a year, around 1/6 and 1/12. Those of 2004-2010 can be found in the directory OECD. This publication is also convenient because the pdf-file has a table of contents with links. Downloads are not free however. Even though OECD is paid 100% by taxes.

⁴¹⁴ Inverse timeline of Chunlin Liu. When evaluating graphs such as those presented here, please keep in mind that indexes like the S&P, Dow Jones, DAX etc. are not based on a fixed basket of shares, but that the contents of the basket is periodically changed in such a way as to produce a more positive development.

⁴¹⁵ Yahoo, 27/5/13.

As from here, the chronicle has a somewhat different character. The remainder of the chronicle is more impressionistic. It adds support for the hypothesis of the structural character of phenomena. But it is not strictly necessary for the analysis and explanation, and for the substantiation of the conclusions and measures. It wants to:

- Give an impression of the consequences of the earlier events;
- Show that the crisis is far from over;
- Give an impression of the actions of governments and supervisors (too late, many, and of dubious quality);
- Give an impression of the mental climate of the times.

Someone who is mainly interested in causes and lessons of the crisis may skip the remainder and jump to the Analysis.

January 2009.

8/1/09. The Bank of England lowers the discount rate to 1.5%. It has not been this small for 300 years.

9/1/09. The German government takes an interest of 25% in Commerzbank, to prevent bankruptcy due to liquidity shortage.

14/1/09. The Greek government debt is downgraded by S&P.

15/1/09. The Irish government nationalizes the Anglo Irish Bank.

16/1/09. The ECB lowers the discount rate with 0.5 percentage points to 2%.

19/1/08. The UK government announces a plan for support of the banking sector.

20/1/09. Spain loses its AAA rating of S&P.

26/1/09. President Obama appoints T.F. Geithner, till then chairman of the NY Fed, secretary of the Treasury.

29/1/09. «The US House of Representatives has passed President Barack Obama's US\$ 819 bn economic stimulus package. The bill would cut taxes for people and businesses by US\$ 275 bn, while pumping more than US\$ 540 bn into a range of initiatives including road and bridge repair, increased unemployment benefits, investment in new technology and renovations to 10,000 schools.»⁴¹⁶

February 2009.

5/2/09. The Bank of England lowers the discount rate from 1,5 to 1%.

The value of the Chinese export of February 2009 was 28% less than that of February 2008.⁴¹⁷

March 2009.

2/3/09. «American Insurance Group (AIG) announces a \$61.7 billion loss in the fourth quarter of 2008, the largest in US corporate history. The US Treasury Department and the Federal Reserve announced a restructuring of the government's assistance to AIG in order to stabilize the company and enhance its capital and liquidity.»⁴¹⁸

5/3/09. The «Bank of England announced that it would undertake a policy of “quantitative easing”. The Bank will purchase £75 billion of assets using money which it will create. The aim is to boost the economy and prevent inflation undershooting its 2% target. This is accompanied by a further interest rate [decrease] to 0.5% (from 1.0%). Although the 0.5% rate is the floor for UK interest rates in the crisis, the level of quantitative easing is increased during the subsequent months.

⁴¹⁶ Inverse timeline of Chunlin Liu.

⁴¹⁷ Inverse timeline of Chunlin Liu, under 11/3/09.

⁴¹⁸ Timeline UK House of Commons p. 30.

The ECB cuts interest rates to 1.5% from 2%.»⁴¹⁹

6/3/08. «The Bank of England (BoE) has created £75bn of new money to pump into the economy over the next three months. The BoE conceded that it had run out of options on interest rates after cutting rates as close to zero as possible and needed to take additional unorthodox measures to prevent a slide into deflation.»⁴²⁰

13/3/09. «On US television programme The Daily Show, host Jon Stewart lambasts CNBC's Jim Cramer and the network itself for not alerting investors and viewers to the financial crisis. "You knew what the banks were doing, and yet were touting it for months and months," Stewart said. "The entire network was. And so now to pretend that this was some sort of crazy, once-in-a-lifetime tsunami that nobody could have seen coming is disingenuous at best and criminal at worst."»⁴²¹

In the first half of March 2009 the most important US indexes of share prices, such as the Dow Jones Industrial Average and the S&P 500, reached their lowest level of the period 2000-2015. In other words: as from March 2009 they started to climb. Though with substantial interruptions. The approximate date of the minimum may be related to the publication of operating results of publicly traded companies for 2008 and the last quarter of 2008. In general, these numbers become known in February.

«18 March 2009: the Fed steps up its policy of "credit easing" similar to the quantitative easing employed by the Bank of England: "to help improve conditions in private credit markets, the Committee decided to purchase up to \$300 billion of longer-term Treasury securities over the next six months." This is in addition to the \$1.25bn of mortgage-backed securities and \$200bn of agency debt that has been, and will be, purchased in 2009.»⁴²²

19/3/09. «The US Federal Reserve announced plans to buy US\$300bn of US government debt, triggering a plunge in bond yields and the dollar. The US central bank also said it was more than doubling its purchases of securities issued by Fannie Mae and Freddie Mac to US\$1,450bn. It said it now expected to keep interest rates near zero for an 'extended period' of time.

The [UK] Financial Services Authority announced a sweeping overhaul of the UK's financial regulatory regime, marking a break with its previous 'light-touch' approach and attempting to set a new global standard for the post-crisis world. Chairman Lord Turner set out plans to curb banks' ability to take excessive risks by forcing them to hold more capital and increase their holdings of liquid assets and cash.»⁴²³

«23 March 2009: the US Treasury announces details of the public-private bank purchase of toxic loans and securities. Using \$75-100bn of TARP funds, the Treasury will invest in the purchase of toxic assets that remain difficult to sell on the market. Reducing risk to encourage private investment, the Fed will make available low-interest loans for purchasing securities while the FDIC will offer guarantees against losses on loans. The Treasury hopes the [Federal Reserve] bank will initially make \$500bn of purchases, potentially rising to \$1tr; profits will be shared equally by the Treasury and private sector.

26 March 2009: US Treasury unveils plans for a new regulatory framework. The framework details four components of regulatory reform: addressing systemic risk, protecting consumers and investors,

⁴¹⁹ Timeline UK House of Commons. Note that even though the facts had by now shown beyond any doubt that regulation and supervision had been completely inadequate for more than a decade, the people who had always claimed that the financial system was as sound as can be believed when they say that an inflation of 2% serves the general welfare.

⁴²⁰ Inverse timeline of Chunlin Liu.

⁴²¹ Inverse timeline of Chunlin Liu. If Jim Cramer really saw things, and should have done something about it, why not the government and supervisors? Why doesn't Jon Stewart say anything like this?

⁴²² Timeline UK House of Commons p. 31.

⁴²³ Inverse timeline of Chunlin Liu.

eliminating gaps in the regulatory system and fostering international coordination.»⁴²⁴

It becomes known that in the last quarter of 2008, the gross domestic product (GDP) of the USA shrank at a rate of 6.3% per year. That of the UK shrank 1.6% as compared to the preceding quarter. In the last quarter of 2008 the Irish GDP was 7.5% less than it was in the last quarter of 2007.⁴²⁵

In March the number of unemployed in the 27 EU-states was 20 million.⁴²⁶

April 2009.

«2 April 2009: Having jointly pledged to repair the financial system, restore lending and rebuild trust, the G20 meeting also saw the “Enhancing Sound Regulation and Strengthening Transparency” (WG1) and “Reinforcing International Cooperation and Promoting Integrity in Financial Markets” (WG2) working groups report back. While WG2 mainly focused on the creation of a “college of supervisors”, WG1 offered 25 specific recommendations including broadening regulations to cover all systemically important institutions, the use of pro-cyclical capital and liquidity buffers, pan-national regulatory harmonization and improved regulatory provisions in key areas such as credit rating agencies and derivative trading.»⁴²⁷

2/4/09 continued. «Meeting in London, the G20 reached an agreement to tackle the global financial crisis with measures worth US\$1 trillion (£681bn). The International Monetary Fund (IMF) will receive an extra US\$750bn to help nations that have been particularly hard hit. The G20 has pledged around US\$250bn to boost global trade. Speaking on behalf of the G20, UK Prime Minister Gordon Brown announced the following steps:

- Bankers' pay and bonuses will be subject to stricter controls.
- A new Financial Stability Board will be set up to work with the IMF to ensure co-operation across borders.
- There will be greater regulation of hedge funds and credit ratings agencies.
- A common approach to cleaning up banks' toxic assets.
- The world's poorest countries will receive US\$50bn in aid.»⁴²⁸

7/4/09. «UK car sales fell by 30.5% in March, compared with the same month last year, the latest industry figures have shown.»⁴²⁹

8/4/09. «The Securities and Exchange Commission (SEC) created five new proposals aimed at curbing short selling which has been blamed for exacerbating the financial crisis. One of the five proposals included bringing back the uptick rule, which was abolished in 2007. The uptick rule only allows someone to short a stock if the last sale price was higher than the one before it. The SEC will open the proposals to 60 days of comment by the public before voting to pass them.»⁴³⁰

9/4/09. «Wells Fargo reports that it will record first quarter profits of \$3 billion later this month. The profit was more than double what analysts had expected due to a strong showing of its mortgage banking and smooth integration with its acquisition of Wachovia.»⁴³¹

13/4/09. «Goldman Sachs reports first quarter earnings of \$1.81 billion, better than analysts expected. [...]

SEC Chairman, Mary Schapiro, meets with credit rating agencies, investors, and academics about

⁴²⁴ Timeline UK House of Commons p. 31.

⁴²⁵ Timeline University of Iowa (under 26/3/09) and the inverse timeline of Chunlin Liu (under 26 & 27/3/09). 1,60% in a quarter is equivalent with 6,248% per year.

⁴²⁶ Inverse timeline of Chunlin Liu, under 1/5/09.

⁴²⁷ Timeline UK House of Commons p. 31. Note that most or all of the recommendations had already been recommended years ago by authorities/ experts, but were not acted upon by the responsible supervisors. And though the words of 2/4/09 may sound nice, it is far from clear that they are acted upon, and effectively.

⁴²⁸ Inverse timeline of Chunlin Liu.

⁴²⁹ Inverse timeline of Chunlin Liu.

⁴³⁰ Timeline University of Iowa.

⁴³¹ Timeline University of Iowa.

possible changes to the credit rating industry. Among the issues discussed were investor reliance on the credit rating agencies, ways to increase competition in the industry, and possible new business models for the rating agencies.»⁴³²

15/4/09. «Fortis Bank has seen a €20.6bn loss for 2008 following write-downs on debt and the division of the business.»⁴³³

16/4/09. «UBS announces an estimated first quarter loss of \$1.75 billion and cuts of 8,700 jobs by 2010, more than 11% of its work force.»⁴³⁴

20/4/09. «First-quarter profits at JPMorgan Chase have come in ahead of expectations, despite falling 12.5% from a year ago to US\$2.1bn. The group's investment bank reported a profit of US\$1.6bn, and the forecast-beating results sent its shares up 2.6% on Wall Street.»⁴³⁵

21/4/09. «The Global Financial Stability Report, issued by the International Monetary Fund (IMF), increased its estimate on writedowns of US originated assets to \$2.7 trillion. Projections show that total writedowns could reach \$4 trillion, with 2/3 coming from the banking industry.»⁴³⁶

23/4/09. «Morgan Stanley announces a [...] first quarter loss of \$578 million.»⁴³⁷

24/4/09. «The FDIC and National Credit Union Administration close four more banks and one credit union bringing the total for the year to 29 so far. This is significantly higher than the 25 banks in 2008 and 3 in 2007.»⁴³⁸

29/4/09. «Lithuania's economy shrank by 12.6% in the first quarter compared with the same period of 2008 - the largest year-on-year fall in the EU since the recession began.»⁴³⁹

30/4/09. In the first quarter of 2009 the economy of the USA shrank at a rate of 6.1% per year. Export volume decreased 30%.

The Fed kept its discount rate close to 0%.⁴⁴⁰

In the last year of the second world war, the average government debt of the “advanced economies” had increased to about 90% of the gross domestic product (GDP). See the graph below.⁴⁴¹ By 1975, the debt percentage had decreased to about 25%. From 1975 to 2008 in the OECD countries the gross debt steadily increased to about 80% of GDP (the net debt to 43%).⁴⁴² In 2009-2012 it increased

⁴³² Timeline University of Iowa.

⁴³³ Inverse timeline of Chunlin Liu.

⁴³⁴ Timeline University of Iowa.

⁴³⁵ Inverse timeline of Chunlin Liu.

⁴³⁶ Timeline University of Iowa.

⁴³⁷ Timeline University of Iowa.

⁴³⁸ Timeline University of Iowa.

⁴³⁹ Inverse timeline of Chunlin Liu.

⁴⁴⁰ Inverse timeline of Chunlin Liu (both of these remarks).

⁴⁴¹ P. 27/28, Reinhart & Rogoff *From Financial Crash to Debt Crisis*. In the directory Encyclopaedia under 20100303.

⁴⁴² Definition of “net government debt”: Net financial liabilities are defined as the gross financial liabilities of the general government sector less the financial assets of the general government sector. Such assets may be cash, bank deposits, loans to the private sector, participation in private sector companies, holdings in public corporations or foreign exchange reserves, depending on the institutional structure of the country concerned and data availability.

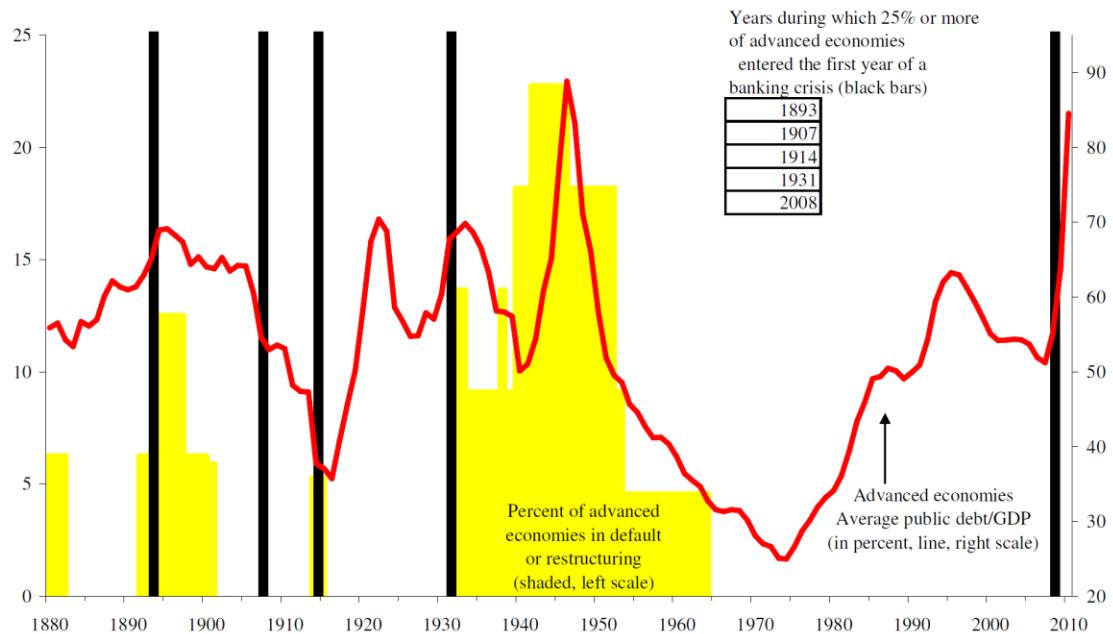
Definition of “gross government debt”: Gross financial liabilities are defined as the debt and other liabilities (short and long-term) of all the institutions in the general government sector, defined by ESA95/SNA93 (ESA= European standardized accounts; SNA= system of national accounts), subject to data availability. For the United States, Flow of Funds estimates are used, which value debt at face value. The gross data are consolidated within and between the sub-sectors of the general government sector, national sources permitting.

The status and treatment of government liabilities in respect of their employee pension plans in the national accounts have been diverse across countries, making international comparability of government debts difficult. The current interpretation of the 1993 SNA is that: i) “autonomous” funded pension plans should be classified outside the general government sector, which entails that their assets and liabilities are not reflected in the general government debt data; ii) non-autonomous pension plans should be classified inside the general government sector and only the funded component should be reflected in the general government liabilities. Furthermore, the 1993 SNA recommends that the liability inherent in unfunded schemes be recorded as a

further to over 100% (net 66%).⁴⁴³ In spending more than their income, governments take an unknown but in principle large risk.⁴⁴⁴ They make themselves dependent on the capital market (or specific lenders) and interest rates. Because government expenditure is specified by law, deficits are illegal. Even if they are approved after the fact. But apart from their legitimacy it is obvious that they cannot increase indefinitely. The only question is when and how things will go wrong.

«In April [2009], the EU orders France, Spain, the Irish Republic and Greece to reduce their budget deficits - the difference between their spending and tax receipts.»⁴⁴⁵

FIGURE 14. Sovereign Default on External Debt, Total (domestic plus external) Public Debt, and Systemic Banking Crises: Advanced Economies, 1880-2010
(debt as a percent of GDP)



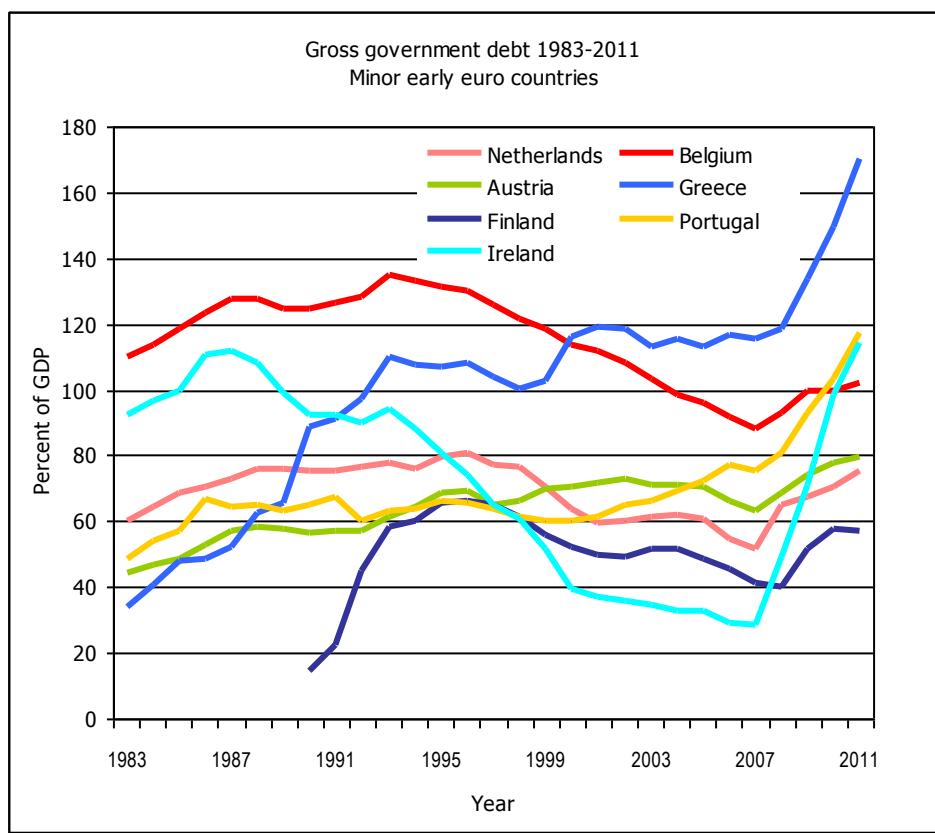
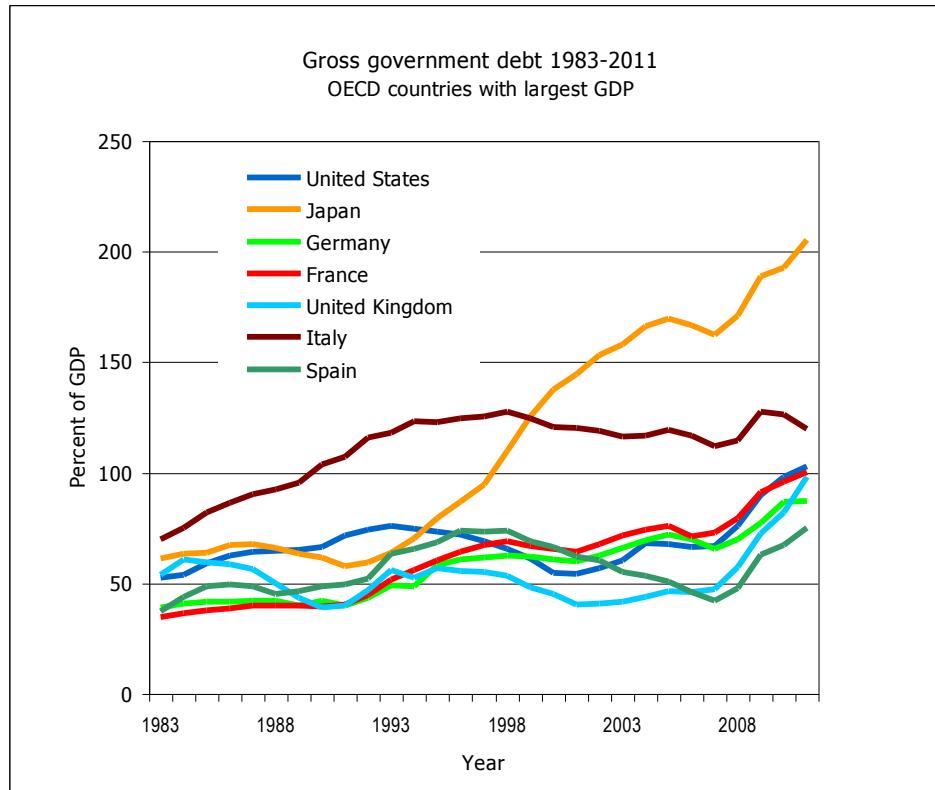
memorandum item for the government sector. However, while some countries have produced some estimates of these implicit liabilities, few follow the 1993 SNA recommendation.

Source of this footnote: the web page *Notes to statistical annex tables 25-33* of *OECD Sources and Methods*. Only available at the OECD website. The page can be found in the directory OECD, under 20130521.

⁴⁴³ The data about government debt come from tables 32 and 33 in the Annex Tables of the *OECD Economic Outlook*. There one can also find the relevant definitions.

⁴⁴⁴ “Large” could and should probably be defined more or less quantitatively, say in terms of unemployment and/or loss of income of certain groups of citizens, but for the present the example of Greece may suffice.

⁴⁴⁵ BBC News Timeline Eurozone Crisis. (Webpage of 19/4/12).



May 2009.

1/5/09. «Regulators seize Silverton Bank of Atlanta, a bank which provided services to other

banks. This is the largest bank failure so far in 2009, with \$4.1 billion assets.»⁴⁴⁶

8/5/09. «The European Central Bank announces that it would lower its main refinancing rate to 1% and continue to provide unlimited short-term and longer-term liquidity to the market for at least a further 12 months. The ECB also announced its intention to purchase €60bn of euro-denominated covered bonds (a particularly safe form of asset-backed security) from primary and secondary markets.»⁴⁴⁷

3/5/09. «East Asia announces plans to create a \$120 million emergency fund to help the countries withstand the global financial crisis. Japan and China will provide 32% of the funds, South Korea 16%, and the remaining amount to be contributed by the Association of South East Asian Nations (ASEAN).»⁴⁴⁸

4/5/09. In the first quarter of 2009 the demand for mortgages in the USA increased for the first time since the beginning of 2007.⁴⁴⁹

5/5/09. «Japan has offered US\$100bn in financial assistance to Asian countries hit by the global financial crisis. Tokyo announced at a meeting of the finance ministers of the 10 countries of the Association of South-East Asian Nations in Indonesia that it would set up a Y6,000bn (US\$61.5bn) bilateral currency swap scheme, on top of a US\$38.4bn commitment to the multilateral Chiang Mai initiative. The Chiang Mai deal, a \$120bn currency scheme that has been under discussion for years, was formally agreed by the Asean countries at a meeting with the finance ministers of Japan, China and South Korea.»⁴⁵⁰

13/5/09. «U.S. Treasury releases proposals to regulate OTC derivatives. Aims include amending the Commodity Exchange Act (CEA) to include larger margin requirements and stronger risk controls as well as increased authority to police fraud and manipulation.»⁴⁵¹

15/5/09. «The economies of the 16 countries that make up the eurozone declined by 2.5% in the first three months of 2009, the EU's statistics agency Eurostat said. A sharp fall in German exports was a key factor in the decline.»⁴⁵²

20/5/09. «Japan's economy shrank a record 4% in the first quarter as companies slashed investment and exports. This is the quickest drop since records began in 1955.»⁴⁵³

«In the wake of the most significant financial crisis since the Great Depression, the [U.S.] President [Obama] signed into law on May 20, 2009, the Fraud Enforcement and Recovery Act of 2009, creating the Financial Crisis Inquiry Commission [FCIC]. The Commission was established to "examine the causes, domestic and global, of the current financial and economic crisis in the United States."

The 10 members of the bi-partisan Commission, prominent private citizens with significant experience in banking, market regulation, taxation, finance, economics, housing, and consumer protection, were appointed by Congress on July 15, 2009. The Chair, Phil Angelides, and Vice Chair, Bill Thomas, were selected jointly by the House and Senate Majority and Minority Leadership.

The FCIC is charged with conducting a comprehensive examination of 22 specific and substantive areas of inquiry related to the financial crisis. These include:

- fraud and abuse in the financial sector, including fraud and abuse towards consumers in the mortgage sector;
- Federal and State financial regulators, including the extent to which they enforced, or failed to enforce statutory, regulatory, or supervisory requirements;

⁴⁴⁶ Timeline University of Iowa. The “which” replaces “who” in the original.

⁴⁴⁷ Timeline UK House of Commons p. 32.

⁴⁴⁸ Timeline University of Iowa. The “East Asia” is not defined or specified. By mentioning “\$120bn”, the entry for 5/5/09 below suggests that it refers to ASEAN.

⁴⁴⁹ Timeline University of Iowa.

⁴⁵⁰ Inverse timeline of Chunlin Liu. The relation with the previous statement is not fully clear. Alternative sources could not be found. The information has been included to show that and how the crisis affected Asia, and that Asian countries also took internationally coordinated measures.

⁴⁵¹ Timeline University of Iowa. Remember that in 1998/1999 only the proposal to discuss regulation of OTC already cost Brooksley Born her CFTC job.

⁴⁵² Inverse timeline of Chunlin Liu.

⁴⁵³ Inverse timeline of Chunlin Liu.

- the global imbalance of savings, international capital flows, and fiscal imbalances of various governments;
- monetary policy and the availability and terms of credit;
- accounting practices, including, mark-to-market and fair value rules, and treatment of off-balance sheet vehicles;
- tax treatment of financial products and investments;
- capital requirements and regulations on leverage and liquidity, including the capital structures of regulated and non-regulated financial entities;
- credit rating agencies in the financial system, including, reliance on credit ratings by financial institutions and Federal financial regulators, the use of credit ratings in financial regulation, and the use of credit ratings in the securitization markets;
- lending practices and securitization, including the originate-to-distribute model for extending credit and transferring risk;
- affiliations between insured depository institutions and securities, insurance, and other types of nonbanking companies;
- the concept that certain institutions are 'too-big-to-fail' and its impact on market expectations;
- corporate governance, including the impact of company conversions from partnerships to corporations;
- compensation structures;
- changes in compensation for employees of financial companies, as compared to compensation for others with similar skill sets in the labor market;
- the legal and regulatory structure of the United States housing market;
- derivatives and unregulated financial products and practices, including credit default swaps;
- short-selling;
- financial institution reliance on numerical models, including risk models and credit ratings;
- the legal and regulatory structure governing financial institutions, including the extent to which the structure creates the opportunity for financial institutions to engage in regulatory arbitrage;
- the legal and regulatory structure governing investor and mortgagor protection;
- financial institutions and government-sponsored enterprises; and
- the quality of due diligence undertaken by financial institutions;

The Commission is called upon to examine the causes of major financial institutions which failed, or were likely to have failed, had they not received exceptional government assistance.

In its work, the Commission is authorized to hold hearings; issue subpoenas either for witness testimony or documents; and refer to the Attorney General or the appropriate state Attorney General any person who may have violated U.S. law in relation to the financial crisis.

On November 17, 2010 the Commission resolved, by majority vote, to deliver its report in January 2011, rather than on December 15, 2010. The Commission will conclude its operations by February 13, 2011, as prescribed.»⁴⁵⁴

29/5/09. «Standard and Poor's downgraded its view of the UK to 'negative' from 'stable' for the first time since it started analyzing its public finances in 1978. It said the UK's finances were deteriorating faster than expected. The change came as data confirmed that new government borrowing has soared, to a record of almost £8.5bn in April. [...]

Japan's factory output has jumped at its fastest rate in more than 50 years, but higher unemployment figures have dampened hope of an early recovery. Output rose by 5.2% in April from the previous month, the biggest monthly gain since 1953, official figures show. The jobless rate hit 5% in April, up from 4.8% in March.

India's economy grew 5.8% in the first three months of the year compared with the same period last

⁴⁵⁴ Announcement on the FCIC website 17/12/10. The law referred to can be found under 20090520 in the directory FCIC.

year, which was better than had been expected. The official gross domestic product figure was down from 8.6% annual growth seen in the first quarter of 2008.»⁴⁵⁵

June 2009.

1/6/09. «The US economy shrank in the first three months of 2009 at a slower pace than had originally been estimated by the Commerce Department. Gross domestic product (GDP) declined by an annual rate of 5.7% in the first quarter, less than the 6.1% that had been estimated in April.»⁴⁵⁶

2/6/09. «Stock markets in emerging economies are experiencing a strong resurgence. Since its March 2009 low, the MSCI emerging markets index has gained 68 percent, compared with a 43 percent gain in the developed markets index.»⁴⁵⁷

3/6/09. «U.S. banks generate more capital than required by regulators, selling common stock and nonguaranteed debt to raise more than \$85 billion since May 7. Mutual funds and other large institutional investors are buying aggressively and stock prices reflect the improving climate. Bank of America shares are up 263 percent from their March low, JP Morgan is up 118 percent.»⁴⁵⁸

4/6/09. «The Bank of England maintains its headline interest rate at 0.5%, and votes to continue with its asset purchase facility.»⁴⁵⁹

In a report “Cost of Freddie Mac’s Affordable Housing Mission” of 4/6/09, submitted to the Business Risk Committee of the Board of Directors of Freddie Mac one can read the following:

- «Our housing goals compliance required little direct subsidy prior to 2003, but since then subsidies have averaged \$200 million per year.
- Higher credit risk mortgages disproportionately tend to be goal-qualifying.
- Targeted affordable lending generally requires ‘accepting’ substantially higher credit risk.
- We charge more for targeted (and baseline) affordable single-family loans, but not enough to fully offset their higher incremental risk.
- Goal-qualifying single-family loans accounted for the disproportionate share of our 2008 realized losses that was predicted by our models.
- In 2007 Freddie Mac failed two subgoals, but compliance was subsequently deemed infeasible by the regulator due to economic conditions. In 2008 Freddie Mac failed six goals and subgoals, five of which were deemed infeasible. No enforcement action was taken regarding the sixth missed goal because of our financial condition.
- Goal-qualifying loans tend to be higher risk. Lower household income correlates with various risk factors such as less wealth, less employment stability, higher loan-to-value ratios, or lower credit scores.
- Targeted affordable loans have much higher expected default probabilities... Over one-half of targeted affordable loans have higher expected default probabilities than the highest 5% of non-goal-qualifying loans.»⁴⁶⁰

10/6/09. «10 banks are allowed to exit the U.S. TARP program. The first to exit include American Express, Goldman Sachs, Morgan Stanley and JPMorgan Chase. Combined, they will return \$68.3 billion, more than a quarter of the federal bailout money issued by TARP since October 2008.»⁴⁶¹

17/6/09. «BRIC country leaders (from Brazil, Russia, India and China) convene in Yekaterinburg, Russia for [a] one-day summit. BRIC countries account for 40 percent of the world’s population and 15 percent of its economy. The BRIC countries seek a greater voice in the global economy and a more diversified approach to its management, voicing criticism of the U.S. dollar’s role as reserve currency and calling for comprehensive reform of the United Nations. BRIC leaders mean to “send a message

⁴⁵⁵ Inverse timeline of Chunlin Liu.

⁴⁵⁶ Inverse timeline of Chunlin Liu.

⁴⁵⁷ Timeline University of Iowa.

⁴⁵⁸ Timeline University of Iowa.

⁴⁵⁹ Timeline UK House of Commons p. 32.

⁴⁶⁰ Quoted by FCIC Wallison report on p. 518/46.

⁴⁶¹ Timeline University of Iowa.

to Washington” about the economic interests and representation of emerging economies.»⁴⁶²

18/6/09. «President Obama reveals a dramatic overhaul of way [sic] the U.S. government oversees financial markets. The sweeping changes, criticized by some as too hasty, aim to promote innovation while discouraging abuse. They propose:

For the Supervision of Financial Institutions

- A new Financial Services Oversight Council of financial regulators to identify emerging systemic risks and improve interagency cooperation.
- New authority for the Federal Reserve to supervise all firms that could pose a threat to financial stability, even those that do not own banks.
- Stronger capital and other prudential standards for all financial firms, and even higher standards for large, interconnected firms.
- A new National Bank Supervisor to supervise all federally chartered banks.
- Elimination of the federal thrift charter and other loopholes that allowed some depository institutions to avoid bank holding company regulation by the Federal Reserve.
- The registration of advisers of hedge funds and other private pools of capital with the SEC.

For the Regulation of Financial Markets

- Enhanced regulation of securitization markets, including new requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans.
- Comprehensive regulation of all over-the-counter derivatives.
- New authority for the Federal Reserve to oversee payment, clearing, and settlement systems.

For Consumer Protection

- A new Consumer Financial Protection Agency to protect consumers across the financial sector from unfair, deceptive, and abusive practices.
- Stronger regulations to improve the transparency, fairness, and appropriateness of consumer and investor products and services.
- A level playing field and higher standards for providers of consumer financial products and services, whether or not they are part of a bank.

For Government Management of Financial Crisis

- A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects.
- Revisions to the Federal Reserve’s emergency lending authority to improve accountability.

For Improved International Regulatory Standards and Cooperation

- International reforms to support our efforts at home, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools.

Treasury Secretary Tim Geithner will chair the administration’s planned “council of regulators”. The Council, composed of eight heads of the top regulation organizations, would co-ordinate policy and advise the Federal Reserve on emerging risks.»⁴⁶³

23/6/09. «On June 23, 2009, the Tweede Kamer [the second of the two chambers of Dutch parliament] unanimously approved a proposal of its Presidium to charge a temporary parliamentary commission with an inquiry into the crisis of the financial system. The same day the Temporary

⁴⁶² Timeline University of Iowa.

⁴⁶³ Timeline University of Iowa. Its sources are websites. The text very much looks like political propaganda. It may be quoted from a press release. Note the “our” under the last dot. As will be seen in the Analysis, most (if not all) of the proposals are unnecessary, and the real causes of the crisis are not addressed. As is underlined by the fact that Geithner had been head of the NY Fed for many crucial years.

Commission Inquiry Financial System is installed.»⁴⁶⁴

«The Tweede Kamer approved a proposal stating that the purpose of the inquiry is to make a contribution to adequate operation of the financial system in general and in the Netherlands in particular. On this basis the inquiry proposal specifies two central questions:

“What are the causes of the recent turbulent developments in the financial system, and what recommendations can be made on the basis of the findings of the inquiry for a more adequate operation of the financial system?”»⁴⁶⁵

In the present report, the Temporary Commission Inquiry Financial System is called after its chairman, Jan de Wit: Commission De Wit, or CDW.

25/6/09. «Bank of England’s six monthly *Financial Stability Report* noted that “market sentiment has improved in recent months ... Perceptions of banks’ resilience have improved ... Market contacts report somewhat better conditions in funding markets, with signs that creditors are willing to provide finance without government guarantees, though term funding in unsecured money markets remains constrained. Notwithstanding these positive developments, balance sheets of banks internationally remain weak ... As long as these balance sheet vulnerabilities persist, there is a risk to the banking system from further adverse economic or financial sector developments, which could in turn affect lending and economic recovery”.»⁴⁶⁶

29/6/09. «Spiralling government debt around the world has prompted the creation of the first tradeable indices tracking the risks of countries defaulting. Markit, the data provider, has launched four indices of credit default swaps (CDSs)- used as insurance against bond defaults- as investors demand more information about the dangers of the growing debt mountain. These will run alongside CDS for individual countries, which are already traded.»⁴⁶⁷

July 2009.

2/7/09. The UK GDP of the first quarter of 2009 was 2.4% less than that of the corresponding quarter of 2008.⁴⁶⁸

7/7/09. «The worst of the UK's recession is over, according to the British Chambers of Commerce (BCC) business group. A BCC report that surveyed 5,600 companies found that there had been 'welcome progress' in confidence levels between April and June 2009. However, the BCC still expects unemployment in the UK to reach 3.2 million by 2010.»⁴⁶⁹

15/7/09. «UK unemployment rose by a record 281,000 to 2.38 million, in the three months to May, the Office for National Statistics has said. The jobless rate increased to 7.6%, the highest in more than 10 years.»⁴⁷⁰

16/7/09. «China's economy accelerated significantly in the second quarter, with gross domestic product expanding by 7.9%, ahead of analysts' consensus estimates. The surge in growth was driven by the government's aggressively loose fiscal and monetary policies, introduced late last year, with most of the funding coming from record lending by state banks.»⁴⁷¹

August 2009.

6/8/09. «The Bank of England increases its quantitative easing by a further £50 billion to £175 billion, while maintaining interest rates at 0.5%.»⁴⁷²

⁴⁶⁴ CDW1 p. 28/24.

⁴⁶⁵ CDW1 p. 29/25

⁴⁶⁶ Timeline UK House of Commons p. 33.

⁴⁶⁷ Inverse timeline of Chunlin Liu.

⁴⁶⁸ Inverse timeline of Chunlin Liu.

⁴⁶⁹ Inverse timeline of Chunlin Liu.

⁴⁷⁰ Inverse timeline of Chunlin Liu.

⁴⁷¹ Inverse timeline of Chunlin Liu.

⁴⁷² Timeline UK House of Commons p. 33. As a reminder: quantitative easing is the printing and distribution of money by the central bank. It brings money in circulation by buying threatened securities (that is: other kinds of printed paper representing contracts).

November 2009.

25/11/09. «The Chancellor tells the House that the Bank of England provided liquidity to Halifax Bank of Scotland and Royal Bank of Scotland from October 2008. The support provided peaked at £36.6 billion for RBS (17 October 2008) and £25.4 billion for HBOS (13 November 2008), and in return the banks deposited collateral at the Bank of England and were charged fees. *The Financial Times* reported that “although Lloyds shareholders were told [during the acquisition process] HBOS would have to ‘substantially rely for the foreseeable future’ on Bank of England liquidity support, they found out only the extent of the stricken bank’s problems” when the Chancellor made his statement to the House. The Chancellor said “there has been no cost to the taxpayer”, and added that the Treasury had provided an indemnity to the Bank in respect of its liquidity operations.»⁴⁷³

December 2009.

In October Greece got a new government. In December the new government announced that the debt of the Greek government was much larger than the preceding government, of Kostas Karamanlis, had said. According to the OECD’s *Economic Outlook* 2011-1, in 2009 the debt was net 101% and gross 132% of GDP.⁴⁷⁴

In *Credit Crisis- The Essentials Overview*, The New York Times writes:

«[...] by the year’s end, many big banks were reporting large profits and all but one had repaid or were in the process of returning their bailout money to the federal government. But many businesses, especially small ones, reported that credit was still tight and only a fraction of those homeowners the Obama administration had hoped to help with a \$75 billion foreclosure prevention program had reached agreements with their banks. Unemployment rose steadily all year to the highest levels seen in a generation, and anger over the crisis, the banks, the bailout and new rounds of large bonuses became a potent force in politics.»⁴⁷⁵

2010.

January 2010.

HUD publishes a *Report to Congress on the Root Causes of the Foreclosure Crisis*. It asserts that the pursuit of gain is the moving force behind the crisis:

«[...] the sharp rise in mortgage delinquencies and foreclosures is fundamentally the result of rapid growth in loans with a high risk of default- due both to the terms of these loans and to loosening underwriting controls and standards. Mortgage industry participants appear to have been drawn to encourage borrowers to take on these riskier loans due to the high profits associated with originating these loans and packaging them for sale to investors»⁴⁷⁶

The high profits are an invention of HUD, as witnessed by for example annual reports of Fannie and Freddie, the report *Cost of Freddie Mac’s Affordable Housing Mission*⁴⁷⁷, and of course, the perceived need to place them in receivership. The annual reports point to the relatively low profits and relatively high costs and risks of mortgages bought to comply with the AH-goals. That is: HUD policy. Risks (and costs) which were realized in the crisis.

As seen in the chronicle of the years preceding the crisis, the “mortgage industry participants” were not “drawn” to encourage borrowers to take on riskier loans, but (strongly) pushed.

«In January, an EU report condemns “severe irregularities” in Greek accounting procedures.

⁴⁷³ Timeline UK House of Commons p. 33. The rectangular brackets are from the original.

⁴⁷⁴ OECD *Economic Outlook* 2011-1, tables 32 and 33.

⁴⁷⁵ NYT website, updated Jan. 10, 2011.

⁴⁷⁶ Quoted by Pinto on p. 155.

⁴⁷⁷ Mentioned under 4/6/09.

Greece's budget deficit in 2009 is revised upwards to 12.7%, from 3.7%, and more than four times the maximum [of 3%] allowed by EU rules.»⁴⁷⁸

April 2010.

«8 April 2010: the difference (or “spread”) between yields of Greek government bonds over their German equivalent (Bunds) hit the highest point since Greece joined the European single currency. The spread was 456 basis points, indicating that investors are demanding a premium of 4.56% to hold Greek government bonds compared to Bunds, even though both are denominated in Euros.

12 April 2010: Euro area member states state that they have agreed upon the terms of the financial support that will be given to Greece, if it asks for it, including up to €30 billion for financing needs. Reuters reported that “together with at least 10 billion euros expected from the International Monetary Fund in the first year, it could add up to the biggest multilateral financial rescue ever attempted”.»⁴⁷⁹

June 2010.

In a speech on 18/6/10 Sheila Bair of the FDIC said the following about mortgage origination:

«First, we must recognize that the financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices. [...]»

Traditional mortgage lending worked so well in the past because lenders required sizeable down payments, solid borrower credit histories, proper income documentation, and sufficient income to make regular payments at the fully-indexed rate of the loan. Not only were these bedrock principles relaxed in the run-up to the crisis, but they were frequently relaxed all at once in the same loans in a practice regulators refer to as "risk layering."»⁴⁸⁰

Nevertheless:

«Sheila Bair’s advice was not followed in the recently enacted Financial Reform Bill. In Section 941, Congress charges regulators with defining the characteristics of a “qualifying residential mortgage”. Such a mortgage should have “underwriting and product features that historical loan performance data indicate result in a lower risk of default.” Conspicuous in their absence from the list are LTV and borrower credit history. This is a repeat of the identical error made by Congress when it passed the GSE Act of 1992 and pushed the GSEs into reduced downpayment and other loosened lending standards.»⁴⁸¹

FHFA simplifies the affordable housing goals. The FCIC Wallison report evaluates the changes as follows:

«When Congress enacted the Housing and Economic Recovery Act of 2008 (HERA), it transferred the responsibility for administering the affordable housing goals from HUD to FHFA.⁴⁸² In 2010, FHFA modified and simplified the AH goals, and eliminated one of their most troubling elements. As Fannie had noted, if the AH goals exceed the number of goals-eligible borrowers in the market, they were being forced to allocate credit, taking it from the middle class and providing it to low income borrowers. In effect, there was a conflict between their mission to advance affordable housing and their mission to maintain a liquid secondary mortgage market for most mortgages in the U.S. The new FHFA rule does not require the GSEs to purchase more qualifying loans than the percentage of the total market that these loans constitute.

This does not solve all the major problems with the AH goals. In the sense that the goals enable the government to direct where a private company extends credit, they are inherently a form of government credit allocation. More significantly, the competition among the GSEs, FHA and the banks that are required under the CRA to find and acquire the same kind of loans will continue to

⁴⁷⁸ BBC Timeline: The unfolding eurozone crisis, 19/4/12.

⁴⁷⁹ Timeline UK House of Commons p. 35.

⁴⁸⁰ Pinto p. 155.

⁴⁸¹ Pinto’s note 405 on p. 156.

⁴⁸² Note that realization of policy goals may be incompatible with supervision (safe and sound operation). It is this incompatibility which can be seen as principal cause of the crisis.

cause the same underpricing of risk on these loans that eventually brought about the mortgage meltdown and the financial crisis.»⁴⁸³

This must have been an individual action of FHFA, and premature at that. It cannot have been based on a sound evaluation. The FCIC was still holding its hearings, and would report only in January 2011.

2011.

On 1 January 2011, Estonia joins the euro area.

Long before the damage of the subprime crisis had been undone, it was joined by a eurocrisis.⁴⁸⁴ Both crises affected almost all the countries in the world, if not directly then indirectly.

In general it seems to be impossible to attribute specific consequences to either the subprime crisis or the euro (debt) crisis. Neither is it clear whether the eurocrisis was triggered by the subprime crisis. It certainly was not caused by the subprime crisis. As noted earlier, sooner or later a euro debt crisis was unavoidable. The only difficulty was to forecast the approximate date and form.

In 1991 the EC had set norms for budget deficits and government debts. The norms may be debatable, but they were definitely not too strict. For many years they were exceeded as a matter of course. But no corrective action had been taken. Greece had been admitted to the euro area while its debt was 104% instead of less than 60%. See above, under 2000.

Instead of putting Karamanlis and his henchmen in prison because of fraud and other inappropriate conduct, and to make a long term plan⁴⁸⁵ for the restoration of the Greek public finances, the EU and IMF forced Greece to solve its problems in a relatively small number of years. The debt problem is old and very large. Taking account of the meaning of a debt of the size of GDP and its long history, one must conclude that it is highly improbable or impossible to solve it in say 5 years.⁴⁸⁶ At least not without making very many innocent victims.⁴⁸⁷ The more so since it is the opposite of justice to punish innocent people with unemployment and tax increases while allowing the responsible politicians to go free and unpunished.^{488, 489}

In fact, many of the politicians who are co-responsible for increasing the debt of the government of their country in the past 20 years are still in power, or have more powerful (and better paid) positions. For several years president Barroso of the European Commission and managing director Lagarde of the IMF were minister in a EU country, and co-responsible for budget deficits and increasing government debt.⁴⁹⁰ To mention just a few examples.

⁴⁸³ FCIC Wallison report pp. 518-9/546-7.

⁴⁸⁴ The timelines for the subprime crisis used in this chronicle end at the following dates:

- University of Iowa 25/6/09.
- UK House of Commons 12/4/10. (The last two pieces of info concern the Greek crisis).
- Inverse timeline of Chunlin Liu 21/8/09.
- Wiki Subprime crisis impact December 2008, apart from incidental remarks about later events.

That at least was the state of affairs at the end of May 2012, when most of these files were downloaded.

⁴⁸⁵ By long term I mean 10 or more years. A long term should have been proposed to minimize the suffering of the innocent Greek people.

⁴⁸⁶ This reflects the situation in 2011. The Greek crisis would last until at least 2016. By that time the loans had multiplied, and were extended for decades.

⁴⁸⁷ The innocence is not complete. In “democratic” countries civilians make themselves co-responsible by voting. And by not protesting, if I knew of any meaningful way to protest.

⁴⁸⁸ Probably even to continue living well off the spoils of their term in power.

⁴⁸⁹ Note that civilian victims of military violence are quite generally called “innocent civilians”. Civilians are protected by the law of war, at least formally. If this kind of protection is necessary and just, why is there no law protecting them against actions like those of the EU and IMF, or even Karamanlis? But at least in “democratic” countries civilians are not entirely innocent. Participation in elections makes them co-responsible.

⁴⁹⁰ See the file about Barroso, and for Lagarde the Reuters paper Eurogeddon, under 20120802. For budget deficits and government debt see one or more of the *Economic Outlook* publications of the OECD.

Chapter 7.

The financial crises of 2007-2013.

Part B. Analysis.

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7B.1. Introductory notes.

Table of contents of this section.

1. System instability as a fundamental cause of crises.
2. The concept of “cause” in connection with the crisis.
3. How the analyses and evaluations in this chapter came to be made.
4. Explanation of the structure of this chapter.
5. Methodological note.

This section discusses topics of a general nature. The discussions provide necessary background for the main body of this chapter. They present some basic facts, and explain some of the characteristics of the contents of the chapter.

1. System instability as a fundamental cause of crises.

Systemic sensitivities and mechanisms for amplifications of disturbances.

Experience shows that financial economic crises are not exceptional. They occur several times a century, at irregular times. They differ in character, size and consequences. No two are the same. They seem to be unpredictable. As a phenomenon, crises are not hard to understand. They occur because the financial economic system has properties which make it unstable. The instability means that disturbances of certain types are amplified by the system. Such disturbances can have consequences which are very much larger than their initial size would make one expect. In an unstable system, large consequences need not have large causes. In a stable system on the other hand, disturbances are reduced by the system, or at least do not grow. The following shows properties which make the financial economic system unstable.

For a start it should be noted that to a large extent financial economic valuations are subjective and arbitrary. They are determined by “the market”: by the opinions of buyers and sellers. They are determined by the confrontation of supply and demand. In general they are determined by the supply and demand of a marginal amount of the product involved. Especially crises show that valuations may change substantially and fast. The size of the changes, and the time of their occurrence, seem hard to predict however. It may seem obvious for example that home prices cannot rise forever. That sometime they will stabilize or start to fall. But even if this is acknowledged, it is quite another matter to predict the time of the turnaround, or the maximum price level.

The value of products is often determined on the basis of relatively marginal and sensitive

quantities, such as the size of the supply or demand on a given day. The value of an enterprise (on the stock market for example) is determined in part by its income of the last year and quarter, and the expectations for the future. Its income can be called a marginal quantity because it is the difference between quantities like revenue and costs. Both of which are much larger, and may be very much larger, than their difference. Enterprise income is called sensitive because it may depend relatively strongly on factors which are hard to manage by the enterprise. Such as interest rates, price developments in different markets, and availability and cost of suitable employees.¹ A relatively small decrease in the value of yearly sales due to the arrival of a new competitor may turn profit into loss.²

The market value and share price of an enterprise are very sensitive to changes in perceived profitability, now and in the future. There is good reason for this. An investor is interested in the yield of his shares. Both in the absolute sense, and relative, with respect to other investment possibilities, such as bonds or a savings account. He will choose the investments with the highest yield and best prospects, in his personal judgment. Of course an investor can take account of more aspects. But that does not change the fact that almost everybody who must choose between possibilities which differ only in yield, will choose the most profitable.

The future is uncertain. That of some enterprises and matters more than that of others. Confidence in the future varies. An increase in uncertainty means more risk, and reduces all kinds of market values, and vice versa. Dependence on forecasts therefore contributes to the sensitivity of valuations.

By the way it can be noted that more profits in general mean more possibilities for growth, while persistent losses must result in shrinkage, and may threaten survival. Obviously this observation supports the use of profitability as a measure for valuation.

These observations show that the market value of an enterprise is a relatively sensitive quantity. It changes in accordance with profitability, a marginal and sensitive quantity. This agrees with observations of stock and related markets.

If the profitability of an enterprise decreases, and/or the uncertainty about its future increases, its market value diminishes. As a consequence, if the profitability of most or all enterprises decreases, and/or the uncertainty about their future increases, the capital of society diminishes. Not only in markets or on paper, but also in the other part of reality. It is simply (psycho)logical, and practically necessary, that people take account of the general and their personal financial situation. Not only in decisions about saving or investing, but also when taking decisions in daily life, such as shopping for daily needs. If economic prospects look dim, and/or if their capital diminishes, they will be more careful and spend less. When they buy less, the production of at least some products has to be turned back (further). In general this will reduce profits. It may make reduction of production capacity compulsory. Thereby amplifying the causal phenomena.

It follows that in the financial economic system shrinkage can amplify itself. If the system would be stable for shrinkage, shrinkage would cause growth, canceling the shrinkage at least partially. This obviously is not the case. The system is unstable with respect to shrinkage, at least some kinds of shrinkage. Where shrinkage means shrinkage per unit time. There are mechanisms which dampen the speed of shrinkage. Such as a long term order portfolio and the law concerning termination of employment. Nevertheless: historical crises show that both at the stock exchange and in a bankruptcy events may follow one another with surprising speed.

The opposite is true as well: economic growth is a self amplifying phenomenon. Although historical crises show that as a rule shrinkage takes place much faster than growth. This is quite understandable. In practice, growth is not the straightforward opposite of shrinkage. People react differently on growth and shrinkage. One can stop buying unnecessary things completely and immediately. Buying more than one is used to in general takes time. A production chain in general is somewhat elastic. It is somewhat elastic in both directions: output can be increased or decreased, at least to a limited extent. However, beyond the given margins, increasing and decreasing production are very different processes, having very different timescales. Reacting to growth possibilities in

¹ In this study the word “employee” refers to all employees of an organization, including its management.

² In the words of Thomas Ittelson: «Profit is the difference between two large numbers: (1) sales less (2) costs & expenses. Small changes in either can result in large swings in profit (loss)». Thomas R. Ittelson, *Financial statements*, revised and expanded edition, Career Press, Pompton Plains (NJ), 2016, p. 150 (box).

general takes much more time than reacting to a need for output reduction. Finally, for both people and enterprises it is important that there is a big difference between the risks of spending more and spending less. In general the risk of spending too much is appreciably greater than the risk of spending too little.

There is a logical reason for growth after a period of restrained demand due to calamities or impairment of economic processes. This is what happens naturally after a crisis. There is however no logical reason for net growth over and above this making up arrears. There is no logical reason for a surplus of affordable and desirable new products and services over the reduction of needs and costs due to greater efficiency. (Efficiency increases can be seen as a form of innovation too, by the way). In other words: growth can not be expected to continue without end.

Taken together, the above means that in general a period of growth will be followed by a period of shrinkage, and a period of shrinkage by a period of growth. In this connection some people speak of a cycle. Since there is no reason for successive periods to have the same length even approximately, and since both growth and shrinkage may be larger or smaller, possibly making succeeding periods very dissimilar, this is misleading. There are ups and downs, but of possibly widely varying amplitudes and lengths.

Sensitivities and instability explain the crisis of 1929-1932.

The mechanisms sketched in the preceding subsection explain most of the phenomena which can be observed in periods of crisis. Including the crisis of 1929-1932. In the years before that crisis, share prices and price/earnings (P/E) ratios had increased very substantially. A priori it is clear that prices of specific products cannot rise indefinitely without causing some kind of neutralizing reaction. At a given moment things will happen which make some people suspect that a turnaround is around the corner or already taking place. Some of them start to sell, disturbing the previously existing equilibrium between the numbers of buyers and sellers. The growing number of sellers is real. The drop in prices will alert and convince more people of the wisdom to sell.^{3, 4} Especially if the drop was inspired by something real, visible for everybody. As a consequence, the drop in prices continues. Etcetera, depending of the perceived seriousness of the causational phenomenon. Capital is destroyed.

A market is an exchange for possibly marginal amounts of the products involved. All the same, a price decrease on the market affects the value of the whole stock of these products. All owners lose, not only those buying and selling. All owners begin to have doubts about their own financial situation; everybody loses confidence in the economic situation of their country. Everyone who fears having less to spend, will spend less. As a consequence, profits decrease, and may even turn into losses. Even at identical P/E ratios, share prices have to go down. Government income (tax proceeds) decreases as well.

It is clear that a downward development is hard to stop. Indeed, the bottom of the crisis beginning in 1929 was only reached in 1932. And according to the article “Great Depression” in the Britannica 2002, the economic slump caused by the crash «lasted until about 1939». There is a kind of a bottom, because people need food and roof, schools, doctors etcetera. But even basic needs are elastic. There may furthermore be a need for the restoration of confidence by replacing people who occupy the positions which are most important for the operation of the financial economic system. By people who cannot be held responsible for the crisis, and may be believed to be better.

The Britannica 2002 says that «[the reasons for the collapse of the stock market \[of 1929\] are many and complicated](#)». If this refers to the exact nature of the behavior of the relevant actors and the causes of precisely October 24, 1929 as “Black Thursday”, and other details of the crash/crisis, this may be true.⁵ But it is not true that the cause of a crisis is manifold and complex in every sense. The fundamental cause of crises is very simple: the financial economic system is unstable due to the simple

³ Otherwise they will not, and the price recovers. This is seen daily, weekly, monthly: at any time scale.

⁴ The explanation is simplified in several respects. There are always sellers, so what matters is the relative increase of their number. Prices do not need to decrease to be cause for alarm, less growth may be sufficient. Etcetera.

⁵ By definition an “actor” is a person who, or organization which, acts.

mechanisms described above. The details do not matter; in the end they make no difference.

Preliminary note on the role of government and supervision.

When a sector of the economy, or society as a whole, becomes aware of having underestimated uncertainty or risks, significant devaluation of its capital is the logical result. The devaluation will affect the economy and the welfare of many. The question is how such a loss of capital can be reversed, or how its effects can be prevented or reduced.⁶ Increasing the government budget and expenditure may reduce some unwanted consequences, but is not equivalent with recovery of valuations. It may even create new or additional problems, depending on people's spending possibilities and habits, and on the state of the government finances. Devaluation of economic capital in general will be accompanied by less government tax income, not by more. The government can borrow, but borrowing costs money. It entails risks, and reduces future freedom of action.

Security prices are determined by supply and demand on markets operating under conditions set by governments. But governments do not in general actively influence supply and demand. To a lesser extent this also applies to central banks. Central banks do influence interest rates and the amount of money in circulation. Their ability to influence market prices of securities in general is relatively small however.

Contrary to natural persons and enterprises, and as a consequence of their specific duties, governments (states) hardly own securities. One of their important activities is: to tax and spend tax income, supposedly for the general welfare. In the exceptional case that a government has a budget surplus, it might buy back its own bonds or invest in securities. In the last case it has an interest in stable or increasing prices, not in their fall.

The Chronicle shows that phenomena related to the crises have made very many innocent victims. The overwhelming majority were made during and shortly after the crash years 2007-2008, but also in earlier years.⁷ Reparation of the damage caused is very incomplete. The inadequacy of the reparation may be related to the roles of governments in the causation of the crisis. They played a decisive role by facilitating and encouraging various financial institutions, including supervisors, to take unprecedented risks. The same persons and institutions who for many years claimed that the financial economic system was healthy, actually caused the crises. By actions and omissions. According to most people they should legally be responsible for reparation of damage caused. The same persons and institutions are also responsible for prevention of repetition. The Chronicle and following sections show however, that the understanding of the relevant financial economic phenomena by governments and supervisors is fatally deficient.⁸ Governments and supervisors deny any serious avoidable wrongdoing. They deny responsibility for the crisis and the damage done. Given this turbid situation, it cannot come as a surprise that the measures which governments took will be seen to be inadequate. Reparation is limited at best.⁹ The root causes are not addressed.

The maxim "prevention is better than cure" is not really applicable. In the case of large financial crises "cure" is practically impossible.¹⁰ Prevention is the only feasible approach. Law, government and supervisors should ensure that unbearable risks are not taken. This is the *raison d'être* of the supervisors, and one of the main *raisons d'être* of governments. However, nothing in the reports of BIS, CPB, CDW, DNB, FCIC, Fed, IMF or anyone else in the period under consideration testifies to the understanding of the instability of the financial economic system. They show no knowledge or understanding of the mechanisms by which certain negative developments (disturbances) are amplified.¹¹ None admits grave errors.

⁶ Or how the overvaluation could have been prevented in the first place.

⁷ The "related phenomena" include the repressive political and supervisory climate. The victims include those who lost their job or career perspective due to well founded objections against reliance of self-regulation.

⁸ As always in this book, the word "fatally" is used, and only used, if something is bound to cause great harm.

⁹ Reparation should be distinguished from saving financial institutions.

¹⁰ Not in the last place as a consequence of inadequate and discriminatory liability law.

¹¹ BIS= Bank for International Settlements; CPB= Central Planning Bureau (of the Netherlands); CDW (parliamentary inquiry) Commission De Wit; DNB= De Nederlandsche Bank, the Dutch central bank & supervisor, in other words: the Dutch Fed; FCIC= Financial Crisis Inquiry Commission of the US Congress; Fed= Federal Reserve Bank of the USA; IMF= International Monetary Fund.

2. The concept of “cause” in relation to the crisis.

In this study, “a cause” means something- a circumstance, mechanism, act, inaction, omission, or whatever- which has a given consequence. A cause is by definition sufficient for a consequence to be realized. But a given cause need not be necessary. A consequence may have different causes. It may, but need not, require the simultaneous occurrence of a number of causes. A consequence may only occur if a number of independent conditions is fulfilled simultaneously. Conditions concerning circumstances, actions, omissions, etcetera.

There is ambiguity (multivalency, arbitrariness) in the use of the word “cause”. The reason being that in general causes have causes. That is to say: in general there is a chain of causes. The cause of a cause may be called cause just as well as any other cause in the chain. An ultimate cause- a cause without a cause- is never or almost never known.¹² This can be illustrated by an example. “Supervision dysfunctioned” can be called a cause (or contributing cause) of the subprime crisis. But then one can ask: what is the cause of this dysfunction?

(Partial) Causes need not be of the same kind. Some partial causes may only affect magnitude, others the time of occurrence. Causes need not have a binary (yes/no) character. There may be important qualitative dimensions. They may be important for prevention of repetition.

Because of the ambiguity of the concept “cause” it is impossible and useless to look for causes in the abstract.¹³ One always has to make a choice.

The analyses in this chapter can be seen as efforts to find causes of the crises. But they have another goal as well. Like the analyses in the other chapters the analyses in the present chapter are aimed at a better understanding of the operation of governments. They should help to understand and explain governments. But understanding and explanation are no more than intermediate goals. Understanding and explanation are means to find out what can or must be done to prevent disasters like crises. Prevention is the final goal of the study. And it is this final goal which is used as the criterion for the selection of the types of explanations and causes. The study looks for explanations and causes which offer starting points for finding solutions.

For the same reason we look for changeable causes. By definition, a phenomenon has changeable causes if the phenomenon is a consequence of causes made by people, or causes which were or can be changed by people. Examples are: avoidable acts and omissions, the ways in which things are regulated (or not) in society and state (including the law), and education. Someone who wants things to go differently in the future is interested in causes which offer opportunities for changes for the better. There are disasters lacking changeable causes, or insufficient changeable causes to explain and prevent the disaster. Such as natural disasters. But it will turn out that the financial crises are wholly man-made. All of its causes can be eliminated. Like the US Financial crisis inquiry commission (FCIC), this study concludes that the subprime (financial) crisis was avoidable. Of the second financial crisis, the debt crisis, this is obvious. In other words: both crises had only changeable and avoidable causes.

Both causes and conclusions can be formulated at different levels of abstraction. Where the causes in the chain of causes are assumed to correspond with levels. The desired abstraction level of causes and conclusions determines what has to be investigated, and how “deep” one has to go. At the chosen level of abstraction no important questions with respect to causes should remain unanswered. In this sense the choice of the level of abstraction determines the required completeness of an investigation.

The choice of a level of abstraction has consequences for the usefulness of the findings of an inquiry. Very deep or abstract causes may not be manageable or changeable. Such as “to err is human”, and the laws of physics. To be manageable and changeable, causes should be part of practical changeable reality. An important example is the call for better risk management. Someone who tries to answer the question how that is to be realized, discovers that the law sets no limits to risk taking. He

¹² This is something to think about, but outside the scope of this study.

¹³ Note that failure to understand the ambiguity of “cause” may give rise to wasteful discussions.

will understand that the risk management was inadequate because limits were fictional and competitors real, and because more risk may mean more profit and market share.

Inquiries like those of the CDW and FCIC should serve a practical purpose. In the case of the crisis: prevention of repetition. The choice of the level of abstraction can therefore best be made with this practical purpose in mind. This means that the set of causes to be discovered should explain the observed phenomena, and offer sufficient handles for changes that make repetition impossible (or at least implausible). With only the first criterion, the concept “cause” remains multivalent, and may yield very different reports.

So the present study tries to find sufficient changeable causes. Where the “sufficient” refers to “changeable causes”, not to “changeable”. The study looks for causes which can be removed. It must be plausible, or provable, that the phenomena under consideration will not occur if the designated causes have been removed. Or at least that the phenomena were unavoidable, and could not have been prevented. To make sure that removal of a certain set of potential causes is sufficient, it will be tried to find all potential causes. Because a chain is as strong as its weakest link, and a single overlooked cause may be sufficient.

False pretensions look like an important cause. But at this point in the study the possibility of an underlying more fundamental cause cannot be excluded. Why are false pretensions omnipresent? The false pretensions may be the consequence of a deeper (changeable) cause. This study anyway does not assume that people can change pretending. It assumes that the incidence of false pretensions is changeable only in so far as selection procedures and appointments are changeable. But these are part of a larger coherent system, which at this point in the study is not really understood. In a coherent system one may not be able to change one part without changing other parts. Before continuing the analysis of false pretensions however, it seems wise to review the phenomena and relations that may be relevant for understanding the developments that resulted in the crises.

3. How the analyses and evaluations in this chapter came to be made.

Rather queer and incredible testimony before the Commission De Wit (CDW) was the reason for looking better at the financial crisis. Initially the report of the FCIC majority was used as a guide. Somewhat later it was supplemented by the minority report of Wallison. Where useful or necessary, the sources of these reports were studied as well. In doing so, and by looking around, much useful literature was found and studied.

With increasing knowledge and understanding the present investigation became more and more independent from CDW and FCIC. Study of the annual reports of the Dutch central bank and the minority report of Wallison showed that the reports of the CDW and the majority of the FCIC could not be relied on. Study of the annual reports of supervisors and reports of the US General Accounting Office (GAO¹⁴) subsequently showed that governments and supervisors had failed very much more than transpired in the reports of the inquiry commissions (CDW and FCIC), let alone the media. Where “failed” is a misleading understatement. In an effort to better understand the commissions and supervisors, the later stages of the investigation were mainly devoted to studies of annual and other relevant reports of supervisors (in a wide sense, including BIS, IMF and OECD), and of hearings by CDW and FCIC.

After the initial phase, the work on this chapter 7 was mainly guided not by any of the documents mentioned, but by the wish to get a picture and explanation of the phenomena. To get a picture that is consistent¹⁵ and answers all important “thinkable” questions. And which provides starting points for the development of a sufficient set of measures for the prevention of similar phenomena. Given the picture and explanation, it should be plausible to assume that the measures are necessary and have the desired effect.

4. Explanation of the structure of this chapter.

¹⁴ In 2004 the name was changed into Government Accountability Office.

¹⁵ Internally, and with all available evidence.

The next section, 7B.2, Education and sciences, tries to answer the question: how could so many people fail if the education system is excellent and economic science is at a high level? The section tries to solve the apparent inconsistency.

Like the above subsection about instability, section 7B.3, Risk, rating, risk management, and liability, is a reaction to the observation that all or almost all of the principal actors and investigators lack even elementary, for their function essential, understanding of the basic concepts of probability theory, and of the necessity of boundary conditions for risk management. Their lack of understanding can be seen as part of the explanation of the crisis. This observation is also important when evaluating the competence of the principal actors, and the development of measures for prevention of repetition.

In analyses of the crises it is useful to make two types of distinctions. In the first place with respect to function. The different kinds of function are:

1. Political and governmental;
2. Supervision (including regulation to implement laws);
3. Rating;
4. Banking;
5. Investigation (the inquiry commissions).

These functions are fulfilled in the framework of hierarchical organizations. In that kind of organization one distinction is of decisive importance, not only in theory, but also in practice: that of the boss at the top, and his or her subordinates. The correctness and relevance of this distinction is confirmed by the empirical evidence.¹⁶ That's why a second distinction will be made, with two categories:

1. Heads (and top managers);
2. Subordinates.

The sections 7B.4-7B.8 correspond to these classifications. Section 7B.9 gives summaries and conclusions.

The empirical evidence, including that about selection processes, shows that most subordinates (and other citizens) differ from the heads of their organization with respect to norms, values and competences. From the point of view of prevention of crises, it is of great importance to find the answer to the question: how it is possible that subordinates have not been able to exert any correcting influence, in spite of their number and competences. This question is not asked or answered by the inquiry commissions, or by others. Only very little positive information has been found about the role of subordinates in organizations involved in the crisis. Though very numerous, they are nearly invisible. A little other information can be inferred from the absence of certain types of information. The findings will be discussed where fitting. There is however not enough empirical material to warrant a separate section on subordinates.

The analysis will show that the principal characters are neither honorable nor competent. Apart from their words in public, their conduct is very different from what their job requires, from what almost everybody expects of them, and from what they themselves assert may be expected of them. There is ample empirical evidence about them. In the inquiries of CDW and FCIC they played a dominant role. (There too their subordinates were hardly visible). Because they occupy key positions in society and in the explanation of the crises a separate section is devoted to them (7B.8).

The reports of CDW and FCIC are not discussed as such. There is no separate (sub)section about them. They will be evaluated in the course of the discussion of other subjects. It seemed to be inefficient to spend more words on them. Still, the reports and other products of the commissions have been studied thoroughly, even if not every part in every detail. They are very useful and highly recommended. But they have important deficiencies. Important reasons for not spending more words on them are the inadmissibly defective methodology, hearings, conclusions and recommendations of the commissions, and the availability of more than enough contemporary documents. Where "inadmissibly defective" also means: inconsistent with applicable norms. In general the defectiveness can already be inferred from internal analysis, and otherwise from inconsistency with contemporary

¹⁶ Both about the financial crises and most of the other cases mentioned in this book.

documents.

This analysis, part B of chapter 7 about the financial crises, is based on the Chronicle and numerous preliminary studies about specific persons and organizations. For several of these persons and organizations a document has been made with the most indicative or important evidence, summaries and conclusions. These documents are excerpted in the appendices or included in the dossier. The appendices may be unfinished. They may represent a stage in the study of the subject matter. They have been structured for easy use. Their function is to facilitate access to the information about their subject. Which may be voluminous, inaccessible and chaotic. Even more than the present analysis, the appendices may be seen as a guide to the sources. As intermediates between analysis and sources. Taken together, the reports of the preliminary studies were far too voluminous to insert in the Chronicle or analyses (if functional as regards contents). In the analyses only the largest common denominator of the conclusions has been integrated, and the most important or fitting specific findings.

5. Methodological note.

About the crisis and about other subjects, “experts” or high officials frequently make assertions which one does not seem to be allowed to question.¹⁷ Rarely if ever do such people admit that they don’t understand things. They rarely show uncertainty about their own statements or about the incorrectness of conflicting statements. The crisis has shown however that many of the important statements of the principal characters were inadequately founded and untrue. The suggestion of certainty was fully unjustified. The principal characters did not understand the system at all. Their self-confidence was based on quicksand, and their lack of doubt and prudence irresponsible. And these characteristics had terrible consequences.

For this reason, when listening to an interview or reading a report or whatever, the reader is advised to frequently ask himself what some assertion is based on, or could be based on.¹⁸ Even in important cases this question may only be answerable with: there cannot be an adequate basis. This applies for example to the assertion that «[the evidence to date suggests that dramatic growth in new instruments for risk transfer and the greater role of nonbank financial institutions have contributed to a more stable and more efficient financial system](#)», which was often heard in the prehistory of the subprime crisis.¹⁹ The crisis has shown that there was not and cannot have been sound evidence or proof. If the assertion had been true, there would not have been a crisis. The evidence mentioned in the assertion must have been an invention (or unfounded belief) of the speaker, and it follows that the speaker is unreliable and irresponsible. In principle the assertion could be a mistake. In this case it would have been a very consequential mistake. Whether or not an assertion can have been a mistake can sometimes be inferred from the internal evidence of the sentence, or from the context. These may or may not suggest openness or careful study and consideration. Sometimes it may be necessary to compare the probability of mistake with that of an intent to make believe. Anyway: experience shows that only few things are certain, and (for example!) that one can hardly ask too many questions.

7B.2. Education and sciences.

Table of contents of this section.

1. Introduction and conclusions.
2. Essential shortcomings of common education.
3. Economy education and economic science.
 1. The subculture of economists.
 2. The textbook *History of the American Economy*.

¹⁷ As regards the crises, the dossier is full of examples. See especially the annual reports and the hearings.

¹⁸ And please don’t forget that a reference or source doesn’t always give a proof.

¹⁹ Remarks by Mr Timothy F. Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Global Association of Risk Professionals (GARP) 7th Annual Risk Management Convention & Exhibition, New York City, 28 February 2006. BIS Review 14/2006.

3. The textbook *The heart of the economy*.
4. Two editions of the textbook *Economics* of Sloman c.s., separated by a crisis.
5. The textbook *Essentials of Strategic Management- The Quest for Competitive Advantage*.
4. The education and science of law.
5. Closing remark.

1. Introduction and conclusions.

Whether one evaluates the contents of education itself, or evaluates people's education on the basis of their functioning, in both cases one has to conclude that it is insufficient. Many of the phenomena described in this report, including the financial crises, are incompatible with the hypothesis of good education. And this applies to both general and specialized, disciplinary, education. In order to specify the deficiencies, this section will consider general education, economics education, economic "science", law studies, and the "science" of law.

Relatively much attention is paid to economics because as regards the financial crises it is the most relevant discipline, and because a majority of the people responsible for the financial system had studied economics at a (renowned) university. Without doubt, the same applies to a majority of employees of supervisors and organizations like BIS, IMF and OECD.²⁰

The law fixes the boundary conditions for human activities. If it were a science, law science should reflect critically and detachedly on these boundary conditions. The social importance of such a science is evident. But what nowadays passes for law science does not satisfy the definition of science.²¹ What passes for law science fails completely in its social function. In the subsection on this subject some of the deficiencies of law science as a science will be indicated.

It will be concluded that several subjects which are vitally important for functioning properly in modern day society are either only touched upon in education, or not treated at all. What are called economic science and law science do not satisfy the definition of science. What are called experts in economics are not experts at all, and experts at law probably know part of the law, but cannot be expected to evaluate the law as a scientist should. These and related findings greatly help understanding why crises and other man-made disasters (still) happen. One might even conjecture that they make them unavoidable.

The findings of this section are consistent with the findings of the other sections and chapters. In particular with the misconduct that can be observed in and around the crises (and other cases). None of the fatal events would be understandable if education was good, and if the "sciences" of economics and law were reliable.

The present section evaluates a small random sample of textbooks and articles. They give a similar picture. The selection is more or less accidental. In combination with the observations of 1) consistency with all empirical evidence, and 2) complete lack of any sign of non-representativity, this justifies the conclusion that the findings are representative.

2. Essential shortcomings of common education.

"Common education" refers to the part of the education program that almost everyone passes through. In other words: the concept refers to the basic knowledge and abilities which are acquired in the education system, and are shared by almost everyone. Irrespective of the form in which it is taught, or the specific type of school or didactical method. With minor adaptations many of the following remarks also apply to the other parts of the education system. Including higher education and the studies of economics and law.

One can be brief about this subject. In the light of this report, the evaluation of education is simple.

²⁰ See the appendices and the Wikipedia pages, both about specific persons. (The Wikipedia pages can be found in various directories, especially Encyclopedia/Persons and the directories of specific organizations. The name of the person always figures in the file name).

²¹ In this report, science is defined as the endeavor to find reliable explanatory knowledge about a coherent set of phenomena of given types. It is the reliability that requires openness, honesty, a critical attitude, consistency, and the testing of hypotheses. For elucidation and discussion one can consult encyclopedias.

It only requires replacement of a politically desired fiction by what your eyes show you. And comparison of the (purely logical) conclusions of this report with the thinking of the people around you, on radio and TV, in news items and “analyses” in newspapers, journals and books. And with the premises of this thinking. Someone who makes this comparison can only conclude that the “knowledge” of most people about social and political phenomena consists of little more than illusions and gaps. And that as far as their thinking is concerned, most people live in a fantasy world which has little to do with the real world. In other words: whatever the contents and organization of present day education, the result is utterly insufficient.

People do not know that government and parliaments primarily cooperate in performing a farce with the purpose of preventing replacement of illusions by a truthful picture. In particular the illusions that people are represented, and that government is supervised by parliament. People don’t know that this supervision is incidental and arbitrary at best, and in general absent. They don’t know that there is no supervision of the supervision. That supervision by parliament is not prescribed by law (or otherwise), and that inadequate supervision goes unpunished and unnoticed until something goes wrong badly. People know, but don’t realize, that nowhere else in society representatives are fully empowered for 4 years, without the least possibility of instruction or recall between times. That someone who calls himself representative does not for that reason represent anybody (beside himself).

The illusions about, and the gaps in, the knowledge and understanding of the operation of government can be attributed in the first place to education. In the second place it can be attributed to the systematic confirmation of misconceptions by publicists who don’t (but should) know better,²² and by politicians whose careers depend on these misconceptions. Education analyses neither theory nor reality. It does not teach to think critically and constructively about the phenomena described in this study. It teaches the theory of government, suggesting that theory equals reality, without showing crucial differences. Doubts arising in practical daily life are reasoned away with good intentions, the inevitability of mistakes, and the fiction that we are living in the best possible world, and that this is therefore best possible.²³

In other respects as well, education does not sufficiently prepare people for functioning in modern society. That is: as a citizen in the social context of a town, country and world. Neither does it prepare properly for working in a hierarchical organization. Irrespective of the nature of the work: management or something else. People cannot and do not know in what kind of environment they may land. (And as many cases in this report show: reality may be literally beyond imagination). They may know how it should be, but cannot have the slightest idea about reality. Those who believe that education gives a reliable picture of reality are taken by surprise, and helpless. Even those suspecting that practice is worse than theory will not have the means to cope with it. At least not if they wish to respect the norms and values which most people consider desirable or necessary.²⁴

Education does not teach how organizations operate. It does not tell that in practice, hierarchy often means dictatorship. In spite of efforts to conceal this; for example by suggesting that critical remarks and reasonable (alternative) proposals are always welcome.²⁵ Education does not tell that as a rule, codes of conduct, integrity codes, professional codes etcetera are mainly meant as propaganda. To give outsiders a positive picture of a company, profession or whatever.²⁶ It does not tell that these codes do not give rights to employees, and that breaches can be made with impunity. It does not explain why separation of powers is good for society at large, and bad for hierarchical organizations.²⁷ It does not explain how hierarchical organizations can deal properly with breaches of codes in spite of union of powers, if society cannot. Of course, previous cases have already shown that in important cases breaches of codes were not treated properly at all. Worse: most cases suggest that breaches are a

²² Or don’t want to know better, for social and career reasons.

²³ And that wars and crises are unavoidable.

²⁴ And which are the only defensible ones. See *Communication and norms* (available as pdf file on the internet), or www.lawoflogic.net.

²⁵ But there is not the least guarantee that they will not be thrown in the dustbin right away. There is no procedure which guarantees that remarks and proposals are treated reasonably.

²⁶ Integrity codes also regard other forms of misconduct than shown in this book. If the top is not involved, as in cases of theft or sexual harassment low in the hierarchy, a code may function properly. The top however can breach a code with impunity. And the top protects everyone doing what it asks of them, directly or indirectly.

²⁷ The “powers” are: law making, judiciary, and executive. The law includes what is often called “regulation”.

conditio sine qua non for a successful career. And that an appeal to a code marks an employee for ever. That it leads to isolation in the organization and immeasurable misery. But to nothing useful.²⁸

The education program is neither the only problem, nor the ultimate cause of the problem(s). The antiquated and theoretical character of the program, and the lack of interest in preparing pupils and students for the real world, can be partially explained by the closed character of the world of education. Almost all teachers (including university professors) lived their entire lives in the world of education. They never worked, as an insider, outside education. Even if they learned something about the outside world from practical experience, and were able to replace part of their illusions by more reliable pictures, it would be a miracle if they could transform these into an orderly explanatory description, usable in education; and if they could get the approval for actual use from the authorities. In every other case teachers have to comply with the prescribed programs, book selections, etcetera.

Finally, in general the formulation of education programs is managed by governments. If only by selecting the members of “independent” program commissions.²⁹ Compliance with an approved program may be a requisite for subsidy of either the education institution and/or students taking courses.

3. Economy education and economic science.

Note. This subsection also uses results of later sections of this chapter.

The subculture of economists.

The terminology “subculture” is used because there is an important common denominator in the thinking about economic questions by economists, and because the norms and values defining this denominator differ in important respects from those of society at large. Money is the dominant value of this subculture. Sometimes a publication begins by telling that non-financial values will be considered on an equal footing with financial values. For example by translating non-financial values in numbers of dollars. But as a rule the promise is entirely forgotten in the remainder of the publication.³⁰ The “science” of economics is not an empirical science. Often the relationship between quantities and assertions of economics and reality is undefined and unclear. Premises are almost never formulated unambiguously and exhaustively. For these and more reasons economic theories and assertions cannot be relied on.

The values necessary for the development of economics as a science are inconsistent with the positive picture of the accomplishments of economics which economists seem to think they need to proclaim for career purposes. If economics were a science, economists would show much more restraint with respect to their accomplishments. They would be much more careful in the use of economics in their work. As it is, the false pretensions are a recipe for (continued) corruption of economics as a discipline.

The existence of a distinct subculture of economists can be explained by the combination of the sorry state of economics, the shared self-interest of most economists, and the large influence of education institutions on economical thinking and thinking about economics in society. The education institutions are the place where almost all economists are educated. Outside the world of education, the institutions are influential through the economists they have trained, through their relatively large contribution to the production of new economic publications, and by providing advice and “experts”.

It should be noted that this section cannot and does not conclude that economics is worse than any other discipline. Law is just as bad or worse. The point is that economics is of far more importance for

²⁸ See in particular the whistleblower cases in the following chapter, and the reports of the projects in the Dutch ministry of education in the preceding ones.

²⁹ The inquiry commissions CDW and FCIC clearly show what this means.

³⁰ An example is Richard A Posner *Economic Analysis Of Law* 5th edition, 1998, Aspen Law and Business, a division of Aspen Publishers, Inc., a Wolters Kluwer Company (formerly published by Little, Brown and Company), ISBN 1-56706-562-7, hardcover, xxii+802 pp. The assumption that everything of value can be translated in a number of dollars is debatable. The assumption can be qualified as “1-dimensional” thinking.

the financial economic system and politics than most other disciplines, and failed disastrously. That is why it is studied more closely: to explain this failure. And to find out what can be done about it.

The book "History of the American Economy" of Walton & Rockoff.^{31, 32}

Chapter 23 of this book is entitled *The Great Depression*. After a discussion and analysis of the depression of 1929-1932 (or 1939) comes a section where the authors ask and answer the following question:

«CAN IT HAPPEN AGAIN?

No one, unfortunately, can say for certain that such a depression cannot happen again. But there are many reasons for thinking that a collapse on the scale of the Great Depression is a remote possibility under modern circumstances.

One reason is that we are not likely to repeat the same mistakes. The Federal Reserve, with better data at hand and with the experience of the Great Depression laid out in many books and articles, is unlikely to permit a complete collapse of the banking system. Moreover, because we are no longer on a gold standard, the Fed's ability to create dollars during a crisis is virtually unlimited.

The same is true of fiscal policy, although here we cannot be quite so confident. Faith in a balanced budget seems to be hard to shake, even under very dire circumstances. Nevertheless, it seems likely that conditions similar to those of the early 1930s would be met today with tax cuts and increased spending on a substantial scale. Many sorts of spending, such as unemployment benefits, would increase even without specific congressional actions — the so-called automatic stabilizers.

The private economy, too, is less vulnerable to economic collapse. The industrial sector, particularly producers of consumer durables, seems to be the most vulnerable to sudden shifts in demand that lead to massive layoffs. But this sector is now relatively much smaller compared with the service sector than it was in the 1930s. The rapid increase in two-earner households, moreover, has reduced the probability for many families that an economic downturn will completely deprive them of an income.

Finally, there exists a vast network of government programs that would alleviate suffering and, simply by being there, reduce the chance of a paralyzing fear. These include the Federal Deposit Insurance Corporation, the Pension Guarantee Corporation, and others. But however much we may be aware of these facts, it is nevertheless true that the nightmare of the Great Depression comes back to haunt us time and again when conditions in one sector or another take a turn for the worse.³³

This section is uncritical to such an extent as to be useless and misleading. What it says has more to do with belief than science. The authors don't seem to be aware of essential implicit and incorrect assumptions. For none of the important assertions do they give substantiation or sources.

- What is the basis for the assertion that “we are not likely to repeat the same mistakes”? “Not likely” is of course rather vague, unspecified. But modern economists seem to have forgotten, for example, that the French revolution was the consequence of government debt run out of control. A look at the Annex Tables of an OECD *Economic Outlook* would have shown the authors that the US gross government debt in 1997 was 72% of GDP,³⁴ and that for Belgium and Italy it was more than 100%. In 2010 the Greek government debt would almost result in a revolution (in Greece). So the assertion that “we” are not likely to repeat

³¹ *History Of The American Economy* 8th Edition, Gory M. Walton (University Of California, Davis) and Hugh Rockoff (Rutgers University), The Dryden Press, Harcourt Brace College Publishers, 1998, ISBN 0-03-024579-6 p. 536-7.

³² Already as a boy the author was interested in history. Later on he added economics. Witness the paper *R&D en economische structuur* (R&D and economic structure) in ESB (1988). He bought the book of Walton and Rockoff around 2000 because of interest in history and economics. Not for a special purpose.

³³ *History Of The American Economy* pp. 536-7.

³⁴ OECD Economic Outlook 2000-1 table 34.

the same mistakes not only lacks substantiation, but is incompatible with facts.

- “[The Federal Reserve, with better data at hand](#)”: are the data only better than those of 1920-1930, or better for the world of 2010 than those of 1920-1930 for the world of the Great Depression? After all, the financial world has changed. The answer is: only the first. In the GAO report of 1994 Walton & Rockoff could have read that supervision lacks important information. They could have drawn the same conclusion from their own analysis, if they had made it. As it is, their remark reflects no more than blind faith and wishful thinking. It shows that the authors are not aware of the fact that financial institutions only provide supervisors with information prescribed by regulation, and that regulation may be inadequate due to political interests, goals or stupidity. Neither do they seem to be aware of the possibility that supervision is inadequate.
- The “[Great Depression \[may be\] laid out in many books and articles](#)”. But that does not mean that it is understood, or that its essential features are understood. In the introduction of the chapter Walton & Rockoff themselves admit: “[scholars are still far from full agreement on all the issues](#)”. They do not even understand the most essential feature, the instability of the financial economic system. If they did, they would be much more careful in their assertions and forecasts.
- Which problems can be solved by printing dollars? Certainly not all! The question is: which specific problems can be solved that way? What are the side effects? Is it clear that printing dollars solves more problems than it creates? For example by increasing inflation and decreasing trust in money?
- “[Faith in a balanced budget seems to be hard to shake](#)” sounds rather comical after 2009. It sounds comical because of a euro crisis caused by unsupportable debts of governments, very large government debts in general, and because of the tough measures considered necessary to reduce deficits and debts. But already in 1998 it was a curious remark. As noted earlier, in that year US government debt was 72% of GDP. Such a debt is proof of a long history of substantial deficits and unbalanced budgets. In fact, the US government debt had been increasing since at least 1983. So if a political majority really believed in a balanced budget, it badly failed to live up to its belief. Walton & Rockoff don’t seem to realize that borrowing makes one dependent on lenders. Finally, they seem to have forgotten or misunderstood the French revolution. And finally”: is only the sky the limit for government debts?
- The solutions and emergency measures mentioned in the last three paragraphs may cost a lot of money. Once again Walton & Rockoff seem to presume that money grows on trees. The section would have been much more meaningful if the authors would have made the common sense remark that in normal times a balanced budget is recommendable in order to have room for maneuver in a case of emergency, and to reduce dependency on lenders as much as possible.³⁵
- The paragraph beginning with “[The private economy](#)” is an example of insufficient imagination and reflection. How is it possible that after having noted that the relative size of the industrial sector has decreased, Walton & Rockoff don’t ask themselves which sector(s) have increased, and what risks these sectors may cause? (Especially the financial sector has grown).³⁶ What is the basis for the assertion that the industrial sector “[seems to be the most vulnerable to sudden shifts in demand that lead to massive layoffs](#)”? On a comparative analysis? No source is mentioned. It will be hard to find, for the assertion is simply incorrect. Radical budget cuts by a government have the same effect (as in Greece 2010-2014). The subprime crisis was followed by massive layoffs in the financial sector, and by layoffs in other sectors somewhat later. Sudden shifts in demand may occur in every market, and are not the only relevant variable. Changes in interest rates may have disproportionate effects for example.
- The Federal Deposit Insurance Corporation and the Pension Guarantee Corporation may be

³⁵ And of course, because a balanced budget shows that politicians mean what they say and respect their own (budget) laws.

³⁶ See the FCIC report, or the US Statistical Abstract.

better than nothing, but their guarantees are limited. Walton & Rockoff could better have indicated what exactly is insured, and what part, or to what extent.

In short: the quoted section is unscientific because of the lack of substantiation and reflection, and because of the absence of systematic skepticism. It is unreliable because it is dominated by wishful thinking. This could already have been concluded in 2000. And the incorrectness of the argument is of course most clearly shown by the crises of 2007-2013.

The section demonstrates a complete incomprehension of the worlds of finance, politics, and government. It ignores available knowledge of the political and financial systems which is necessary to reason responsibly and reliably about the matters discussed. Note that Walton & Rockoff also ignore the financial scandals that gave rise to the GAO report of 1994, and the report itself (with warnings suggesting that it can happen again). The misleading nature of the section can be attributed to this broad neglect. A true scientist is permanently on the lookout for falsification.

In general, assertions that something is impossible are very tricky. Very often they turn out to be incorrect. They are very hard to prove rigorously. This has a reason. The point being that there is an essential methodological difference between proving that something is possible and proving that it is impossible.³⁷

The reasoning of Walton & Rockoff supports the assertion that (economics) education does not prepare properly for social functioning. Their book is part of the education of innumerable economists. Who therefore entered society with incorrect, risk promoting illusions. The quoted section causes underestimation of important risks. A sloppy and incorrect reasoning is presented to students as a valid argument of economic professionals.

The textbook "The heart of the economy" by Heertje & Van Sandwijk.³⁸

In Dutch secondary education, children have a number of compulsory disciplines, and have to choose an additional number from a given set of disciplines. The second set includes economics. *The heart of the economy* is the secondary education textbook for a large part of the children who have chosen economics. It is their first acquaintance with economics as a discipline. In so far as people in high functions in society had economics in their education, this book laid the foundation.

The quotes show the treatment of some subjects which are relevant in connection with the financial crises.

«13.6 Deregulation

Competition in markets is not only guaranteed by competition policy, but also by deregulation. Many government rules obstruct free competition between enterprises. We mention some examples.

The opening of shops has always been conditioned by rules. In the Law Opening Hours Shops of 1996 these rules have been relaxed. In the evening shops may remain open longer, and sometimes they may open Sundays. As a consequence shopkeepers can offer consumers more admission and service. In addition, completely new shop formulas have been developed. All this has benefited the consumer, and also improves performance of the shopping sector as regards the creation of new jobs.

The establishment of new enterprises is regulated as well. The rules are given by the Law Establishment Enterprises. Some years ago there were rules for professional skills, engineering, creditworthiness, etcetera. Since 1996 the rules have become less restrictive, making it easier to start an enterprise. Put differently, the thresholds for market entry have been lowered. So that new businesses can step into the market. This improves competition on the market.»

The section gives an incorrect and misleading picture of deregulation. It suggests that deregulation is meant to enable free competition³⁹, and that it is self-evident that deregulation is positive. But the

³⁷ In the last case, one may assume that it is possible, and try to derive a contradiction, showing that it cannot be possible. The problem is that the contradiction in general is very hard to construct.

³⁸ Kernboek 1 VWO. Second edition, 2003. Walvaboek, De Echte Kern BV, Naarden (Netherlands), ISBN 90 6675 169 x.

³⁹ Free competition, to be distinguished from honest or honorable competition.

Law Opening Hours Shops is not an example of rules which hamper free competition. Some people even think that compulsory closing times are necessary for honest competition. Because not everyone can use the new freedoms equally.

A textbook should explain that deregulation is a concept with many meanings. It should illustrate this with examples of rules and/or laws of different kinds. Both of necessary or desirable rules and unnecessary and undesirable rules. It should point out that there are rules which are formulated in general terms and applicable widely, and rules which are specific, and applicable only in special cases. It should explain why the rules are what they are. It should indicate their supposedly positive and negative effects. It should stimulate reflection, and show the harmful consequences of superficial argumentation and jumping to conclusions. Because of the wide variety of rules and laws, a simple and general judgment about deregulation is impossible.

The section *Deregulation* gives the students a bad example by authoritarian dogmatic instead of critical arguing, and by suggesting that general assertions can be proven with one or two examples. It pays no attention to the definitions of the concepts used. It seems not to be aware of the wide meaning of “deregulation”. The section gives the students two unsound lessons:

- Far reaching conclusions can be drawn on the basis of examples and tattle;
- Deregulation is good.

The prisoner's dilemma, supervision and government as seen by Heertje-Van Sandwijk. The treatment of games and the prisoner's dilemma (PD) “game” in section 5.5 is deficient as well, though less fundamentally than that of deregulation.⁴⁰ The technical concept of “game” is not defined or explained, and several sentences are unclear. But the most important is probably that the book neglects to show one of the most important reasons for instituting supervision and a government.

In the second half of the section the book analyses the following PD-game:

		Airline B	
		75,000 passengers	50,000 passengers
Airline A	75,000 passengers	(M\$ 4, M\$ 4)	(M\$ 6, M\$ 3)
	50,000 passengers	(M\$ 3, M\$ 6)	(M\$ 5, M\$ 5)

The section concludes:

«So the outcome of the game is that both airlines choose to transport many passengers. It follows that the profit of both airlines is the same, M\$ 4. [...] If the airlines A and B would agree that they both would transport a relatively small number of passengers, they make a greater profit. For this reason one often sees that enterprises which regularly play such games [...] make agreements among themselves [...]. These enterprises then form a cartel. As we saw in the preceding section, cartels are forbidden, because they obstruct competition.»

The book does not explain why competition is more important than profit maximization.⁴¹

It is clear that taken together, the airlines benefit from compliance with the agreement to transport only 50,000 passengers. However, they can profit from breaching the agreement one-sidedly, and try to get more passengers (without the other airline noticing).

Very generally it is a fundamental problem to ensure compliance with agreements. If both parties benefit from the agreement, without benefiting more by a breach, compliance is no problem. Otherwise it is. The PD game is a model for situations where compliance is beneficial for the parties taken together, and where the separate parties benefit from non-compliance. The game indicates how the problem of non-compliance can be solved. At least: under what condition there is an efficient solution. It can be solved profitably if the difference between the total profits in the different cases is sufficiently large to install and pay a supervisor/judge/enforcer. In the example M\$ 1. This is the most important lesson of the PD game. It is important because this type of situation is met very frequently. Namely in all those cases where compliance with rules of conduct is beneficial for, or desired by, a group of people (say the population, or mankind), but irritating or costly for individuals (and/or individual states).

⁴⁰ Section 5.5, Game theory, pp. 75-6.

⁴¹ And what about GDP growth?

In other words: the PD game shows for which type of problems judicial and police organizations and government can be a solution, and under what condition they can be a solution instead of an expenditure which does not pay itself back.

Heertje-Van Sandwijk neglect to note this. Both in section 5.5, section 8.10 *Supervision*, and section 9.1 *Government*. Worse, section 9.1 opens with the following assertion:

«In our open and mixed economy the central government has three functions:

1. the allocation function;
2. the redistribution function;
3. the stabilization function.»⁴²

Maybe the authors mean: “As far as the economic performance of a country is concerned, the central government has three functions”. But that is not what they say. And the assertion is not proven or substantiated. Which is not very surprising, for the enumeration is incomplete, and the assertion therefore incorrect. Namely because not only any society, but even optimal economic performance, requires regulation and compliance, and not only for the purpose of allocation, redistribution and/or stabilization. Failure to mention this fundamental role and to substantiate it with the PD game is a missed opportunity, to put it kindly. It also illustrates a lack of understanding by the authors.

The Chronicle and Analysis of the crises show that this lack of understanding of the role of government and supervision is general. With this kind of economics education, the failure of the regulation and supervision of the financial system, and the ensuing crises, should surprise nobody.

Two editions of the textbook “Economics” of Sloman c.s.⁴³

This is an undergraduate university textbook. It is introductory, and covers all of economics. Its selection was due to availability in the public library of The Hague, and the availability of both an edition from the year 2000, and an edition from 2009. The first from long before the crises, and the other from shortly after the crisis. It is an English textbook, with relatively many data and examples related to the UK. But the style is that of an American textbook, and the English context need not hinder use anywhere.

For the purpose of evaluation a list of questions was formulated. This was done before studying the books. The questions are relevant in the context of the crises. The next step was to study both editions of the book in order to see whether and how the questions were answered. The quality of the set of answers is assumed to be a reliable indication of the quality the textbook and of the economics education as preparation of people who played and play a role in and around the financial system in 1990-2010.⁴⁴ The following list gives the questions and the conclusion of the evaluation of the edition of the year 2000. The conclusion of the evaluation is expressed as a number with a value 0, 1,... 10, and a short explanation. A “0” means that the textbook is silent about the subject(s) of the question. A “10” means excellent treatment.

1. Are the concepts “economics” and/or “economic science” described clearly and defensibly, and does the book cover economics as described? - 4: *economics is defined in terms of some theoretical constituents. It lacks the distribution mentioned in the definition by the Merriam Webster.*⁴⁵ *The book does not define economics in terms of phenomena in practical reality. It covers only part of economics. In the part that is studied, essential aspects or topics are missing;*
2. Are opinions and value judgments distinguished properly from facts? Is the style of the book

⁴² Heertje & Van Sandwijk p. 128. According to p. 129 “stabilization” means stabilization of economic development.

⁴³ *Economics*, 4th edition, published 2000. John Sloman with the collaboration of Mark Sutcliffe. Prentice Hall & Financial Times, ISBN 0-13-085342-9. 772 pages + table of contents, appendices and index.

⁴⁴ The assumption being based on common sense. It should be obvious that the result of the evaluation depends only very weakly on the precise specification of the assumption. Dropping or changing a few questions would not affect the result, for example. (The evaluation is stable with respect to changes in the assumptions).

⁴⁵ Economics 1: a social science concerned chiefly with description and analysis of the production, distribution, and consumption of goods and services.

- reflective, or does it (implicitly) make important assumptions without noticing?- 4: sometimes, sometimes not (both questions);
3. Is attention paid to the choice of added value as basic measuring stick, instead of the change of the value of assets, and is the choice justified?- 3: no;
 4. Economic growth: what are the costs and benefits, why would it be necessary, what is it good for?- 7: the discussion considers a wide variety of aspects, it certainly isn't one sided, but in the end it implicitly concludes that growth is mandatory;
 5. The mixed economy: Is the book aware of the fact that only a part of the economy is a market economy? Does it discuss the types and sizes of the different industries⁴⁶? Does it describe the historical development of the relative sizes?- 4: the fact is known, but nothing is done with it. There is only marginal interest in the non-market part of the economy;
 6. Is attention given to differences in decision making in the market and non market parts of the economy (in the different "industries")?- 4, but this is a very kind valuation. There is very little or no attention for this subject;
 7. Is attention given to public choice?- 0: no;
 8. Is attention given to the role of law and government in economic activities?- 3: marginally;
 9. Is attention given to contents and influence of law and regulation?- 2: marginally;
 10. Is attention given to the influence of liability and criminal law on decision making and processes?- 0: no;
 11. Is attention given to the role of supervision?- 0: some things are said, but very insufficient. In this case, the "0" expresses the ratio between attention given and attention needed;
 12. Is attention given to risk and risk management, and the concepts bearable and unbearable⁴⁷?- 0: no;
 13. Is an explanation given of the dangers or risks of an unbalanced balance of payments (or the absence of risks)?- 5: something, but unsatisfactory;
 14. Is an explanation given of the dangers or risks of a large government debt (or the absence of risks)? 0: no.

The book may give a reliable picture of economic thinking. But it clearly has an insufficiently critical attitude towards that thinking, or accepts it blindly. Too many practically and theoretically important questions or subjects remain unmentioned. So much so that considered as a preparation for functioning in society, whether as an economist or otherwise, the textbook is not only deficient but insufficient and inadequate. If trusted and used as part of a basis for decision making on economy related matters, it will often lead to erroneous decisions and actions.

The second edition takes account of the subprime crisis. But crucial lessons have not been learnt. The information about the crisis and the analysis of the crisis are very superficial. Important facts are missing. No mention is made for example the government policy regarding affordable housing and deregulation, and the fatal dysfunctioning of the supervisors and governments (with respect to the financial system). The PD game is treated in the way of Heertje-Van Sandwijk. Not as an explanation of the raison d'être of judges, supervision and government. After the crisis the subject of supervision (regulatory bodies) is still treated only marginally.

In connection with the crisis moral hazard is mentioned: «The temptation to take more risks when you know that someone else will cover the risks if you get into difficulties. In the case of banks taking risks, the "someone else" may be another bank, the central bank, or the government»⁴⁸ But liability and criminal law remain unmentioned.

The answers to the list of questions are the same for both editions.

Adding up: the two editions of this textbook can be seen as part of the explanation of the crises. They show that nothing or hardly anything has been learnt from the crisis.

⁴⁶ In generalized sense, so as to cover all "economic" activities. That is: all activities involving money. For a specification see for example the Statistical Abstract USA 2012, table 670, p. 437.

⁴⁷ Or "financial responsibility".

⁴⁸ Sloman & Wride *Economics* 7th ed (2009) p. 512.

The textbook "Essentials of Strategic Management- The Quest for Competitive Advantage".⁴⁹

This is a textbook for undergraduate and graduate students in business studies.⁵⁰ Chapter 9 is entitled "Strategy, Ethics, and Corporate Social Responsibility". It has a section "What do we mean by business ethics".⁵¹ It begins with the following "definition":

«Business ethics involves the application of ethical principles and standards to the actions and decisions of business organizations and the conduct of their personnel.»

It doesn't say what these principles are. A little bit farther on one reads:

«Much of the crisis in residential real estate that emerged in the United States in 2007-2008 stemmed from consciously unethical strategies at certain banks and mortgage companies to boost the fees they earned on home mortgages by deliberately lowering lending standards to grant home loans to people whose incomes were insufficient to make their monthly mortgage payments. Once these banks and mortgage companies earned the fees on the so-called subprime loans they made to unqualified borrowers, they secured the assistance of investment banking firms to bundle these and other home mortgages into collateralized debt obligations and mortgage-backed securities, found means of having these high-risk securities assigned triple-A bond ratings, and auctioned them to unsuspecting investors, who later suffered huge losses when the borrowers began to default on their loan payments. The consequences of crafting strategies that cannot pass the test of moral scrutiny are manifested in sharp drops in stock price that cost shareholders billions of dollars, devastating public relations hits, sizable fines, and criminal indictments and convictions of company executives.»

This is all that is said about the crisis. If the ethical principles forbid selective and unfounded accusation, or exaggeration of misconduct, then this quote violates these principles. It is not clear whether it is true what this paragraph says, even if misconduct by banks may be considered as cause of the crisis. Substantiation is not given. As Chronicle and Analysis show, unethical behavior of banks explains only a part of the toxic mortgages and securitization. Moreover, as Wallison and Pinto show, it was HUD that began pressing for lowering lending standards.⁵² Which in practice requires unethical behavior. Furthermore, some supervisors, for example the Fed, have duties with respect to mortgages and lending which they (knowingly) neglected, with fatal consequences.⁵³ In the management and control of the financial system by supervisors, Congress and government, unethical behavior had a decisive influence. Their unethical behavior was of a different nature, and may have other causes than that of banks.

Very strictly speaking, accusing a specific group of organizations of unethical behavior, while remaining silent about similar behavior of other groups, need not mean that only the first group behaved unethically. But in practice it suggests that there is no reason for accusing the other groups, and therefore that nothing is wrong with them. It is a trick of politicians, which is unethical, and violates the norms and values of science. It is an important lack of openness. The textbook fails to let the students know that the management of the organizations concerned may require them to comply with unethical decisions and activities. Due to this omission the text fails to prepare students properly for working in organizations. Could it be that organizations sacrifice ethical principles in the "Quest for competitive advantage" of the book's title?

It can be concluded that the assertions in the quote are superficial and selective at best. On the one

⁴⁹ *Essentials of Strategic Management- The Quest for Competitive Advantage*. Third Edition. John E. Gamble (University of South Alabama), Arthur A. Thompson, Jr. (University of Alabama), Margaret A. Peteraf (Dartmouth College), McGraw-Hill- Irwin. 560 p., 2012, ISBN 978-0078029288. The author is grateful to dr. H. Zandvoort for drawing attention to this book. According to p. x of the preface «Our coverage of business ethics, core values, social responsibility, and environmental sustainability is unsurpassed by any other leading strategy text.» The names of the authors are printed at the end of the preface.

⁵⁰ According to the webpage of the publisher and the preface.

⁵¹ On pp. 188-9.

⁵² See the Chronicle. It could be added that HUD did so in order to realize the American Dream of one President after another.

⁵³ Responsibility b of the Fed: «supervising and regulating banking institutions, to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.» Cited in the Chronicle.

hand the unethical behavior of banks is “obviously” caused by greed. On the other hand the need for finding the cause of the unethical behavior of supervisors and governments does not arise, since their conduct is simply ignored. The evidently frequent breaching of codes of conduct is ignored as well, once more making explanation unnecessary. Scientifically speaking the analysis is grossly inadequate. As part of a textbook its one-sidedness gives the students an incorrect and potentially fatally deficient picture of reality. In a more general practical sense, it is a guarantee for repetition.

4. The education and science of law.

In the discipline of law it is even worse. The following is the summary of my article *The science of law, an evaluation*.⁵⁴ In 2006 the article was submitted for publication in the Dutch Jurist Magazine (Nederlands Juristenblad), a widely circulated weekly for everyone with a law training or interest in Dutch law. It was meant as a contribution to the then current discussion about the scientific character of the (hypothetical) science of law. The editor requested shortening, but after shortening the article was not accepted either. No reasons were given. The article enumerates characteristics of “scientific” books and papers in law which are incompatible with the norms of science. The following is a summary.

«On the basis of quotes of key paragraphs [this paper shows] that as a rule, publications in the science of law do not satisfy elementary conditions of logic and science. [A skeptical, critical attitude is missing systematically]. The most important characteristics of the publications which detract from their scientific character can be summarized as follows:

[...]

What suggests unreliability:

1. Many important assertions have an authoritarian character;
2. Authorities disagree about many important subjects;
3. The reference frame is provincial;
4. Inconsistency is accepted, and sometimes defended explicitly;
5. The science of decision making is virtually unknown;
6. It is assumed that words have a meaning of themselves (need no definition);
7. Conclusions are not drawn, and summaries are not given;
8. The discussion takes place within small margins around the status quo, and the argumentation seems directed at keeping it there;
9. The status quo is defended with fake arguments;
10. In the argumentation errors are made which invalidate the argument.

What is missing:

11. Substantiation of assertions about facts;
12. Awareness of [unjustified] suffering caused by the law;
13. Analysis of the motivation and making of the law;
14. Awareness of the relation between law and politics;
15. Attention to the [practical and factual] development of law;
16. Attention to law in general education;
17. Efforts at ordering the set of norms and values;
18. Universalism, skepticism, criticism and disinterestedness.

[...]

These and other characteristics not only hinder progress in the field of law, but social progress as well.

[In the article] recommendations are made to improve the scientific character of the “science” of law. Such as:

- systematically distinguishing between law and politics;
- distinguishing between education programs for professions requiring a law study and programs for law scientists;

⁵⁴ In Dutch. The article can be found in the directory Miscellaneous, under 20110826.

- introduction of the subject law in all levels of education.»

Due to the lack of a scientific attitude in law education and literature, especially the science of law, but also the education of law, leave very much to be desired. And there are even more reasons than mentioned above. Quite often judges have shown not to have the slightest idea of probability calculus and statistics, and of physics, chemistry and biology, when acquaintance with these sciences is absolutely necessary to be able to judge a suit reliably and responsibly. Furthermore, the grounds of the claim that judges have a good knowledge of men, and can reliably find out for example whether the accused is simulating, are entirely unproven. In fact, there is empirical evidence showing that they do not have this knowledge, and let themselves be misled. In several cases concerning risky new materials and pollution judges swallowed the “wir haben es nicht gewußt” (we didn’t know) of experts from Philips Duphar to Chemie-pak.⁵⁵ This shows that they never had real contact with natural sciences and scientists,⁵⁶ and do not understand them. It is simply nonsense to think that an expert natural scientist doesn’t know that this or that is risky, and will consider safe what isn’t or is unknown. He understands probability and statistics, and knows that certainty is extremely rare. A judge could and should know that any expert is aware of that. Anyway, it follows that in the mouth of an expert, “we didn’t know” is either downright nonsense or intentional deceit. “Know” is indeed too strong a word if there is a probability of less than 100% of danger, and if consequences may depend on circumstances.

Like teachers, the vast majority of judges spent their lives in education institutions and law courts. They lack practical experience in other social environments. As a consequence, many of their ideas are not based on reality but on untested hypothetical theories or illusions.

5. Closing remark- Supportive evidence from *Inside Job*.

The documentary film *Inside job* gives very relevant and rather unique information about university economics. It shows that even economics departments of the most prominent universities do not require staff to disclose the names of parties which subsidize research or researchers in the publications reporting on subsidized research. The film includes an interview with John Campbell, chairman of the Harvard economics department, explicitly saying this. Campbell denies similarity with a doctor prescribing medication produced by a company he invested in. Campbell pretends to see no conflict of interest.⁵⁷ Whatever he says, the policy means that possible conflicts of interest remain invisible, and that disinterestedness is suggested where specific interests are served. The film also gives an example of a “scientific” article which gave a positive evaluation of the financial situation of Iceland:

«The [Icelandic] economy has already adjusted to financial liberalization, which was already completed a long time ago, while prudential regulation and supervision is generally quite strong.»⁵⁸

The evaluation was unfounded. It was based on no more than hearsay, and paid for by the Icelandic Chamber of Commerce.

7B.3. Risk, rating, risk management and liability.

Table of contents of this section.

1. Introduction and some conclusions.

⁵⁵ Well known major Dutch cases. Other examples are given in chapter 8.

⁵⁶ Which for convenience is assumed to include mathematics and mathematicians. Mathematics being an essential instrument for the exercise of these sciences, and of course, a very valuable discipline in itself.

⁵⁷ Which is possible only by denying the dictionary definitions of words. I.e.: it is possible only by lying.

⁵⁸ The photo of a reference to this paper, with the “stability” in the title replaced by “instability”, also shows that the paper is from 2006. The text of the paper above the quote shows complete lack of understanding of “instability”: «There are three traditional routes to financial instability that have manifested themselves in recent financial crises: 1) financial liberalization with weak prudential regulation and supervision, 2) severe fiscal imbalances, and 3) imprudent monetary policy. None of these routes describe the current situation in Iceland.»

2. The concept of risk: probability and consequences.
3. Classifications of risks in financial institutions.
4. Decision making, liability and criminal law, and risk management.
5. The lack of understanding of the fundamental position of supervisors as regards information about (systemic) risk.
6. The undiscussed hypothesis of the social benefits of unlimited freedom of risk taking.
7. The inquiry commissions don't show understanding of fundamental difficulties in rating and dealing with risks.
8. Another example of a dangerous lack of understanding: of "mathematical models".
9. More explanations of failing risk management and reckless behavior.
10. To conclude: the wider implications of the observed phenomena.

1. Introduction and some conclusions.

The Chronicle of the crises shows that for many years, all principal persons in supervision and government have taken unbearable risks. They did not fulfill their (legal) duties, and behaved irresponsibly.⁵⁹ But they have not been held accountable and have not been criminally prosecuted. Often their careers have progressed as if they had functioned excellently and no crisis had ever occurred. The immense costs of the crises are borne for almost 100% by innocent people.

Analysis of the history and legal background of the decade before the crises shows that the principal persons had insufficient reasons to do what their duties required. Government officials had no reason to supervise supervision properly, and no reason to create a safety net for the case that their assumptions would turn out to be erroneous. All mechanisms intended for control failed completely. One of the most important conclusions of this study is, that the supposed mechanisms for self correction in the political systems of the present world simply do not work at all. The existing political systems completely fail to correct themselves.⁶⁰ It is hard to believe that this will not lead to even greater disasters.

The present section shows that risks and risk management were handled irresponsibly and incompetently. There is no evidence that shows that the principal persons had an adequate understanding of risk and risk management. On the other hand there is ample evidence which unambiguously shows a lack of understanding.

Meaningful risk management is only possible if the consequences of realization of risks are known, at least approximately. Where "the consequences" means: all relevant consequences. But due to deficiencies in criminal and liability law, and the conduct of supervisors, the consequences of misconduct of financial institutions and supervisors for the people who were responsible for that misconduct, are obscure, and to a large extent arbitrary ("discretionary").⁶¹ Most misconduct in and around the financial system goes unpunished. The people responsible for the suffering of millions are not held liable. Instead, they are allowed to keep on living excessively well off the profits of building castles in the air. The problem is mentioned by the inquiry commissions, but analyzed superficially at best, and not in such a way as to help finding solutions or useful recommendations.

The inquiry commissions conclude that the supervisors and principal persons acted irresponsibly and failed to do their duty. But the commissions do not try to find the causes of the misconduct. They don't ask themselves what can be done to make supervisors and principal persons act responsibly and do their duty. The answer is nevertheless simple. At least if it is not accepted that innocent people are victimized by avoidable behavior of other people. (Present reality being, that only the personal

⁵⁹ In the hearings of the inquiry commissions they did not account for actively misleading the public and for omitting to take necessary action.

⁶⁰ The political systems were very successful in blaming the financial system, and diverting attention from their own responsibilities, actions (deregulation, affordable housing) and omissions (supervision of supervision, thinking before doing). See for example the explanations of the subprime crisis in the textbooks *Economics* and *Essentials of Strategic Management* discussed above.

⁶¹ Most events are the result of more than a single preceding event, or a single phenomenon. It may be difficult to establish the (quantitative!) contributions of the relevant causes to a given loss. Although it may be rather easy if a single party could and should have prevented the loss. In other words: sometimes an easily solvable problem may be presented in an unsolvable way.

interests of authorities are inviolable). The logical consequence of this norm is, that those who caused harm are responsible for reparation or compensation, and are punished if they cannot repair or compensate. This is a solution for both the problem of irresponsible behavior and that of shifting costs to innocent people. In addition the solution provides a safety net and realizes equality of adjudication with respect to liability and criminal law. Which can be considered as a sufficient reason on its own.

A relatively large part of the blame for the subprime crisis has gone to the rating agencies. But whatever errors they may have made, it seems they did not violate the law. In other words: if they are to blame, so is the lawmaker. Another problem with blaming the rating agencies is, that neither before, during or after the crisis anyone explained what a good rating looks like, and formulated norms or a guidance for ratings. Rating is related to forecasting, and has fundamental and practical difficulties and limitations. No document in the dossier shows any understanding of these difficulties or limitations. The problem is not even noted. It is easy to say that certain ratings are no good, but something quite different to even define a feasible, good and useful rating, let alone produce it. If the assumptions which were made for a specific rating are listed as completely and explicitly as possible, then nobody will find the rating useful. Furthermore, even the best possible rating will change with at least some kinds of changes in the environment. Because of the instability of the financial economic system large uncertainties are inevitable. Changes in laws and lack of supervision may add to the uncertainties. In the present circumstances it is impossible to expect much of ratings.

It has been said, without adequate substantiation, that better ratings would have prevented the crisis. This assumes that “better rating” is well-defined, and that warnings about risks are heeded. Some people undoubtedly do, but the question is: would that have been sufficient to prevent a crisis? Were irresponsible actors not sufficient to cause a crisis? The GSEs felt forced to increase their risks in order to realize the AH-goals, and warned about the possible consequences for profitability, but HUD didn’t mind.

Clearly without liability or limits on acceptable risks better ratings cannot be expected to have a sufficiently large positive effect.

Finally it is noted that in none of their annual reports did the supervisors describe how they defined and supervised the risk management by the financial institutions.

2. The concept of risk: probability and consequences.

In this study the concept of risk is defined as the probability that a specified harmful event takes place, or that the event takes place in a given period. The risk may be time dependent. It may for example increase in time, as a consequence of increasing uncertainties.⁶² In both cases it is unknown if and at what date and time the risk will be realized (= the event takes place). The event may never take place at all. In practice furthermore many things can go wrong more or less independently. Then the resulting risk is the “sum” or the aggregate of the relevant risks. “Sum” between quotation marks because the summation in general is not as simple as adding 1 plus 1.

A living being may die any future year. For every age it has a probability (risk) of dying. The probabilities per year may differ. It is certain (only) that it will die within 200 years.

Bridges are built in such a way that the probability of collapse within say 30 years is extremely small. There is a probability per year, but that probability is very much smaller than the probability that I will not be able to pay the interest on my loan next year.

It is important to distinguish between knowledge or understanding of a risk and knowledge of the date of its realization. These are two different things. The risks may be known and understood, but the time of realization a mystery. Financial economic bubbles are a very important example. In hindsight it may be funny to speak of an internet or housing bubble and the bursting of the bubble. But it is something very different to forecast the week, month or even year of the maximum of the S&P 500, or the bursting of a bubble. It is one thing to know what risks the financial system is running, and something else to be able to predict when exactly it will run out of control, and to what extent.

⁶² The definition is in agreement with the Merriam-Webster of 2002. Except that Merriam-Webster (significantly) says nothing about the dimension time. It speaks of risk in the abstract, not about risk “per unit time”, and apparently time independent.

The use of the concept “risk” in (“professional”) financial and economic practice is dangerously sloppy. In general the dimension time is neglected. One speaks of changing risks, but not in terms of time dependent risks. In financial and economic practice, taking account of risks seems to mean: taking account of the present risks in the present circumstances. That is: taking account of what can happen in the present world. Not in the possible circumstances of a few years hence. It seems to be assumed that the world will remain the same.

The level of thinking can be illustrated with a quote from the hearing of Van Wijnbergen by the Dutch inquiry commission De Wit. In the quote, Van Wijnbergen asserts that all central bankers, with the exception of Trichet, act on the basis of a deficient risk-concept. He warns of the danger of this deficiency:

«What is the use of a buffer? When the weather is bad, you use it, when the weather is good you fill it. The system of capital requirements works quite the other way around. The way it works gives banks more room for taking risks if they perform very well. That is exactly when you would like to rein them in. We heard mister Wellink say: the buffers should be filled. So when the weather is bad you are supposed to supplement them. That is destabilizing. Trichet is the only central banker who seems to understand. Around that time he said: to me this seems a bad time for bigger capital buffers, now you should use them. We call that [requirement to supplement in bad times] procyclical, instead of anticyclical. The system is procyclical. Which means that it amplifies the [hypothetical!] economic cycle, and that is a real design error. The emphasis laid by DNB on supplementation of capital buffers is actually wrong.»⁶³

In this study, risk management is defined as management aimed at the reduction of risks and/or their potential consequences in such a way that they remain or become reparable and/or bearable. This may mean declining to do things which cause the risk of irreparable harm and/or unbearable costs. Since risks change in time, one should not only take account of the risks of today- as nearly all central bankers are supposed to think⁶⁴ but of all possible risks in the foreseeable future.⁶⁵ And at a time when it is possible to take them into account. In bad times it may be too late.

For this reason Basel III proposes a counter-cyclical buffer, of at most 2.5%:

«The amount of the counter-cyclical buffer will range from 0%-2.5% of risk-weighted assets. The exact amount of the counter-cyclical buffer will be decided by national regulatory authorities and will generally be determined by the amount of credit in an economy, with more credit leading to a higher buffer.»⁶⁶

As noted, risk is defined as the probability of a specific event. But what really counts in practice are the consequences of this event, and especially the harm it causes or represents. The reason for the definition is the clarity it offers, especially regarding the distinction between different aspects. The risk may be clear and unambiguous, while the consequences may be endless in space and time, and difficult to trace and describe. It may be unclear whether certain consequences can be ascribed to the event under consideration, or- partly- to unrelated other causes. Distinguishing between risk and consequences will not however prevent the incidental adoption of the terminology “large risk” of common parlance not for a large probability, but for large potential damage. Even if the probability is small.

In practice risks are always estimates. The true risk can be larger or smaller. In general it is larger. The reason being that there is no reliable method for finding all the risks. One never can be sure of having found them all. Experience shows that there are always risks which have been overlooked. Sometimes risks that could have been known, sometimes new risks. In the course of time the risks people are exposed to have changed. Many health risks have decreased. But many other risks have increased due to the growth of the world population, economic and technological development; in

⁶³ Hearing reports CDW1 p. 25.

⁶⁴ Please remember that together they have tens of thousands “expert” employees (advisors...).

⁶⁵ This regards both the qualitative and quantitative dimensions of risks. New risks may arise, and old ones may become smaller or larger.

⁶⁶ Joe Larson, *The Basel Capital Accords*, April 2011, pp. 25-6. The 2.5% lacks any objective basis.

combination with laws which permit risk taking with impunity. Practically if not theoretically. Both in an absolute and a relative sense many more people than a century ago are confronted with consequences of human error and misconduct, and risks created by people.

The estimation (ideally measurement) of risks, that is: of the size of the probability per year (or some other unit of time) for a specified event to happen, is difficult. It is a kind of forecasting. Much more is possible than is acknowledged by governments and by dependent people and organizations. But forecasting remains very imperfect, especially as regards social and economic developments. It is nevertheless evident that there are many risks whose realization will cause unprecedented numbers of victims. In the chapters 21 and 22 of its report, the FCIC paints a dramatic picture of the consequences of the subprime crisis.⁶⁷ But the FCIC does not try to find out what prevention of this misery would require of risk management and the law. This will be elucidated in following subsections.

In an unstable system even a small risk per unit time can be sufficient to destabilize the system. If fluctuations occur, and the risk refers to the probability of a fluctuation being sufficiently large to destabilize the system, the risk can be interpreted as inversely proportional to the time at which destabilization will occur. Those asserting that the financial crisis was caused by small risks, which “everybody thought” would never be realized, thereby show that they do not understand the concept of risk, and never seriously studied the financial economic system.

3. Classifications of risks in financial institutions.

Summary and conclusions.

1. Financial institutions distinguish the following (“technical”) risks:
 - a. credit risk (exposure to loss resulting from a counterparty’s failure to meet its financial obligations. Say to pay interest or pay back a loan);
 - b. market risk (adverse movements in the price of a financial asset or commodity, including changes in interest rates);
 - c. legal risk (an action by a court or by a regulatory or legislative body that could invalidate a financial contract);
 - d. operations risk (inadequate controls, deficient procedures, human error, system failure, or fraud).
2. Lobbying and relation management can be seen as a part of risk management, aimed at reducing the risks caused by supervision and changes in regulation, in particular of liability and criminal law.

With the exception of its last paragraph, this subsection is somewhat technical. It is meant to give an impression of the way in which people in financial institutions thought (and think) about risks.

In financial institutions, risks are distinguished according to nature and/or origin:

«The risks posed by derivatives use include

- (1) credit risk (as defined earlier: derivatives credit risk is the exposure to the possibility of loss resulting from a counterparty’s failure to meet its financial obligations);
- (2) market risk (adverse movements in the price of a financial asset or commodity);
- (3) legal risk (an action by a court or by a regulatory or legislative body that could invalidate a financial contract); and
- (4) operations risk (inadequate controls, deficient procedures, human error, system failure, or fraud).

These general types of risk exist for many financial activities, but the specific risks in derivatives activities are relatively difficult to manage, in part, because of the complexity of some of these products and the difficulties in measuring these risks. For example, because derivatives might be used

⁶⁷ See also *Inside Job*. Don’t forget Iceland.

in conjunction with other assets and liabilities, measuring the extent of market risks of derivative products alone is not sufficient to understand firms' total market risk.»^{68, 69}

The same distinction is also made in annual reports. In that of Freddie⁷⁰ about 2006 one reads for example:

«Risk Management

Our portfolio investment and credit guarantee activities expose us to three broad categories of risk:

- (a) operational risks,
- (b) interest-rate and other market risks, and
- (c) credit risks.

Risk management is a critical aspect of our business. Effectively managing risk enables us to accomplish our mission and generate revenue and long-term value.»⁷¹

Freddie distinguishes two types of credit risk:

«Mortgage credit risk is the risk that a borrower will fail to make timely payments on a mortgage or security we own or guarantee. Institutional credit risk is the risk that a counterparty that has entered into a business contract or arrangement with us will fail to meet its obligations.»⁷²

Freddie describes its risk management on pp. 56-80/68-92. It looks impressive, but weak points are easily found. Two examples from p. 78/90:

«*Credit Risk Sensitivity.* Our credit risk sensitivity analysis assesses the assumed increase in the present value of expected single-family mortgage portfolio credit losses over ten years as the result of an estimated immediate 5 percent decline in home prices nationwide, followed by a return to more normal growth in home prices based on historical experience. [...]»

Mortgage Loan Insurers. We have institutional credit risk relating to the potential insolvency or non-performance of mortgage insurers that insure mortgages we purchase or guarantee. We manage this risk by establishing eligibility standards for mortgage insurers and by regularly monitoring our exposure to individual mortgage insurers. We also monitor the mortgage insurers' credit ratings, as provided by nationally recognized statistical rating organizations, and we periodically review the methods used by the nationally recognized statistical rating organizations.»

The results of the credit risk sensitivity analysis can be found on p. 93/105 of the annual report. There is no indication that more than direct consequences have been taken into account. While it is evident that a 5% decline must have many more effects, for both Freddie and its business partners. And such a decline has causes too.

It is not clear what is assumed about “normal growth”, and “historical experience”. In both cases, the assumptions may be no more than wishful thinking.⁷³ It is doubtful whether a reliable risk analysis may assume that in the end (=?) everything will remain as it was. In historical perspective, crises (and revolutions) are normal. And major crises are never solved quickly.

It is unclear whether the “manage” in the paragraph “Mortgage loan insurers” represents something effective. It doesn’t seem so. Especially questionable is the assumption that the insurers will not have problems when Freddie has. Namely because Freddie is very large. Therefore it seems highly implausible that nobody else has problems when Freddie has. Correlation of problems seems much more plausible. The only question is: how large is this correlation? It may depend on the cause of

⁶⁸ GAO 1994 pp. 9/11 and 4/6 (definition credit risk). The AR 2006 of Freddie calls this “derivative counterparty credit risk”, see p. 64/76 of that AR. A useful overview is also given by: 19940731_Risk management guidelines for derivatives_BIS-bcbsc-211.pdf. Although questions may be asked about the feasibility of the norms proposed by this report. Is possible what this report considers proper, or what it requires? Can the proposed models be developed at all? If so, can their reliability be guaranteed? Can this be done for costs less than the total benefits?

⁶⁹ Note that this may make rating a separate product difficult or impossible.

⁷⁰ The choice of AR 2006 of Freddie is arbitrary, and is not intended to suggest that Freddie did better or worse than others. Except that the year was chosen for two reasons: 1. well before the crisis (to maximize independence of the crisis); 2. close to the crisis (to maximize relevance).

⁷¹ Freddie Mac Annual report 2006 p. 26/38.

⁷² Freddie Mac Annual report 2006 p. 66/78.

⁷³ In other words: this obscurity is a major risk for a shareholder.

Freddie's problem.

Another paragraph raising questions is the following:

«To date, we have not incurred any credit losses on OTC derivative counterparties or set aside specific reserves for institutional credit risk exposure. We do not believe such reserves are necessary, given our counterparty credit risk management policies and collateral requirements.»⁷⁴

The text shows that Freddie relies for 100% on its preventive policy. It assumes that this policy is 100% effective. It is not clear however what will happen if its assumptions prove to be too optimistic. Since the assumptions seem to exclude circumstances found in many historical situations, and ignore the GAO, CGFS and OFHEO mechanisms and scenario's, a contemporary reader had plenty reason for skepsis.

A connection with available capital (very little!) and/or available reserves is not laid. It is not explained what risks the available capital allows Freddie to take, and/or what events it can cope with without outside help.

The obligation to make an annual report presents an integrity problem to a management. On the one hand annual reports should give a truthful account. On the other hand the management wants to give a good impression of its performance. It wants to inspire trust. In the present day management culture, the management knows, and doubts not. It is always right, and therefore defensive. (As if in permanent fear of its position). This situation creates uncertainty for outsiders. They cannot be sure of what lies behind the façade. Whether the self-confidence of the management is justified, or overly pretentious. In the present example, the critical outsider cannot escape the conclusion that Freddie's risk management is inadequate. Mainly because its assumptions are unrealistically optimistic: they ignore both historical experience (such as crises), and fully ignore scenario's as sketched by the GAO in 1994-1999 and OFHEO's systemic risk report of 2003.⁷⁵

Finally it should be noted that the risk perception of financial institutions may be erroneous, and that the financial institutions are not open about all of their risks. They may see as a threat what may turn out to be a blessing, and vice versa. Important risks are caused by supervisors and governments. For the financial institutions, much depends on the quality of supervision. Changes in regulation may cause significant costs. Especially changes in liability law which would increase the liability of corporations and the personal liability of their principal managers. For these and similar reasons, lobbying and other forms of relation management can be seen as part of the risk management of financial institutions. If one does, and if one adds up the consequences of the subprime crisis for the financial system, one can only conclude that in general the risk management of the financial institutions, and even more that of their managers, was very effective.

4. Decision making, liability and criminal law, and risk management.

Summary and conclusions.

1. Because of shortcomings in liability and criminal law, and because of skewed remuneration systems, employees of financial institutions had no compelling reason to take risks seriously. They had good financial reasons to choose the most profitable opportunity, irrespective of external costs and risks.
2. There wasn't even good reason to find and analyze risks.
3. Strict liability and criminal law are crucial boundary conditions for effective risk management. Strict and personal liability and criminal law will cause avoidance of unbearable risk, while allowing for risks of which the consequences can and will be repaired or compensated.
4. Capital requirements, including those of the Basel accords, seem to be intended to preclude liability and crimination. But it is evident a priori that they can only do so to a minor extent.

⁷⁴ Freddie Mac Annual report 2006 p. 66/78. The counterparty credit risk management policies are outlined on pp. 64-5/76-7. Note that the value of collateral may depend on market pricing.

⁷⁵ OFHEO= Office of Federal Housing Enterprise Oversight.

- Which is confirmed by the crisis.⁷⁶ The capital requirements are fundamentally inadequate.
5. If good or effective risk management is defined as management effective in reducing risks and their potential consequences to such an extent that they are bearable, then the risk management of the financial institutions that went bankrupt, and only theirs, was not effective. But supervisors or governments never defined specified norms for “good risk management”, and set no limits on risk taking. They did not try to ensure that liability and criminal law had a preventive effect. They effectively gave financial institutions a free rein, and allowed the bill for disasters to be passed on the innocent general public.
 6. The financial institutions had and have no good reason to be substantially more careful in their risk taking. But because of the competitive environment and the possibility of large profits, they did and do have reasons for taking large risks.
 7. The inquiry commissions blame financial institutions for inadequate risk management. But they do not point out that regulatory limits on risk taking are missing, and that a competitive environment stimulates risk taking. They do not mention any binding norms, and seem to base their reproaches on vague moral considerations. They fail to note that financial institutions (and other people and organizations) can take “too much” risk with impunity, and often are not effectively liable.
 8. The CDW and FCIC do not try to find the causes of the supposedly inadequate risk management, and do not analyze the influence of liability and criminal law. Even though they were asked to find the causes of what went wrong.
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One could say that the subprime crisis was caused by taking too much risk. For if something goes entirely wrong in a sequence of events which lies within the bounds of what is theoretically possible, and which is similar to a sequence that unrolled before, then by definition too much risk was taken. In other words: the risk management was insufficient. Risks were taken directly by people buying a mortgage⁷⁷ and by financial institutions. Other kinds of risk were taken (indirectly) by supervisors and governments. Where it should be noted that only a minority of the mortgage buyers, many of the mortgage sellers, and all supervisors and governments took too much risk.

Mortgage sellers in the US reduced mortgage requirements to such an extent as to increase the risks to an unprecedented level. It was evident that an increase in the interest rate and/or fall in home prices would inevitably lead to problems. Unbearable risks were also taken in the trade with mortgage backed securities and securities related to them. On such a scale that systemic risk was caused. Inevitable developments or fluctuations would start processes which could bring the financial system to a complete standstill. Supervisors and governments systematically ignored information and recommendations about systemic risk. Nothing was allowed to block deregulation and affordable housing policies. Supervisors and regulators simply failed to do their duty.⁷⁸ Their reassuring bragging was unfounded nonsense.

After the crisis had become a fact, the risk management of financial institutions was severely criticized. The FCIC has shown that some institutions didn't take risk management seriously. Obviously this is only possible if supervision fails as well.⁷⁹ Sometimes a risk manager was only appointed because it was required by regulation. It is clear that financial institutions took risks they couldn't bear. Their risk taking was lawful however. It was in accordance with regulation, and tacitly permitted by the relevant supervisors.

The reports of the inquiry commissions do not say what risk management should look like, and

⁷⁶ And of course, the authors and supporters can always say that the last version solves all remaining problems. They have nothing to fear when this turns out to be untrue.

⁷⁷ In 1990-2005 the percentage of bad mortgages grew “exponentially”: much faster than linearly. See for example the histogram on p. 45 of the report *Housing at the tipping point* of Zandi et al. of Moody's economy.com (in the dossier), and the histogram on p. 9 of the FCIC staff-study *The mortgage crisis*, also in the dossier.

⁷⁸ The concept of regulators comprises both supervisors and government.

⁷⁹ Warnings had been given. On p. 9/11 of the GAO report of 1994 one reads: «Regulatory examinations of the major bank dealers that were done from 1990 through 1992 identified some serious weaknesses in these dealers' risk-management systems, such as failure to set or follow risk limits.»

why. They don't say what risks are prohibited and for what reason. On the other hand they do suggest that 100% safety is undesirable because it would hinder "real economic activity". But if no limits are set for risk taking, if liability of institutions and employees is absent or minimal, and if there is competition, then it is only logical, if not necessary for survival, that unbearable risks are taken. In such an ("self regulatory") environment there is no coupling of the external consequences of actions of employees with their own well-being. In particular no coupling that necessitates careful consideration of risks, and rejection of unbearable risks. This is explained in the following.

"Taking too much risk" means: taking too much risk in decision making, or when making a choice between different alternatives. By definition in the framework of risk management.

For an important part, risk taking can be discussed in the context of decision making. This has a great advantage, since decision making is a very general process. Every conscious action or omission is preceded by decision making. Analysis of decision making often yields results which are also applicable to decision making in other fields. For this reason we take a closer look at decision making.

Decision making is a process for making a choice between a number of alternatives.⁸⁰ Where an "alternative" can be an activity, a product, a proposal, or something else one can choose. Each alternative has consequences. Partially known, partially unknown. In general there are possibilities and risks.

Suppose that each alternative may have a limited number of potential consequences, that these potential consequences are known, and that the consequences can be appraised with money. Then a specific consequence has a monetary value. The value can be positive or negative. In the last case one can speak of costs or damage. Suppose furthermore that it is possible to estimate the probabilities of the realization of the different potential consequences. Because of the meaning of the concept probability, the expected yield of an alternative is the sum of the products of the probabilities and values of the consequences.

If all costs of all potential consequences of each given alternative are bearable and payable by the actor/decision maker, then the actor can optimize his results by choosing the alternative with the greatest expected yield. In that case the choice is easy because he can do this without running the risk of going bankrupt or something equivalent.⁸¹ The choice is difficult however if the alternative with the greatest expected yield is coupled to risks with unbearable consequences.⁸² What to do then, and why? Can the choice be accounted for, and if so, how?

In the years before the crisis risks with unbearable costs have been systematically underestimated or ignored. Many people and organizations acted as if only the best possible consequences would come true.⁸³ Only more or less direct risks were taken into account, and not necessarily in an adequate way.⁸⁴ They were underestimated by assuming that circumstances would not change more than what was considered probable, reasonable or whatever. Systemic effects, that is: cumulative indirect effects, and worst case scenario's assuming evaporation of trust in types of securities, were ignored. The GAO reports of 1994-1999 and OFHEO's systemic risk report were ignored. The principal persons "forgot"

⁸⁰ The decision making procedure presented here can be called optimal decision making. It is optimal as measured by the (subjective) norms and values of the decision maker. In the literature it is sometimes called rational decision making. But in the opinion of the present author the only meaningful definition of "rational" is: consistent. That is: consistent with experience and reliable knowledge. For this reason, the word "rational" is superfluous, and is not used in this study.

⁸¹ This is the case when you invest your own money, as long as you don't strictly need it for your livelihood. If your investments lose all of their value, you lose everything, but don't harm anyone. And you do not even indebt yourself. Banks nevertheless advise investing in a mix. Which doesn't give the maximal yield. At least not for the investor.

⁸² Note that the situation is not symmetric: profits can always be cashed by the actor, irrespective of their size. But an actor can only bear limited losses, the remainder is automatically rolled off. And there is also the possibility of irreparable damage, such as people being killed or handicapped.

⁸³ Or that the government/taxpayer would help out in the case of realization of an unbearable risk. One speaks of "moral hazard" if politicians or government officials suggest that the government will act as a safety net for certain calamities.

⁸⁴ As we saw in the case of Freddie.

⁸⁵ moreover that not only the probability matters, but in the first place the product of probability and consequences.⁸⁶

Additional difficulties for making estimates of consequences and risks are the instability of the system, and the fact that major negative consequences inevitably cause many different effects, and not only in the financial system. Social and economic effects seem hard to predict.⁸⁷ Furthermore there is no generally accepted method for measuring the misery inflicted on innocent victims.

Decision makers may have thought that they could afford to pay little more than lip service to risks and risk management because they thought that there was no reason to fear liability and/or punishment. The facts have shown that this notion was correct. Perhaps they also thought they could rely on the quality of regulation and supervision, and in case they would be held accountable, on the excuse that they thought they might rely on that.

The above seems to be a sufficient explanation of the conduct of the principal persons. If there is no obligation to repair or compensate damage caused, then the corresponding risks do not need to be addressed (or only partially). One is free to take risks at the potential cost of outsiders. Especially in the case of an alternative combining large potential profits with the risk of unbearable consequences.

If however contrary to the present law, innocent outsiders have to be safeguarded from undesired effects of the activities of other people, then all potential costs of a chosen alternative should be payable with the available capital.⁸⁸ Including the costs of “improbable” consequences. And this applies not only to separate decisions and activities, but also to the sum total of the activities of an institution. Not only the potential costs of any given activity should be bearable, but also the sum of the potential costs of all activities taken together.

From the above it follows that the limitations of liability and criminal law, in combination with insufficient supervision and other norms, can fully explain the taking of unbearable (“irresponsible”) risks. Adequate liability and criminal law are crucial conditions for effective risk management. Strict and personal liability and criminal law will cause avoidance of unbearable risk, while allowing for risks which can and will be repaired or compensated.

The effect of deficient liability and/or punishability is amplified by a corresponding skew remuneration method. Namely a remuneration method which gives a decision maker/ risk taker a bonus or gratuity in case of positive results, without similar deduction or fine in case of negative results (including those for outsiders). Under such conditions there is no need to weigh costs and benefits without bias. On the contrary: it is advantageous to chose the alternative with the largest potential profit, and to disregard costs and risks for outsiders. The consequences for the decision maker(s) are effectively decoupled from those for outsiders.

The inquiry commissions mention compensation systems and bonuses as a contributing cause of the crisis.⁸⁹ This means that they acknowledge the influence of financial incentives. Nevertheless neither the commissions nor others note that the observed (inadequate) risk management would have been extremely improbable if liability and criminal law had been much more strict and personal. They don't note that liability and criminal law (may) have a decisive influence on risk taking. And that the given law does not give reasons to take less risk, or manage risks differently, than in the decade before the crisis. In the preceding paragraphs this was argued theoretically. The events of 2007-2013 support the theory.

With its conclusion and other remarks the FCIC suggests that the risk management should have been more strict. But it does not explain why an organization would take less risk under unchanged liability and criminal law. There is no indication at all that the detested risk management was

⁸⁵ It is unclear what would be the correct or best word. That depends on the integrity and competence of the principal persons. “Forget” assumes sufficient knowledge. What evidence is there for that assumption?

⁸⁶ For example in the discussion about “tail risks”. See the hearing of Wellink in CDW1 and the speech of Geithner in NYC 28 February 2006.

⁸⁷ Seem: historical experience shows that the prediction: “ultimately nothing will change” is very reliable.

⁸⁸ The fundamental norm implies that causing irreparable damage is strictly forbidden. It can only be allowed after explicit approval of everyone concerned, after full and correct information. See for example *The law of logic*.

⁸⁹ FCIC report p. xviii/18 and CDW1 section 5.4 on pp. 76/73 and following.

incompatible with any law or regulation. It therefore follows that the FCIC implicitly concludes that liability and criminal law were (are!) too lax, and should be more strict. But it doesn't state this explicitly.

Notwithstanding the fundamental importance of risks and risk management, the inquiry commissions gave them only superficial attention. Nothing is said about the meaning of "good risk management". As if it is evident what "good risk management" requires.⁹⁰ But perhaps also because serious discussion would reveal that economists and (other) politicians prefer a fundamentally unsafe system, and don't really mind about the risks for the overwhelming majority of the population. For example because they assume that risk taking is necessary to keep the economy going or growing. In combination with an inability or unwillingness to explain or defend such an assumption, and an inability to understand that strict liability does not preclude risk taking. After having read the Chronicle and the section on education, the reader will understand that their assumption is based on quicksand and/or fantasy. Of course, in a democracy it is unacceptable that such crucial assumptions are not accounted for in public.

The FCIC majority concludes that "[risk management at many systemically important financial institutions were a key cause of this crisis](#)".⁹¹ The CDW recommends "supplementation and sharpening" of, if you please, the "Banking code". Not a law, but a noncommittal code. The recommendations of CDW are very vague and elastic.⁹² If repetition of a crisis like that of 2008 is to be prevented, or if innocent people are to be safeguarded from damage caused by such an event, then risk management should not only become better but sufficient. "Supplementation and sharpening" need not mean that limits will be set on risks. It should anyway be discussed and decided openly which risks and damage are to be permitted. Without answers to these questions, systems of risk management cannot be evaluated objectively. It should be clear how much risk may be caused for each citizen (not on the average), and to what extent innocent citizens may be duped, for example by loss of job or loss of a retirement pension. And of course why. Why stealing is forbidden, and causing risks like these is permitted. And why a citizen would accept a person or organization to create such risks for him or her.

The inquiry commissions do not describe the consequences of the freedom to take unlimited risk. They are silent about the acceptability of this freedom. Which actually is the freedom to harm innocent people. They do not discuss the problems this freedom causes for individual institutions if there is no effective supervision.

The commissions do not try to find out which set of measures would be sufficient to prevent similar crises. Although it is evident a priori that the effect of vague and elastic recommendations can be nil. In short: as regards risk and risk management they fall so far short of the mark that in this field no improvement is to be expected.

Both commissions conclude that the subprime crisis was caused by avoidable human activities, and that it caused immeasurable suffering and damage. Both commissions fulminate against bonuses and payouts at retirement. The FCIC was established to [«examine the causes, domestic and global, of the current financial and economic crisis in the United States»](#), and the CDW was asked:

[«What are the causes of the recent turbulent developments in the financial system, and what recommendations can be made on the basis of the findings of the inquiry for a more adequate operation of the financial system?»](#). How then is one to explain their complete silence about the problem or impossibility of using liability law to recover damages, and criminal law to punish the guilty, and how is one to explain that they don't mention weaknesses in liability and criminal law as contributing cause of irresponsible behavior?

The inquiry commissions suggest, but don't show, that the crisis would not have taken place, or

⁹⁰ As often, it is possible that some or all of the writers and speakers (in hearings) are simulating.

⁹¹ FCIC report p. xviii/18.

⁹² A recommendation is called elastic if it can mean anything between nothing and very much, depending on interpretation and implementation.

have been far less devastating, if the risk management had satisfied the norms of the time. The problem of the financial institutions may have been that such norms didn't (and don't) exist.⁹³ Already for this reason alone the critical remarks of the commissions about the risk management of the financial institutions are misleading. If it is unclear what good risk management requires, if good risk management means suicide (in the absence of effective supervision), or if there are no credible alternatives for the actual risk management, then the complaints of the inquiry commissions about this management are misleading half truths. The more so if they actually don't want fundamental change, but don't want to say so.

In the chapter on education and sciences the reader has already seen that textbooks in economics and law pay no attention to the influence of (liability and criminal) law on (economic) decision making. The hypothesis that the general welfare is served by limited liability is neither mentioned nor discussed. One may compare this with the attention given to the Iliad and Odyssey.

For a discussion of more general aspects of liability and criminal law the reader is referred to the next section, 7B.4, especially subsection 7B4.3.

5. The lack of understanding of the fundamental position of supervisors as regards information about (systemic) risk.

Summary and conclusions.

1. To ensure compliance with rules which possibly hinder individual institutions but are beneficial for the group, one always needs an independent person or organization with effective supervision as specific duty. Therefore self regulation is a contradiction in terms. A group which wants to regulate itself will install an independent person or organization to ensure compliance.
2. This fact was ignored before the crisis by all supervisors and governments. If they had the competencies necessary for their jobs, they would have known and understood, and not have talked nonsense about self regulation and deregulation.
3. These facts are not mentioned by the inquiry commissions.

The inquiry commissions do not (explicitly) note that the law⁹⁴ does not prescribe "good risk management", and (therefore) does not sanction inadequate risk management. As mentioned earlier, "good risk management" isn't even defined, let alone in a verifiable way. The commissions do not note that risk management is dictated at least in part by liability and criminal law. The law allows enterprises to go bankrupt, and saddle society with their debts. Only in exceptional cases does bankruptcy have negative consequences for responsible employees.

The relevant laws have been decreed on the basis of theoretical assumptions and/or political dogmas. They have never been evaluated in the light of practical experience, including crises. Indeed, the crises can be considered as falsification of the assumptions of the relevant laws. The discussion of this subject will be resumed in connection with liability and punishability.

Probably as a consequence of the superficial discussion of risk and risk management, the inquiry commissions give no attention to the fundamentally different roles of institutions and supervision with respect to risk and risk management. This is an important subject because the total risk for society-including "systemic risk"- may be very much larger than the simple sum of the risks for individual institutions. In the USA, the Fed was responsible for systemic risk. Both the facts and its annual reports show that the Fed did simply nothing about this part of its duties.⁹⁵ Its annual reports should

⁹³ Neither the inquiry commissions nor any document in the dossier says anything about this.

⁹⁴ When only law is mentioned, this concept is supposed to include implied regulation.

⁹⁵ Its head, Alan Greenspan, assumed that this was not necessary. He supposed that self regulation was sufficient. And of course the Fed is a hierarchical organization. With Greenspan as boss, for too many years.

tell what the Fed did about it in the given year. But they are completely silent.⁹⁶ The duties of the Dutch DNB are formulated only vaguely. Because of the national distribution of duties it is nevertheless clear that the treasury secretary is responsible for the system as a whole, either directly or via DNB. Parliament is supposed to be responsible for supervision of both the secretary and DNB.

Because financial institutions have only little information about the finances of other institutions and about the supervisors, individual institutions are handicapped in the calculation of their risks. Much is (very) uncertain. As for the ordinary citizen, who cannot know the financial situation of his bank, and has to rely on the supervisors too. Because of deficiencies in regulation and practical difficulties, the same holds for supervisors, though to a far lesser extent, and in a somewhat different way.

Still, to know the different types of risks, to know what they depend on, and to know their potential consequences one only has to know how the financial system works: with what instruments (products) and how. One doesn't need thousands of numbers per month from each of the financial institutions.

At least the people who are responsible for the conduct of a group of competitors have to know and understand the prisoners' dilemma (see above, in the section on education and science). They should know and understand that competitors may have an interest not only in regulation, but also in compliance with regulation. In other words: if they have an interest in rules, then they have an interest in (effective) supervision. It is simply untrue that rules cause costs and hinder by definition. The question is not: rules or not, but: which rules? Everybody who is responsible for the conduct of a group of competitors must know and understand that self regulation is a contradiction in terms. In a single more simple word: nonsense. The reason being that a group that wants to regulate itself (and is sufficiently competent) will install an independent person or organization to ensure compliance. To ensure compliance with rules which hinder individual institutions but are beneficial for the group, one always needs an independent person or organization with this specific duty.

In spite of this, in the years 2000-2008 many of the principal persons (or their spokespeople) have systematically and explicitly argued for self regulation, deregulation, and less supervision. They abused their power by ignoring critics and trying to silence them. And by refusing to learn.⁹⁷

6. The undiscussed hypothesis of the social benefits of unlimited freedom of risk taking.

Summary and conclusions.

1. In relatively inconspicuous remarks in the reports of the inquiry commissions the chairmen of the Fed and DNB claim that unsafe capital requirements, and therefore the transfer of the larger risks to the general public, is necessary to keep the economy going.
2. No substantiation is given.
3. The assumption is of great practical importance, but discussed by neither commissions nor politics in general.⁹⁸
4. Although only few activities are subject to strict liability, regulation of economic activities in other sectors of the economy allows much less transfer of risks to the general public. This evidently does not hamper their economic prosperity.
5. No other sector of the economy has avoidably caused disasters of the size of the crises caused by the financial sector.⁹⁹

■

In the reports of the inquiry commissions one may find one or two incidental remarks which reveal

⁹⁶ See the Fed appendix.

⁹⁷ See the textbooks in economics and law.

⁹⁸ Neither is it found in the economy textbooks mentioned earlier. Because of its general interest and importance, it should have been discussed.

⁹⁹ Excepting wars, which might be attributed to "the political sector".

a reason why no limits are set on risk taking. The remarks are not discussed by the FCIC, or even noticed explicitly. Neither in any other document in the dossier by the way. In the FCIC report one reads:

«Greenspan [...] said in a 1999 speech that the successful resolution of the 1998 crisis showed that “diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress.” The President’s Working Group on Financial Markets came to a less definite conclusion. In a 1999 report, the group noted that LTCM and its counterparties had “underestimated the likelihood liquidity, credit, and volatility spreads would move in a similar fashion in markets across the world at the same time.” [...] However:] “Policy initiatives that are aimed at simply reducing default likelihoods to extremely low levels might be counterproductive if they unnecessarily disrupt trading activity and intermediation of risks that support the financing of real economic activity.”»¹⁰⁰

But what are “extremely low levels”, and what is “unnecessarily”? How does the PWG know all risks and their consequences, and all benefits? How does or did it measure the costs and benefits? Who gave it permission to weigh these costs and benefits? Why does the FCIC not discuss these crucial questions thoroughly?

Note that Greenspan implicitly asserts that an example can prove a general proposition. This is simply untrue: examples cannot prove general propositions. By definition (of “general”) a hypothesis which is asserted to be generally true can be falsified by a single example. Greenspan didn’t know what he had to know, and mankind does not learn what it can learn and needs to learn to avoid disaster.¹⁰¹

President Wellink of DNB, the Dutch counterpart of Greenspan, told the CDW on 2/12/11:

«You only have to require a capital of 100% and a few other things, and you get a safe system. At the same time however you get an economy that doesn’t work. Therefore you have to find a balance.»¹⁰²

This is an incorrect description of the problem: the balance is not to be found, but chosen. And Wellink does not explain why it has to be chosen in a particular manner, and by bankers. Nobody does. It is furthermore not a fact that one has to find a balance, but an opinion. Moreover, the tacit governmental permission for balancing, and the acceptance of an intrinsically unsafe system are far from self-evident. Traditionally, nobody is allowed to hinder, or cause damage, for others.

PWG and Wellink are misleading in another respect as well. They wrongly suggest that risk taking is impossible in a safe system, and that safety is incompatible with a healthy economy. This is untrue. Under strict liability, risks can still be taken, but not at the cost of other people. Only the possibility of “privatizing profit and socializing losses” is cut off.¹⁰³ Comparison with other types of economic activity shows that the economy will not come to a standstill if enterprises are made liable. And last but not least: does Wellink really want to say that the system works?

As an outsider one would like to be able to trust responsible people to deal seriously with risks and their consequences. One would like them to cause no more damage for outsiders than they can and will repair or compensate. The secret policy of supervisors like PWG and DNB and their governments means that risks for outsiders will remain large and at most partially repairable, and that costs will remain to be “socialized”.

7. The inquiry commissions don’t show understanding of fundamental difficulties in rating and dealing with risks.

Summary and conclusions.

1. The rating agencies made important unnecessary errors. They did not operate in accordance with

¹⁰⁰ FCIC report p. 58/86.

¹⁰¹ Of course, Greenspan may have said things he does not believe.

¹⁰² Report of the hearings of CDW2 (TK 2011-2012, 31980 nr. 62), 2/12/11, p. 1304.

¹⁰³ The summary “privatizing profit and socializing losses” can be found for example in the transcript of the hearing of Greenspan by the FCIC on 7/4/10.

- generally accepted ethical norms.¹⁰⁴ But if their ratings were relative, they cannot be blamed for much of the crisis.
2. “Safest” does not mean “safe”. Even AAA could and should not have been considered safe.
 3. There is no indication that there was a (regulatory) reference frame with norms for ratings.
 4. There was no system for independent quality control.
 5. The ratings are misunderstood or misinterpreted by the inquiry commissions. The misunderstanding may be related to lack of understanding of risk.
 6. The inquiry commissions do not ask themselves what good ratings would look like. They don’t formulate realistic¹⁰⁵ quality requirements, and say nothing about quality control.
-

One of the simplistic misunderstandings about risks is that very small risks will not be realized because they are very small.¹⁰⁶ This idea is completely erroneous. On the average it may take longer for a smaller risk to be realized than a larger risk. But only for some kinds of risks, and on the average. Both a small and a large risk can be realized already tomorrow, or even today. The crucial empirical fact is that risks are realized, if not sooner than later. No significance can be attached to the fact that nothing happened for many years.¹⁰⁷ Think of Russian roulette.

Knowledge about the existence and size of a risk does not imply knowledge of the time it will be realized. This is why it is called a risk: it may, but need not, take place in a specific period. With hindsight one can speak of a bubble, and say that everyone should have seen the implosion coming. But before the turnabout of the prices- for example- one can only guess when exactly the prices reach their maximum and will start falling.

For these reasons it is not fair to accuse a rating agency of bad ratings if a small risk is nonetheless realized, assuming of course that it has been mentioned:

«While BSAM¹⁰⁸ was wrestling with its two ailing flagship hedge funds, the major credit rating agencies finally admitted that subprime mortgage-backed securities would not perform as advertised.»¹⁰⁹

It is incorrect to suggest that rating agencies make predictions about the performance of securities, enterprises or whatever. Even less when circumstances change unpredictably. As when it turns out that supervisors kept ears and eyes closed instead of doing what is necessary to ensure the safe operation of the financial system. Reproaches would be justified if the rating agencies had ignored certain risks, or if estimated risks would be realized significantly more often than their size indicated, and this systematically. In other words: with a statistically highly improbable frequency. But this is not what the FCIC asserts. The FCIC knows that:

«The ratings were intended to provide a means of comparing risks across asset classes and time. In other words, the risk of a triple-A rated mortgage security was supposed to be similar to the risk of a triple-A rated corporate bond.»¹¹⁰

I.e. that the rating agencies estimated the relative risks of one kind of product with respect to the risks of another. The FCIC nevertheless writes about ratings as if the risk estimates were absolute. It does not analyze the rating methods in order to find out whether they were adequate for making comparative estimates.¹¹¹

Consider furthermore that it is generally accepted that all kinds of predictions are adjusted in the

¹⁰⁴ None of the organizations in and around the financial system did, possibly excepting organizations which this study does not mention by name.

¹⁰⁵ Realistic meaning that the requirements can be met at least theoretically. Not everything can be predicted reliably for example.

¹⁰⁶ In general the “very small” is no more than an estimate or even assumption. Often there is no reliable method for the calculation of risks, the events that will follow realization, and the size of these consequences.

¹⁰⁷ One of the mistakes of the supervisors and governments.

¹⁰⁸ BSAM= Bear Stearns Asset Management.

¹⁰⁹ FCIC report p. 242/270.

¹¹⁰ FCIC p. 120/148.

¹¹¹ The assertion that the ratings were relative is consistent with the graph of the ABX-indices in the Chronicle at the turn of the year 2006-2007. The graph contradicts the assertion that the ratings AAA-BBB⁻ are meaningless. It may even indicate that the corresponding ratings were quite good.

course of time. From weather forecasts to predictions of economic growth. The FCIC nevertheless seems to expect or require little less than perfect predictions. But it didn't ask itself what such predictions could or should look like. It ignores the problem that a responsible rating should be heavily conditional. That is: provided with innumerable ifs and buts. It therefore does not note that such a rating would be almost useless. That it can be used for little more than comparison of very similar products. Of which the value depends on almost the same variables. It would certainly not be useful for the comparison of investing in gold vs. MBS.

The hearings of employees of rating agencies by the FCIC on 2/6/10 show that the quality of the ratings was subordinate to the preservation or growth of market share. Human resources management was aimed at eliminating assertive, quality minded employees, and keeping and attracting tractable people.

The assumption that the price developments of constituent parts of composite securities are uncorrelated or weakly correlated (independent) is an unforgivable error with very grave consequences.¹¹² If the risks were independent, then a number of inferior BBB may indeed add up to high quality AAA. But only under that condition. If there is correlation, then BBB adds up to BBB, in agreement with common sense. Even with the most elementary understanding of economics the assumption of independence cannot be understood or defended. And in any case it should have been explicitly mentioned.¹¹³

The justification of reproaches at the address of the rating agencies depends at least in part on the legal norms for the format and contents of ratings. Supposing that legal norms were given.¹¹⁴ The "AAA" etcetera is no more than a convenient summary. It is nonsense to assume that a rating will hold for all eternity, and that AAA guarantees 100% safety. The commissions nevertheless seem to assume or require this. Perhaps this lack of understanding explains why they paid no attention to the way in which the risks of securities are actually described by the rating agencies, and to the way they should be described ideally. This may explain why they judge so easily.

But however described, risks remain risks. It is generally accepted that in a casino one should not wager more than one can pay. Institutions in the financial system may risk more than 10 times what they can pay. Nothing like this is noted by the commissions.

In connection with the evaluation of competencies the following is remarkable. In session 3 of the hearings of 2/6/10 "expert" Witt of Moody's is hardly or not able to explain how AAA can be made on the basis of BBB.¹¹⁵ He makes much more ado than necessary. And the FCIC clearly needs more than half a word.

Like everyone else, the rating agencies could have known that the financial economic system is unstable. Since this is very important for risk management, they should have noted this systematically in the elucidation (and/or appendices) of their ratings. The instability does not affect all securities equally, and is therefore even important for relative ratings.

The rating agencies play no role in Basel I. They do in Basel II. The text of Basel II mentions "internationally recognized rating agencies". About the definition of "rating" Balthazar remarks:

«Rating systems must have two dimensions: one for estimating the PDs [= probability of default] of counterparties (we treat this in this chapter) and one to estimate the LGD [= loss given default]

¹¹² If the witnesses don't lie, this error also demonstrates insufficient quality of education. The error is unforgivable anyway, because the condition of independence is part of the same elementary probability theory used to show that the combination of risks yields a lower total risk. This theory is taught in the first year of university physics and mathematics.

¹¹³ It may have been, but the author doesn't know: nobody in the dossier has said anything about this. It is a great pity that FCIC or CDW have not described ratings, or the rating of one specific product, in some detail.

¹¹⁴ If not, the question arises as to the legal basis for, and the meaning of, the reproaches. And the legal norms should be complemented with a system for sanctioning non compliance.

¹¹⁵ See the file with the transcript of this session in the directory FCIC/Hearings. The explanation is elementary probability theory.

related to specific transactions.»¹¹⁶

It is not clear how systemic risk is to be dealt with. Nothing is said about norms for rating agencies or rating methods, or a system of independent periodic evaluation of ratings. In point 15 on p. 4/12 the revised version of Basel III mentions a IOSCO *Code of conduct fundamentals for credit rating agencies.*¹¹⁷ Point 120 on p. 52/60 and following discuss the integration of the code in the Basel agreement.

8. Another example of dangerous lack of understanding: of “mathematical models”.

Summary and conclusions.

1. Its discussion of quants and models shows that the FCIC doesn't know what mathematics is.
2. As a consequence, it misrepresents the cause of some errors of financial institutions. Not mathematics and computers caused problems, but quants who built incorrect models on the basis of incorrect assumptions.
3. As another consequence, the problems of models in organizations, and the inability of management to evaluate supposed experts, remain unmentioned.

■ That the understanding of the FCIC of even slightly mathematical aspects leaves much to be desired can also be seen in the discussion of the role of “quants”: quantitative analysts. The FCIC seems to think that these people can do what they are supposed to do, and that it is clear how that is to be done.¹¹⁸ And that this is mathematics.

«As early as the 1970s, Wall Street executives had hired quants- analysts adept in advanced mathematical theory and computers- to develop models to predict how markets or securities might change. Securitization increased the importance of this expertise. Scott Patterson, author of *The Quants*, told the FCIC that using models dramatically changed finance. “Wall Street is essentially floating on a sea of mathematics and computer power,” Patterson said.

The increasing dependence on mathematics let the quants create more complex products and let their managers say, and maybe even believe, that they could better manage those products' risk. JP Morgan developed the first “Value at Risk” model (VaR), and the industry soon adopted different versions. These models purported to predict with at least 95% certainty how much a firm could lose if market prices changed.»¹¹⁹

The ideas and assumptions of the FCIC (and Patterson) are without foundation, and incorrect. It is nonsense that “Wall Street is essentially floating on a sea of mathematics and computer power”. Wall Street was not dependent or floating on a sea of mathematics, but on debatable and incorrect assumptions. Not computers and mathematics were the problem, but quasi scientific assumptions. If they only depended on mathematics there would not have been a crisis.

The models referred to in the quote were no more than hypothetical and esoteric theories, which were unambiguously falsified by the crisis. The quants couldn't what they pretended, or what their superiors thought or said they did.

In general the use of models by organizations is a great risk:

- Their inscrutability is no measure for quality;
- They are understood by very few people at most;
- Those who work with them often cannot describe and communicate about them understandably;
- They are not discussed freely, openly and critically.

¹¹⁶ Balthazar, *From Basel I to Basel 3*, p. 115. In the dossier.

¹¹⁷ IOSCO= International Organization of Securities Commissions. The first version of Basel III, of September 2010, says nothing about this. The revised version is of June 2011. Both versions can be found in the dossier. They have dates 20101216 and 20110601 respectively.

¹¹⁸ Probably like their managers.

¹¹⁹ FCIC report p. 44/72.

As a rule, quants cannot be evaluated by their superiors. They may be believed on the basis of past results, but as experience- including the subprime crisis- shows, these are no guarantee for the future. So they must have been believed blindly, and against reason. With respect to the quants and models, managements demonstrate irresponsible wishful thinking. It doesn't seem far-fetched to assume that the simplistic and incorrect notions of the FCIC about mathematics and models are representative of those of managements in general.

9. More explanations of failing risk management and reckless behavior.

Summary and conclusions.

The following are some of the explanations of failing risk management and reckless behavior:

1. Especially in management, daring to take risks for many years was considered positive if not necessary. Fearless with respect to risks was seen as the character trait distinguishing the entrepreneur or manager from the common people.
2. A general failure to understand that self regulation is a contradiction in terms, and that adequate supervision and regulation are beneficial for the sector as a whole. This failure can be explained by the appointment of dishonorable, incompetent persons by similar persons, and by defective education.
3. The fiction that (strict) liability can be safely replaced by capital requirements of less than 100%, as in the Basel accords.
4. There were good reasons for taking risks, and no compelling reasons for being careful about risks, least of all about risks for outsiders.
5. Unprofessional and irresponsible affordable housing policy by successive US governments and presidents.
6. Pressure from the US government on supervisors and financial institutions to support its affordable housing policy by tolerating greater risks.
7. Deregulation policy by many governments: itself reckless, and facilitating recklessness.
8. Failing supervision, including that by parliaments.
9. Failure especially by those responsible to understand or openly discuss “risk” and “risk management”.

■

How could so many people take (much) more risk than they could bear?

In the case of mortgage buyers it can be explained by wishful thinking and badly founded optimism about the development of their income and home prices. In general it can be partially explained by lack of understanding of the concept of risk, inability to estimate (total) risks, and the absence of authoritative norms for (un)acceptable risks. All this in a situation of competing institutions, and an enterprise and executive culture which highly values “the courage to take risks”, and looks down on risk avoidance. An executive culture in which risk avoidance is equated with failure to use opportunities. And indeed, there is indeed a risk that the competition uses opportunities better than you do, and will marginalize your organization by success. As long as things go well, one seems to be able to continue taking (more) risks.

The inquiry commissions did not explain that, and why, a group of competitors endeavoring to increase market shares at each other's expense needs effective supervision. They did not explain why in such a situation self regulation is nonsense and a contradiction in terms, and why effective supervision isn't harmful but beneficial, at least for the group. They did not point out that this is a general phenomenon. That it is not only relevant for financial institutions in the narrow sense, but also for the rating agencies.¹²⁰ In their hearings and reports nothing contradicts the hypothesis that the commissions and other principal persons did not or not sufficiently understand this. Nothing contradicts the hypothesis that they terribly underestimated the importance of insufficient supervision in allowing developments which would sooner or later inevitably precipitate a crisis. The lack of

¹²⁰ For the last see the FCIC hearings of 2/6/10, in the directory FCIC/Hearings.

understanding can next be explained by the appointment of dishonorable, incompetent persons by similar persons, and by failings in education.¹²¹ Although failings in education are not an excuse: somebody with the necessary talents can correct them rather easily. And anyway: somebody accepting a responsible job should have the know how necessary for that job. Neither doing one's best, nor being just as good or even better than similarly dishonorable, incompetent persons, is enough.

There are no (binding) norms for risks. Instead, there are capital requirements. Capital requirements are relatively easy to understand and verify. In the hearings of the inquiry commissions lots of principal persons have declared that they have always tried to increase the capital requirements, that their efforts met with strong resistance, that they nevertheless made important progress, that things can always be improved, etcetera. As if capital requirements ensure safety, and make risks bearable. They don't. More capital may reduce risk and harmful consequences. But it is unclear under what conditions they will be sufficient. Capital requirements, as they are understood up to now, may be useful. But they are certainly not sufficient for adequate risk management. Compliance with capital requirements guarantees nothing. Basel I didn't, and Basel II, III and IV don't or won't either. The percentages of the required capital, and the definition of "capital", are a political compromise, not based on any reliable argument or theory. They are not calculated to reduce the remaining risk to less than a certain, generally accepted, maximum. The facts prove that the requirements valid at the time were very insufficient, even though each agreement had been presented with just as much fanfare as the former. But the most important fact is that capital requirements do not offer any guarantee for safeguarding outsiders.¹²²

All this could and should have been known by those concerned. In the first place by the supervisors. They should have analyzed the situation and its implications at least in their annual reports.

The idea of replacing liability and punishability by capital requirements is incompatible with the equal rights principle. A citizen buying a mortgage has to satisfy much stronger requirements. And the crisis (and for example *Inside Job*) shows that there is every reason to distrust financial institutions and their supervisors and regulators.

As noted earlier, in spite of Basel it is entirely unclear how financial institutions can or must deal with risks. Basel sets no limits to risk taking. Notwithstanding Basel, employees will profit from upside chances, while having little or nothing to fear from (more distant) downside risks. Capital requirements do not change the situation in decision making. Or maybe they do, but in a far too obscure, indirect, complicated, and variable¹²³- that is: meaningless- way. The essence is that benefits and costs (including those for outsiders) need not be taken into account as being equally important.

The many and excessive payouts to CEO's, CFOs etcetera as soon as financial institutions began to turn in losses in the beginning of the crisis are just as many examples of this systematic bias. The compensation systems of the US and the Netherlands differ quite a lot. But the extremely high salaries of Balkenende, Bos, Kok, Ruding and Zalm show that in the Netherlands too politicians have nothing to fear from responsibility for deficient laws, failing supervision and high government debt.¹²⁴ The preventive effect of existing law is clearly non existent. The crises, and the reactions to the crises, show that the principal persons had no reason to do their job properly.

Please don't forget that in many other fields of human activity liability and criminal law are used to influence and/or punish behavior, and to recover damage. In other words: the law (politicians) is inconsequential: there are fundamentally different rules for similar (mis)behavior.¹²⁵ As a consequence it is possible to "privatize profits and socialize losses".¹²⁶ In this sense there is no equality before the law.

¹²¹ And more, to be discussed in more detail later.

¹²² And indeed, nobody asserts as much...

¹²³ Because the capital requirements change with the value of the (leveraged) "products", such as loans or (other) securities.

¹²⁴ This refers to their jobs and salaries after they left politics.

¹²⁵ In this study, "inconsequential" is supposed to mean: differently in similar cases.

¹²⁶ As noted before, the summary "privatizing profit and socializing losses" can be found for example in the transcript of the hearing of Greenspan by the FCIC on 7/4/10.

For example the annual reports of the GSEs show that institutions were well aware of the affordable housing policy of the federal government, and actively contributed to its implementation. The FCIC minority report of Wallison shows that the government, especially HUD, exerted pressure on mortgage sellers to ease mortgage requirements.¹²⁷ Modern governments are all-powerful. Institutions meet governments in 1001 ways, and have a great interest in being seen as cooperative by governments (and politicians). By refusing to actively support government policy, institutions not only forgo great potential profits, but are sure to meet problems in other areas. Of course the easing of mortgage requirements increases the risks. But who can ignore the President of the USA?

The inquiry commissions did not or hardly look into the communication between governments and supervisors. Nothing shows that they studied the minutes of their meetings. But even if supervisors are not expressly required (by law, as the Fed) to actively support government policies, it is no more than plausible that they tried to cooperate as well as possible. (Their heads were appointed without exception by governments). Not only with housing policy but also with deregulation. Although this is not sufficient to explain the bragging in the annual reports, and the misleading reassuring picture painted of their part of the financial system. These can only be explained by a combination of incompetence and lack of integrity.

Remains the explanation of the affordable housing policy of the federal government. Or rather: the irresponsible implementation of that policy. For of course, affordable housing is a very nice goal. Nothing wrong with that. What was very wrong was the dogmatic interpretation of the given situation, and the authoritarian way in which the government wanted to change it, without due care, without thinking about the consequences, and without periodic critical evaluations. No risk analysis, no risk management. No due regard for warnings, such as by OFHEO. Nothing had been learned from the soviet experience with five-year plans. Housing was to be affordable, and the quantitative goals had to be realized. The (hypothetical!) control of government by parliament didn't work at all. The representatives of the people supported their irresponsible leaders, and showed no fear for people's control by non-re-election.¹²⁸ Here too we see a combination of incompetence and lack of integrity. All vital positions are occupied by unsuitable persons.

Both the actual risk management and various remarks of the FCIC seem to reflect deficient understanding of risk management, and absence of awareness of this deficiency. The problem is wider however. As shown by the Wikipedia page "risk management":

«Risk management is the identification, assessment, and prioritization of risks (defined in ISO 31000 as the effect of uncertainty on objectives, whether positive or negative) followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. Risks can come from uncertainty in financial markets, project failures (at any phase in design, development, production, or sustainment life-cycles), legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attack from an adversary, or events of uncertain or unpredictable root-cause. Several risk management standards have been developed including the Project Management Institute, the National Institute of Science and Technology, actuarial societies, and ISO standards. Methods, definitions and goals vary widely according to whether the risk management method is in the context of project management, security, engineering, industrial processes, financial portfolios, actuarial assessments, or public health and safety.

The strategies to manage risk typically include transferring the risk to another party, avoiding the risk, reducing the negative effect or probability of the risk, or even accepting some or all of the potential or actual consequences of a particular risk.

¹²⁷ The Chronicle shows that in the period considered, the mortgage requirements were gradually weakened.

¹²⁸ Which can be explained by the unlimited possibilities of (concerted) manipulation by politicians, also of the "free" but dependent press.

Certain aspects of many of the risk management standards have come under criticism for having no measurable improvement on risk, whether the confidence in estimates and decisions seem to increase.»¹²⁹

The first sentence looks like a definition of the concept “risk management”. It is multivalent, and therefore inadequate. In addition it makes risk management dependent on subjective valuations. The “or to maximize the realization of opportunities” not only creates ambiguity, but possibly even a contradiction.¹³⁰ For as explained earlier, the alternative with the largest expected yield (for a given institution) may be attended by the largest risk. In general, the alternative with the smallest risks is not the alternative with the largest expected yield.

The second paragraph only concerns risk in the sense of possibilities for events with negative consequences, not about opportunities for profit. The text does not address the potential conflict between the “positive or negative” in the definition.

For outsiders risk management in the Wiki sense is useless. Due to the ambiguities created by “economic” and “or to maximize”, risk management in the Wiki sense ensures neither reduction of harmful consequences nor avoidance of unbearable costs. It offers no guarantee at all.

The ambiguities of the Wiki page relativize the critical attitude of the inquiry commissions. The Wiki page shows that their critical attitude is incompatible with mainstream thinking about risk management, and needs much more explanation. The commissions should have told what they mean by (good) risk management, and why. They should have shown under what (legal) conditions good risk management is to be expected, and why.

10. To conclude and to be kept in mind: the wider implications of the observed phenomena.

When trying to learn lessons from the crises it is very important to realize that there were and are not only risks of a financial or economic nature, but that there are probably much larger risks in areas such as armaments, conflicts within and between states, the environment, and nano and genetic engineering. In these areas too:

1. There are well founded doubts and questions about safety;
2. There is reason to assume that the probability of personal profit of decision makers is given a much higher priority than the risks for outsiders;
3. There are empirical and theoretical reasons to assume that supervision does not do what it has to;
4. It is assumed that sufficiently small risks will not be realized, or have no consequences;
5. People behave as if non realization of a risk means that it does not exist.

7B.4. Failures of governments and parliaments.

Table of contents of this section.

1. Summary and conclusions.
2. Introduction and overview.
3. Insufficient liability as a cause of reckless risk taking and the transfer of consequences of risk realization to innocent outsiders.
4. Hierarchical organization.
5. No supervision of supervision. Supervision and government policy: a risky combination.

¹²⁹ Wikipedia “Risk management” 16/2/12. The text was reformatted by the present author. For sources see the Wiki-page. Some sources can be consulted only at cost. This applies for example to the ISO-documents. If the Wiki-page gives a reliable picture of the ISO-directive, then the directive has important deficiencies. It would seem that compliance with the directive offers little more than a semblance of safety. Not all deficiencies have been noted here. To avoid misunderstanding: according to the present author the text is useless due to essential lack of clarity and other deficiencies.

¹³⁰ Note that the text has “opportunities”, not “expected results”.

6. Inadequate appointments.
7. Deregulation.
8. Housing policy: affordable housing, community reinvestment act, and tax relief.
9. Moral obligations.
10. Government and supervision were unprepared for a crisis. Practical circumstances as explanation of inconsequent and arbitrary conduct.
11. Lobbying.

1. Summary and conclusions.

1. At least in the following areas governments and parliaments have failed to do what legitimate governments and parliaments are required to do, and to such an extent that they can be considered as the principal cause of the subprime crisis:
 - Regulation (including the law);
 - Supervision of supervisors;
 - Hierarchical organization;
 - Appointments;
 - Deregulation;
 - Housing/mortgage policy;
 - Permitting lobbying.
- It is plausible that appropriate action in any single one of these areas would have prevented the crisis.
2. Liability and criminal law are hardly or not relevant for, or administered to, employees of organizations and political functionaries. The law is inconsequent, and there is no equality of adjudication. The law is incompatible with respect for (other) people.¹³¹ As a consequence the persons indicated have insufficient reasons to think before they act (or decide to do nothing). The law admits of recklessness towards outsiders, and maintains dishonorable and incompetent functionaries. Harmful consequences of their activities and omissions can be transferred to outsiders with impunity and without costs.
3. The law is incompatible with the traditional right to be safeguarded. The breakdown of this traditional right dates from the 19th century. It was said to promote the general welfare. This was never proven. No effort at evaluation has ever been made. In the light of the crises (and other phenomena) the assertion cannot be maintained.
4. To a certain extent, reduction of incentives for proper conduct can be compensated by other rules and supervision. There is however no safety net if the rules and/or supervision are ineffective. In the decades before the crises, both rules and supervision failed.
5. The supervision of supervisors by governments and/or parliaments was insufficient. Governments and/or parliaments adjusted law and/or regulation insufficiently to developments in the financial services sector, or made the discrepancy and risks even worse.
6. In the decades before the crises governments and/or parliaments acted (and failed to act) as if risks don't exist, or can be taken with impunity.
7. No member of government or parliament has shown any understanding of the operation of the financial system as a whole, of the processes, of vital parts, and the conditions for safe and adequate operation.
8. Nothing shows awareness of the instability of the financial system.
9. The regulation of hierarchical organizations facilitates their degeneration into dictatorship. The operation of all organizations in the financial system, and all organizations responsible for its proper operation, show that integrity, corporate and other codes, and whistleblower regulations, are inadequate. Self correction of these organizations is almost impossible and has not taken place.¹³²

¹³¹ In the strict sense: respect is violable. In general with impunity, and without obligation to repair damage caused.

¹³² This is most easily and clearly seen by comparing annual reports of supervisors of a series of years around the crisis, say 2006-2010.

10. That all¹³³ principal persons have failed can be explained as follows. The combination of present-day election systems and the absence of liability and punishability causes dishonorable and incompetent governments and parliaments. Honorable people without false pretensions don't stand a chance. Governments and parliaments appoint all heads of all essential (semi) public organizations. Such as supervisors.
11. The combination of present-day election systems and the absence of liability and punishability for principal persons and organizations is the Achilles' heel of the democratic constitutional state. The system does not imply a need for integrity or competence.
12. The illusion that deregulation, more freedom without liability and punishability, promotes the general welfare is incompatible with common sense, experience, and the theory of the PD game. The PD game shows that regulation (limitation of freedom) and supervision can be in the best interest of an industrial sector such as the financial system.
13. The ministry of HUD of the US dictated the GSEs 4-year plans for affordable housing goals,¹³⁴ and exerted pressure on mortgage sellers to cooperate. The goals were systematically increased. As a consequence, mortgage requirements were reduced and risks increased. The HUD policy was purely dogmatic. Professional know how about policy making was systematically ignored.
14. Many people blame banks for immoral behavior. But if moral behavior is important, why doesn't the law require (specified) moral behavior?¹³⁵ The more so since it is generally acknowledged that one is free within the bounds of the law. If there are competitors, it is obvious that competitors will use their freedom to the limit.
15. Blaming governments and supervision for unethical behavior is well founded. But their behavior is not only unethical: they simply didn't do their legal duties.
16. Supervisors and governments had no policy or plans for eventualities. The absence of preparation, the speed of the developments, the pressure of the circumstances, the incompetence of the principal persons,¹³⁶ and the fact that their organizations were adapted to the normal situation- not to a crisis- can explain that during the crisis relatively many errors were made. The bankruptcy of Lehman may be one of them.
17. The fact that the supervisory system was not adjusted to changes in the financial system, or worse, that supervision was weakened when safety required strengthening, can be partially explained by the influence of the banking lobby. Assertions claiming that lobbies have a positive influence by providing information and expertise, and that politicians know how to handle lobbies, have been convincingly falsified by the subprime crisis. For the purpose of information the world wide web offers a transparent alternative. Lobbying in its present forms, and cooperation with lobbying, should be prohibited and criminalized. Apart from this, lobbyists, just like everybody else, should be liable and punishable for the consequences of their activities.
18. Less money and less people for supervision (for example due to budget cuts) normally reduces the chance of finding infringements of applicable norms. If that should not result in an increase of misconduct, then the product of the amount of the fine and the chance of getting caught should remain the same. In other words: reduction of the chance of getting caught should always be accompanied by a proportional increase in fines. Experience shows that governments and parliaments don't do this. They don't seem to understand, or there is malicious intent. So once more: lack of integrity or competence, or both.

2. Introduction and overview.

Governments and parliaments, and only they, determine the framework in which persons and corporations in a given country live and work. In so far as the operation of a financial economic system can be influenced by laws and regulation, governments and parliaments are responsible in the

¹³³ With the partial exception of Born of the CFTC. Partial because she gave up. See the Chronicle, under 1998 and 1999. She let herself be eliminated. She furthermore participated in the FCIC. And did not dissent.

¹³⁴ See for example Pinto, *Government housing policies etcetera*, p. 149, paragraph c.

¹³⁵ The first norm of moral behavior seems to be: do not harm another. But who proposed to introduce strict liability, or to extend existing liability?

¹³⁶ Both as regards management and the operation of the system and the economy.

last resort for what happens in that system. They determine the boundary conditions. Where “boundary conditions” are to be understood in a wide sense. Laws determine what is permitted and forbidden, and the obligations of people and corporations. They determine the kinds and amounts of taxes, and the redistribution of the taxes paid. Laws establish innumerable organizations, give them tasks, powers and budgets. Last but not least they prescribe the appointment procedure for the heads of these organizations. Both the regulatory and financial possibilities of modern governments and parliaments to exert influence are unimaginable. It may be true that they cannot do everything they want, even supposing they know what they want, and don't want things which cancel each other out. They cannot prevent people from ignoring red traffic lights. But they could have prevented the crises of 2007-2013 with the powers, instruments and information they had at the time. Neither quantitative nor qualitative changes were necessary.

At least in the following areas governments and parliaments have failed to act properly, and to such an extent that they can be considered as the principal cause of the subprime crisis:

- Liability and criminal law.¹³⁷ Deficiencies in these laws effectively promote risk taking. They safeguard persons behaving irresponsibly, and force innocent outsiders to pay the price of the misconduct of such persons;
- The supervision of supervisors;
- The regulation of the hierarchical organization;
- Appointments;
- Deregulation;
- Housing/mortgage policy (CRA and AH);
- Lobbying.

The failures in these areas will be described below. If governments and parliaments had done what they could and should have done,¹³⁸ then there would not have been a crisis. But they are not only responsible because they failed to do what they should have done. They are also responsible for the appointment of insufficiently honorable and competent people in all key positions. Many governments and parliaments moreover are responsible for thoughtless deregulation policy, and the corresponding weakening of supervision.

The US government, including Congress, was furthermore responsible for the subprime crisis because of its affordable housing policy.

The second crisis, the debt crisis, was caused by government debts which seemed to become irredeemable, and by inadequate international (EU) regulation. All western governments and parliaments are responsible for this situation. In this field too they took unbearable risks.

Methodological remark.

Because governments and parliaments, and only they, are responsible for the law and its enforcement, in an evaluation like the present one, an assertion about a person or corporation having failed should always be accompanied by the question whether or not his/its actions or omissions were in accordance with the existing legal framework. If not, the follow up question is what possibilities the law offers for obtaining redress and for sanctioning the transgressor. Possibilities both in a formal and practical sense. A formal possibility may be practically useless for example by impossible requirements regarding proof. If possibilities do not (practically) exist, the law may be ignored at no cost and with impunity. (Probably at the cost of other people). In such a case there is no reason to expect that people and corporations comply with the law. Can such a law be called adequate? If not, governments and parliaments failed in their duty as lawgivers.

A politician cannot call a norm or value important if he does not try to get it translated into regulation. If he does not try, he shows that his words are empty window dressing, and that he is unreliable.

¹³⁷ And the corresponding procedural laws, for example where they require proof of risk of causation of harm instead of proof of safety. This principle is a risk in itself.

¹³⁸ Should have done: if only because of the constitution, which they swore to abide by.

3. Insufficient liability as a cause of reckless risk taking and of the transfer of consequences of risk to innocent outsiders.

In the present report liability always refers to:

- Harm caused by avoidable behavior of people. Harm could have been avoided if these people had made another choice. The “avoidable behavior” may be activities or omissions. The latter when there is a duty to act;
- Respect for, and safeguarding, people who did not approve of the harm causing activities or omissions.

Liability means that harm has to be repaired or compensated. Avoidably causing harm obviously violates the respect principle. Avoidably causing irreparable harm is the worst one can do. It should be discouraged as much as possible. When people cannot repair or compensate the harm they caused, adequate punishment may ensure the best possible preventive effect. In other words: punishment can serve as a complement to liability.

This section discusses those aspects of liability and punishability which are more or less directly relevant for the behavior of the principal persons and organization in connection with the financial crises. More fundamental and general aspects will be treated in section 13 of chapter 9. Of course, the boundary is not sharp, and all aspects could have been integrated in a single chapter. The problem is that liability and punishability are relevant for all cases studied, and cannot be missed in an analysis of the financial crisis. The author kindly asks the readers’ understanding for the choice made.

Summary and conclusions.

1. According to traditional law everybody is personally liable for the consequences of his doings (and omissions), and punishable if he cannot repair or compensate the damage he caused. There are logical and practical reasons for this rule.
2. Governments, parliaments, and corporations and their employees have limited liability. They asserted and assert that on balance this is beneficial for society. This is no more than a hypothesis. Theoretically (logically) it is clear that repairable damage can be compensated if the sum of benefits and costs is positive. However, in many historical cases one can only get a positive sum if human rights and irreparable damage to people’s lives are counted for nothing.
3. To a certain extent a limitation of liability can be compensated by the combination of suitable norms and supervision. But only if the supervisor of the supervisor is strictly liable. If the ultimate supervisor can dysfunction with impunity, disaster is only a matter of time. Because of incomplete knowledge and understanding, norms and supervision may not prevent damage. They don’t provide compensation. By replacing traditional liability with norms and supervision governments and parliaments bound themselves to ensure effective supervision. With respect to the financial supervisors, all western governments fatally neglected this duty.¹³⁹
4. The ultimate problem is the lack of effective corrective sanctions for the dysfunctioning of members of parliaments.¹⁴⁰ The “representatives” don’t defend the interests of the people, and do not work honorably and competently.
5. There is a close relationship between liability and criminal law on the one hand, and risk management on the other. Nearly all forms of dysfunctioning shown in the Chronicle of the subprime crisis can be attributed to insensitivity for the consequences of one’s actions and omissions. The insensitivity can be explained by the (effective) limitation or absence of liability and punishability. Everyone in responsible positions could afford to take risks which cannot be

¹³⁹ The “all Western governments” can be concluded from the IMF and BIS reports. The statement does not mean that other governments are better, only that other governments may not have been involved, or that the available information does not allow reliable evaluation.

¹⁴⁰ Note the amazing fact, that there are no noticeable exceptions. Nobody admits that in the period 1994-2006 they should have been much more critical of deregulation in the financial system, the financial supervisors and AH policy (with arguments such as presented on this report). To mention just three simple examples.

afforded under traditional law. Almost all negative consequences had to be borne by innocent outsiders. Those who caused the crisis by dysfunctioning have hardly suffered at all. Many of them continued their career as if nothing had happened. Sometimes with a salary which is a multiple of their former salary.¹⁴¹

6. A long time ago, limitation of liability could in theory be motivated by the hypothesis that it serves the general welfare, that its net effects are positive. In the light of the crises the hypothesis should either be abandoned or evaluated.¹⁴² It should be abandoned if violation of human rights and causation of avoidable irreparable damage are strictly forbidden.¹⁴³ But nobody mentions evaluation or abandonment. Including the inquiry commissions. Which suggests a general lack of analytical abilities, and/or awareness of the incorrectness of the hypothesis, in combination with the idea that raising doubts may harm one's personal interests.
7. In the 19th century, supposedly on the basis of the hypothesis that it serves the general welfare, governments and parliaments departed from traditional law, and abolished the general (strict) obligation to repair or compensate damage caused by avoidable activities. This makes governments and parliaments much more responsible for the consequences of the crises than they would have been if they had left traditional law intact.¹⁴⁴
8. Without liability people have no compelling reason to take account of costs for outsiders. Therefore liability law can best be defined in such a way that actors are forced to consider all costs, and treat all costs equally. Punishment replaces the part of the externally caused costs which actors cannot pay.
9. One should become liable upon voluntarily assuming a job or embarking upon an activity.
10. Liability and the complementary punishability are logically necessary, and improve decision making and reparation of damage caused. Reduction of bonuses has no similar effect. In other words: making liability and punishability more consequent is an effective measure, restriction of bonuses is useless.
11. Members of governments and parliaments have effectively placed themselves and the organizations which they finance with tax receipts above the (normal) law.
12. Restoration of strict liability, supplemented by punishability where needed, solves several connected problems:
 - It necessitates taking account of all costs and benefits, opportunities and risks;
 - It greatly reduces the dependency on supervision and supervision of supervision;
 - It makes the law more just and consequent;
 - It makes liability law compatible with respect for people (present limited liability is not).

Introduction. Logical principles of law, and reactions to infringements of these principles.

From the definitions of subjective and objective it follows that norms and values are subjective.¹⁴⁵ But if people want to communicate meaningfully with one another on a voluntary basis, then they must accept the following rules:

1. It is not permitted to harm another person, "harm" being defined by the other person. As a consequence, activities causing risks need prior permission of everyone running a risk;
2. Avoidable harm is repaired as well as possible by the actor, and if reparation is not

¹⁴¹ This applies for example to Dutch former ministers Balkenende, Bos and Zalm.

¹⁴² Or rather: In the light of the crisis and other disasters. For it is not difficult to argue that both world wars of the 20th century could and should have been prevented by France, the UK, the USA and many smaller countries, even independently or in small combinations. See for example W. Shirer, *The Collapse of the Third Republic*.

¹⁴³ The "strictly" meaning: not allowed at all. In other words: it is not permitted to harm a single person even if it would benefit 1000 other people. At least without prior permission (after full and correct information).

¹⁴⁴ Supposing the last two crisis to have happened under traditional law, which seems improbable. Even though crises may be possible under full liability and even harsh criminal law. Such laws do not eliminate the fundamental instabilities indicated early in this analysis. But they do make people think- twice- about the consequences for others.

¹⁴⁵ See the paper *Communications and norms* by J.F.C. van Velsen, as pdf-file on the internet, www.lawoflogic.net.

- possible, compensated;¹⁴⁶
3. If avoidable harm or hinder was and/or is caused, and the actor is unwilling and/or unable to pay compensation or reparation, then the victim can appeal to an independent judge;
 4. Who is to decide about subjective aspects;
 5. If full reparation or compensation is impossible, the actor is punished in a way that is proportional and discourages actors from repeating the behavior that caused the harm.¹⁴⁷

The five fundamental norms are logical and objective in this sense, that they are premised by, or follow from, the agreement which must (implicitly) be made in order to be able to communicate. For further substantiation the reader is referred to the literature.¹⁴⁸

Without agreement about these rules there can be no communication deserving to be called communication.¹⁴⁹ Nobody can be assumed to communicate voluntarily if these rules are not accepted. They can therefore be considered as the most fundamental principles of law.

Taken together the norms constitute a basic law. As far as known, this basic law has been accepted as law by all nations of all times, even though systematically violated by governments. Everyone considered it reasonable or natural, even if unaware of the reason.

Liability versus norms+supervision.

Modern law is not self-evident.¹⁵⁰ Only a small part of the law is logical, and the logical part only concerns what can be called traditional activities. Such as concluding contracts, buying and selling, and theft by natural persons. This part of the law was developed from what Roman lawyers called the law of the nations, and from the common law. The differences are relatively small. However, as from the 19th century, governments have modified parts of the law in a fundamental way. The changes mean a break with traditional principles of law. They concern especially the law regarding public and private organizations, and their employees. The changes facilitate risk taking. Organizations need no longer fully compensate damage caused: their liability is limited. In important cases liability is replaced by norms. As long as regulatory norms are complied with, there is no liability. Often the norms are debatable however. They may reduce damage or risks, but need not eliminate them. It may be too easy to claim compliance. Failure to comply may be hard to prove. In any case the costs of damage due to activities within the framework of the norms are shifted to outsiders.¹⁵¹ Norms moreover don't cover all the risks. Working with norms assumes that the norm-setter has complete knowledge and understanding. This assumption is almost never correct. Even serious damage cannot be ruled out. An important example is the bankruptcy law. This is the pre-eminent example of shifting costs of failure to the rest of society.

Important are furthermore the procedural aspects of the law. Here not the safeguarding of obviously innocent outsiders has priority, but all kinds of questionable procedural requirements.^{152, 153}

¹⁴⁶ Avoidable harm, not (only) intentional harm. "Accidental" harm is not excluded either.

¹⁴⁷ Discouragement/ preventive influence is necessary because of the irreparable (irreversible) nature of the damage caused.

¹⁴⁸ For example *Het recht van de logica* (Eburon, Delft, 2003, in Dutch) or *Communication and norms*.

¹⁴⁹ In the terminology of John Locke: then only meaningless sounds or scrawls are made.

¹⁵⁰ Nor consistent. At least if rules of law are called inconsistent if they assume inconsistent premises. For example for liability and punishability.

¹⁵¹ "Damage" is and should always be assumed to include risks, since in general and in the long run risks always mean damage.

¹⁵² Limitation of liability and punishability for organizations is not so conspicuous because organizations are not people. One therefore expects differences. It seems logical that the law for organizations differs from the law for natural persons. Specific corporate law seems necessary. And once differences are accepted, one will more easily accept differences where equality would have been possible and even logical. Once differences are accepted, one will not so easily notice that corporate law favors corporations as compared to the corresponding law for natural persons. And of course the interested people will do nothing to undeceive you.

Below some examples of differences will be given. For another and more comprehensive discussion see chapter 9 of *The law of logic*.

As regards his work, an employee is in general considered as a representative of his or her organization. Formally he or she acts in the name of the organization. Concerning the actions and omissions of the employee

As a rule compliance with norms is supervised by organizations set up for that purpose. The system works if these organizations do what they have to do, and if the fines¹⁵⁴ for infringement of the norms are sufficiently large to make compliance cost effective. The history of the financial system and many other cases show that neither is the case: supervisors often do not do their duty, and the fines are far too small.¹⁵⁵

From the above it can be concluded that modern law encourages risky and reckless behavior of corporations and their bosses, and that in a sense this is intentional.¹⁵⁶ It is correct to speak of encouragement because limitation of liability means that corporations have no financial reason to take all costs into account. What is profitable for a corporation may be harmful for society (including the corporation). Modern law implicitly allows transfer of costs of harmful consequences of activities and omissions of corporations to people who have nothing to do with these activities or the decision making about them. It allows responsible bosses to hide behind their corporations. In general, actors need not pay damages in full, and are not punished proportionally. Because of the technological possibilities and the scale of many activities in the modern world this is asking for disasters. And they came.

Liability and optimization of behavior.

Strict liability is necessary to optimize behavior from the point of view of society as a whole.¹⁵⁷ If one wants people to act in such a way as to realize the greatest progress or improvement for society as a whole, then one should oblige them to take all costs and benefits of intended actions into account. Not only costs for themselves. Without strict liability people have no compelling reason to take account of costs for others. Therefore liability law can best be defined in such a way that people are forced to consider all costs, and treat all costs equally. Conversely it is only too understandable that regression (including accidents and disasters) may result from excluding important categories of activities or people from liability.¹⁵⁸

Optimization of behavior in this sense also optimizes prevention. It stimulates actors to think and be more careful, and not to take unbearable risks. It requires them to ask prior permission of everyone potentially affected.¹⁵⁹

not the employee him/ herself is addressed, but the organization. Since organizations almost always have a hierarchical structure, (only) the highest boss is formally responsible. Which means that only the highest boss can speak for the organization, or somebody designated by him for that purpose.

If a corporation has caused harm, questions may arise which rarely arise if harm is caused by a natural person. For example the questions whether the harm was predictable, who were responsible formally and materially, and who knew what. In spite of the (unambiguous) hierarchical structure line managers are only rarely imprisoned because of an offence of one or more of their employees.

Politicians and jurists suggest that it is very difficult to implement the concept of punishment for corporations. Organizations are supposed to be important for employment and economic growth. (An argument that also applies to natural persons, and is only a matter of proportionality). Often corporations can hire lawyers of a much better quality than that of the judges and prosecutors. Interests and policy have priority over equal rights and adjudication.

As a consequence of these and other differences organizations almost never fully compensate damage caused.

¹⁵³ And which are rarely if ever discussed publicly. In general under the pretence of being too technical.

¹⁵⁴ As opposed to theoretical fines. What is essential are the total costs of the offender. If a judge halves a formally sufficient fine, the effect may be the same as no fine at all, because such a fine does not change the cost effectiveness of ignoring the norm in question. From what can be seen of the study of law and its textbooks, it seems probable that most jurists simply don't know and understand this.

¹⁵⁵ And adjudication and the relevant procedural law may be inadequate. This has not been studied any further for reasons of time.

¹⁵⁶ Here, "corporations" include all organizations which are not fully liable in the common sense, as an ordinary citizen.

¹⁵⁷ According to the Merriam Webster 2002: strict liability (1896)= liability imposed without regard to fault.

¹⁵⁸ As demonstrated by all the cases, including the financial crises.

¹⁵⁹ Not just a majority.

For the same reasons actors should be punished if they cannot completely repair or compensate the damage they have caused. For example when people are wounded, mutilated or killed. Punishment replaces the part of the costs that the actors cannot pay. Note that this punishment is primarily meant to ensure that people think before they act, and that they take all possible costs into account. When making a decision or choice, punishment should be seen as a risk, as a possible cost. Punishment should prevent harmful decisions.

The distribution of the relative contributions of the various participants in damage causing activities can be left to the participants themselves. If they cannot agree on the distribution, they can ask a mediator or judge to fix it, at their own cost. It may be useful to have general rules for the determination of the distribution, so that people know what to expect.

The respect principle¹⁶⁰ means that it is forbidden to transfer costs to people who did not give prior approval to the harm causing activities. Approval is only approval when given explicitly and personally.¹⁶¹ Implicit agreement inferred from an assumed agreement with the given political system is sheer fantasy and indefensible. To be defensible, approval has to be given after full, correct and understandable information. If one cannot know what one approves, approval is meaningless and invalid. Ditto when information was withheld or incorrect.

Risk management depends on boundary conditions. It is undefined, and practically impossible, as long as the boundary conditions are undefined or ambiguous. This is especially important in a competitive environment. The absence of clarity on this point is one of the reasons for the failure of the risk management of financial institutions in the run up to the subprime crisis, and up to now. Strict liability and (personal) punishability when recovery is impossible, provides the required clarity. They mean that damage must always be repaired or compensated, at ones personal risk.

Liability and punishability are much more important than bonuses. Or the reduction thereof. The purpose of liability is to compensate innocent people when other people have caused avoidable harm. Reduction of bonuses does not contribute the least to this kind of compensation. There isn't even reason to assume that it will reduce risk taking. If liability and personal punishability are accepted, there is no reason to meddle with bonuses.

Liability due to a blamable prior choice.

When considering questions of liability it may be relevant to know and understand the assumptions which are (tacitly) made about an actor, and about the conditions for liability and culpability. Suppose that an action or omission has led to harm. The action or omission may be unavoidable, or the best possible, in the given circumstances. But the circumstances may have been predictable, and the actor may have voluntarily and avoidably chosen to accept the risk created by the circumstances, or (wrongly) assumed that he or she could manage without causing harm. If it is assumed that causing harm or the risk of harm creates liability, then the last choice creates liability, even if the action or omission considered in isolation does not. This is why driving drunk may be fined, even when no accident was caused.

Another important example is the acceptance of an impossible job. The job being impossible in the sense that even doing one's utmost best is sure to be insufficient. As a rule the media and the courts ignore that members of governments and parliaments, and heads of large organizations, accept jobs, or participate in activities, which mean that they regularly take or approve decisions which they understand at most partially and cannot reverse, and of which they don't understand and can bear the risks etcetera. They ignore that acceptance of impossible jobs or circumstances is avoidable, and therefore cannot serve as an excuse. Many failures are the inevitable consequence of the indefensible acceptance of an impossible job or activity. Acceptance of an impossible top management position creates top risks. Such as the risk of having to approve decisions one understands at most by half, and

¹⁶⁰ Also called the safeguarding principle. It is the right to be safeguarded from the effects of avoidable activities of others. It can be called the respect principle because it means that an actor truly respects the opinions of the people potentially affected by his activities.

¹⁶¹ Not by a "representative".

the risks implied by the necessity to believe people one does not know and cannot reliably assess.¹⁶² Doing one's best after having made an indefensible choice, need not be sufficient to avoid disastrous errors. Timely reversal of the misstep by resignation is the only way to escape causing irreparable harm.

It is not making errors in an impossible job that is avoidable and blamable, but the acceptance of an impossible job.

Liability, risk management, and bonuses.

Risk management depends on boundary conditions, especially conditions regarding potential costs. Risk management is undefined, and practically impossible, if the boundary conditions are undefined or ambiguous. This is especially important in a competitive environment. The absence of clarity about boundary conditions is one of the reasons for the failure of the risk management of financial institutions in the run up to the subprime crisis, and up to now. Strict liability, and (personal) punishability when recovery is impossible, provides the necessary clarity. They mean that potential damage must always be repaired or compensated, at ones' personal risk.

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Liability and criminal law as remedy against dysfunctioning supervision and politics.

Theoretically speaking the bias in decision making processes indicated in the section about risk management can be obviated by suitable regulation and supervision. Something similar applies to every system where liability is restricted to at most the damages caused by exceeding norms. Such a system only works as it is supposed to work if politics and supervision function properly. As regards the financial system they failed systematically, and during many consecutive years (from at least 1995). There was no supervision of supervision.¹⁶³ The top of the hierarchical pyramids did little more than live in style at the public expense. Politicians can only be trusted to protect themselves. As shown clearly for example in the cover up by inquiry commissions. In this respect there is no difference between political parties, or between the parties in the government, and those in opposition. All politicians neglected their duties, acted irresponsibly. None broke the veil of complacency.

Therefore the question is how to reduce the dependency from politics and supervision. The above analyses suggest: by making sure that the decision makers know that they will share in the consequences of their decisions. In a way that is proportional to the consequences for the victims. Independent of whether the decision maker is politician, entrepreneur, manager, or somebody else. In other words: by ensuring an effective coupling between consequences for the decision maker(s) and those for other people. It is unclear how this can be realized without (effective) expansion of liability and punishability. Liability and punishability should be expanded in such a way as to give decision makers and actors good reasons for safeguarding outsiders, and in such a way that damages can always be recovered from the responsible decision maker(s) and/or actor(s). Whether or not there are norms and supervision. Politicians and supervisors should not be excluded from liability and punishability.

The "effective" in "effective coupling" also refers to the procedural law.¹⁶⁴ In combination with the

¹⁶² Not to speak of the perceived requirement of always defending past decisions and activities, however indefensible and however harmful. The perception of this requirement can be seen as part of the culture of the top of both industry and politics. Of course, it violates the integrity principles of chapter 4.

¹⁶³ Not in the USA, not in the Netherlands. In this respect there is no difference between these states whatsoever.

¹⁶⁴ Procedural law regulates the administration of justice. Especially but not only the functioning of the courts. Substantive law describes all other rights, obligations, and other stipulations with the status of law. Examples of substantive law are: civil law, criminal law, budget law(s), laws instituting all kinds of agencies, the appointment of their heads, their duties, etcetera. Procedural law provides the means to enforce substantive law if and as indicated by substantive law. Without procedural law, substantive law may be misleading. With different bodies

substantive law, procedural law should be improved in such a way as to safeguard innocent outsiders as fully as possible, and make the responsible decision makers and actors repair or compensate damage caused as completely as possible, and if they can't, punish them. Procedural law should be subordinated to the safeguarding principle. Line managers for example should always share in the liability for activities or omissions of their unit.¹⁶⁵ Their share should only be reduced if they can prove for example that the damage is due to activities or omissions which are contrary to their directives, as proven by the absence of proof of their agreement¹⁶⁶ and by the other activities and omissions of their unit.

Essential aspect of the “effective” is the transfer from politics to the judge. The evidence presented in this report shows that politicians share too many interests which are contrary to the interests of the people they are supposed to represent. They cannot be trusted.

Governmental organizations are only evaluated by themselves or interested parties.

This subsection presents more supporting reasons for the measures indicated in the preceding subsection. In addition, it points out a deficiency of democratic constitutional states which affects all or almost all cases mentioned in this report.

Governmental organizations, including organizations called into being by laws, have distinctive characteristics. An essential characteristic is that their budget is provided by a ministry. Every year there are discussions between the ministry and the organization about the budget for next year. At least as regards their budget, these organizations are dependent on the ministry. They are responsible towards the ministry for the way they spend their budget. This is important because it may engender a conflict of interest between their formal duties and financial interests. Reality is that a minister or secretary wants every outsider to think that his organizations are perfect, and that he is in full control of them. For this reason these organizations in general are shielded by their ministry. At the same time a ministry should evaluate the operation of its organizations critically. It should evaluate them from a neutral, independent point of view. They never do however.¹⁶⁷ Ministries never evaluate their organizations critically, as a truly independent outsider would do. Critical evaluation creates a risk for the reputation of the minister, and for the budget of the ministry. Many of the cases studied here involve dysfunctional government organizations. None of the cases shows a critical attitude of a parent ministry. Instead, parent ministries show a shielding and defensive attitude.

As regards their work, civil servants are responsible towards their superiors. The same applies to the superiors; the highest in the hierarchy being responsible towards the minister. Who always is a politician. In the given constitutional framework, politicians are evaluated only by their peers. For a civil servant inside an organization, the law only exists in so far as his management respects it. The management knows that not all legal precepts or instructions mean what they appear to mean. They know too that many stipulations are not accompanied by rules sanctioning infringement. Which means that such stipulations can be ignored with impunity. And they are ignored in fact, even in important cases. Where “important cases” means: cases with large and extensive consequences. The rules

of substantive law may correspond different procedural laws. Such as “criminal procedure”. Not all stipulations of substantive laws are enforceable. For more information the reader may be referred to an encyclopedia or textbook on law.

¹⁶⁵ A line manager is a manager who is a constituting part of the hierarchical pyramid. An employee at the base of the pyramid is connected with the officer at the top (CEO, minister, what have you) by a series of line managers. Of different levels. A series in a ministry could be: employee, head of section, head of department, director-general, secretary-general, minister. As a general rule, formal communication, and communication about anything substantial, between any levels and between parts of the organization, is forwarded through the line managers concerned.

¹⁶⁶ For example by a signature for approval of the proposal for an action or omission.

¹⁶⁷ Outsiders might think that the positive picture is only painted for the outside world, and that behind the scenes one knows better and has a neutral and critical attitude. But 1. there is no evidence supporting this view (while there is ample evidence for the contrary view); and 2. the experience of about 25 years of the author at the ministry of education of the Netherlands is that the subsidized organizations are never seriously evaluated or criticized. Note that this is consistent with the observation of always increasing government budgets, and increasing inefficiency of services provided by government-paid organizations.

concerning integrity, duty and whistleblowing are examples. All cases show that these rules have no practical significance. Even though it is clear for example that openness of the organizations of the supervisors would almost certainly have given rise to much more and well founded discussions of the risks of the financial system. Open discussions would have made a crisis much less likely. It could easily have prevented them. Other examples are the complete neglect of the systemic risk duty by the Fed, the almost complete neglect of this duty by DNB, the absence of control of the supervisors by governments and parliaments,¹⁶⁸ and the dishonorable and unprofessional evaluations of government organizations by the Dutch General Accounting Office (DGAO).¹⁶⁹

A fundamental and important difference between politicians and government organizations on the one hand, and private citizens and organizations on the other, is that much damage due to mismanagement and misconduct of public administration is not justiciable, and that it is not judged by independent judges but by the peers of those responsible, often including those responsible themselves. The inquiry commissions are an example of this “regulation”. They fit perfectly in the system: the law is made by politicians; private citizens and organizations are judged by judges, and politicians and government organizations are judged by politicians. None of the actions or omissions of governments, parliaments and supervisors that have caused or should have prevented the crises, is justiciable.¹⁷⁰ As a consequence everyone who contributed actively to the creation and extent of the crises, or could and should have taken action to prevent them, can enjoy the fruits of his parasitism in perfect freedom. These people were and are remunerated as if they always did their job properly.

Public administrators have effectively placed themselves above the (normal) law.

4. Hierarchical organization.

How faulty regulation of hierarchical organization, dishonorable and incompetent heads, and lack of control, supported a long and undisturbed growth of the explosive power of the crisis.

Preliminary notes.

The most important elements of the empirical basis of this subsection are:

- The Chronicle of the crises;
- The annual reports of the supervisors (including BIS, IMF and OECD);
- The preceding chapters;
- The next chapter, especially the sections about whistleblower cases.

As elsewhere in this study (and reality!), omissions may be just as important evidence as actions.

The subsection may use conclusions of other (sub)sections of this Analysis, including later (sub)sections.

Summary and conclusions.

1. For all practical purposes hierarchical organizations are dictatorships. The three powers, legislative, executive, and judicial, are united, instead of separated as in society at large. Hierarchical organizations are allowed to be opaque: nobody can see and know what goes on inside, and only the head or his spokesperson is allowed to tell the rest of the world what the head wants the world to believe about the organization.

¹⁶⁸ Strictly speaking, supervision of the supervisors by governments and parliaments is not explicitly prescribed by law. However, supervision is regulated by law, the heads are appointed by the government, and at least in the Netherlands supervision is generally paid with taxes. The law also describes the purpose of the organization. Governments and parliaments receive their annual reports. At least implicitly they have to either approve the operation of the supervisors, or give their comments. Finally, it is evident that if governments and parliaments are responsible for the safe operation of something, say the financial system, they have to actively monitor this operation, and act where and when necessary. In the case of the financial system they obviously didn't.

¹⁶⁹ In Dutch: Algemene Rekenkamer. The DGAO evaluates ministries and many other government organizations. This is therefore clearly a major problem.

¹⁷⁰ Some banks and some of their employees have been brought to court. See the FCIC report, and annual reports of the SEC and possibly other supervisors for the years following the subprime crisis. Analysis and outcomes of the cases show the weakness and ineffectiveness of the law for corporations, in agreement with earlier remarks.

2. The political system appointed dishonorable and incompetent secretaries of the Treasury and heads of supervisory and other organizations. These people did not understand risks, denied and/or underestimated them, and so on. They ignored or did not understand signals from their employees. They rejected them without sound arguments, and could not or did not discuss them properly. The principal persons were not listening and tolerant, but repressive.
3. Governments and parliaments, and only they, are responsible for a regulation of hierarchical organizations that enables dishonorable and incompetent heads to remain in power notwithstanding dysfunctioning of themselves and their organization.
4. The inadequate regulation of hierarchical organizations, together with a lack of supervision, must be held responsible for the stability of a disastrous complacency of these organizations and their heads, and of their insensitivity to, and repression of, other points of view.
5. The inadequate regulation of hierarchical organizations, together with a lack of supervision, must be held responsible for the insensitivity of the top management of the supervisors for warnings and proposals from their own employees. The supervisors had more than 10,000 employees, many of whom were highly educated. It is unthinkable that none of them accepted the conclusions of the GAO of 1994-1999 and OFHEO's systemic risk report of 2003, and that none of them tried to bring the management to its senses. The fact that the management didn't listen and respond constructively proves its incompetence, if not its lack of integrity.
6. Employees had insufficient possibilities to get a hearing for sound arguments, and to ensure responsible operation of their organizations. Apparently, integrity codes and whistleblower regulations had insufficient practical significance.
7. The concept of "organization culture" suggests an equivalence of employees which in hierarchical organizations does not exist. Employees have to comply with norms and values set by the management. The concept "organization culture" can only have been invented to (wrongly) suggest that the top management cannot be held responsible for everything the organization does and does not. That it has to cope with an organization culture it does not approve of.
8. Discussions in governments and parliaments about matters pertaining to the financial system were characterized by a lack of common sense and sound reasoning. Governments and parliaments seemed unable to distinguish sense and nonsense, or refused to make this distinction. Maybe because it would threaten interests and/or unfounded but inviolable dogma's. They allowed or actively supported repression, and stifled critical discussion. They maintained regulation which permitted principal persons to manage their organizations as dictators, and which excludes self-correction.
9. Together with the absence of effective correcting forces, the repressive attitude of the politically appointed heads explains the stability of the supervisory and deregulation policy 1995-2007.
10. Present regulation of hierarchical organizations precludes early warning of society about activities or omissions of hierarchical organizations which create (great or even extremely great) social risks.
11. Even though the inquiry commissions were requested to discover the causes of the subprime crisis, they gave no attention whatsoever to the operation of organizations as organization, or to any of the preceding conclusions. They give no explanation for the fact that government and supervision have failed notwithstanding thousands of highly qualified experts.

Measures which seem necessary to prevent the observed dysfunctioning are listed at the end of this subsection.

Introduction.

The crises were caused by dysfunctioning hierarchical organizations. This subsection analyses the empirical evidence about the operation of hierarchical organizations as organizations that may shed light on the causes of the dysfunctioning. Organizations operate in accordance with, and within the bounds set by, applicable regulation. Therefore special attention is given to the relation between the dysfunctioning and regulation of hierarchical organizations. The subsection also explains how large organizations can dysfunction seriously notwithstanding thousands of highly qualified employees.

Much of the dysfunctioning can be attributed to dangerously inadequate regulation. The respons-

ability for the regulation lies with governments and parliaments. Only they make laws. Still, part of the blame for the fact that nothing is changed goes to the inquiry commissions. They were silent about all subjects mentioned in this subsection.

As usual in this study, the analysis tries to discover causes which are changeable. The analysis of this subsection makes quite clear what must be done to ensure that hierarchical organizations fulfill their duties, and to avoid that they endanger society. The result is the list of measures which concludes the subsection.

Most of the following concerns hierarchical organizations in general. But some specific discussions may concern only supervisors, or organizations with a public mission. This is not a serious restriction: with minor changes the text applies to organizations with other missions.

Hierarchy and dictatorship.

Someone who observes reality as revealed by the subprime crisis and other cases without prejudice will conclude that “hierarchical organization” is hardly more than an euphemism for dictatorship. Sometimes perhaps an enlightened dictatorship, but at other times certainly just as oppressive.^{171, 172}

Those who think that the word “dictator” is too strong should study some whistleblower cases, and realize that a dictator does not dictate everything for everybody. Dictating every detail is impossible. It is not in agreement with the facts of dictatorships which are generally acknowledged to be a dictatorship. A dictator is the head of a hierarchy. It is true that proportions and the consequences of contradiction are important and may (but need not) differ a lot.¹⁷³ But contradiction can easily be limited or prevented (or promoted!) by selection and seemingly subtle means.¹⁷⁴ And several whistleblower cases show that in hierarchical organizations in democratic constitutional states dissenters can be terrorized as if laws don’t exist. The difference between a dictatorship and a hierarchical organization is not fundamental but gradual. It is not hard to imagine a dictatorship which is mild as compared to some of the hierarchical organizations operating in and around the financial system.

That only few people see the heads of hierarchical organizations as dictators can be explained by:

- the use of the terminology “(hierarchical) organization” and the restriction of the terminology “dictatorship” to states which are far away from ours in space and time;
- the general acceptance of the idea that everybody has a boss;
- the general acceptance of reality as the norm;
- the success of the efforts of the management to give their employees the illusion that they have influence, and
- the selection of employees who perceive hierarchy as normal, good and/or necessary.

Another factor is the control of information by the management: employees do not know what is happening in other parts of their organization. They may not even know what orders have been given (“requests have been made”) to their own managers.

For many employees their job is their life, or a very important part of it. In general they want to keep it, and some of them are ambitious. This affects the way they look at their organization and its management. It is a matter of self-interest for many employees to try and interpret events which they observe in their organization positively.

Union of powers. Unity of opinion. The irrelevance of codes.

In hierarchical organizations there is no separation of powers. Execution, regulation and evaluation are in the hands of one and the same management; the same individuals. Which is of course a

¹⁷¹ Regrettably, the author knows of no reliable studies of this subject.

¹⁷² Of course, one will not notice repression if one always says yes and amen and believes in Leaders.

¹⁷³ Contradiction of the dictator: opposition.

¹⁷⁴ The experience of the author in more than one (hierarchical) organization shows that very little pressure is sufficient to silence most people completely.

fundamental characteristic of a dictatorship.¹⁷⁵ And completely contrary to what is considered desirable and normal in democratic constitutional states.

The absence of separation of powers is essential for the practical significance of codes of conduct, integrity codes, and similar sets of norms. The codes are made by the people who supervise compliance, including compliance by themselves. This presupposes integrity of the top management. However, in all cases considered we saw that the assumption of integrity of the top management is incorrect.

The run-up to the crises, the crises themselves, and the hearings, demonstrate the practical irrelevance of the codes. The Chronicle and appendices teem with examples. The following example is exceptional (and slightly comical) in its clarity:

«Integrity. To ensure trust in Fannie Mae, Fannie Mae must be trustworthy.

Every individual at Fannie Mae- from our Board of Directors to the Chairman and CEO to senior management to every employee- is held to the highest standards of honesty and integrity.

Integrity is woven into the Fannie Mae culture. As CEO, I strive to establish the highest standards of integrity by policy and by example. Our highly independent Board of Directors holds me, as CEO, as well as senior management and the entire company, accountable for our high standards of integrity. The Board of Directors and each employee sign explicit Codes of Conduct, which are available on our corporate Web site, fanniemae.com. Fannie Mae's corporate justice system and a range of checks and balances provide three-dimensional protection of our integrity.»¹⁷⁶

This is written by Franklin D. Raines, Chairman and Chief Executive Officer of Fannie, in his letter to the shareholders, in the first pages of Fannie's annual report 2002. He was lying:

«In September 2004, [Fannie's supervisor] OFHEO discovered violations of accounting rules that called into question previous filings. In 2006, OFHEO reported that Fannie had overstated earnings from 1998 through 2002 by \$11 billion and that it, too, had manipulated accounting in ways influenced by compensation plans.»¹⁷⁷

In Fannie several if not many people must have known about the fraud. Is it credible that everybody approved? In spite of having signed a Code of Conduct?!¹⁷⁸

For a simple employee, the union of powers may make use of the freedom of speech quite risky (supposing it applies). Everybody knows that free use of this freedom may affect one's career negatively, if not destructively. All cases in this study, and the report of the FCIC, show repression. None shows promotion because of justified criticism. In fact, the author doesn't know a single example of such a promotion.

Although the documents contain very little empirical information about it, in the organizations concerned with the financial system there must have been as many opinions as people. There must have been differences of opinion about the consequences to be attached to the risks pointed out by the GAO and to its recommendations. However, neither in their operation nor their annual reports can anything be discerned about internal reflection or discussion about these questions. Differences of opinion are never acknowledged.

The hierarchical structure of organizations, and the legal framework in which they operate, facilitate suppression of opinions differing from those of the top management. Everything in the organization depends on the openness, integrity and competence of the top. If these are seriously deficient, employees have no other choice than submission or departure.¹⁷⁹ The phenomenon is

¹⁷⁵ At least in practice, for in many dictatorships the three powers are formally separated. Of course, to mislead the population and help clients to defend the system.

¹⁷⁶ Fannie AR 2002 p. 5/7.

¹⁷⁷ FCIC report p. 122/150.

¹⁷⁸ Why has this not been noted by the FCIC?

¹⁷⁹ In this report, departure is seen as "passive selection", active selection being the procedure which the management applies when it wants to get rid of an employee and replace him or her by an other one.

remarkable, because it would be very easy for the top management to do it very differently. After all there is no real need for the unrealistic suggestion that the organization has only one opinion. On the contrary: logically speaking it is in general plain nonsense to suggest that there cannot be any doubt about the correctness of conclusions, decisions and policies of the organization (= its top management). In general the suggestion that there can be no doubt is simply stupid and misleading.

Quite apart from theoretical considerations, the Chronicle, annual reports, and hearings show very clearly that the internal checks and balances of organizations, if present, failed completely. This also applies to possible whistleblower regulation and codes of conduct. Nothing in the sequence of events betrays a positive influence of their existence.¹⁸⁰

The fiction of an organization culture.

The concept “organization culture” is misleading nonsense. The concept suggests an equivalence of employees which in hierarchical organizations is merely imaginary. Employees have to comply with norms and values set by the management. Not by what the management says, but by what it gives and does not give its signature; by who is and who is not promoted; and by who is given and never given a gratuity. In the end, all this is determined by the top, and by nobody else.

Experience shows that employees consider codes of little consequence, and ignore them. Instead, they closely watch the decisions taken by the management. Especially the decisions about promotions to and within the management. That is what (operationally) defines (embodies) the norms and values of an organization (the “organization culture”). Many employees never adopt these norms and values. They try to avoid dilemmas or try to find compromises between how they think things should be done and how they think the management wants them to be done. Thereby losing their chances for promotion. In other words: suggesting that the employees of an organization share an “organization culture” is misleading, and an insult to many employees. An organization doesn’t have a single culture. And the culture of an organization certainly is not defined by a published code. One should at least distinguish between the culture of the top management and the culture of most of the employees in the basis of the hierarchy.

The top of hierarchical organizations has an interest in making believe in the fiction of (a single) “organization culture”. If an “organization culture”

- would really exist,
 - would exist independent of the top management, and
 - would have characteristics hampering the proper operation of the organization,
- then it could also hamper the proper functioning of the top management. Belief in a single culture, voluntarily and collectively adopted by all employees of an organization, implies belief in a shared responsibility for everything that is happening in an organization, and for what it does in society. Someone who forgets the hierarchical nature of the organization and believes in a kind of autonomous organization culture may conclude that the top is the victim of this culture. Because changing a culture is difficult, or is at least said to be difficult, the fiction of an autonomous organization culture furthermore supports the claim that it is difficult to change an organization. But actually it is only a fiction. In reality the top defines and dictates the culture. The only thing needed to change the culture is to change the top.

The inquiry commissions treat organizations as single persons, ignore thousands of employees, and pay no attention to the internal operation of organizations.

The reports and hearings of the inquiry commissions show that their mental picture of hierarchical organizations is anthropomorphic.¹⁸¹ The commissions see an organization as a single person. None of

¹⁸⁰ A negative influence of the codes is its misleading or defrauding effect on prospective employees and outsiders. The codes suggest a guarantee. They are meant to suggest that the organization can be trusted. People did trust them, but the trust was not justified at all.

¹⁸¹ Anthropomorphic means: having human form, is like a human. In the present context: organizations are considered as, and thought and reasoned about as if they were people. They aren’t. Sometimes “doing as if” may be harmless. But often it is misleading, unjust, etcetera: simply unfounded and wrong. An assumption which

them questions the present day legal framework of hierarchical organizations. As a rule,¹⁸² the inquiry commissions see only the top of organizations, and seem to think that it is representative. However, there is no logical reason for believing that the formal representative of an organization represents the organization in any other sense. A hierarchical organization is not a democracy. The head of a hierarchical organization need not do or say what everyone or a majority of his employees thinks or advocates. The inquiry commissions do as if no distinction needs to be made between formal appearances and reality. They show no interest in the internal operation of these organizations. Even though they knew or concluded that in the years preceding its culmination none of the organizations involved in the crisis operated appropriately. They do not explain how this tallies with their assignment: finding the causes etcetera.

There is little in the reports of the CDW and FCIC, and in the reports of their hearings, that shows that the principal persons in supervision and government were heads of (very) large organizations. There is even less that shows that together they had more than 10,000 (ten thousand) employees.¹⁸³ If the principal persons show that they are aware of being member of an organization, it is hardly more than a formal recognition or lip service.¹⁸⁴ They never explain how it is possible that none of their brilliant, hard working employees¹⁸⁵ saw the systemic risk of mortgage backed securities, repo markets, etcetera, and why internal reports and warnings were shoved aside. The inquiry commissions didn't ask for an explanation. Nowhere do the principal persons report internal differences of opinion, doubts, discussions, proposals for policy changes and so on. Even though their absence is inconceivable. The principal persons don't behave themselves as representatives of the organization. They behave as if they are the organization; as if nobody else matters.

That the inquiry commissions pay no attention to the fact that organizations not only have a head but also a body consisting of thousands of employees is especially remarkable because the commissions were asked to find the causes of the subprime crisis. Of course one can conclude that by doing as they did, they implicitly confirm the egocentrism of the principal persons and the dictatorial nature of hierarchical organizations. Still, the commissions fail to point out that abuse of power by dictatorial managements may be part of the cause of the crises. They don't seem to see a need for explaining that government and supervision have failed notwithstanding thousands of highly qualified (educated) experts.

Repression in hierarchical organizations, and its dangers for society.

It is at any rate unbelievable that all employees were convinced that everything was under control, and that all of them were blind to the risks. Even if the education is inadequate, there were GAO reports too. The attempt of Born of the CFTC to make the OTC market more transparent was widely publicized. It is probable that Born acted on the initiative of employees, for that is how hierarchical organizations work. Just like Born, the heads of other supervisory organizations, and the Treasury (under)secretary, must have received this kind of signals and proposals.¹⁸⁶ There is no evidence of any adequate reaction. The managers must have thought they knew better, thought wishfully, or found political desirability and/or conformism more important than the requirements of their duty. And they had the power to ignore any signal or proposal, and to silence the messenger(s).

The reactions to the GAO reports and the initiative of the CFTC of those in power in the financial-

leads to erroneous conclusions. An *anthropomorphism* is an assertion or argument in which a non-human object is treated as if it were a human being. Always beware!

¹⁸² A minor exception is Moody's, in the FCIC hearings on 20100602. See the hearing reports under that date.

¹⁸³ The numbers of employees of the most relevant supervisors are given in the corresponding appendices.

¹⁸⁴ Wellink for example asserts that he means "we" when he says "I". While his material assertions are incompatible with the annual reports and OFS publications of his DNB.

¹⁸⁵ As they assert explicitly in their annual reports.

¹⁸⁶ The FCIC report gives several examples of signals which were ignored, but only or mainly in financial institutions in the restricted sense. Of course, the reports of the GAO of 1994-1999 are the most important example, but of external origin.

political world were no more than dogmatic wishful thinking arguments.¹⁸⁷ Nobody using his brains could and would rely on self regulation, and everyone using his brains and knowing the main facts would come to the same conclusions as the GAO and CFTC.¹⁸⁸

After Born had been shoved aside, every well-informed and thinking observer could conclude that the establishment didn't want to acknowledge the risks indicated by GAO and CFTC, and didn't want to do anything about them. He could conclude that the establishment would silence everyone pleading for more transparency or regulation. That Rubin and Summers (both of the Treasury), Greenspan (Fed), and Levitt (SEC) form a closed front, endeavoring to eliminate all opposition. This explains why since 1999 nothing is heard anymore in the vein of the GAO reports, or of the CFTC proposals. The situation must have been felt to be hopeless. Everyone had been terrorized.^{189, 190}

The BIS-CGFS reports of 2003 and 2005 can be presented as evidence showing that at least part of the employees of the supervisors knew better. The reports leave very much to be desired. They suggest a lot of compromising, suppression and repression. Which implies that quite a few of the employees must have taken the risks much more seriously than the establishment. It is remarkable that DNB and Fed, and probably most others, did little or nothing with these reports.¹⁹¹ However, in the context of this subsection the most important observation is that there were signals, not only in 1994-1999 but also in 2003-2005, and that the managements kept ignoring them.¹⁹²

If we take into consideration everything we know about hierarchical organizations, then it seems almost certain that there have been employees in all ministries and supervisory organizations who spoke up, but were not listened to by their management. And in case they didn't give up: there is unambiguous proof of repression.¹⁹³ Namely in the hearings of employees of Moody's and the case Born. The hearings speak for themselves. As regards the case Born: isn't it extremely improbable that persons like Rubin, Summers, etcetera, are more tolerant and open towards their employees than towards colleague Born? The case Born very clearly shows how these people handled common sense warnings.¹⁹⁴ In short: it has to be assumed that the principal persons got signals not only from outside, but also from their own employees. They ignored and repressed them all. As is clear from the quasi-arguments, facts and hearings, they did so for no good reason. The fact that warnings were not heeded can only be due to the concerted use of power by dishonorable and incompetent people.

Of course the inquiry commissions should have looked for the relevant facts and explanations. As it is, they say almost nothing about the internal operation of any of the organizations involved in the subprime crisis. They give it no analytical attention whatsoever.

Here it is concluded that from the large group of employees signals must have been sent up to the principal persons, accompanied by proposals for solutions. But only in too few exceptional cases did principal persons take them for what they were worth. In general top managements preferred stupid dogma's over common sense, and abused their power to silence dissenters in and outside their organizations.

¹⁸⁷ The Wiki-page about Brooksley Born calls the arguments "neoliberal" or "neoconservative". See the dossier or the Wikipedia. The page speaks of a "war of ideologies". This seems unnecessarily mystifying and politicizing. There is no need for difficult words or references to schools or ideologies. The supposed convictions of Greenspan et al were based on nothing more complicated than blind faith and/or wishful thinking. As Greenspan later admitted. If the metaphor "war" is applicable at all, then it refers to a war not of ideologies, but of sense against nonsense.

¹⁸⁸ Of course, the use of ideologies (= hypothetical or even falsified theories), is equivalent to not using one's brains.

¹⁸⁹ See also the episode about Born and Summers beginning after about 24 minutes in *Inside Job*.

¹⁹⁰ Merriam Webster 2002: terrorize= to fill with terror or anxiety.

¹⁹¹ A fact that isn't noted by CDW and FCIC.

¹⁹² Note that the GAO did note the OFHEO systemic risk report.

¹⁹³ At the same time nothing betrays any tolerance, openness or similar virtues on the side of the principal persons with respect to people having different opinions. Why don't the principal persons say anything about internal discussions? Have no such discussions been held? Of course there were. It is all very strange. Because minutes are made of almost all serious meetings in organizations this could be checked easily. At least if you really want to find causes, and really want to explain.

¹⁹⁴ In *Inside job* Gnaiza says that he personally warned Bernanke. Bernanke showed no sign of relevant thinking.

From this it follows that:

- The political system appointed dishonorable incompetent principal persons who did not understand risks, denied and/or underestimated them, and so on; did not understand or ignored signals from their employees, or rejected them without sound arguments; and could not or did not discuss them properly. The principal persons were not open but repressive.
- Employees had insufficient possibilities to get a hearing for common sense. Apparently, integrity codes and whistleblower regulation had insufficient practical significance. The hierarchy operated as a repressive dictatorship.
- Governments and parliaments may not have realized the dangers of the combination of hierarchical organization and inadequate heads.¹⁹⁵ They did not supervise properly. They weren't able to distinguish sense and nonsense, or refused to make this distinction because it would threaten unfounded but inviolable dogma's, interests or whatever. They supported or participated in repression, and stifled critical discussion. They maintained regulation which permitted principal persons to manage their organizations as dictators, and precludes self-correction.

Conclusions.

The above shows and explains the possibility of long term dysfunctioning of hierarchical organizations. Prime causes are the (political) appointment of unsuitable heads in combination with de facto nearly absolute powers, and the absence of adequate checks and balances. Heads of hierarchical organizations, especially (semi) governmental organizations, have the possibilities to stay in power regardless. Their formal accounting obligations are limited, and their practical accounting obligations almost nil. The chapters about the Dutch ministry of education, the whistleblower cases, and the hearings of the employees of Moody's by the FCIC show without exception that asking attention for dysfunctioning have only one result: repression of the employee-messenger. The law facilitates this. The conduct of ministers in and around the cases suggests that this is intentional. In the given circumstances there is no incentive for self correction.

The observations of this subsection furthermore explain why the quality of an organization need not be proportional to the number and quality of its employees. Neither is it proportional to the relative number of highly educated employees. It is the quality of the top, and especially its integrity and openness, which determines the quality of an hierarchical organization. The subprime crisis and other cases show that as a rule this quality is very insufficient.

The insufficient integrity and competence of the top can be blamed on

- the unsound way of appointment of these people;
- the implicit selection of people who imagine being able to do the impossible;
- the lack of incentives for proper fulfillment of duties, or the lack of sanctions for non-fulfillment.

In other words: the lack of liability and punishability. Notwithstanding the kind and reasonable impressions heads make in public interviews, when cameras and microphones are absent they may behave as repressive dictators with impunity, using their power to create a glorious image of themselves and their organization, and keeping information about dysfunctioning indoors. For employees there is almost no protection against retaliation for voicing criticism. They can do nothing if the top ignores its own code of conduct or similar codes.

It should not be forgotten that the situation means great injustice with respect to everybody who stood up for society and was silenced explicitly or implicitly, and was consequently limited in his or her personal development and career. Most of all towards people who were "selected away" because they didn't want to work in organizations with two faces.

In a theoretical analysis, the hierarchical character of an organization can be distinguished from the appointment and quality of the top. From a superficial theoretical point of view a hierarchical organization could have an adequate top: honorable and competent. But upon reflection there are seen

¹⁹⁵ If they wanted to abolish the safety net of liability they should have understood. Governments and parliaments should know what they are doing, and otherwise not meddle.

to be at least three problems:

- If the duties of the top are too extensive and/or difficult, and/or require more than any human being can provide, then nobody is truly competent. Somebody who nevertheless claims so is by definition dishonorable;
- Dishonorable and incompetent top managers have plenty possibilities to keep themselves in power;
- It is in their interest to help and shield each other. It is also in their interest that there are no honorable and competent people in their neighborhood. Such people could expose them, and might feel obliged to.

The phenomena indicated in the last two points can be seen in all the cases studied. Possibly the best in the history of the subprime crisis (including its official inquiries).

Finally it should be noted that repression of criticism in hierarchical organizations increases the risks for society. The risks for society are increased already by coloring the concepts critical and criticism negatively. It is harmful to suggest that a critical attitude means a pessimistic and negative attitude. It causes systematic underestimation of risks. In the selection of employees it may be understandable that preference is given to people who make no or less “difficulties”, but is risky as well. Especially when this is done systematically, and all managers are “optimists” disliking (thinking) “pessimists”.¹⁹⁶ In general the selection bias results in a population of employees who are (relatively) docile, and either do not reflect, or only tell their managers what they think if they expect a positive reaction. Often the top is intolerant with respect to other opinions than its own, and does not want to hear other opinions more than once, if at all. As clearly demonstrated by Greenspan, Summers and others in the case of the financial crisis, and in the cases in the Dutch education ministry.

By this mechanism hierarchical organizations make themselves blind to misconduct, errors and risks. Including risks for their environment.

The following measures seem to be necessary to prevent the observed dysfunctioning:

1. All jobs, duties, etcetera should be executable properly, given formal responsibilities. Including or especially the jobs of the top managers and heads of organizations. Sometimes this will require reorganization, for example by redistribution of formal responsibilities, splitting up of organizations, and sometimes discontinuation of certain activities;
2. The dictatorial form of the hierarchical organization, without separation of powers, should be abolished. Organizations should have believable mechanisms for the maintenance of codes and for (self) correction;
3. Selection and evaluation procedures should ensure that people are evaluated as regards honorable and competent fulfillment of duties. (This presumes point 1, and excludes political appointments);
4. Suppose that in an organization with a public purpose such as supervision there are different well founded opinions about the fulfillment of the duties of the organization. Then these should be made public, together with their substantiation, at least in the annual reports of the organization. Difference of opinion is normal and should be tolerated and functional. The pretension of certainty about any single opinion is misleading and dangerous;
5. Liability and criminal law should be aimed at preventing causation of damage, and at reparation or compensation if damage has been caused. It should prevent dysfunctioning that can cause unbearable risks. It should therefore also prevent appointment of dishonorable and incompetent employees;¹⁹⁷
6. If the management does not adequately respond when an employee reports dysfunctioning, then the employee may appeal to an independent outside judge. (In accordance with separation of powers). If the judge declares that the report is well founded, then the employee should be rewarded, and the dysfunctioning employees compensate all costs they have caused to be made. Including the costs of the correction of the effects of their dysfunctioning. In addition they should

¹⁹⁶ Note that this goes a far way towards explaining the systematic character of (project) budget overshoots.

¹⁹⁷ Again: 1. “Incompetent” means: not sufficiently competent for the given function; 2. Everyone on the paylist of an organization is called “employee” in this study. Including the CEO and other top managers.

be punished. They should be evaluated (by people independent of the organization) to see whether they are fit for their functions. In general this will entail a change of function or dishonorable discharge (for proven unsuitability). The employee who rightly reported keeps his function. Obstruction of this employee will be punished with dishonorable discharge.

Most of these measures will return in this or another form in chapter 9.

5. No supervision of supervision. Supervision and government policy: a risky combination.

The Chronicle, the annual reports and other reports of the supervisors, and the reports of the CDW and FCIC show clearly that governments and parliaments have failed utterly in their supervision of the supervisors. This may even be a misleading understatement. It may be more correct to assert that they did not supervise the supervisors at all, except to make sure that supervision did not interfere with their reckless policies.

Both in the USA and the Netherlands attentive reading of the annual reports of the supervisors was enough to see that the supervision was inadequate. Already at the time of their publication. For substantiation the reader is referred to the appendices, and of course to the easily accessible annual reports themselves. The reports are not adequate as reports. They do not report properly about the activities. Of some important activities nothing is reported.

Not only the responsible ministers and parliament could and should have known this, but the media too.¹⁹⁸ It could and should have been known to everyone concerned with the financial system that the supervision was inadequate, and that this greatly increased the risks inherent in the financial system. Everyone could have noted that none of the supervisors, governments and parliaments reacted adequately to the analyses and recommendations of the GAO of 1994-1999, and those of OFHEO and GAO of 2003-2004. Even though these reports explicitly concerned systemic risk. Everyone should have understood that the relevance of these analyses and recommendations grew even faster than the financial system itself.

The annual reports (and other reports) could and should have given rise to questions for the supervisors. Material questions too. But questions were not asked. In the years 2000-2010 no improvement of the annual reports is noticeable.

The crisis is a confirmation of the failure of the supervision of the supervisors. The crisis is the empirical proof of what is shown by analysis of the documents.

It is not difficult to imagine mechanisms enabling people outside government and parliament to contribute to the supervision and where necessary correction of supervisors. Citizens could be given the right to appeal to a specialized independent judge with complaints about a report of an organization which is paid in a large part by taxpayers money. The judge could assert that the report as such, or matters which are referred to in the contents, are not up to specified generally accepted standards. The judge could order correction. He could set a time limit for correction. He could fine responsible employees, or have them fired, because of proven lack of integrity and/or competence.

Obviously such judges and their assistants are not to be appointed directly or indirectly by (ex)politicians.

It is not self evident that a given system of supervision covers all relevant institutions and activities. At several points the FCIC mentions unregulated and quasi-regulated activities. The attempt of Born of the CFTC to get OTC regulated more effectively cost her her job. The organization of the supervision is a form of regulation, and therefore the responsibility of government and parliament. It is their responsibility to organize and regulate the financial supervisors in such a way that the financial system operates for the benefit of the general welfare, and operates without making innocent victims. In part, governments, parliaments and supervisors seem to have failed as a consequence of belief in self-

¹⁹⁸ It is true that it may be a problem that a majority in parliament is simply dumb, acting authoritatively and irresponsibly, without proper argumentation. Just using the power of the majority. Obviously, citizens should have possibilities to do something about such a situation.

regulation and deregulation. In the first place they should never have believed any such thing. The belief was based on unproven illusions. The belief proves their inability to reason properly. The use of such a belief as the foundation for the execution of a highly responsible job proves their utter incompetence. But even if some form of belief is considered acceptable, then the knowledge that not everyone believed should have made them realize and accept the possibility that they were wrong. They should have understood that a mistake of this type might have disastrous consequences. They should have managed this risk. They didn't. They put all their eggs in one basket. So once again they did not behave as professionals but as reckless gamblers.

Many words have been wasted on the powers of supervisors. They are wasted and misleading because in the run up to the crisis their powers have never been a problem. See the annual reports of the supervisors. There were big problems with supervision, but they had nothing to do with powers. The supervisors had many more powers and possibilities, but appropriate use of the freedom to publish annual reports would have been enough to prevent a subprime crisis.¹⁹⁹ As long as a supervisor can inform government, parliament and the public, there need not be a problem of powers. Government and parliament have all the powers they want. The real problems of 2000-2010 were that the supervisors were authoritative and repressive, that their policies were dominated by faulty dogma's, and that they had no risk management. This was combined with the failure of parliaments and governments to supervise the supervisors. Parliaments and governments too were dominated by faulty dogma's and the absence of risk management. Their attitude seems to have been based on the idea that everything goes well of its own accord.²⁰⁰ The Fed completely (= 100%) ignored one of its four main responsibilities: that of «[maintaining the stability of the financial system and containing systemic risk that may arise in financial markets](#)».²⁰¹ Administration nor Congress seems to have noticed. At any rate they took no action. Why worry if all goes well?

The conclusion must be that there were and are big problems indeed, but that they had nothing to do with powers. And it should not be forgotten that giving dishonorable and incompetent people (more) powers definitely creates (new) dangerous risks.

Governments and parliaments want all kinds of things, often without bothering about contradictions (and costs). As a consequence they may create conflicts of interest or unsolvable problems. These may be transferred to supervisors. For example if they are not only to supervise ([to ensure the safety and soundness of the nation's banking and financial system](#)), but also to take account of government policy.²⁰² In other words: supervisors may have to compromise between their supervisory duties and contributing to government policy. The alternative may be: obstructing government policy. In such a situation it may be impossible to fulfill a supervisory duty properly. This conflict is evidenced in the Fed. A quote in the FCIC report from its hearings shows that the Fed perceived affordable housing policy as a priority.²⁰³ It is clear that this means asking for problems.

It isn't clear whether other supervisors had to take account of governments policies as well, or wanted to do so voluntarily. At any rate they say nothing about it in their annual reports.

The inquiry commissions say nothing about this.

6. Inadequate appointments.

¹⁹⁹ No democratic government can afford to discharge one critical supervisor head after another. Let alone discharge a group of concurring supervisor heads.

²⁰⁰ And perhaps that somebody would blow a whistle when something was wrong. This would have been inconsistent and wishing against better judgment, for they themselves had done everything they could to silence critics. Especially by the regulation of the hierarchical organization, appointment of repressive incompetent heads, and allowing the terrorizing of whistleblowers. For the last see the following chapter.

²⁰¹ Fed AR 2006, p. 5 of the pdf-file.

²⁰² «[The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government](#).» p. 3, Functions and purposes of the Fed. Brochure, in the directory USA/Fed.

²⁰³ See the Fed Appendix, the quote of Fed governor Susan S. Bies in the FCIC hearing of 11/10/10. See also FCIC p. 21/49.

Summary and conclusions.

The failure of all principal persons in and around the financial system in the years 2000-2008 can be explained by the combination of election and appointment processes, and the absence of liability and punishability.

Trying to get elected for an impossible job requires lack of integrity. The procedure obviates the need for competences other than that of getting elected. The elected depends on the loyalty of his peers and his close associates. Honorable and competent people don't feel at home in this company. They are a threat for those who do like this company. They are a threat to be kept out.

All heads of government organizations and agencies are appointed by elected politicians. The CV's and past records of these politicians show that there is no reason to assume that they are capable to judge the suitability of people for these jobs. The history of the crisis and other cases confirm what may be expected a priori: that the heads were not suitable. Experience suggests that they may have been selected chiefly for their stubborn adherence to the prevailing political dogma's, and for proven loyalty.

These observations explain the failure and its systemic character. The combination of actual election and appointment processes, and the absence of liability and punishability are a dangerous weakness of the "democratic constitutional state". The subprime crisis and other cases show that they can have disastrous consequences.

■

As regards the integrity and competence of the principal persons the facts are clear. The analysis is straightforward. This simplicity is more than offset by the difficulty of the problem that they bring to light.

This subsection is restricted to the principal persons in the public sector. In the context of this study attention for the appointment of these persons is useful, and attention for the appointment of the principal persons in the private sector is not. The reason being that a decent law and suitable principal persons in the public sector are both necessary and sufficient to prevent crisis like the subprime and government debt crises and other avoidable disasters. A decent law and integrity and competence in the public sector will automatically lead to improvements in the private sector. The public sector is the key. The private sector operates under supervision of, and within regulatory framework made by, the public sector. Which is not to say that understanding of the role of the principal persons of the private sector is not important. It evidently is. It is evaluated in the section *The principal persons*.

The principal persons in the public sector are either politician or appointed by politicians. The most important politicians are elected. Government and parliament appoint the heads of almost all organizations in the public sector. Major problem is that the most important officials of the present day "democracies" are selected by the worst procedure. Namely elections.²⁰⁴ Elections on the basis of inadequate information. Mainly on the basis of artificially created images, and assertions and promises which do not bind the candidates. There need not be the least correlation between image and reality, and often they are very different indeed. All important appointments and developments in the world nevertheless depend on elections. As a consequence of the election process the most powerful persons are in many respects the least suitable, and the most dangerous. Few people have a more exaggerated opinion of themselves, more false pretensions, and less scruples about misleading and harming the public ("if necessary").

Dishonorable and incompetent people can be nominated safely, because they are only really accountable towards their friends and colleagues. As regards their functions they are not liable or punishable. Citizens cannot start a lawsuit against them for what they did or do in an official capacity. Public prosecution is under control of the government (or people appointed by the government). In other words: under control of friends or colleagues.

The ability of getting elected does not imply the ability for public office. Indeed, there is little or nothing in the CV's, or rather, the past records, of most members of governments and parliaments that

²⁰⁴ Under inadequate boundary conditions. For example with respect to financing and non-binding promises.

shows suitability for functions in government or its supervision.²⁰⁵ The CV's or past records give no reason to suppose that they are capable of ensuring the adequacy of regulation or to supervise public administration and governmental agencies. Their pretence exceeds their competence by far. For all principal persons of the crises, the facts clearly show that their pretensions about suitability were false. Already the fact that these people never show any serious doubts about their opinions and proposals, is proof of a dangerous lack of self-knowledge and lack of understanding of the uncertainty of human knowledge.

It is true that specialized education and experience is not always necessary even for an apparently specialized job. However, the ability to apply common sense, the ability to learn and use what has been learnt, the will and ability to discover things, and the willingness to accept and defend findings, are essential (though not sufficient). Of course these abilities should not be pretended but proven. All of them and more were missing in the principal persons and in the public manifestations of their organizations. The principal persons did not learn. They did not accept the findings of sound analyses (as of the GAO). Instead of open, the principal persons were dogmatic. They defended ill founded fictions at all costs, including dishonorable. Witness Born. Only irresponsible stubbornness and repressive use of power can explain that even thousands of highly qualified employees were unable to change one-sided policies based on evidently risky fictions.

Regarding the ability of politicians to appoint suitable heads of government organizations (including agencies) the following may be noted. The CV's and past records of politicians show that there is no reason to assume that they are able to evaluate competencies and integrity of people, and their suitability for a given job. (Supposing- against better judgment- that they understand what a job requires). On the basis of the cases and their vital personal interest it must be assumed that in selecting people, they give priority to loyalty and the ability to talk oneself out of every problem. The last at least in appearance, in the absence of good questions and opponents who don't accept nonsense. All facts presented in this study are consistent with the hypothesis that loyalty towards one's peers is an inviolable priority,²⁰⁶ and that among the principal persons integrity and competence was utterly insufficient. In fact, the incompetence can serve as an explanation of the loyalty: someone who lacks necessary competence can only maintain himself with the support of his likes.

7. Deregulation.

Summary and conclusions.

“Deregulation” is an ambiguous concept that can better be avoided. A smaller number of rules can mean more and heavier restrictions, obligations, formalities or whatever, and vice versa. In the prehistory of the subprime crisis it meant more freedom irrespective of the consequences for outsiders.

The belief that deregulation- insufficiently restricted freedom- benefits the general welfare, is incompatible with common sense, experience, and the results of analysis the prisoner's dilemma game. The PD-game shows that regulation (restriction of freedom) and effective supervision can be in the best interest of both the specific economic sector and society as a whole. Not the quantity of the rules is the problem, but their quality.

This kind of analysis is confirmed by many practical situations where only fools would propose deregulation. Advocating deregulation is proof of disqualifying incompetence.

It has to be assumed that the deregulation policy has had a undermining influence on the effectiveness of supervision.

²⁰⁵ Many CV's can be found in the Wikipedia and other pages of the internet. The reader should be warned. In general they are not reliable. Many or most (>90%) of the CV's are positively colored (up to and including adulatory). They should always be compared with past performance. Many CV's of principal persons of the subprime crisis cannot stand this test. Important examples are Geithner, Greenspan and Summers. Of course, the incompatibility gives rise to questions. In the present case, one can better study the Chronicle and the underlying sources, and judge the CV's on the basis of the facts.

²⁰⁶ Was Born forced to leave for violating *this* code?

The deregulation policy is a good example and proof of the stupidity of the people responsible for the operation of the financial system, including many economists. It is proof of a failure to learn, and of a failure to (understand and) apply available knowledge. Notwithstanding government organizations with thousands of highly educated employees.

In the first place the word “deregulation” is ambiguous and misleading. The fact that politics and enterprise advocate deregulation definitely doesn’t mean that they are converted to anarchism. The point is that a single fundamental or general rule can mean more than hundred specific rules. Very many rules could be abolished if liability and punishability would be accepted as general principles of law in the sense described earlier. This would make the law much more understandable too. But this kind of simplification (deregulation) is certainly not what politics and enterprises want. They don’t want more liability and punishability. They want freedom without duties or obligations. Anyway, use of the word “deregulation” ignores the fact that a rule can mean much and little. Less regulation need not mean more freedom or less bother. Not the number of rules or “amount” of regulation matters, but their contents.

In the second place unqualified deregulation policy ignores that

- some rules are meant to prevent innocent people from being harmed by avoidable actions or omissions of other people;
- rules can solve problems, and/or increase efficiency.

For these same reasons a group of (wise) people can voluntarily appoint or accept a referee or judicial system. This seems not to be known to the preachers of deregulation. They don’t seem to be acquainted with the prisoner’s dilemma either. Regrettably, one could not have learnt it from the textbooks of Heertje and Sloman. See the section on education, 7B.2. The prisoner’s dilemma is a model for (= simplified version of) situations in which it is beneficial for a group of people or organizations to accept a set of rules, and to pay costs to ensure compliance with these rules. One such situation is that of competing enterprises. Another that of competing athletes or football teams. In fact, what contest would be possible without rules and a referee? Observation of the rules is not self-evident. It may be profitable for any separate enterprise or contestant to ignore the rules. Belief in self-regulation therefore proves incompetence: absence of knowledge and understanding which are absolutely necessary for one’s job, and could and should have been present.

Conversely the absence of rules and supervision in this kind of situation will in general give suboptimal results. Where it should be realized that “suboptimal” includes “disastrous”. During a long term of absence of rules and supervision a bad situation can grow worse, if people take more and more liberties to keep up with the competition, or try to overtake the competition and win a bigger market share. As happened and happens everywhere, and especially in the financial sector in 1995-2008. Do you think that baseball or football would benefit from abolishment of rules and umpire?

This is not to say that all rules are beneficial or necessary. No doubt there are foolish and unnecessarily harmful rules. But examples don’t warrant generalization. Generalization means throwing out the baby with the bathwater. As the crisis showed on a very large scale.

The idea of deregulation can be seen as an implementation of “liberalization” and “liberalism”. The Merriam-Webster of 2002 describes “liberalism” as follows:

«[2b:] a theory in economics emphasizing individual freedom from restraint and usu. based on free competition, the self-regulating market, and the gold standard

[2c:] a political philosophy based on belief in progress, the essential goodness of the human race, and the autonomy of the individual[,] and standing for the protection of political and civil liberties

[2d:] the principles and policies of a Liberal party.»

The most tragical- though revelatory- of the concept and this description is that it only mentions the actor. It completely ignores other people. It makes no mention of any boundary condition. On the contrary: it mentions “freedom from restraint”. It ignores the problem it implicitly raises: that not only one single individual, but all people have the same right to freedom.

Much misery in the world can be understood as a consequence of the fact that to a large extent, law and politics are characterized by this very same near-sightedness. There is very much attention and priority for the freedom of actors, and very little for due care and guarantees for others. The prevailing attitude of top politicians, managers and administrators means a step backwards with respect to the freedom principle as formulated in the *Declaration of the rights of man and citizen* from the French

revolution.²⁰⁷ Article 4 asserts:

«Freedom means that everything is allowed that does not hinder anyone, so that the exercise of the natural rights of everyone can only be restricted in order to guarantee the exercise of the same rights by others. The restrictions can only be determined by law.»

The validity of this article is confirmed in the preamble of the French constitution of 1958.

More or less by definition, someone respecting himself will only voluntarily agree with a freedom principle if it is combined with the safeguarding principle. The safeguarding principle is a logical condition for communication. No law or government can change that.²⁰⁸

The Chronicle and the FCIC report show that it is actually an understatement to say that the political climate of 1995-2008 was characterized by deregulation. In crucial decision making processes the climate was rather anti regulation. The gospel preached by Greenspan and the apostles of the financial system dictated: no rules but self-regulation. It is obvious that this must have undermined the morale of the supervisors, and weakened their position with respect to the institutions they had to supervise. This is no excuse for the supervisors: they were at least formally independent. But it underlines the irresponsibility of Greenspan, and of the people, governments and parliaments who advocated or condoned similar stupidities.

8. Housing policy: affordable housing policy, community reinvestment act and tax deduction for mortgage interest payments.

Summary and conclusions.

1. The Chronicle and the study of Wallison (FCIC) show the disastrous and fundamental role of the authoritarian and unprofessional implementation of the AH and CRA policies. It is plausible that the influence of these policies has been amplified by the idea that the government is the boss of the country, and should be obeyed; and by the “American Dream” rhetoric of successive US presidents, which precluded an open and critical discussion.
2. The FCIC majority downplays the role of the AH and CRA policies, and asserts that pursuit of profits was the cause of the deterioration of the quality of mortgages. Its conclusion is incompatible with contemporary evidence, and logically incorrect. Both the argumentation and the method of inquiry of the FCIC majority in this case are inadequate. They give rise to the suspicion that the conclusion is biased intentionally, and that the FCIC uncritically adopted the view of HUD. (Which was responsible for the AH and CRA policies).
3. In several countries tax deductibility of mortgage interest payments is used as a means to promote home ownership. The deductibility reduces the amount of taxes received by governments. Around 2010 Dutch politicians started bothering about budget deficits and government debt. In order to reduce them, they looked for ways to increase taxes. Abolishment of the deductibility of mortgage interest payments was considered a good idea. Just as good as the introduction of the deductibility several decades earlier. Abolishment was accepted by government and parliament. The consequence was a general and substantial impoverishment of the population. This and other tax increases mean more power for politicians. Politicians effectively punish the population and reward themselves for decades of spending more than was available.

The AH and CRA policies.

The Chronicle shows that the government policy with respect to the American Dream of home ownership was the ultimate cause of the poisoning of the securities which caused the crisis. The subprime crisis would not have happened without the AH and CRA policies. There is no indication that HUD, the government department for housing and urban development, inquired into the feasibility of (especially) the affordable housing goals before dictating them. There is no indication that the responsible politicians have tried to find out whether the steadily increasing housing goals

²⁰⁷ *Déclaration des droits de l'homme et du citoyen*. Dated 26/8/1789.

²⁰⁸ The safeguarding principle was explained before. For its logical nature, see *The law of logic* (Het recht van de logica) or *Communication and norms*. Bibliographical data were given before.

could be realized without lowering mortgage requirements and substantially increasing the risks for mortgage sellers and buyers. On the other hand it is clear that HUD exerted pressure on mortgage sellers, and that HUD and supervisors received and ignored signals about increasing risks. The process resembles that of the planning economy of the Soviet Union in the first half of the 20th century. The goals have to be realized willy-nilly. Don't look before you leap. That was the motto for the implementation of the American Dream.

The role of the government policy with respect to home ownership is obvious and simple. It was thoroughly chronicled and analyzed by Pinto and Wallison. Their reports are in the dossier. For this reason there is no need for more analysis of this subject in this chapter. Two aspects remain to be mentioned however. The first is the influence of the AH and CRA policies on the supervisors, and on Fannie, Freddie, and other financial institutions. All cases concerning policy implementation show that actors tend to conform themselves to the perceived wishes or policy of government officials. That is: they show a debatable form of submissiveness. Many people and organizations do as if the government is the head of society and has to be obeyed. They may be formally independent, and it may be their duty to act independently (for good reasons). But in practice they rarely do. It probably helps that the government selected heads of the supervisors who would not jeopardize their policies.²⁰⁹ Because of this experience it has to be assumed that supervisors try to avoid actions that may thwart realization of government goals. So the housing policy and deregulation policy had the same effect: that of weakening supervision.

The second aspect is the influence of the ("American Dream") rhetoric around the AH and CRA policies. That is: the influence of formulations of policy goals intended to make everyone support the government, and opposition difficult or impossible. The Chronicle gives examples of such statements by presidents. Annual reports of Fannie give more examples.²¹⁰ This kind of rhetoric is harmful and dangerous because it precludes criticism and open discussion, which are of vital importance to reduce risks. Given American attitudes, the rhetoric cannot have left the supervisors untouched.

Wallison vs the FCIC majority: a methodological analysis.

Regarding the influence of the AH and CRA policies and their implementation, the FCIC minority report of Wallison leaves nothing to be desired. It is clear and well substantiated. His report only suffers from one-sidedness: the role of other factors is belittled without sufficient arguments. In general Wallison's argumentation about the non-causal character of other factors is convincing. But a non-causal factor can still have had a facilitating or amplifying effect. Competent action by supervisors, instead of negligence based on erroneous dogma's, could have prevented the crises. But from the point of view of the present report it is more important that Wallison's report is a correcting complement to the FCIC majority report. In fact, Wallison wrote his report because the majority trivialized or denied the role of the AH and CRA policies. So the question arises: what is wrong with the inquiry of the majority? How can one see from their report that something is wrong with it?

For the answers to these questions the section *Affordable housing goals: "GSEs cried bloody murder forever"* of the majority report is crucial. It is mainly based on "information" from hearings of principal persons by the FCIC. That is: hearings of people who are responsible for the operation of a part of the financial system, and have an interest in a favorable representation of the prehistory of the crisis. They actually are suspects. For this reason their "information" should never be accepted as true or reliable without corroboration and (comparative) analysis. Interviews with potential suspects can supply ideas, especially at the start of an inquiry. The following step should be: finding and analyzing facts and contemporary documents. The FCIC majority concludes that all the persons it has interviewed functioned inadequately in the run up to the crisis. Therefore these persons cannot be considered as experts and reliable witnesses.

As the source of information about the influence of the AH goals on the safety and soundness of the GSEs the FCIC majority uses an employee of HUD...:

«The former HUD official Mike Price told the FCIC that while the "GSEs cried bloody murder

²⁰⁹ Of course this is a strong argument against the appointment of supervisors by governments.

²¹⁰ See especially that of 2001, with the unbelievable cover: "The American Dream Decade". This refers to 2001-2010.... It is copied in the appendix Graphs, 7C.11.

“forever” when it came to the goals, they touted their contribution to increasing homeownership. In addition, Price and other HUD officials told the FCIC that the GSEs never claimed that meeting the goals would leave them in an unsafe or unsound condition.»

Apart from the (tendentious) exaggeration, the “cried bloody murder” agrees with the later annual reports. But the last assertion doesn’t. If the FCIC majority had studied the relevant contemporary documents, there would have been no need to ask Price this question. Even if the FCIC was not aware of these documents, it should not have questioned HUD about opinions of GSEs. For HUD has an evident interest in downplaying its own role and suggesting recklessness of GSEs. For the reasons given and to be given, the question is suspect. As if the FCIC majority wants to prove something that it knows not to be true.²¹¹

In the first place there were annual reports. See the Chronicle, the appendices and the annual reports themselves. The FCIC should at least have mentioned and discussed them. Next, there should be minutes of all more important meetings of GSEs with HUD. And finally there must have been correspondence between GSEs and HUD about the goals and other matters. The FCIC could and should have asked for them. If necessary the people concerned could have been asked for elucidation. The fact that there is no indication whatever that the FCIC majority did any of these things, shows at least that this part of its inquiry was inadequate from a methodological point of view. But it also gives rise to the question whether the FCIC acted in good faith. Wallison does use contemporary documents, and he hardly uses interviews which took place after the facts. That’s why his approach gives a very different picture.

On the basis of its interviews, the FCIC majority asserts that not the AH or CRA policy but the pursuit of gain was the principal motive of the GSEs. Because of both the very precise realization of the goals and the annual reports this does not deserve belief. If profit maximization was their primary purpose, why didn’t they realize much higher percentages, or the same percentages earlier? As the annual reports explain, and the FCIC majority does not refute, the argument about the primacy of profit is incorrect. The point is that taking more risk reduces profits. In its 10K forms, Fannie says that it must take more risk in order to realize the AH goals, and therefore put up with a smaller profit. The annual reports show that Fannie gave priority to the AH goals. The blindly increased goal percentages explain the increasing numbers of delinquencies. Without AH goals and with profits as primary purpose this defies explanation. The text of the FCIC majority contradicts the contemporary documents of the GSEs, and is logically untenable.²¹² Fannie’s 2004 10K form is crystal clear.²¹³ Of course annual reports can lie as well. But in this case they are logical and consistent, while the story of the FCIC majority is not. The whole approach of the FCIC of this subject is suspect, and seems biased. The FCIC doesn’t even mention the annual reports, let alone refute the relevant sections. Finally, if the FCIC majority were correct, then the AH and CRA policies would have been superfluous. In the prehistory of the crisis, they obviously were not thought to be so.

Tax deduction of mortgage interest payments.

The US had its AH and CRA policy, but governments of other countries had their own policies and regulations to promote home ownership. An important regulation is that of tax deductibility of mortgage interest. For example in the US and the Netherlands interest paid for a mortgage can be subtracted from gross income when calculating taxable income.²¹⁴ This means that the effective interest rate is between 1/2 to 2/3 of the rate paid to the mortgage seller.

When everything else remains equal, lower interest rates make homes more affordable. They increase the number of people able to buy a house, or a more expensive house. And vice versa. Similarly, introduction of tax deductibility of mortgage interest lowers monthly costs, and increases home prices. In fact, the prices of all homes rise, and the wealth of all homeowners is increased.

²¹¹ If you want to “prove” something that isn’t true, this is how to do it. Select the person you expect to give the desired answer.

²¹² The Chronicle of January 2010 suggests that the FCIC has adopted the view of HUD.

²¹³ See especially p. 47/52. This is in the section risk factors, but includes some reporting.

²¹⁴ In the US at least since 1986, and up to and including June 2010. See Pinto 20100814 pp. 37, 150 and 151. The deductibility exists in more countries. Because it didn’t seem to serve a useful purpose, no effort has been made to compose a list of countries.

Conversely, reduction or abolishment of the tax deductibility will in general decrease the home prices and the wealth of homeowners. If prices of economic goods are determined by their proceeds, and if the tax on the highest part of income is about 50%, then tax deductibility means that half of the interest paid is returned to the tax payer. This again means a change in value of the home of about a factor of 2. Because for many people their house is a large part of their property, and because mortgage interest is a significant part of people's incomes, this part of tax law and policy has important consequences for people's welfare and well being. It follows that changes in this kind of regulation can make home owners much more or less wealthy.

The regulation has important consequences for the tax incomes of governments. A schematic calculation suffices to get an impression of the difference between deductibility and non deductibility. Let the monetary value of the total volume of houses be called H. Suppose the average mortgage interest rate is $100xR\%$.²¹⁵ Suppose that 50% of the mortgages has been redeemed. Then the interest paid by home owners is $R \times (0.5 \times H)$, and the tax foregone is 0.5 times this amount: $0.5 \times R \times (0.5 \times H) = 0.25 RH$.²¹⁶ If the average mortgage interest rate is 4%, then $R = 0.04$ and $0.25 RH = 0.25 \times 0.04 \times H = 0.01 H$.

In general there is also a property tax. In the Netherlands and around 2013 it was 1.2% of the property value. Reduction of home prices by 50% therefore costs a government every year $0.012 \times 0.5 \times H = 0.006 H$. The Dutch government explains or motivates the 1.2% as a kind of income tax on a fictitious 4% interest rate. The 1.2% is fixed by law.²¹⁷

So if the interest rate is 4%, government tax income increases by $0.010 - 0.006 H = 0.004 H$ if the deductibility is abolished. The difference increases with increasing interest rate, and vice versa.

Of course the conclusion depends on the assumptions. The calculation is simple however, and the outcome is only proportionally sensitive for changes in the assumptions. Because of the margin between 0.01 and 0.006 the conclusion is not very sensitive for small changes in the assumptions.²¹⁸

In the Netherlands, for decades, the deductibility was considered as self-evident and beneficial. But in the financial crisis, when politicians began to feel pressure to reduce budget overruns and government debt, politicians of all parties suddenly began to see all kinds of reasons for its abolishment. Of course without saying that abolishment would increase government income and help reduce deficits (if everything else remained equal or went in the same direction). None of them defended the deductibility!²¹⁹ The arguments were actually nothing new, and it was not explained why deductibility had been introduced at all if there were so many arguments against it. The only thing that had changed substantially in all these years was the government debt. The only credible motive for abolishment of the deductibility is tax increase. Politicians obviously find tax income more important than stability of the law and the welfare of the citizens. The politicians in power, and only they, systematically spent more than available in the treasury. Instead of retracting they seize even more power. Because that is what tax increases mean: more power about what is done and not done in a country.

In 2012 the Dutch market for houses had come to a standstill. This must have been the effect of the crises and the uncertainty about the deductibility of mortgage interest. The new government Rutte II²²⁰ has a plan that was presented as a long term plan. But many people don't believe it will remain as it is, without further changes. In November 2012 the Dutch Central Statistics Office announced that in the last quarter the Netherlands had been in a recession. It mentioned three causes: less export, less consumer spending, and the housing market standstill. In other words: the introduction of the deductibility of mortgage interest some decades ago would have been nice, but only if it could have lasted. Which means: if politics had cut its coat according to its cloth, and would not have forced itself to seek for possibilities for tax increases and new taxes.

²¹⁵ The x in $100xR$ meaning multiplication: $100xR =$ hundred times R.

²¹⁶ For convenience, and in agreement with mathematical custom, $R \times H$ is written RH.

²¹⁷ It is not adjusted yearly to the interest rate for example. (As many other rates are).

²¹⁸ It is stable. Stability refers to small changes however. In reality, the steady drop in interest rates until at least 2016 may have turned the scales: keeping interest deduction may have been more profitable for governments.

²¹⁹ Note that this must have been a covertly concerted action.

²²⁰ The second government of prime minister Mark Rutte.

Abolishing deductibility of mortgage interest in principle means a drastic impoverishment of home owners. However, this impoverishment can only be seen in specialist financial economic statistics. Not or hardly in the general ones which are used as indicators of welfare and the health of the economy. This is a consequence of the primitive state of economics, which is overwhelmingly biased towards income, and hardly looks at capital. The yearly change in GDP plays a dominant role in policy, the change in national economic capital (an unknown term!) none at all.²²¹ If national economic capital would be considered just as important as GDP, then abolishing deductibility of mortgage interest payments would be considered just as acceptable as halving incomes... In other words: it would be unacceptable.²²²

9. Moral obligations.

Summary and conclusions.

1. In so far as they have not been laid down in the law, it is not clear what moral duties people have and why. The more so if these duties are considered insufficiently important to be included in the law. Blaming financial institutions in the narrow sense for unethical behavior is therefore debatable. It ignores the competitive context of these institutions. There are good reasons however for accusing governments and supervisors of immoral conduct. They systematically neglected their legal duties.
2. Consequent liability and criminal law can prevent much of the observed misconduct, and limit negative unjustifiable consequences.
3. If the financial institutions in the narrow sense misbehaved systematically, then either the supervision was inadequate, or the duties and powers of the supervisors and/or other parts of the law. In the first case the supervision of the supervisors by governments and parliaments was insufficient, in the second case governments and parliaments failed to make adequate laws.
4. None of this is discussed by the inquiry commissions.

■ On p. xxii/22 of its report the FCIC majority concludes:

«We conclude there was a systemic breakdown in accountability and ethics.»²²³

The explication shows that in this case “systemic” refers to the financial system in the narrow sense: excluding supervision. What is meant by “accountability and ethics” is not explained. Is it supposed to mean more than laid down in the appropriate regulation? It is entirely unclear. In particular the FCIC nowhere explains why anyone should feel, or be, bound by more than the law.

Forcing mortgages down the throats of people who cannot afford them may be called unethical. But it costs the lender money too. It would cost a lender (much) more if liability and criminal law were more strict and consequent. This is not noted and discussed by the inquiry commissions.

Apart from “lax regulation”, the explication only mentions employees of institutions in the narrow sense. But the report of the FCIC majority, and its other conclusions, show that the “breakdown” is even more evident in supervision and government. If non fulfillment of legal obligations, and promotion of reduction of mortgage requirements without due care for the consequences isn’t proof of unacceptable lack of accountability and ethics, what is?

The FCIC does not explain why financial institutions are bound by more than the law (and law-dependent regulation). The FCIC ignores the fact that many institutions compete with one another. It also ignores the conflict this implies between protection of market share and what the FCIC considers morally desirable (but does not specify). If the extra-legal moral requirements had been found important in 1995-2005 say, why were they not included in law or regulation? In other words: if the FCIC majority really considered compliance with extra-legal moral norms important, then it should have blamed Congress and government for not including them in law or regulation. But it didn’t.

²²¹ This may also be due to a very different, political motive: government (tax) income is directly related to GDP, and only very weakly to capital.

²²² Probably it would not have been introduced in the first place.

²²³ This is its conclusion 6.

It is quite unclear why people or organizations might be expected to observe more (restrictive) norms than included in law or regulation. The more so if “freedom” is considered very important. It is clear however why one may expect more from some organizations than from others. If it is assumed that a person (organization) is bound by the law, and otherwise free, then there is no good reason for expecting him (it) to give priority to extra-legal norms which threaten his (its) welfare. This argument does not apply to public monopoly organizations such as government organizations and supervisors. Their legitimacy depends on proper public accounting, and therefore on behavior which should be responsible in a wider sense than that of the law. In general moreover, they have no competitors.

As noted before, the dilemma of the financial institutions in the narrow sense: extra-legal ethical behavior at the cost of enterprise success, is a variant of the prisoner’s dilemma game. In this case it is solvable by making a binding agreement about the norms to be observed, a provision for supervision of compliance, and fines or other sanctions for infringements. Competent governments understand this. Solution of this kind of problem is one of the main reasons for their existence. As it is, the weakness of liability and criminal law may be a reason for the competing financial institutions not to regulate themselves. It is inefficient. In other words: the fact that the group did not regulate itself can be blamed on inadequate liability and criminal law.

Nothing like this is mentioned by the inquiry commissions.

10. Government and supervision were unprepared for a crisis. Practical circumstances as explanation of inconsequent and arbitrary conduct.

Summary and conclusions.

Supervisors and governments were responsible for the beneficial and safe operation of the financial system, but had no policy and plans for eventualities. In this regard too they did not do their legal duty. Their organizations and human resources may have been adapted exclusively to the normal operation of the system. Adjustment to crisis circumstances costs time, and may require employees with other abilities, and another organization structure.

Because of human deficiencies, care must always be taken in explaining human behavior: there need not be any logic. But for the reasons given here, extra care is necessary when explaining behavior in the crisis. The lack of preparation, the speed of the developments, the pressure of the circumstances and the incompetence of the principal persons can explain that more errors were made in the crisis than in other times, and that allowing Lehman to go bankrupt was just one of them.

■

In its conclusions the FCIC majority asserts:

«[...] the government’s inconsistent handling of major financial institutions during the crisis- the decision to rescue Bear Stearns and then to place Fannie Mae and Freddie Mac into conservatorship, followed by its decision not to save Lehman Brothers and then to save AIG- increased uncertainty and panic in the market.»²²⁴

The reason for letting Lehman go bankrupt that Treasury secretary Paulson gave to the FCIC in his hearing: the lack of a bank willing and able to take over Lehman à la Bear, is incredible both because of the inadequacy of the argument and the seriousness of the potential consequences. The argument is inadequate because it implies that a sufficiently large bank will always be forced into bankruptcy, irrespective of its importance for the financial system. For because of its size (and/or the size of its liabilities) a sufficiently large bank cannot be taken over.

The report of the FCIC majority clearly shows that there was no previously thought out policy, and that there were no plans for eventualities. Not at the Treasury department, and not at the Fed. There is no indication of even the outline of the main features of a policy: a set of basic rules of behavior.

The story of Paulson could very well be due to rationalization by hindsight. Constructed to fit the misleading illusion that every action, certainly of the government, has an understandable reason, or serves understandable interests. As may have been noted in one of the first chapters of this report, this

²²⁴ FCIC p. xxi/21.

kind of rationality is no more than a figment of the imagination, a falsified hypothesis. Perhaps there were good reasons for letting Lehman go bankrupt. But there is no proof of any policy. On the contrary: the available evidence suggests its absence. Nobody mentioned a convincing interest. The opposite is much more probable. Namely that not bankruptcy but rescue was in the interest of the financial system and society.

The number and competencies of the employees of the supervisors and the Treasury were probably adapted to the set of activities in normal circumstances ("peace time"). If not very much preparatory work had been done for dealing with the circumstances of 2007-2008, and especially those of September 2008, in the decade preceding them, then it is evident that the supervisors and Treasury cannot have been adequately prepared. There is no evidence of preparatory work of the kind required. Adequate preparation is extremely improbable because all documents are consistent with the assumption that all principal persons, without exception, were taken by surprise by the events. Which is understandable because the events were incompatible with their (erroneous) dogma's. Even while the crisis was unfolding they seem to have remained optimistic. (As a true believer should). The reactions of the supervisors and Treasury departments clearly were 100% ad hoc.²²⁵

Similar considerations may explain Paulson's proposal of 3 pages of 20/9/08. Especially in September 2008 catastrophic events followed one after the other, or were even simultaneous. In answer to a question of FCIC member Murren for examples of mistakes, Paulson mentions the submission of this proposal. He calls it a communication mistake. It seems much more probable that it was not so much a mistake as one of the many consequences of the pressure of time and inadequate preparation and competencies. (Which obviously may cause communication errors too). Due to the lack of prior preparation, time, competent people, and tiredness, it was simply impossible to come with something better at short notice. (Of course, this is one of the great dangers of bad risk management, belief in stupid dogma's and repression and elimination of critics). Paulson and his collaborators must have thought: matters are completely running out of control, a soothing signal is imperative, and anything is better than nothing.

The proposal of 3 pages is consistent with the assumption of the absence of blueprints and preparation.

11. Lobbying.

Summary and conclusions.

Part of the blame for the reduction of the mortgage requirements, the worsening of law and regulation, and the non-regulation of some classes of risky financial products, goes to lobbies. Even though the government officials who listened to them and acquiesced in their wishes bear a greater responsibility. In any case realization of the goals of these lobbies increased the risk of a crisis.

The suggestion that lobbies have a positive influence by supplying information and expertise, and that politicians know how to deal with them, that is: to correct for bias, has been falsified by the subprime crisis. For the information function the internet offers a transparent alternative.

In its present forms, lobbying and cooperation with lobbying should be prohibited and made a punishable criminal activity. Apart from that, lobbyists should be liable and punishable for the consequences of their activities (and omissions). Like everybody else.

■

At least two lobby groups have contributed to the origin, growth and extent of the subprime crisis: the banking lobby and the CRA lobby, the NCRC.²²⁶ The last can be held co-responsible for

²²⁵ The GPRA- and annual reports of the Fed do give a report of the crisis, including the activities of the Fed, but these activities are not considered in the light of a coherent and substantiated policy framework. For example in the light of a policy aimed at control of systemic risks in case of a significant disturbance. Pp. 53-5/63-5 of the Fed AR 2008 gives arguments for various liquidity provisions, and pp. 55-6/65-6 for buying assets. Pp. 56-8/66-8 gives arguments for supporting Bear Stearns, AIG, Citigroup en BofA (but not for the specific form of the support). The measures and arguments confirm the ad hoc character of the Fed's activities.

²²⁶ As regards the banking lobby: *Inside Job* contains parts of an interview with Scott Talbott, Chief lobbyist of the Financial Services Roundtable.

promotion of the systematic reduction of mortgage requirements. And therefore for the fundamental growth of the risks and poisoning of mortgage backed securities (MBS). The growth is called fundamental because the risks of conventional mortgages were bearable, but those of the new contracts were not. For information about the activities of this lobby see the FCIC minority report of Wallison and both reports of Pinto. Typical for the religious-dogmatic character of the lobby is the introduction of the Acknowledgements of the NCRC report *CRA Commitments* of 2007:

«The National Community Reinvestment Coalition (NCRC) is the nation's trade association for economic justice whose members consist of local community based organizations. Since its inception in 1990, NCRC has spearheaded the economic justice movement. NCRC's mission is to build wealth in traditionally underserved communities and bring low- and moderate-income populations across the country into the financial mainstream.»

Of course it was already known for centuries that supposedly good intentions are not sufficient for good results. But mankind is seen unable to learn, and the subprime crisis is the umpteenth sad example. As a consequence of the blind and unthinking lobbying of the NCRC its intended beneficiaries suffered most. The NCRC realized the opposite of what it intended. It destroyed wealth instead of creating it. Closer examination of the activities of the NCRC is obstructed by the removal of annual reports and the quoted report from its website.²²⁷

The hypothesis that governments and parliaments know how to deal with lobbying, and that lobbying has a (net) positive influence has been falsified by the subprime crisis. The following gives an impression of the banking lobby in the FCIC majority report.²²⁸

«In response [to big losses by speculation/ deficient or incorrect information], the U.S. General Accounting Office [GAO, May 1994] issued a report on financial derivatives that found dangers in the concentration of OTC derivatives activity among 15 major dealers, concluding that “the sudden failure or abrupt withdrawal from trading of any one of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole.” While Congress then held hearings on the OTC derivatives market, the adoption of regulatory legislation failed amid intense lobbying by the OTC derivatives dealers and opposition by Fed Chairman Greenspan.»²²⁹

Replacement of the Glass-Steagall Act by the Gramm-Leach-Bliley Act (GLBA) in 1999 would enable, or rather legalize,²³⁰ the merger of Travelers with Citibank. To effect this replacement, the financial sector spent some US\$ 190 million on lobbying in Washington. The GLBA allowed a holding to cover various types of financial activities, from insurance to securities trade.²³¹

After²³² the fraud and fall of Enron, «[...] the regulators failed to take timely action. They missed a crucial opportunity. On January 2, 2003, one year after the collapse of Enron, the U.S. Senate Permanent Subcommittee on Investigations called on the Fed, OCC, and SEC “to immediately initiate a one-time, joint review of banks and securities firms participating in complex structured finance products with U.S. public companies to identify those structured finance products, transactions, or practices which facilitate a U.S. company’s use of deceptive accounting in its financial statements or reports.” The subcommittee recommended the agencies issue joint guidance on “acceptable and unacceptable structured finance products, transactions and practices” by June 2003. Four years later, the banking agencies and the SEC issued their “Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities,” a document that was all of nine pages long.»

Why did the Senate accept this? Because of the deregulation policy, and pressure from financial

²²⁷ As the dossier shows this is the only significant exception of this kind.

²²⁸ It has been tried to find examples which do not, or as little as possible, depend on interviews after the fact.

²²⁹ FCIC p. 47/75.

²³⁰ For the merger had already taken place. For details see also *Inside Job*.

²³¹ FCIC pp. 54-5/82-3.

²³² And before as well!

institutions? The last had severely criticized drafts. «When the regulators issued the final guidance in January 2007, the industry was more supportive. One reason was that mortgage-backed securities and CDOs were specifically excluded. [...] Those exclusions had been added after the regulators received comments on the 2004 draft.»²³³

In 2005 the Fed and other supervisors investigated mortgage practices:

«The study “showed a very rapid increase in the volume of these irresponsible loans, very risky loans”».

Therefore the supervisors wanted to send a “guidance” to the institutions concerned. A “guidance” was considered sufficient. But first they sent a draft:

[The draft-guidance] «warned lenders that low documentation loans should be “used with caution.” Immediately, the industry was up in arms. The American Bankers Association [= a lobby group] said the guidance “overstate[d] the risk of non-traditional mortgages.”»

And more soft-pedaling. Moreover:

«The need for guidance was controversial within the agencies, too. “We got tremendous pushback from the industry as well as Congress as well as, you know, internally,” the Fed’s Siddique told the FCIC. “Because it was stifling innovation, potentially, and it was denying the American dream to many people.”»

«Opposition by the Office of Thrift Supervision [= OTS] helped delay the mortgage guidance for almost a year. [...] Another challenge to regulating the mortgage market was Congress. She [= Fed governor Bies] recalled an occasion when she testified about a proposed rule and “members of Congress [said] that we were going to deny the dream of homeownership to Americans if we put this new stronger standard in place.”»²³⁴

Lobbying contributed to deregulation (“self regulation”), and prevented adequate law and regulation and supervision. The federal government allowed itself to be used by lobbies, even though it could and should have been clear that the wish list of the financial sector lobbyists was contrary to the interests of society at large. And possibly even contrary to the interest of the financial sector itself.²³⁵ The government permitted lobbyists to play a decisive role in important law and regulation making. It seems not to have been in control. It didn’t even play a critical role. Stupidity was trump.

It is sometimes said that lobbyists are no more than experts who inform. If that would be true they could better put their information on a public website on the internet. Or even better: in public forums offering the opportunity for comments and discussion. So that untruths, half truths, and misstatements can be noted.

The idea of lobbying is incompatible with the idea of representative government. Lobbying is detrimental to the way of representation as (supposedly) meant by the constitution and the law.

By making liability and criminal law consequent, lobbyists become liable and punishable for the consequences of their activities.

7B.5. National supervision.

Table of contents of this section.

1. Summary and conclusions.
2. Explanation of the failure of the supervisors- summary.
3. Introduction.
4. The supervisors: evaluation of their annual reports.
5. Supervision in the USA.

²³³ FCIC pp. 204-5/232-3. CDO= collateralized debt obligation.

²³⁴ FCIC pp. 172-3/200-1. Note that with respect to the responsibility of the politicians in power these are very important paragraphs. They show the influence of political goals on supervision irrespective of interference with the primary (if not inviolable?) duties of the supervisors. Siddique implies that similar pressure existed inside the Fed.

²³⁵ Note that lobbyists have a self interest which can be contrary to the interests of those they represent.

6. Supervision in the Netherlands.
7. The conclusions and recommendations of the inquiry commissions with respect to supervision.

1. Summary and conclusions.

1. None of the studied reports describes which financial supervisor does or should do what, and where there are gaps in the supervision. This applies at both the national and international level. Supervisors depend in part on other supervisors, including supervisors in other countries. Annual reports nor other documents provide clarity about the situation.²³⁶
2. The events and annual reports support the hypothesis that the supervisors don't know which supervisor does exactly what, and where there are gaps in the supervision.
3. The supervisors do not show how they supervise. They do not describe what supervision means in practice. Is it (partly, entirely?) based on declarations of the institution under supervision? What does risk based supervision mean? How is adequacy of this method evaluated? What are the limitations of financial supervision, the remaining risks?
4. A description and evaluation of the supervision of the financial system is missing. There is no picture of the way supervisors and financial institutions communicate, and of the agreements they made.
5. In the years 1994-2008 the supervisors systematically drew too optimistic conclusions about the developments in the near future. (They said nothing about the long term). Governments and parliaments accepted their conclusions uncritically. Supervisors, governments, and parliaments could and should have known that the conclusions did not have a sound basis.
6. Supervisors pointed out risks, but played them down. They misled for example by suggesting that "weighing everything" the most probable would happen.²³⁷ Conclusions like that demonstrate an unprofessional and dangerous lack of understanding of the concept of probability, and/or insufficient communication competence.
7. In other respects too, the annual reports of the supervisors leave much to be desired. The insufficient quality of the annual reports is compatible with their failure in the years 1994-2008, and with their conduct during the crisis.
8. The supervisors in the US and Netherlands demonstrate no knowledge and understanding of the system as a system, of the processes, vital elements, and the factors on which the safe and sound operation of the financial system depends in an essential way. The annual reports only pay attention to parts, and not in a systematic way.
9. Nothing shows awareness of instabilities of the financial system.
10. The understanding of the concept "risk" is insufficient. Governments, supervisors and others do not evaluate risks in the light of their size or potential consequences, but only on the basis of their existence, irrespective of the consequences.
11. Governments and supervisors do not know how to deal with risks. The annual reports of the supervisors show that they do not think in terms of possible scenario's. They suggest that they compare possibilities. They claim that a positive course of events is the most probable. Henceforth they ignore every other possibility.
12. There was no risk management whatsoever. No plans were made for any other scenario than the (supposedly) most probable.
13. In their annual reports the supervisors assert that the public can trust them, and that they successfully do what they have to do. That they even set an example. There is no trace of doubt or modesty.
14. After the crisis they denied wrongdoing.
15. In the period under consideration, only the GAO and OFHEO published reports about risks of the financial system that pass muster. In 1994-1999 the GAO published reports about derivatives and systemic risk, and in 2004 a report about GSE regulation. In 2003 OFHEO published a report on

²³⁶ Including those of for example IMF and OECD. As regards the US, the already quoted section *Financial Regulatory Structure* of the GAO report of 1999 comes closest.

²³⁷ An argumentation error also made by John Locke, in *An Essay concerning Human Understanding* IV, XVII,16.

GSEs and systemic risk. The recommendations of these reports were insufficiently (or not) implemented. Neither at the time nor later. They were rejected by the financial supervisors. Partly on the basis of fake-arguments; partly by keeping silent about them.

16. In their annual reports, none of the supervisors has shown knowledge of the GAO and OFHEO reports, and CGFS reports about similar subjects. (Neither has any government official). Only the FCIC mentions the first GAO reports.²³⁸ Former director Falcon of OFHEO mentions OFHEO's systemic risk report in his hearing by the FCIC. The FCIC does not try to find out why the reactions to these reports were inadequate. Even though it is clear that an adequate reaction would have prevented the crisis, and that understanding the reactions is a key to understanding how things can go wrong.²³⁹ The responsible people simply did not do what they could and should have done.²⁴⁰ Without giving a valid reason.
17. If the secretaries of the Treasury and the heads of the supervising organizations would have had the competencies necessary for their jobs, they could and should have drawn the same conclusions as the GAO or OFHEO on the basis of their own independent analysis. There is no evidence that they did.
18. The impression of expertise made by the heads and spokespeople of the supervising organizations (and other principal persons) is incorrect.
19. Although there is much overlap of important duties of many financial supervisors and international organizations like BIS, IMF, and OECD, and advisory bodies like CPB, and although there is even more complementarity, the (annual) reports of these organizations say next to nothing about cooperation and coordination.^{241, 242} They do not refer to one another, and don't discuss each other's analyses and conclusions.
20. The only significant energetic coordinated action by the top financial authorities in the years before the crisis was that of Greenspan, Levitt, Rubin and Summers in 1998-9. It had an obstructive purpose: avoiding regulation of OTC, and the elimination of initiator Born.²⁴³
21. All supervisors and related organizations (BIS, IMF, OECD and the like), made their own analyses of the state and stability of the financial economic system. Without due regard for the work of predecessors and similar organizations. All of them use a technical terminology and appear to be written by experts. They are substandard and unprofessional all the same. The analyses are not even truly useful, because the only thing one can know for certain is that they cannot be reliable. The most essential deficiency being a lack of knowledge and understanding of both the relevant literature and the financial system. As proven by mutual comparison, and by comparison with the oft mentioned GAO, OFHEO, and CGFS reports. Because of their importance and uniqueness, ignorance of these reports is inexcusable. Every analysis that wants to be reliable should take account of the relevant literature, and discuss it appropriately. This is simply what professionalism and reliability mean.
22. If the supervisors had been aware of a great danger, they could and should have issued a joint warning, preferably in collaboration with scientists. They didn't.
23. The supervisors failed (and fail) to warn for budget deficits and excessive government debts.
24. It is an understatement to say that the supervisors failed. They actively misled. They made no honorable and competent efforts to do their duty. They were unacceptably uncritical and complacent. The warnings they gave (if they gave them) were unclear and ambiguous. They misled the outside world by saying that they could be trusted to keep the financial system safe and

²³⁸ Only this caused the author to find them.

²³⁹ The GAO report was submitted to Congress. Congress should have understood that the supervisors and Treasury would not react adequately unless Congress forced them to.

²⁴⁰ The "could" depends on competence. So the "could" is meant metaphorically, assuming they had the abilities necessary to understand the GAO reports, understand their importance, and implement the applicable recommendations. They certainly did not do what they had been taught at school and college etcetera. For the common part of education does show the harmful consequences of dogmatism and repression.

²⁴¹ The President's working group (see below) is not mentioned in the AR 2006 of the Fed, nor in that of the SEC. (Other AR have not been checked for this).

²⁴² In the US, some supervisors were competitors... See the FCIC report.

²⁴³ See the Chronicle, under 1998 and 1999.

- sound. They bragged about themselves. They always gave an optimistic picture of the financial system, hampering the risk management of all actors in the financial system.
25. This applies with minor adaptations to BIS, IMF en OECD.
 26. Notwithstanding claims about the global nature of the financial system and the interdependency of countries, and although it is evident that the safety and soundness of say European banks depends on the safety and soundness of the US financial system, none of the supervisors pays attention to the quality of supervision in (important) other countries.
 27. The IMF had a Financial Sector Assessment Program. Its evaluation of Dutch financial supervision proves that it is inadequate and misleading.²⁴⁴
 28. During the period under consideration, the people with the relevant responsibilities had a fatal lack of self-knowledge, of understanding of the processes and interactions in the financial system and their risks, of openness, and of awareness of their responsibility. Exceptions were the people involved in the GAO reports of 1994-1999 and 2004, and those in the OFHEO systemic risk report of 2003.
 29. There is no accessible information about the influence of annual and other general reports of supervisors on the risk management of the institutions.

2. Explanation of the failure of the supervisors- summary.

The observations about the supervisors can be explained by the following characteristics of the top of these organizations:

1. Essential lack of integrity and competence.
2. False pretensions, arrogance, insufficient skepticism with respect to their own abilities, insufficient willingness to listen to, and to work on the basis of, sound arguments, insufficient doubts about the right to ignore opinions of others, insufficient willingness to account for their actions and omissions. Instead of this: dogmatic and authoritarian thinking and attitude.
3. Lack of understanding of the financial system and of its instability, and of the concept of risk.
4. Inability to reason and communicate about risks and an uncertain future.
5. (Internal and external) repression of opinions and even facts which they don't like. Within the organization difference of opinion is not permitted. Irrespective of the number and quality of the employees.
6. It does what it can to make people think of their organization as a single person, and that the opinions of this person represent the best if not infallible thinking of the aggregate of its hundreds or thousands highly qualified experts.
7. Lack of willingness (and maybe ability) to publish facts, analyses, opinions, recommendations, etcetera which are incompatible with prevailing political or their own thinking, but which their duty requires them to publish.
8. Lack of willingness (and/or ability) to cooperate with similar organizations, and experts outside the financial system.
9. A desire to brag: we supervise excellently, so our institutions are in excellent shape, we can be proud of our job and ourselves, and public and system may rely on us.

And by:

10. Dependency instead of independency of the supervisors. For three reasons:
 - a. Most supervisors are formally independent. But for example the Fed “must work within the framework of the overall objectives of economic and financial policy established by the government”.²⁴⁵ This created a conflict of interest.
 - b. The heads (and boards) are appointed by politicians. To all appearances they select people who, notwithstanding their duties and formal independence, give priority to the wishes of what seem to be seen as friends, colleagues or political superiors.

²⁴⁴ «According to the IMF the supervision of the financial institutions satisfies the international norms very well, and belongs to the best practices in the world.» DNB AR 2004 p. 66/64, quoted in the DNB appendix. If true, this disqualifies the IMF program. See below, and the DNB appendix.

²⁴⁵ Pp. 2-3 of *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005.

- c. Financial dependencies.
- 11. Repressive signals and/or actions of supposedly authoritative persons or organizations. Especially the president and government officials (including Congress).
- 12. Regulation which is fatally deficient. Supervisors have nothing to fear from not doing their duty.
- 13. Complete lack of supervision of the supervisors by parliaments and governments.

3. Introduction.

The law provides for organizations which have supervisory and regulatory duties with respect to the private, commercial organizations of the financial system.²⁴⁶ The law may require them to specify applicable laws, and/or give more technical regulation.²⁴⁷ They supervise compliance with applicable regulation. They do their job for the benefit of society as a whole, for the general welfare. Together they have to ensure that the system operates as may be expected of it. That is: in a way that is beneficial for everyone. For a specification of the duties of the supervisors the reader is referred to the appendices, the annual reports, or other contemporary pre-crisis documents.

The US has quite a few financial supervisors. They are responsible for overlapping parts of the system, but not for the whole system. They may compete with each other for the favors (customership) of institutions. They will be listed below. The Netherlands has two financial supervisors, DNB and the Authority for the financial markets (AFM). It should not be forgotten that in all countries, the minister of finance (secretary of the Treasury) is the ultimate and most powerful supervisor. Beside the national supervisors there are international organizations which periodically publish about the development of the international and most important national financial economic systems: the Bank of International Settlements (BIS), the European Central Bank (ECB), the International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development (OECD). Twice a year the IMF publishes a specific *Global Financial Stability Report*.

All supervisors yearly publish an annual report.²⁴⁸ As the name indicates, an annual report should describe the activities in the year under consideration, and the results obtained. It should give a picture of the state of affairs of the part of the system for which a supervisor is responsible. Including problems and risks. In the annual report supervisors can account for their policy and activities. They can use the annual report as an instrument for the fulfillment of their duties.

As from about the year 2000 the annual reports of the supervisors are available as pdf-files on their websites. Beside the annual reports most supervisors publish reports about specific topics. In the framework of this study the most important of these reports are the stability reports of BIS, BoE (Bank of England), DNB, ECB, and IMF. In agreement with their (ill-founded) belief in self-regulation, stability reports were not published by US supervisors.

There has been a lot of discussion about the adequacy of the powers given to the supervisors. Whatever the merits of such a discussion, there can be no doubt about the duty and possibility of the supervisors to report problems by means of their annual reports, and to do this timely and completely. And to submit all requests and/or recommendations which they deem necessary for the proper fulfillment of their duty.

Supervisors are hierarchical organizations. They were instituted by law, and the law prescribes how their heads are appointed. In general they are appointed by a secretary (minister) or the president (with the approval of parliament). Often they are subordinate to this person in one way or another, or perceive subordination. If only because they depend on them for (part of) their budget. In general supervisors do not operate fully on their own. In general they confer periodically with their paymaster. As regards the financing of the supervisors the US is exceptional. In general US supervisors are not paid by taxpayers. Some are paid by the institutions supervised.²⁴⁹ However, this doesn't make the supervisors independent from the federal government.

The remainder of the section discusses the operation of the supervisors with respect to the crisis.

²⁴⁶ I.e. the financial system in the narrow sense. Together with rating agencies and supervisors, the private commercial organizations form the financial system in the wide sense.

²⁴⁷ For this reason they are sometimes called regulator.

²⁴⁸ In principle. OTS didn't. See the introduction to its AR 2007, of the OTS appendix..

²⁴⁹ For the Fed see p. 11 of the Fed brochure Purposes and Functions (2005).

The Chronicle showed that supervision failed disastrously. But it also failed with respect to problems (“accidents”) unrelated to the processes which resulted in the crises. Problems which also would have occurred if there had been no crisis. Examples are: DSB (an upstart Dutch bank), Icesave, and the Ponzi-scheme of Madoff (and the large scale participation in the scheme by many banks everywhere). The similarity with the crises is, that all these problems were caused by taking unbearable risks. And by inadequate supervision. Adequate (“unpolitical”) supervision would have prevented all of them, including the damage they have caused.

4. Supervision: evaluation of the annual reports.

Summary and conclusions.

1. The annual reports of all supervisors ignore the GAO reports of 1994-1999, the systemic risk report of OFHEO,²⁵⁰ and the risks that motivated Born. (At least in any practical sense). The annual reports are systematically rose-colored. Everybody understanding the events of 1994-1999 only a little could have concluded that the annual reports are unreliable, and that large risks were not addressed by supervisors or governments.
2. From the unchanging style of the reports²⁵¹ it is clear that effective supervision of the supervisors was absent.
3. In a technical sense as well the annual reports leave much to be desired. That is: as reports of the policy and activities in the given year, also in the light of the policy and activities in the preceding years.

Besides the facts of the crisis, nothing shows the dysfunctioning of the supervisors as clearly and indisputably as their annual reports. Especially those of 2006-2008. A better proof of the false pretensions of the supervisors than these annual reports is hardly imaginable. In the light of the crises the reports show a combination of nonsense and complacency which seems surrealistic. The reports almost always suggest that everything is under control and runs smoothly. Some reports proudly show the prizes won with the previous edition of the annual report.

Amazing is the fact that there are very few exceptions. Apart from the GAO reports of 1994-1999 and 2004, the OFHEO systemic risk report of 2003, and with the (early) exception of Born, there were no reliable voices in the financial wilderness. The OFHEO systemic risk report was itself an exception, given a series of misleading annual reports. Whatever people like Strauss Kahn (IMF) and Wellink (DNB) asserted before inquiry commissions.²⁵²

The annual reports of the supervisors are exceptionally important because of the information they give about the functioning of the supervision, and because they are not affected by hindsight. For a report like this they are extra welcome because they are accessible for everyone. You can easily check everything for yourself. For the benefit of this book, annual reports of all of the supervisors mentioned have been studied and evaluated. The evaluations are fairly extensive. Therefore only their summaries and conclusions and a few quotes are presented in the main text. The evaluations can be found in the appendices. The annual reports themselves can be found in the dossier.

The GAO report of 1994 explains why the supervisors couldn’t have a reliable picture of the robustness of the financial system. See for example the section *Regulators Are Not Collecting Sufficient Information on Credit Risk and Earnings* on pp. 70-1/72-3 of this report. Supervisors could and should have known. If they hadn’t read or heard, they should have been able to infer it themselves, and been aware of it. Without such (and other) information, they never should have asserted that the

²⁵⁰ Even OFHEO itself ignored it! The report was probably made by a relatively small unit. Upon completion and publication, everybody else will have congratulated them, but continued his or her own work as before. Without active management work in an organization does not change fundamentally. The same was seen in the Dutch education ministry.

²⁵¹ And the absence of annual reports of the Office of Thrift Supervision (OTS) up to and including 2006!

²⁵² Both claim to have warned always and everyone. Regrettably their warnings left no trace in their annual reports or anywhere else. For Dominique Strauss Kahn (DSK) see *Inside Job*. For Wellink see the appendix Wellink.

system was healthy and that the financial institutions worked well. They couldn't know. And they didn't.

The motivation for the rose-colored picture presented by the annual reports may be the same as that of political organizations in general. They want to "prove" that they work well by creating the illusion that the system for which they are responsible works well. Failure and criticism of "their" institutions means failure and criticism of themselves as the responsible supervisors. Experience tells us that the positive picture is often incorrect. The absence of modesty and doubt in the annual reports is misleading and imprudent. It is an affront to the reader, who is supposed to believe unrealistic stories. Prudence is only discernible in some clever diplomatic formulations.

In general, parliaments, governments, and media seem have accepted the annual reports. Their comments can only have been marginal. No substantial improvements can be observed.

The annual reports were not only inadequate as regards content, but also as regards technical aspects. Of important unfinished business the next annual report may say nothing, without any explanation. For an example see the appendix about DNB. The selection of subjects treated seems arbitrary. See the appendix on DNB, and compare with the reports of other supervisors, and/or the international organizations mentioned above.

In the annual reports 2008 of most supervisors one can see what should have been reported in the annual reports of 2007 or earlier years, but wasn't. A clear and rather shocking example is the SEC.

In most of the annual reports a list of important actions and publications is missing. This is one of the things every contemporary could have noted. Including parliaments, governments, and media. Parliaments and governments could and should have done something about it. They didn't. So in this respect too the accounting by means of the annual report was superficial. And another form of accounting doesn't exist. The lists, and the accessibility of the publications, are important because the supervisors have thousands of employees, and because the financial system is very large. It produces a significant part of the national income. Ordering supervision-relevant information about the system is therefore very important. The annual reports could function as a guide to other publications. If you know what to look for you can often find them on a website. But the organization of publications on the websites of supervisors- the browsability- often leaves much to be desired, and seems to be an as yet unsolved problem.

None of the annual reports of any of the supervisors contains a section or chapter with a discussion of activities, policies and/or recommendations of sister-supervisors or relevant international organizations like BIS, IMF and OECD. Cooperative activities get little or no attention.

Explanation of the nature of the annual reports.

The following is meant to explain the misleading annual reports, and to inform. It gives a picture of the making of annual reports, and of the wall employees run up against when they try to make annual reports of their organization more useful and reliable. The picture is based on the personal experience of the author in the ministry of education, the factual annual reports mentioned in this report, and common sense.

Before continuing it may be useful to remark that not only the annual reports of the supervisors of the financial system were/are too rose-colored. The same can be said of the annual reports of the Dutch education supervisor, and its colleague for health care. One cannot escape the conjecture that the causes and mechanisms are general.

Usually draft annual reports are composed by a staff department on the basis of contributions of the various departments of the organization. Where the contributions are annual reports of the various departments. In principle everything is done as in the preceding year. Boundary conditions seem to be: 1) the annual report should not give rise to difficult or unpleasant comments or questions, and 2) it should show or suggest as much as possible that the organization performed excellently, and even better than the preceding year. Where necessary the staff department edits the contributions. In principle in consultation with the department concerned. In addition the staff department writes a draft introduction or something similar, and a draft side letter to be signed by the head of the organization.

Annual reports are public. Employees can read the annual reports of their own organization and those of other relevant organizations. In the case of the financial system in the years before the crisis,

the employees could have seen that the annual reports did not give a reliable picture.²⁵³ Just like the appendices they could have seen the misleading complacency and the gross underestimation or burking of risks. And the experts should have.²⁵⁴ If they had already been working in this organization for a number of years, they could know that the annual reports were always like this. And that government, parliament and media accepted them without comment. If someone would nevertheless venture text amendments which though justified would attract attention and give rise to questions, then it is extremely improbable that his manager would approve them, and pass them on to his superior. In a hierarchical organization even the remark that something is unusual passes for an (weighty) argument. An annual report is mandatory. An organization with power sees it as a necessary but irrelevant ritual. It makes something that resembles an annual report because it has to, but it need not give a truthful picture of the (most important) policies and activities, and of the environment of the organization. Nobody feels responsible for the content, and everybody knows for sure that he or she will be held responsible for commotion caused by changes in style or content, and even more if this gives rise to serious comments or questions.

With regard to the annual report there is a very strict risk management.

5. Financial supervision in the USA.

Summary and conclusions.

1. The heads of the supervising organizations are appointed by the senate in agreement with, and on proposal of, the president.
2. In their annual reports, none of the supervisors gives an overview of the operation of the financial system. That is: of the different types of financial products, the roles they play in which processes, relations between products and processes, and risks, especially of devaluations/ downgrades and their sequel. By implication there was (and is) no overview and analysis of systemic weak points.
3. In their annual reports, none of the supervisors gives an overview of the organization and operation of the supervision of the financial system. None of them gives a clear picture of his responsibilities,²⁵⁵ and of the relation between these responsibilities and those of other supervisors and/or the government. They don't inform about the gaps in supervision: what is and what is not supervised, and what information is needed for what, but missing. They give no picture of what they cannot do or are not permitted to do in order to be able to guarantee that the institutions they are required to supervise are safe and sound, or to what extent, and what that means.
4. The annual reports of the supervisors did not inform about (general) risks threatening the safe and sound operation of the institutions under their supervision. At the same time, they did not say that they had insufficient information or authority to do their work properly.²⁵⁶
5. The supervisors ignored the recommendations of the GAO of 1994-1999. The reports of the GAO and the OFHEO systemic risk report show that even on the basis of a relatively simple analysis important conclusions can be drawn about systemic risks. The facts show that no other supervisor was able or willing to make such an analysis. None (including OFHEO!) acted in accordance with their conclusions.

²⁵³ Those for Dutch education and health care don't give a truthful picture either. Where the insufficiency of education does not refer to the deficiencies noted in 7B.2 above, but to the norms of the given education system. Symptomatic is the observation that the systematic fraud in higher professional education (the "HBO-fraude"), and the problems of the institutions InHolland and Amarantis for higher professional education were not revealed by the supervisor, but by whistleblowers, students and other people. As in the case of the financial supervisors, there was no investigation of the failure of the supervisor. The responsible employees of the supervisor kept their position.

²⁵⁴ This applies mutatis mutandis to the yearly Education reports (Onderwijsverslagen) of the education supervisor. As proven by various scandals in the period considered in this report.

²⁵⁵ The Fed indicates its four main responsibilities, but does not for example explain how these responsibilities relate to the responsibilities of other supervisors, and what activities of what kind of banks it supervises in which way.

²⁵⁶ In its AR, OFHEO, supervisor of Fannie and Freddie, did ask for more powers, but did not explain why.

6. In fact, they seem to have done nothing at all with the aforementioned reports, even though they grew in relevance and importance as time progressed.
7. The supervisors nevertheless do as if they are excellent. They show no doubt about their ability to guarantee a safe and sound financial system.
8. In the years under review, all supervisor annual reports are reassuring, and therefore misleading. The reports gave their readership, including financial institutions, an erroneous picture of the safety and soundness of the US financial system and its products.
9. The Fed and OFHEO had to take government policy into account. It is plausible but not clear that this also applies to other the supervisors. And even if there is no formal obligation, they may have felt an informal obligation. It is clear that in the years 1995-2007 deregulation was the fashion, and that this affected supervision. Conflicts or compromises between supervision and policy cannot explain the dysfunctioning and failure of supervision, but it may have contributed.
10. Perhaps the most blatant example of neglect of duty is the fact that the Fed simply paid no attention to one of its four main responsibilities: «maintaining the stability of the financial system and containing systemic risk that may arise in financial markets». ²⁵⁷ In the Fed's annual report no activity in this field is reported. Indeed, none of the facts of the crisis is incompatible with the hypothesis of complete neglect.
11. The supervision of the supervisors is a duty of government and Congress. They could and should have concluded the above when the annual reports were published. They could and should have taken corrective action.
12. The annual reports of the years after the crisis show no trace of acknowledgement of errors or failure. They don't report about self evaluations (assuming they were made).
13. The combination of facts and annual reports shows that the supervisors, government and Congress were insufficiently competent and honorable.
14. None of this is studied by the inquiry commissions.

The organization of financial supervision in the USA.

The federal system of supervision is regulated by the federal government. The states have supervisors too. The pre-emption conflict noted by the FCIC might be a reason for some description and analysis, but in the present context this does not seem to have much added value (even though it may be important). ²⁵⁸ The discussion in this report is restricted to federal supervisors.

The most important financial supervisors in the US are:

- The Federal Reserve Bank (the Fed)
- The Securities Exchange Commission (SEC)
- The Commodity Futures Trading Commission (CFTC)
- The Office of Thrift Supervision (OTS)
- The Office of the Comptroller of the Currency (OCC).

The GSEs were supervised by the Office of Federal Housing Enterprise Oversight, OFHEO, and, since GSE securities were traded in exchange markets, by the SEC. OFHEO was part of HUD.

There is an appendix on each of these supervisors. The appendices provide basic information and an evaluation.

From the point of view of organization, the system of supervisors of the US seems rather complicated and opaque. From the point of view of duties (“responsibilities”) and activities it gives rise to many questions. For these reasons it would have been very useful if in the introduction or an appendix of their annual reports the supervisors had given an overview of the supervision system and their own role in that system. This would also have given an opportunity to point out gaps in the system. Both as clarification and to avoid illusions. But none of the supervisors or the PWG (see below) did so.

For understanding the operation of the supervision system the following section from the GAO

²⁵⁷ P. 5 of the pdf-file of Fed AR 2006.

²⁵⁸ See the FCIC-report, p. xxiii. Search for example for “state regulat”. The pre-emption is an example of (ab)use of power by the central supervisors to overrule more prudent state supervisors and regulation.

report *LTCM: Regulators Need to Focus Greater Attention on Systemic Risk*²⁵⁹ is very valuable:

«Financial Regulatory Structure.

Hedge funds are generally not subject to direct federal regulation, instead they are indirectly “regulated” by the banks and securities and futures firms that are their creditors and counterparties. The regulators’ role is to ensure that those banks and securities and futures firms are practicing prudent risk management, including the risks they take in dealing with hedge funds. A primary mission of bank regulators is to promote the safety and soundness of the banking system, and this is achieved primarily through ensuring the safety and soundness of individual institutions. Three federal bank regulators oversee banks, some of which are also subject to state regulatory oversight. Bank regulators have the authority to establish capital requirements, establish information-reporting requirements, conduct periodic examinations, and take enforcement actions. The Federal Reserve, the lender of last resort for banks and other financial institutions, also has an additional objective of ensuring the overall stability of the U.S. financial system.

SEC’s and CFTC’s primary purposes are to protect investors or customers in the public securities and futures markets and to maintain fair and orderly markets. Unlike the bank regulators, which can regulate all bank activities, SEC and CFTC are authorized to regulate only activities involving securities and futures and only those entities that trade these products. SEC regulates activities involving securities and the firms that trade these products. Such firms include broker-dealers, which must register with SEC and comply with its requirements, including capital requirements. Broker-dealers must also comply with the requirements of various self-regulatory organizations (SROs) of which they are members, such as the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD). CFTC regulates activities involving FCMs,²⁶⁰ which must also comply with rules imposed by futures SROs²⁶¹ - the various futures exchanges, such as the Chicago Board of Trade and Chicago Mercantile Exchange, and an industry association, the National Futures Association (NFA). SEC and CFTC have the authority to establish capital standards and information reporting requirements, conduct examinations, and take enforcement actions against registered broker-dealers and FCMs, but generally not their unregulated affiliates.

The U.S. financial regulatory system has evolved over time, in part in response to financial crises. For example, SEC and the Federal Deposit Insurance Corporation (FDIC) were created during the depression to fill perceived gaps in the regulatory structure. In the 1980s and 1990s, crises and disruptions in markets have revealed additional regulatory gaps. Many of these gaps have been filled by extensions of authority rather than by the creation of new agencies. For example in 1990 and 1992, in response to the Drexel bankruptcy, Congress provided SEC and CFTC, respectively, with authority to obtain information from certain broker-dealer and FCM affiliates. However, SEC and CFTC still lack consolidated regulatory authority over securities and futures firms.»²⁶²

Theoretically the supervision is coordinated by the President's Working Group on Financial Markets (PWG):

«In 1988 Executive Order 12631 established the President's Working Group on Financial Markets. The Working Group is chaired by the Secretary of the Treasury and includes the Chairman of the SEC, the Chairman of the Federal Reserve and the Chairman of the Commodity Futures Trading Commission. The goal of the Working Group is to enhance the integrity, efficiency, orderliness and competitiveness of the financial markets while maintaining investor confidence.»²⁶³

“Theoretically” because the supervision system is far too large to be coordinated in this way. The author does not know how the PWG worked in practice, but it could have worked as an umbrella for a more realistic coordination structure. However, in the years before the crises there clearly was insufficient constructive coordination. There was effective coordination for the elimination of Born and, one may conjecture, for the appointment of kindred spirits in the case of vacancies in the top of a

²⁵⁹ Of 1999, in the dossier.

²⁶⁰ FCM= futures commission merchant.

²⁶¹ SROs= self-regulatory organizations.

²⁶² 1999 GAO report pp. 7-8/9-10.

²⁶³ Wikipedia-lemma “U.S. Securities and Exchange Commission” 23/7/12.

supervisor.

To a certain extent, financial institutions were free to choose their supervisor. As a consequence, some supervisors had to compete with other supervisors:

«Richard Spillenkothen, the Fed's director of Banking Supervision and Regulation from 1991 to 2006, discussed banking supervision in a memorandum submitted to the FCIC: "Supervisors understood that forceful and proactive supervision, especially early intervention before management weaknesses were reflected in poor financial performance, might be viewed as

- i) overly-intrusive, burdensome, and heavy-handed,
- ii) an undesirable constraint on credit availability, or
- iii) inconsistent with the Fed's public posture."

To create checks and balances and keep any agency from becoming arbitrary or inflexible, senior policy makers pushed to keep multiple regulators. In 1994, Greenspan testified against proposals to consolidate bank regulation: "The current structure provides banks with a method... of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. The pressure of a potential loss of institutions has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate."²⁶⁴ Further, some regulators, including the OTS and Office of the Comptroller of the Currency (OCC), were funded largely by assessments from the institutions they regulated. As a result, the larger the number of institutions that chose these regulators, the greater their budget.»²⁶⁵

An important institution in the world of supervision in a wider sense is the General Accounting Office (GAO). The Wikipedia describes this organization as follows:

«The GAO was established as the General Accounting Office by the Budget and Accounting Act of 1921. This Act required the head of GAO to "investigate, at the seat of government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds, and shall make to the President ... and to Congress ... reports [and] recommendations looking to greater economy or efficiency in public expenditures". According to GAO's current mission statement, the agency exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.

The name was changed in 2004 by the GAO Human Capital Reform Act to better reflect the mission of the office. While most other countries have government entities similar to the GAO, their focus is primarily on conducting financial audits. The GAO's auditors conduct not only financial audits, but also engage in a wide assortment of performance audits.»²⁶⁶

Supervision in action.

The appendices give general information, and evaluations of annual reports, of Fed, SEC, CFTC, OCC, OTS en OFHEO. At the beginning of each of these appendices is a section *Summary and conclusions*. What follows below are impressions. For a more systematic and informative treatment the reader is referred to the appendices.

OTS deviates from the other supervisors in not having published an annual report for many years. The annual report about 2007, dated 19/12/07, is the oldest the author could find on the internet. The appendix OTS gives general information about OTS and an evaluation of the annual reports 2007 and 2008. The annual reports show that lots of things escaped the attention of OTS, or that it lacked integrity, or both. Section 19.3 of the FCIC majority report describes the result. The section is an uninterrupted sequence of scandals. An example:

²⁶⁴ This may not only prevent *excessive* regulation. For how is the *sufficiency* of the regulation/ supervision ensured?

²⁶⁵ FCIC p. 54/82. (Lay out changed slightly). See also the hearing of Geithner by the FCIC on 6/5/10. Search for "choose the regulator".

²⁶⁶ Wikipedia 7/8/12.

«In February 2008, AIG reported billions of dollars in losses and material weaknesses in the way it valued credit default swap [CDS] positions. Yet the OTS did not initiate an in-depth review of the credit default swaps until September 2008.»

By way of an explanation, director of OTS «Reich told the FCIC that before 2008, AIG had not been a great concern. He also acknowledged that the OTS had never fully understood the Financial Products unit, and thus couldn't regulate it. “At the simplest level, . . . an organization like OTS cannot supervise AIG, GE, Merrill Lynch, and entities that have worldwide offices. . . . I would be the first to say that for an organization like OTS to pretend that it has total responsibility over AIG and all of its subsidiaries . . . it’s like a gnat on an elephant- there’s no way.” Reich said that for the OTS to think it could regulate AIG was “totally impractical and unrealistic. . . . I think we thought we could grow into that responsibility. . . . But I think that was sort of pie in the sky dreaming.”

[President of the NY Fed] Geithner agreed, and told Reich so bluntly. Reich told the FCIC about a phone call from Geithner after the rescue. “About all I can remember is the foul language that I heard on the other end of the line,” Reich said. He recalled Geithner telling him. “‘You guys have handed me a bag of sh*t.’ I just listened.”»²⁶⁷

In March 2008 Reich was still saying that «the Savings and Loan industry remained vibrant due to the effectiveness of regulators». ²⁶⁸ This clearly was a false pretension and misleading. OTS was responsible for significant parts of AIG, IndyMac and WaMu. If Reich really thought OTS couldn't vouch for the safety and soundness of such institutions, he should and could have reported that a long time ago. That OTS couldn't handle them, and/or shut its eyes, also follows from an inquiry of the Treasury department:

«On 26 February 2009, the Treasury Department's inspector general released a report citing laxity at the OTS under Reich for adding significantly to the \$10.7 billion in FDIC losses from the IndyMac failure, as well as the estimated \$270 million in losses suffered by uninsured depositors. The report concluded that, under the law, OTS should have taken Prompt Corrective Action against IndyMac in May 2008. Commenting on the report, Inspector General Eric Thorson dismissed Reich's claim that Senator Schumer's letters caused the failure. Marla Freedman, the assistant inspector general for audit, detailed a pattern of excess risk-taking and abuse of the lending process at IndyMac and the OTS's consistent and concurrent failure to act. Mr. Reich said in a letter to the inspector general that he agreed with the agency's filings.»²⁶⁹

The report of the Treasury department and the comment of Freedman prove that supervision of supervision is possible.²⁷⁰

Reich had been appointed by president George W. Bush. Earlier in his career president Bill Clinton had appointed him Director of the FDIC.

In the meantime Geithner had a record amount of butter on his head. At the beginning of his “Message from the Director” in OTS AR 2007 Reich writes:

«This Annual Report is the first such report from the Office of Thrift Supervision in many years, just one of several “firsts” since I came on board as OTS Director in August 2005.»²⁷¹

In other words: for many years there had not been an annual report. Everybody could have noticed. Why did nobody do anything about it? Geithner was President of the Federal Reserve Bank of New York since 17/11/03.²⁷² How is it possible that he, nor the (federal) Fed, Congress or government reacted effectively?²⁷³ Isn't publication of an annual report a minimal requirement for any responsible organization? From many events in 1994-2006 it should have been known that the supervisory system has risky weaknesses. Therefore every expert should have interpreted the absence of an annual report

²⁶⁷ FCIC report p. 351/79. Note that Reich acknowledges the false pretensions of OTS and himself.

²⁶⁸ Wikipedia OTS, referring to the NYT of 22/11/09.

²⁶⁹ Wikipedia OTS 7/2/13.

²⁷⁰ Of course the appendices prove the same.

²⁷¹ OTS AR 2007 p. 3. In the dossier. AR= annual report.

²⁷² And until 26/1/09, see the Wiki page “Geithner”.

²⁷³ Or sooner. The appointment of a new head may have been intended or sold as a corrective measure.

as a symptom of even more serious problems. Apparently Geithner didn't notice, or didn't see a need for action. He has no reason to be surprised when the risks he took materialized.

The most important conclusion of the OTS experience is probably that history repeats itself. For OTS has failed in the same way as its predecessor. OTS was intended to prevent repetition. But as the OTS appendix shows: contrary to what often is suggested or asserted, politicians and political organizations do not learn.

Even if the head or "the organization" him- or itself did not believe in the risks described by the GAO and almost a decade later by OFHEO and BIS-CGFS, then because of their duty they still should acknowledge the possible existence of a risk, and manage it professionally. If only to be able to account properly for their conduct. Because of the opinions of GAO, OFHEO and BIS-CGFS the risk should have been considered real. Perhaps small, but at any rate greater than zero. The apparently small risk was nevertheless very important because it corresponded with extremely large negative consequences. There was more than enough reason to seriously think about preventive measures, and to make plans for halting the avalanche that was on the horizon in the LTCM crisis, and outlined in the GAO and OFHEO reports. Ignoring the risk would only have been permissible if the top managements had been justified in pretending infallibility. Which of course they weren't. As earlier cases show, these people simply don't accept any views but their own.²⁷⁴ Other views are not taken into account only a little, but not at all. And since they are heads of hierarchical organizations, everyone has to comply, or leave. Heads have no need for risk management or learning.

6. Financial supervision in the Netherlands.

Summary and conclusion.

1. The Netherlands has two financial supervisors. Their duties are not very well defined, but together seem to cover all important aspects.
2. What has been said regarding the operation of supervision in the US applies mutatis mutandis to Dutch supervision. There is no fundamental difference whatsoever.
3. Dutch supervision did worse than US supervision in that a much larger part of the banking system was threatened by bankruptcy and needed government help. In fact, almost all of the larger banks had to be taken over by the government.

De Nederlandsche Bank (DNB), the Dutch central bank.

The appendix DNB gives some general information about DNB, and an analysis of some annual reports and Reviews Financial Stability. The last is published since 2004. Since 2007 twice a year, in May and November.

There is also an appendix devoted to Nout Wellink, the president (= chairman, boss) of DNB in the period under consideration. It includes his CV and an analysis of his hearings by the Commission De Wit (CDW). Both appendices have sections with conclusions. It should be noted that especially by means of his role in BIS, Wellink played, or could have played, an important role in the international financial system.

The failure of DNB defies imagination. The size of the failure can be measured by the amount of taxpayers money that was needed to save the Dutch financial system from total collapse and annihilation, and by the relative size of the part of the financial system that was fatally affected by the crisis. Two of the four largest banks had to be taken over by the government. Other banks had to be saved by loans and other forms of support. All this was avoidable. The best sources of information for the history of these events are the reports of the CDW. These reports do not however describe the

²⁷⁴ A sure sign of incompetence, if not outright stupidity.

problems with SNS, LIBOR and Euribor, which erupted a little bit later, in 2013.²⁷⁵ These later problems not only show the failure of the supervision by DNB. They also show that DNB, government and parliament have not learnt the lessons of the crises, and took insufficient corrective action.

The annual reports, the hearings of the inquiry commissions and many other documents show that after the crisis almost all principal persons systematically tried to represent the course of historical events in such a way as to exculpate themselves, as far as possible without incriminating their peers. History is falsified where deemed necessary. With regard to DNB the hearings of Wellink by the CDW provide numerous examples. See the Wellink appendix and the Dutch report *Wellinks meineed*. Three important and inconsistent lies are that Wellink and DNB had always given warnings, that nobody had foreseen the possibility of a crisis, and that our inability to forecast is to blame.

Annual reports actively contribute to the falsification of history. On p. 120/121 of DNB AR 2007 one reads for example:

«The market turbulence of 2007 has shown that the OTD model has serious shortcomings as well.»

OTD means: “originate to distribute”. A bank can sell mortgages as an investment for itself, but can also sell them, or bundle them in mortgage backed securities (MBS). In the last case the originating bank has a much smaller interest in the quality and performance of the mortgages. For buyers of the MBS this means an additional risk. The quoted remark of DNB is misleading if not incorrect. It is incorrect in suggesting that the events of 2007 and 2008 taught something that was not known before. It had been known for many years already that the OTD model has serious shortcomings. In 2003 at the latest. See section V.1 on p. 16/20 of the BIS-CGFS report of that year. A report that was written in collaboration with employees of DNB! There was no need of a crisis to bring the problem to light. So if this isn’t intentional fraud, then at least internal competence and communication, organizational memory and management of DNB were insufficient.

There are many similarities between the supervisors in the US and in the Netherlands and other countries. But there is an important difference as well. Namely the difference in size. As a consequence, the relation is asymmetric. Cooperative events in the US affect events in other countries strongly, and much stronger than conversely. For this reason other countries have a great interest in a properly operating supervisory system in the US. Inadequate regulation and dysfunctioning supervision in the US constitute a threat to the financial stability everywhere on earth. This is theoretically evident, and has been verified empirically many times since the crisis of 1929 at the latest. Supervisors in the Netherlands and other countries should have understood this. They should have been acquainted with the state of supervision in the US and other financially important states. They should have been aware of threats from other countries. When investigating banks (in their own country), supervisors should have noted that banks held American securities such as MBS, CDO and CDS. They should have concluded that the safety and soundness of their banks depends on the quality of the supervision in the US.²⁷⁶ They should have reported questions or problems in their annual reports, and given a warning about the (extra) risks due to lack of reliable knowledge. But they didn’t.

Perhaps Wellink and his colleagues thought that they should not endanger friendly relations with the US by being (“too”) critical. Supposing they didn’t believe blindly, or thought that they had to assume proper (ideal?)²⁷⁷ supervision. There is no indication of awareness of the dependency, and of the risks of inadequate supervision. Note that the care of friendly relations is an example of improper priorities interfering with supervisory requirements.

The Autoriteit Financiële Markten (AFM), the Authority Financial Markets.

The AFM seems to have had little to do with the crises. The author has heard or seen nothing that

²⁷⁵ Both cases are well documented microcosms. The DNB/Rabobank involvement in LIBOR and Euribor is discussed in chapter 8. For SNS there are some files in the dossier at least outlining the case, but maybe they are not sufficiently complete. Studying this case does not seem to have added value however.

²⁷⁶ Supervisors cannot hide behind the “adequate risk management” of their banks, for how could their banks know the risks of American securities? (Of course, the events have amply shown that the risk management was not adequate).

²⁷⁷ Whatever that may be...

suggested that AFM could be an exception in the world of supervision. For these reasons a study of the AFM seemed to have little or no added value, and has been omitted.

As a check some annual reports have been scanned all the same. In the report about 2006 some remarkable “snapshots” were found. They succinctly characterize the thinking of the times. Since they reveal the political spirit of the times more clearly than anything else in this book (or anywhere), and are almost funny for their shameless shortsightedness and stupidity, they (or equivalent quotes) should be included in any report endeavoring to describe and explain the prehistory of the subprime crisis. The snapshots are found on the pages where prominent people in the Dutch financial or economical world give some AFM-relevant opinions. The following two quotes are typical proofs of a climate facilitating the development and growth of the building blocks of a crisis.

The first quote is of Boele Staal, chairman of the Dutch Bank Association:^{278, 279}

«One should prevent that in the century of supervision all those authorities, including the AFM, only fire freely from an isolated position at the institutions under supervision which otherwise may do what they like. This does not serve the ultimate goal of supervision. Likewise generalizing conclusions should certainly not be based on suspicions or random samples. Carefulness should have priority. This applies to the financial sector itself, but also to the way the sector is dealt with.»²⁸⁰

Both “all those authorities” and “fire freely” are examples of tendentious nonsense. “In the century of supervision” more than half of the larger Dutch banks will have to be taken over by the government: AAB, DSB, ING en SNS Reaal... Due to inadequate supervision.

The second quote is of Bernard Wientjes, chairman of the Dutch Employers Association:^{281, 282}

«In the last decades and in many areas the Netherlands has become a society where almost everything is supervised. Government and parliament moreover prefer supervision beforehand, by a system of licences. In my view wrongly. In the Netherlands we have more than thousand systems of licences with millions of licences! That is a very bad situation for enterprise. Enterprise needs freedom.²⁸³ Where it is thought that we can endeavor to realize a society without risk, this is impossible in practice. Don't misunderstand me. VNO-NCW does not object against all rules. We say: 'Prescribe clear rules, and evaluate afterwards'. In this way you show trust in entrepreneurs. Let them know precisely what they should comply with. But settle accounts sternly if they don't stick to the rules. More trust beforehand, and tougher punishment in case of infringements, that should be the principle.'»²⁸⁴

It is downright nonsense that almost everything in the Netherlands is supervised. The facts have shown that there was not enough supervision. And that there was too much freedom. It is obvious that Wientjes never understood the prisoner's dilemma game. (Supposing he has heard of it). After the crisis, the take overs, and the state-loans, no punishment was meted out at all, let alone sternly. Nobody has ever heard of a request by Wientjes to punish for non-compliance. Nobody remembered the quoted nonsense during or after the crisis. Wientjes remained chairman of VNO-NCW as if he had never tried to subvert supervision. Only in 2014 did he relinquish the chairmanship of VNO-NCW, and only because his term was completed.

Note that by means of such statements Staal and Wientjes are actually lobbying for deregulation

²⁷⁸ Dutch Bank Association. In Dutch: Nederlandse Vereniging van Banken (NVB).

²⁷⁹ In 2016 Boele Staal was appointed acting mayor of Arnhem. Apart from this, the internet did not speedily yield his other activities in the years after leaving NVB.

²⁸⁰ AFM AR 2006 p. 62/64.

²⁸¹ Dutch Employers Association= VNO-NCW.

²⁸² According to the periodical Management Scope, in 2016 Wientjes was chairman of the council of commissioners of KPMG (president-commissaris; the council is supposed to supervise the management), and professor of economics at Utrecht University. On 4/9/13 he received an honorary medal from the Dutch ministry of foreign affairs, the Eretekens van Verdienste. (Wikipedia “Bernard Wientjes” 2/5/17).

²⁸³ Literally (euphemistically, metaphorically): “space”.

²⁸⁴ AFM AR 2006 p. 112/114.

and self regulation.²⁸⁵

7. The conclusions and recommendations of the inquiry commissions with respect to supervision.

Conclusion 2 of the FCIC majority reads:

«We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.»²⁸⁶

The FCIC minority of 3 on the other hand does not mention regulation or supervision among the 10 “essential causes” of the crisis.²⁸⁷

The FCIC had not been asked to make recommendations, and it doesn't give them. (It was asked to find the causes). The FCIC majority clearly shows the failure of the supervisors. But it does not analyze or indicate the cause of this failure. Because of their fundamentally deficient analysis, measures based only on the reports of FCIC majority or minority cannot not be expected to be effective.

The first report of the CDW gives several recommendations about supervision. At first glance these seem to be a good beginning. But a closer look reveals that they are insufficient. This can be blamed on the inadequate analysis they are based on. Nothing is said about the integrity and competence of the top, about the selection of the top, about whistleblowing and the silent thousands, and the annual reports. The CDW report suggests a shortage of powers. It recommends reduction of liability of supervisors. This probably means: liability with respect to the institutions under supervision. (It is not explained why this is or was a problem). Much more serious is the problem of liability for social damage²⁸⁸ caused by culpable negligence and other misconduct of a supervisor. None of the recommendations creates or strengthens incentives for appropriate conduct, and/or disincentives for misconduct.

Although pp. 15-17 of Paulson's *Blueprint for a modernized financial regulatory structure* of 2008²⁸⁹ says and proposes important things about the role of the Fed with respect to systemic risk, it seems to start from incorrect premises. It seems to assume that the Fed failed due to a lack of information and authority. As the Chronicle has shown, this is nonsense.²⁹⁰ The Fed completely ignored its responsibility with respect to systemic risk. Probably because mr. Greenspan believed in self regulation, and had a repressive attitude, and all other people in power had been selected for similar beliefs and/or subservience. But as regards improvement of the procedures for selecting and/or appointing managers and other employees, no action is taken.

7B.6. International and other organizations involved in financial-economic affairs.

The Bank of International Settlements (BIS).

Introduction.

«The BIS is an international organization that fosters international monetary and financial cooperation and serves as a bank for central banks. Its head office is in Basel, Switzerland, and it has

²⁸⁵ The quotes show a purely political, dogmatic “argumentation”, a complete absence of any sound argument. They give no evidence proving the safety of the system and the (net) harm done by supervision. No refutation of the arguments of the GAO, BIS-CGFS or OFHEO. Etcetera. The quotes belong in a shouting match.

²⁸⁶ FCIC p. xvii/18.

²⁸⁷ FCIC pp. 417-9/445-7.

²⁸⁸ Social damage= the (all) damage done to human society, or simply all damage caused.

²⁸⁹ In the dossier under 20080331.

²⁹⁰ To a certain extent, the lack of information is correct, but the Fed knew it lacked crucial types of information, and refused to do anything about it. That was the problem, not the lack of information itself.

two representative offices, one in the Hong Kong Special Administrative Region of the People's Republic of China and one in Mexico City. The Bank currently employs 554 staff from 49 countries.»²⁹¹

«BIS Mission Statement

Excellence in service to central banks and financial authorities

The BIS

- Aims at promoting monetary and financial stability
- Acts as a forum for discussion and cooperation among central banks and the financial community
- Acts as a bank to central banks and international organizations

BIS staff emphasize

- excellence in performance
- highest ethical standards
- professional discretion»²⁹²

«The Bank also hosts the secretariats of a number of committees and organizations that seek to promote financial stability:

- The Basel Committee on Banking Supervision, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems and the Markets Committee have been established by the Governors of the G10 central banks over the past 40 years. They enjoy a significant degree of autonomy in setting their agendas and structuring their activities.
- The Financial Stability Forum, the International Association of Insurance Supervisors and the International Association of Deposit Insurers are independent organizations that do not directly report to the BIS or its member central banks.»²⁹³

For information about BIS as an organization, including its management, see the BIS appendix or a BIS annual report.

Conclusions.

1. The role of BIS in the run up to the financial crisis has been evaluated on the basis of the following reports:
 - CGFS²⁹⁴ 20: Credit risk transfer (CRT, January 2003);
 - Joint Forum CRT (March 2005);
 - CGFS 26: Housing finance in the global financial market (January 2006);
 - BIS AR 2006 (June 2006);
 - Joint Forum CRT (July 2008);
 - BIS AR 2009 (June 2009).
2. The reports can be characterized as follows:
 - CGFS 20 on CRT (2003). Notes important risks and obscurities, but handles them irresponsibly and unprofessionally. Makes no recommendations, but restricts itself to outlining issues;
 - Joint Forum CRT (2005). Gives a defective analysis. Implicitly, and only implicitly, shows an utterly unacceptable and very risky state of affairs in and among market participants. Presents valuable recommendations. However, implementation is entirely noncommittal, and

²⁹¹ BIS-AR 2006 p. 155/165.

²⁹² <http://www.bis.org/about/mission.htm>, 13/8/12.

²⁹³ BIS AR 2006 p. 155/165.

²⁹⁴ CGFS= Committee on the Global Financial System.

- governments are not addressed;
- Housing finance (2006). Lacks involvement and shows irresponsible wishful thinking. Makes very soft and non-binding recommendations;
 - BIS AR 2006 (2006). Inadequate as an annual report, because it ignores a large part of the activities of central banks. Analytically it is inadequate too, because of restriction to global/macro aspects, without proper regard for the (potential) influence of micro on macro;
 - Joint Forum CRT (July 2008). There is no evaluation of the implementation of the recommendations of the 2005 report. The earlier recommendations are supplemented with a few new ones. In spite of recent events there is no substantial change with respect to 2005. No vigorous action. Nothing was learned;
 - BIS AR 2009 (2009). Contains useful information about the crisis, but is analytically defective. Like the former annual reports, this one is written as if BIS has perfect knowledge and understanding. There is no trace of awareness of having failed. There is no sign of correction.
3. None of the BIS reports mentions the GAO reports of 1994-1999, acknowledges the correctness of its analyses, and supports its recommendations. Even though there is much overlap in subject matter;
 4. The Housing finance report (CGFS 26) mentions neither OFHEO nor “systemic risk”;²⁹⁵
 5. In spite of overlapping duties, the annual reports of BIS do not mention specific or groups of supervisors, shared opinions or generally supported recommendations;
 6. The reports suggest that they tell the one and only true story. They suggest that no other interpretations, points of view, and opinions are possible and actually exist;
 7. Both ethics and risk management require reports like those of financial supervisors to contain all relevant opinions, judgments etcetera, together with arguments for and against.²⁹⁶ Publishing a single (compromise) opinion, conclusion, etcetera is a demonstration of lack of openness. It is unrealistic, misleading, and potentially dangerous;
 8. As regards the BIS reports it would seem that deviating argumentation and opinions were not judged on their intrinsic merits, but ignored or left unmentioned for unexplained reasons, or modified in a compromise. This is incompatible with professionalism and the mission statement of BIS;²⁹⁷
 9. To a certain extent the reports can be understood as a compromise between material and dogmatic or political motives. To a certain extent, because such compromising is contrary to BIS’ mission statement;²⁹⁸
 10. Some reports frequently express uncertainty. The supervisors do not conclude however that this requires risk management by themselves. That is: by the supervisors. In this regard, they actually assume certainty (about safety, adequacy of self-regulation, etcetera);
 11. What BIS calls annual reports are no annual reports. They do not give an account of what BIS did in the given year. Instead they present macro-economical reviews, similar to those found in the “annual reports” of most other supervisors, IMF and OECD. A (too) short annual report can be found in the appendices of the “annual report”;
 12. The reports can only be explained as results of insufficient integrity and professionalism, inadequate management (including absent coordination), and compromises with dogmatic and/or stupid authorities.²⁹⁹ It is not a matter of lack of information and underestimation of risk, but of intolerance for opinions which differ from those of the top, and refusal to reason and discuss on the basis of arguments. And of the subservience and cowardice of those who understand that this is an unprofessional and unethical practice, and increases the systemic risks;

²⁹⁵ The other reports have not been checked for these terms.

²⁹⁶ Unless convincingly refuted of course.

²⁹⁷ It is incompatible with the “highest ethical norms”: other opinions and people are not respected. Due care requires openness and respect for other opinions and arguments, except when it can be (rigorously) proven that they are wrong. In economics this is rarely possible, if at all.

²⁹⁸ In other words: the mission statement omits mention of norms and values which in practice are more important than those mentioned.

²⁹⁹ Of course this can all be seen as management failures (too).

13. The reports show that the reality of BIS is incompatible with its mission, and that the mission statement is misleading. Examples:
 - “Excellence”: because of very unprofessional and unexplained conduct in vital matters this is plain nonsense;
 - “BIS aims at promoting monetary and financial stability”: Although “promoting” is elastic, and BIS did promote a little bit, it did not do by far what it could and should have done;
 - “BIS staff emphasize highest ethical standards”: the reports show a complete lack of openness,³⁰⁰ and actually are misleading. High ethical standards require openness, for example about compromises;
 - Failures of BIS are not acknowledged, and nothing is done to show the public that the defects indicated in the present conclusions will be repaired, and integrity and competence fundamentally improved.
14. Instead of working in accordance with its mission statement, BIS seems to have worked under the inviolable boundary condition, that nothing is to be said or done that is incompatible with the policy of any of the major supervisors (especially the US Fed). In other words: BIS operated as a political organization;
15. If BIS would consider its mission statement as no more than a noncommittal ideal, and that it cannot and need not respect the norms and values it incorporates, for example because compromises have to be made with central banks and/or others beyond its control,³⁰¹ then it could and should say so in the mission statement. Otherwise it gives rise to the suspicion that the mission statement is primarily meant to mislead the public;
16. The recommendations in the reports are noncommittal. There is never a sense of urgency. Members, participants or supervisors are not asked to report progress. Neither is implementation monitored by BIS (CGFS);
17. None of the reports informs outsiders in a clear way. Texts often are political and/or cryptic.

For substantiation the reader is referred to the appendix, and/or the reports mentioned under point 1.³⁰²

The European Central Bank (ECB).

Introduction.

The ECB is part of the Eurosystem: the set of organizations made up of the ECB and the national central banks of the EU member states whose currency is the euro. For evaluation purposes it is necessary to distinguish the missions and tasks of the different parts of the system.

«The mission of the European Central Bank

The European Central Bank and the national central banks together constitute the Eurosystem, the central banking system of the euro area. The main objective of the Eurosystem is to maintain price stability: safeguarding the value of the euro.

We at the European Central Bank are committed to performing all central bank tasks entrusted to us effectively. In so doing, we strive for the highest level of integrity, competence, efficiency and transparency.

The mission of the Eurosystem

The Eurosystem, which comprises the European Central Bank and the national central banks of the Member States whose currency is the euro, is the monetary authority of the euro area. We in the Eurosystem have as our primary objective the maintenance of price stability for the common good. Acting also as a leading financial authority, we aim to safeguard financial stability and promote European financial integration.

³⁰⁰ In this study openness means: (timely) reporting everything that may be of importance in the given context. It is a form of completeness, and the opposite of secrecy.

³⁰¹ Even though these may have nice codes of conduct too.

³⁰² In the dossier.

In pursuing our objectives, we attach utmost importance to credibility, trust, transparency and accountability. We aim for effective communication with the citizens of Europe and the media. We are committed to conducting our relations with European and national authorities in full accordance with the Treaty provisions and with due regard to the principle of independence.

We jointly contribute, strategically and operationally, to attaining our common goals, with due respect to the principle of decentralization. We are committed to good governance and to performing our tasks effectively and efficiently, in a spirit of cooperation and teamwork. Drawing on the breadth and depth of our experiences as well as on the exchange of know-how, we aim to strengthen our shared identity, speak with a single voice and exploit synergies, within a framework of clearly defined roles and responsibilities for all members of the Eurosystem.»³⁰³

«Basic tasks

According to Article 127(2) of the Treaty on the Functioning of the European Union, the basic tasks to be carried out through the Eurosystem are:

- o the definition and implementation of monetary policy for the euro area;
- o the conduct of foreign exchange operations;
- o the holding and management of the official foreign reserves of the euro area countries (portfolio management);
- o the promotion of the smooth operation of payment systems.

Further tasks

- o Banknotes: the ECB has the exclusive right to authorize the issuance of banknotes within the euro area.
- o Statistics: in cooperation with the NCBs,³⁰⁴ the ECB collects statistical information necessary in order to fulfill the tasks of the ESCB, either from national authorities or directly from economic agents.³⁰⁵
- o Financial stability and supervision: the Eurosystem contributes to the smooth conduct of policies by the competent authorities as regards the prudential supervision of credit institutions and the stability of the financial system.
- o International and European cooperation: the ECB maintains working relations with relevant institutions, bodies and fora, both within the EU and at the global level, in respect of the tasks entrusted to the Eurosystem.»³⁰⁶

“Safeguarding financial stability” is listed in the first paragraph of the mission statement of the Eurosystem and as its third “further task”. It gets due attention in the annual reports of the ECB. Furthermore the ECB publishes a “Financial stability review” (FSR) twice yearly, and a report Banking sector stability (BSS) once a year.

The following conclusions are based on a study of the events and the following ECB reports:

- ECB Banking sector stability (BSS) report November 2006 (dated 20061106).
- ECB Financial stability review (FSR) December 2006 (dated 20061211).
- ECB Annual report 2006 (dated 20070410).
- ECB FSR December 2008 (dated 20090107).
- ECB Annual report 2008 (dated 20090415).
- ECB BSS report August 2009 (dated 20090828).
- ECB FSR June 2010 (dated 20100531).

From the evaluation of these reports it was concluded that studying more reports has little or no added value.

For the substantiation of the following conclusions the reader is referred to the appendix ECB.

³⁰³ ECB website, 24/8/14. https://www.ecb.europa.eu/ecb/orga/escb/html/mission_eurosys.en.html.

³⁰⁴ NCBs= national central banks.

³⁰⁵ ESCB= European System of Central Banks.

³⁰⁶ ECB website, 24/8/14. <https://www.ecb.europa.eu/ecb/tasks/html/index.en.html>

Conclusions.

1. The reports give no indication of the size and consequences of the different risks. Nothing is said about scenario's following the realization of a risk. The reports assume that it is sufficient to note that there is a risk, and/or that it has de- or increased. As a consequence, all risks are considered equal. The reader can only guess at their importance.³⁰⁷
2. Nothing betrays knowledge or understanding of the GAO 1994-1999 reports, and nothing in the ECB reports shows analytic capabilities comparable to those of the GAO. Or of the OFHEO and CGFS 2003 reports.
3. AR 2006 pays attention to government deficits and debts. It stresses the need of fiscal balance³⁰⁸, and of continuation of efforts to reduce deficits and debts. But it does not note that large government debts may be a risk to the financial economic system, and the freedom of operation in general. Even though the average gross government debt of the OECD countries in 2006 was 77%, and the debts of Greece and Italy were above 120%, twice the agreed EU criterion.³⁰⁹
4. In the end, the impression that remains after reading in the selected reports is dominated by ill founded optimistic interpretations ([«...are likely to have enhanced EU banks' resilience to shocks»](#)) or plain wishful thinking. And of lack of clarity about the role and involvement of the ECB.
5. The reports lack recommendations or proposals for action, and do not draw conclusions as regards ECB or other policy. There are many analyses, but they rarely lead anywhere. There are weak exceptions. For example on p. 5 of the BSS report 2006:
[«Nevertheless, the strength of competition in mortgage markets and the potential for the adoption of the rules of the new Basel II Capital Accord in the short-run to release additional regulatory capital, thereby possibly supporting further mortgage lending activity, suggests that banks need to carefully monitor the risks they are taking in mortgage markets.»](#)
This is said in the running text. Not in a list of recommendations or conclusions.
Recommendations are important in themselves, but also because studying phenomena with an eye to recommendations imposes conditions on the analysis. These conditions preclude superficiality and a noncommittal character, and greatly stimulate thinking.
6. According to its own norms, the ECB did not ensure and/or safeguard the stability of the EU financial system adequately. It did and does not even identify the main sources of risk and vulnerability.
7. Like all reports of all supervisors and related organizations, and although they write about the same subjects, the reports of the ECB show little cooperation or division of labor with other supervisors and related organizations.³¹⁰ On the contrary: ECB evaluates the stability of the banking sector on the basis of market indicators and assessments by rating agencies, not on the basis of evaluations by its partners in the Eurosystem.
8. The reports following the crisis of September 2008 give no evaluation of the ECB's inaction and reports published before the crisis. It acknowledges no errors or deficiencies, and does not show any fundamental correction or improvement.
9. A major weakness of all ECB's analyses seems to be that they refuse to say anything that could relate (man made) disastrous events to specific people or organizations.

The International Monetary Fund (IMF).

Introduction.

[«The International Monetary Fund \(IMF\) works to](#)

³⁰⁷ This applies to most supervisor publications, and those of for example IMF and OECD.

³⁰⁸ Fiscal balance= equality of income and expenditure.

³⁰⁹ The numbers are taken from Table 32 of OECD Economic Outlook nr 80 of December 2006 (2006-2). For the EU criteria see the Chronicle.

³¹⁰ Both with national and international organizations. Relevant if not simply better are the Economic Outlook of the OECD and the Global financial stability reports (GFSR) of the IMF. All can be found on the internet or in the dossier.

- foster international monetary cooperation,
- secure financial stability,
- facilitate international trade,
- promote high employment and sustainable economic growth, and reduce poverty around the world.

Created in 1945, the IMF is governed by and accountable to the 188 countries that make up its near-global membership.»³¹¹

«The Board of Governors, the highest decision-making body of the IMF, consists of one governor and one alternate governor for each member country. The governor is appointed by the member country and is usually the minister of finance or the governor of the central bank. All powers of the IMF are vested in the Board of Governors. The Board of Governors may delegate to the Executive Board all except certain reserved powers. The Board of Governors normally meets once a year.»

«The Executive Board (the Board) is responsible for conducting the day-to-day business of the IMF. It is composed of 24 Directors, who are appointed or elected by member countries or by groups of countries, and the Managing Director, who serves as its Chairman. The Board usually meets several times each week. It carries out its work largely on the basis of papers prepared by IMF management and staff.»

The managing directors of the period 2000-2012 were:

- C. Lagarde 5/7/11-
- D. Strauss-Kahn 1/11/07-18/5/11
- R. de Rato 7/6/04-31/10/07
- H. Köhler 1/5/00-4/3/04
- M. Camdessus 16/1/87-14/2/00.

(There are some gaps indeed).

The head office of the IMF is in Washington D.C.

Around 2012 the IMF had approximately 2600 employees.³¹²

The following conclusions are based on a study of the facts and the following IMF reports:

- IMF Global financial stability report (GFSR) 2005-2 (September 2005)
- IMF GFSR 2006-1 (April 2006)
- IMF AR 2006 (September 2006)
- IMF GFSR 2007-1 (April 2007)
- IMF AR 2009 (July 2009).

For substantiation of the conclusions see the IMF appendix.

Conclusions.

1. The role of the IMF with respect to supervisors and governments is unclear, and not discussed. As a consequence the meaning and status of the advice of the IMF is unclear. The unsystematic character and the lack of specification of the advice, and the absence of any kind of monitoring of its implementation, suggest that it isn't clear to the IMF itself either.
2. Until the GFSR of April 2007, reckless optimism is the rule. Opportunities are exaggerated in the optimistic sense, while risks are underestimated. In the GFSR of April 2007 the rose colored glasses have been largely taken off.
3. “To secure financial stability” is one of the four main duties of the IMF. AR 2006 claims that the IMF has “tools for identifying vulnerabilities and weaknesses in its member countries and in the international financial system so that they can be addressed before a crisis erupts”. The reports

³¹¹ Factsheet IMF, 8/8/12. The points have been added for clarity.

³¹² Factsheet IMF, 8/8/12.

don't identify or describe these tools. Neither do they show which "vulnerabilities and weaknesses" they have helped identify. In fact the IMF shows no knowledge or insight better than that of other organizations. IMF studied dangers only superficially, and overestimated positive developments and the supposed stability. IMF not only failed to secure stability, but even failed to warn of real dangers.

4. The reports say nothing about the size and consequences of the risks. No effort is made to trace the consequences of a realized risk, and to describe them in a scenario. No (comparative) analysis of size and consequences was found in the reports. Risks are not distinguished; they could as well be equal. Nothing is said about a method for finding sources of risk; there is no guarantee for completeness.
5. Unbalanced balances of payments are mentioned as a destabilizing factor, government debts are not. The IMF should have done so, and taken action not only to secure stability, but also to prevent being asked to provide (additional!) loans to countries that got themselves into this kind of trouble. Its mission required it to warn timely, clearly and unambiguously, and to make unambiguous recommendations. It could simply have supported those of the GAO.
6. Global imbalances are called imbalances, and seen as a problem. However: why they are a problem and/or risk, and how they can be solved or reduced is not explained.
7. The IMF has 2600 employees. It is impossible to believe that none of them can deliver anything better than what can be found in the reports. The reports therefore show that the management is insufficient. And if the IMF really has no people who can produce anything better, it is just as insufficient.
8. The reports give useful information.³¹³ The information makes an ad hoc impression however. No effort seems to have been made to collect the information necessary for accomplishing the mission, and to present the information in a helpful way. In general, the analyses are superficial.
9. IMF gave potentially effective opinions and advice, but ad hoc instead of systematically. And it did next to nothing to explain the necessity of action. It did not show the consequences of inaction.
10. None of the reports betrays knowledge or understanding of the GAO 1994-1999 reports, and nothing in the IMF reports shows analytic capabilities comparable to those of the GAO. The OFHEO and CGFS reports are ignored as well. In other words: IMF is not acquainted with the literature it should be acquainted with because of its duties and mission.
11. Still, the GFSR of April 2007 sees more risks than all other supervisors. But the IMF overestimates the supposed stability of the financial system just as much as it underestimates the risks. What advice it gives is extremely undercooled.³¹⁴
12. The weakness of the analyses and recommendations in the reports agrees with the failure of IMF to prevent the crises and deal with them. It failed to secure financial stability, a vital part of its mission. Its pretensions were false.
13. There is no sense of urgency and responsibility in any of the studied reports.
14. The IMF has not learnt the most important lessons of the crisis. It has not acknowledged its failure. It has not changed in any fundamental way.
15. There is a general lack of reflection, especially as regards definitions. Hypotheses (illusions) are mistaken for facts. No effort is made to discover and analyze the sequence of consequences which follows the realization of a risk.
16. The IMF is not honorable and not competent. It is utterly unreliable.

The Organization for Economic Cooperation and Development (OECD).

The mission of the OECD.

«The mission of the Organization for Economic Co-operation and Development (OECD) is to

³¹³ Although less and less useful than those of the OECD. Cooperation would be welcome, both from the point of view of efficiency and effectiveness.

³¹⁴ For example: «... ensuring that underwriting standards are maintained is critical to supporting market discipline and, in this regard, recently issued guidelines are welcome.». P. 32 of IMF GFSR April 2007.

promote policies that will improve the economic and social well-being of people around the world.

The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. We work with governments to understand what drives economic, social and environmental change. We measure productivity and global flows of trade and investment. We analyze and compare data to predict future trends. We set international standards on a wide range of things, from agriculture and tax to the safety of chemicals.

We look, too, at issues that directly affect the lives of ordinary people, like how much they pay in taxes and social security, and how much leisure time they can take. We compare how different countries' school systems are readying their young people for modern life, and how different countries' pension systems will look after their citizens in old age.

Drawing on facts and real-life experience, we recommend policies designed to make the lives of ordinary people better. We work with business, through the Business and Industry Advisory Committee to the OECD, and with labor, through the Trade Union Advisory Committee. We have active contacts as well with other civil society organizations. The common thread of our work is a shared commitment to market economies backed by democratic institutions and focused on the well-being of all citizens. Along the way, we also set out to make life harder for the terrorists, tax dodgers, crooked businessmen and others whose actions undermine a fair and open society.»³¹⁵

The OECD's "core values".

- «Objective: Our analyses and recommendations are independent and evidence-based.
- Open: We encourage debate and a shared understanding of critical global issues.
- Bold: We dare to challenge conventional wisdom starting with our own.
- Pioneering: We identify and address emerging and long term challenges.
- Ethical: Our credibility is built on trust, integrity and transparency.»³¹⁶

The following conclusions are based on a study of the Economic Outlooks of 2006-2008 and the facts of the crisis.

Conclusions.

1. The Economic Outlooks contain much valuable information and many relevant observations.
2. The Economic Outlooks have noted the relevant developments with respect to mortgages, balances of payments and government debts, and timely. But they only saw the superficial phenomena. They showed no understanding or even interest in the operation of financial markets.
3. Analytically they are far too superficial. They cannot serve as a basis for recommendations and forecasts.
4. The substantiation of the recommendations leaves very much to be desired. Often they assume risks. But they do not give emphatic warnings. There is no analysis which shows what will happen if something is done or not done.
5. The Economic Outlooks, not in the last place remarks like “steady growth ahead”, suggest business as usual. There are always threats, and there is always room for improvement. But there are no exceptional threats, and nothing that needs to be dealt with urgently.
6. The Economic Outlooks do not refer to conclusions and recommendations of similar studies of similar or related organizations, such as national supervisors and BIS, ECB, GAO, and IMF.
7. There is no trace of modesty, or doubt about economic knowledge and understanding. The OECD gives advice and recommendations as if it were omniscient. After the crisis as before.
8. The OECD's implicit pretension, that it can assess and forecast, is false.
9. The Economic Outlooks are incompatible with the OECD's core values.
10. The OECD has not acknowledged its failure. After the crises, it has not changed in any fundamental way.

³¹⁵ www.OECD.org 3/1/13. Regrettably no mission or similar statement could be found for 2006.

³¹⁶ www.OECD.org 3/1/13. The layout has been slightly adapted.

There is no essential difference with the supervisors.

The Dutch General Accounting Office (DGAO)³¹⁷⁾.

Conclusions (partly based on evidence and analyses presented in earlier chapters).

1. The members of the DGAO are selected by the political establishment.
2. The reports of the DGAO are incompatible with faithful execution of its mission. The reports claim that they critically evaluate government activities. In reality its criticism is superficial at best. Its existence and way of working prevent substantial improvement and protect the status quo.
3. After the crisis the DGAO investigated the Dutch Central Bank (DNB). In other words: it pretends to be the competent to do that. Why then did it make this inquiry so late? It could very easily have seen that (at least) the annual reports 1998-2008 of the bank are unacceptable both in a material and technical sense.³¹⁸
4. After the crisis it did not acknowledge failure, and did not change for the better.

■
The appointment of the members of the Dutch General Accounting Office (DGAO) is political:
«The members of the DGAO are appointed for life by royal decree on the basis of a nomination of three persons made by the Second Chamber of Parliament.»³¹⁹

The royal decree is no more than a government decision.

Directly under the heading of the Factsheet³²⁰ of June 2010 with general information about the DGAO one reads:

«The purpose of the DGAO is to assess and improve the lawful, efficient, effective and honorable functioning of the government and the related organizations. In addition it is the responsibility of the DGAO to contribute to good public administration by exchange of information and cooperation at home and abroad.»

One of the sections of the Factsheet is the following:

«Good public administration.

We investigate both the performance and the functioning of the government. This means that we investigate to what extent policy is implemented effectively, efficient and demand-oriented, and evaluate integrity, transparency and public accounting. In this way we want to help improve the learning ability of public administration. To this end we will pay attention to the information management of the government and to the degree of balance between policy ambitions and available time, money, human resources and means in every investigation in the coming years.»

It is clear that because of its mission, the DGAO should have called attention to the deficient annual reports of the Dutch Central Bank, and that after the financial crises and the inquiries of CDW and FCIC it should have published an analysis like this chapter.³²¹ It should have pointed out the essential deficiencies of these inquiries. The reason for its silence cannot be that it considers itself insufficiently competent for such an analysis. Earlier chapters have shown that the DGAO frequently publishes reports about technical subjects, and also about integrity. After the crisis the DGAO made

³¹⁷ In Dutch: Algemene Rekenkamer.

³¹⁸ In a technical sense= as an annual report, that is: as a report about the activities in the year under review.

³¹⁹ Article 77 paragraph 1 of the Dutch constitution. Other aspects are regulated by the other paragraphs of article 77 and by article 78 of the constitution, and by chapter 4 of the accountability law (comptabiliteitswet). Source: Kluwer Collegebundel 2000/01.

³²⁰ In the dossier, under 20120913. The Factsheet has two pages.

³²¹ Regrettably this means making contradictory assumptions, and is therefore impossible. If DGAO had done this, it would have reported critically long before the crisis erupted. The same causes of silence before the crisis prevent its speaking afterwards.

several inquiries of aid programs for banks, and about supervision.³²²

Something similar applies to the US GAO. See the description of its mission on pp. 7-8/ 13-14 of the GAO Performance and Accountability Report 2004. It is summarized on p. 2/2:

«GAO exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.»

It is obvious that in 2000-2007 the GAO, like the DGAO, has failed its mission very badly.³²³

Like other supervisors the DGAO says next to nothing about the relative importance of different kinds of deficiencies. Little distinction is made between very important and relatively unimportant deficiencies. The DGAO moreover belittles problems by euphemisms. Two examples from the annual report 2012:

1. «As a consequence, countries can still hardly get a complete and reliable picture of each other's financial position. That does not contribute to good decision making.» The last sentence is euphemistic, and therefore unclear. It may have been meant to hide the following: "That hinders accountable decision making, and may make it impossible".
2. «Democratic constitutional states are based on sufficient and correct information which governments give society and its representatives. This applies pre-eminently in these economically particular times.»³²⁴ The "particular" sounds rather ridiculous, because almost everybody refers to these times as "economically bad or difficult times". With good reason of course. One wonders whether this text was written or edited by somebody who softened everything that seemed negative or critical.

But not all unfounded value judgments have been deleted:

«At European level the countries concerned, including the Netherlands, cooperate as good as possible to fight the debt crisis.»³²⁵

The qualification "as good as possible" is not specified or substantiated, and can be deleted without loss. Or rather: can better be deleted, for deletion would avoid the impression of prejudice and unfounded propaganda. For is cooperation in Europe new? Is this specific cooperation necessary? Why? Why only now? Did the DGAO note in earlier years that the Maastricht convergence criteria were ignored, at unknown but potentially great risk? Why only this positive remark, without explanation and proof of the "as good as possible"?

Organizations like DGAO and GAO have to cope with the problem that their resources are far too small to evaluate all government and related activities. They have to make choices, because they can evaluate only relatively few random samples. And they have to ask themselves what their findings mean for the system as a whole, given their dependence on the cooperation of investigated organizations. It is not self evident how they should sample. But even more important for the efficacy and efficiency of their work is that the product of the probability to get caught and the fine is- should be- sufficiently large to be preventive and corrective. It isn't. Furthermore, organizations like DGAO and GAO can investigate and publish findings, but cannot take measures.³²⁶ Whether something is done with their reports depends on others. Sometimes it depends on organizations like ministries, often on governments and/or parliaments. If organizations like DGAO and GAO were honorable, they would be open about these and similar facts, and explain their limited possibilities on their website and in information brochures like the factsheet quoted above. An honorable organization makes sure that people have no illusions about the effectiveness of their activities. They could somewhat strengthen

³²² The DGAO published at least 4 progress reports about the credit crisis (Kredietcrisis), and a report *The supervision of DNB on the stability of banks (Toezicht van DNB op de stabiliteit van banken, 2011)*.

³²³ The defense that the preceding decade (say) has shown reliable evaluations to be without any positive effect is false, because correct and timely information of the public is a condition sine qua non for a democratic society. Without full and reliable information, people's choices have no defensible meaning.

³²⁴ DGAO AR 2012 p. 14/16 first paragraph.

³²⁵ DGAO AR 2012 p. 4/6, the beginning of the section Europe.

³²⁶ To a certain extent there is a chance to get caught, but the fine is certainly zero. Apart from temporary loss of face. The chance to get caught and negative publicity is reduced by the fact that as a rule, DGAO needs or wants cooperation of the organization under investigation, and will need its cooperation in the future too.

their position by including overviews of earlier findings and recommendations and the reactions of those concerned in their annual reports. Especially by noting the absence of adequate reactions or corrective measures. At present they don't (or rarely). Instead they contribute to the continuation of the belief in incorrect illusions. The Factsheet DGAO suggests very much more than warranted. The DGAO cannot do what it asserts, and does even less than what it can do. The DGAO undoubtedly does some useful work. But it does not do what it has to do, and shows no more modesty and integrity, and no less false pretensions than other supervisors. Its support of illusions prevents substantial improvements and protects the status quo.

7B.7. The inquiry commissions CDW and FCIC.

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5. The "Intermezzo: images of the Dutch Central Bank": an example of the inadequate approach of the CDW.
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7. The inquiry of the FCIC has important gaps, serving specific interests.
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14. A missing conclusion: the failure of supervision and government is unthinkable without repressive hierarchical organization.
15. The commissions pay no attention to the influence of liability and criminal law.
16. After the outbreak of the crisis only appearances improved: with another man's money everyone can solve almost every problem.
17. The interviews and parliamentary inquiries as cover up.
18. Support for the hypothesis that a parliamentary inquiry is not meant seriously: eight years after recommendations of an inquiry commission for improvements of accountancy, accountancy turns out to have improved insufficiently or not at all.
19. Two Irish inquiry reports.

1. Summary and conclusions.³²⁷

1. For this chapter the work of three inquiry commissions has been studied: the Dutch Commission De Wit (CDW), the US Financial Crisis Inquiry Commission (FCIC), and the two Irish inquiry commissions. The first two were studied mainly in 2011 and 2012, the third was discovered only in August 2014.³²⁸ In all important respects the first two reports are similar. They will be treated

³²⁷ Conclusions may be partly based on analyses in other sections of this chapter.

³²⁸ The CDW published a second report in 2012. It is the report of a relatively extensive inquiry into developments in the Dutch financial sector in the years of the subprime crisis, especially those which were supposed to require aid from the Dutch government. Like the first report, the second is very useful and interesting. The second report supports the conclusions of the present study regarding integrity and competence of the principal persons and organizations. Especially Wellink and DNB, and the minister of finance (Bos). It

intertwined. The Irish inquiries are more open, and will be treated separately. International financial economic developments since the crisis are compatible with the assumption of representativeness of the CDW and FCIC. Therefore no great efforts have been made to find reports of similar inquiries in other countries. The following points 2-22 (inclusive) refer only to the CDW and FCIC.

2. The CDW and FCIC were composed by parliaments. They were asked to find the causes of the crisis. The members of the commissions have no demonstrable research competence. For this reason it is doubtful whether acceptance to make or lead the inquiry and accept responsibility for it can be called honorable. The incompetence is shown in important methodological errors. The great weight the commissions accord to hearings of people who may be held responsible for causing the crisis and increasing its harmful consequences, and the simultaneous neglect of relevant contemporary documents seem to be the most important examples. Most of the people interviewed were vitally interested in hiding part of the truth and giving an incorrect representation of developments and activities.
3. The commissions state that they studied very many documents. But they give no report of this study, and most of their quotes are not from documents but from hearings.³²⁹
4. If they had really studied the relevant contemporary documents, then there would have been no need to interview people like Bernanke, Bos, Geithner, Greenspan, Paulson, Wellink and Zalm. There are essential contradictions between their utterances after the crisis and documents from before the crisis. If the commissions note the contradictions (and misleading half truths) at all, then in very soft terms.
5. The CDW and FCIC have done very much useful work. They collected and ordered much information. But their work is not well balanced, and fatally incomplete. The commissions did not distribute their attention and efforts proportional to the contribution of the various factors to the origin and size of the crisis. Banking and modern securities got far too much attention; government and supervision far too little. Because it has to be concluded that there would not have been crises if these had functioned properly, a thorough inquiry into the causes of their failure was imperative.
6. The inquiry commissions give no attention to the internal operation of the hierarchical organizations which had responsibilities with respect to parts of the financial system. They give no attention to the functioning of their codes of conduct and other relevant codes. They do as if a hierarchical organization is a single person, the highest boss (CEO, director, etcetera). This way of thinking is misleading³³⁰ because it is unthinkable that none of the many thousands of employees in supervision, HUD and ministries of finance, advocated more responsible conduct, and on very good grounds. Hierarchical organization makes repression easy, and can prevent (self)correction. Because of his power, the operation of hierarchical organizations depends very strongly on the quality of the top functionary. Acceptance of the simplistic anthropomorphism and the refusal to study the internal operation of responsible organizations preclude correction.
7. The CDW and FCIC did not try to find the (changeable) causes of the inadequate operation of government and supervision. Even though it is completely unclear why one should believe that government and supervision can and will correct themselves of their own accord. The FCIC is sharp in many of its accusations, but denies and condones misconduct of the government.³³¹
8. If the commissions tried to keep government (including parliament) out of the wind, they could hardly have done better.
9. The investigation of the role of the affordable housing policy by the FCIC was incomplete, biased and illogical.

didn't seem to be necessary and efficient to spend more time on this report for the present work. It is analyzed extensively in the Dutch report *Wellinks meineed (Wellinks perjury)*.

³²⁹ The staff studies of the FCIC are very useful, but also very selective. Annual reports and supervisor performance (in 1995-2006) are not studied, for example.

³³⁰ In fact, it is incorrect, both formally and informally.

³³¹ See for example the paragraphs around "we make the following observation about government housing policies" on p. xxvii/27 in the chapter *Conclusions of the FCIC*.

10. The Fed was obliged to take government policy into account. Perhaps other supervisors had a similar obligation. This may have caused significant weakening of supervision.³³² The commissions pay no attention to this observation.
11. The commissions do not give a logically closed explanation of the crisis. They do not note that supervision of supervision was completely missing.
12. The FCIC concludes that risk management and rating agencies are important causes of the crisis. This is misleading because the FCIC does not say what an adequate risk estimate should look like. Neither does it say what responsible parties should do if they had such an estimate. The FCIC does not say what a party should do in case of risks it cannot bear. (In particular if it cannot bear the totality of risks). The FCIC does not note that risk estimates depend on changing circumstances and forecasts, and are therefore changeable themselves. It does not note that realization of risks is uncertain, that risks may or may not be realized, and when.
13. The inquiry commissions do not show understanding of the problem of communication and warning about risks. They don't note that all (quasi)experts systematically and incorrectly suggested that only the most probable scenario is relevant. They don't remark that the attention to scenario's should be proportional to their expected³³³ consequences.
14. Neither CDW nor FCIC mention or discuss liability³³⁴ and punishability. This is a essential shortcoming both with respect to (dis)incentives and safeguarding innocents.
15. The inquiry commissions observe systematic dysfunctioning. They implicitly assume that the systematic character is caused by supposedly general human deficiencies. They do not (systematically) look for changeable causes.
16. The analyses of CDW and FCIC are untenable in the light of the GAO reports of 1994-1999 and the annual reports of the supervisors.
17. The neglect of the annual reports and other reports by the inquiry commissions means that the lack of integrity and competence of the financial supervisors and governments have not been analyzed, or not properly, and that nothing is done about it.
18. The shortcomings of the analyses and, as regards CDW, recommendations, mean- among other things- that people whose incompetence and lack of integrity is provable retain their position, or were allowed to move to similar or even more important functions. As a consequence, incompetent and dishonorable people will continue to (dys!)function and be appointed in all key positions in society. Which implies that society will unnecessarily continue running large and potentially catastrophic risks.
19. With their words and the thickness of their reports the CDW and FCIC suggest that they have brought to light what can be brought to light, and done what can be done. They didn't. Instead of instruments for correction they are protectors of dangerous frauds.
20. The selective treatment of the various aspects of the (subprime) crisis supports the impression that the inquiries of CDW and FCIC were more intended to prevent personal consequences for those who were responsible for the safe and sound operation of the financial system, than to find the causes and prevent repetition of this kind of crisis.³³⁵
21. The inquiry commissions pay no attention to education or science.
22. The failure of the CDW and FCIC, combined with that of supervisors and all other relevant persons and organizations, shows that the given modern states are unable to correct themselves. (It would be a dangerous understatement to suggest that their ability to correct themselves is "very insufficient").
23. The reports of the two Irish inquiry commissions consider the Irish banking crisis, and the international context in so far as relevant for the Irish financial system. They investigate the Irish

³³² That the formal obligation was practically important is shown by the declaration of Fed governor Bies in the FCIC hearing of 11/10/10 mentioned earlier. It is quoted in the Fed appendix. See also: FCIC p. 21/49.

³³³ "Expected" in probabilistic sense: the product of probability (the risk) and consequences (upon realization of the risk).

³³⁴ A search for "aansprakelijk" (= Dutch for liable) in CDW1 shows that CDW only uses this concept in connection with supervisors.

³³⁵ People like Coen Teulings, head of the Dutch Economic Advisory Office (CPB) asserted that crises are inevitable. Without any semblance of proof. See the report of the hearing of Coen Teulings in the report of the first series of hearings of the CDW.

system, and do not try to find the causes of the international financial crises. They are much more open than the inquiries of the CDW and FCIC, and shed important light on the internal functioning of all relevant organizations. Their conclusions overlap and are compatible with those of the present study. Their analyses go less deep however. For more detailed conclusions the reader is referred to subsection 19.

2. Agreements and differences between the conclusions of the FCIC and this study.

The conclusions of the FCIC are in blue, the comments of the present author in black.

1. We conclude this financial crisis was avoidable.

Full agreement.

2. We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.

This is expressed too weakly: it proved fatal. "Devastating" is very serious, but not necessarily fatal, deadly. And in this case it was. The financial system could not have degenerated as it did, and the crisis would not have occurred, if the supervisors had operated in accordance with their duty and self proclaimed missions.

The FCIC should have said what it meant, and should have used the same words for the same meanings.

3. We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.

It is obvious that the crisis would not have occurred if the financial institutions (in the narrow sense) had only taken bearable risks. But apart from capital requirements, governments or supervisors have not formulated norms for risks or risk management. The conduct of the banks is not more reproachable than for example the failure to set norms or increase liability and punishability by governments, and the refusal to discuss the question of the greatest admissible risk by the FCIC.

4. We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.

The metaphor "put on a collision course" is even less clear than "devastating" and "key cause".³³⁶ But it is clear that less loans would have been sold if less money had been available, and that there would have been less subprime if less risk had been taken. Whether more transparency (alone) would have helped is doubtful: governments and supervisors also ignored the facts and warnings which were available.³³⁷ They even eliminated messengers!

5. We conclude [that] the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.

This is the only place where the government is mentioned explicitly in the conclusions. The conclusion is agreed with. Although it is incomplete, and in an important respect. By actions and omissions governments have facilitated or promoted developments which implied that risks would grow beyond control. Especially by:

- risk increasing liability and criminal law;
- regulation of hierarchical organizations;
- deregulation;

³³⁶ Use of metaphors should be forbidden in conclusions and recommendations of reports of commissions like the FCIC. The text should contain as few ambiguities (including vagaries) as possible.

³³⁷ Examples: The GAO and BIS reports, and the case Gnaizda. For the last see *Inside Job* and the FCIC report. Repression is seen openly in the case of Born, but can be inferred from BIS reports as well. See the BIS Appendix.

- not supervising supervision;
- appointment of dishonorable and incompetent heads of vital organizations;
- mortgage policy (AH en CRA).

6. We conclude there was a systemic breakdown in accountability and ethics.

Agreement. But more in supervision and government (and FCIC) than elsewhere. These were the only ones who failed a legal duty, which they had accepted voluntarily. Only to them the conclusion applies without exception. Among the banks there were those who kept operating responsibly.³³⁸

7. We conclude collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis.

Agreement. But the conclusion is misleading unless it is noted simultaneously that the collapse is the logical and foreseeable result of the affordable housing and CRA policy of the government.

8. We conclude over-the-counter derivatives contributed significantly to this crisis.

Agreement.

9. We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction.

The rating agencies may have played an important role in the financial system. The question is whether they could have done differently without committing suicide. There was competition, while there were no norms and no supervision. Knowing the political climate of the times, it is plausible that the rating system had been organized intentionally in such a way that it would not encumber risk taking. The FCIC fails to explain how the rating agencies could and should have acted. The lawgiver has done nothing when the judge decided that rating agencies are not responsible for supposedly incorrect ratings.³³⁹

The following important differences stand out in a comparison of the FCIC conclusions with those of the present book:

1. The FCIC report is mainly descriptive. It only gives (short) analyses within the framework of the descriptions. The FCIC drew the conclusions cited above directly from the report, without prior analysis of the whole.
2. The FCIC gives a picture of the financial system which differs from that in the present study. In the terminology of the present study, the FCIC sees the financial system as a collection of financial institutions in the narrow sense. Government and supervision are not treated as integral part of the financial system.
3. The FCIC doesn't know that the financial economic system is unstable. This is important because awareness and understanding of the instability affects the understanding of the roles of the various factors in the preparation and nature of the crisis. Great disasters need not have great causes. Great disasters can sometimes be prevented by small (fitting!) actions.
4. The FCIC fully ignores the opinion that liability should only be limited under conditions which effectively protect innocent people. Such as effective supervision of compliance with the conditions.
5. Nowhere does the FCIC show that it understands that the situation of competing enterprises resembles a prisoner's dilemma game, and that the enterprises may have an interest in (effective) supervision. (Rather the contrary: its report is hard to understand if it would understand the PD-game).³⁴⁰

³³⁸ As the FCIC shows itself. See the FCIC report or the Dutch notes on the report. In large part, these notes consist of quotes with references. So the file may help non-Dutch readers as well.

³³⁹ Because they are no more than "opinions". FCIC p. 120/148. See also *Inside Job*.

³⁴⁰ In agreement with the textbooks Economics.

6. The FCIC has a fundamentally different opinion about the relative importance of the various contributing factors or causes, and of the relative weights of the responsibilities of the various actors.³⁴¹
7. The FCIC fails to conclude that all principal persons had insufficient integrity and competencies. It fails to conclude that the fact that all vital positions were occupied by such people would inevitably lead to disaster. Even if this would apply only to government and supervision.
8. The present inquiry has investigated the behavior of the principal persons before the crisis on the basis of contemporary documents. It concludes that the principal persons had insufficient integrity and competencies. In other words: that they cannot be considered as reliable or even useful experts. They have to be seen as dangerously misleading people. The FCIC on the other hand consults these people as reliable experts even after the crisis. It does not warn against them or against similar people. The FCIC seems to act on the basis of the dogma that these are reliable experts, irrespective of the facts. If one makes such an assumption, one excludes a profusion of explanations.³⁴²
9. The present inquiry concludes that adequate supervision would have (easily)³⁴³ prevented the crisis. The FCIC does not.
10. This study concludes that adequate government would have (easily) prevented the crisis. The FCIC does not. Instead of honorable and competent, governments were dogmatic and repressive. They failed to use common sense.
11. Because it was asked to find the causes of the crisis, the FCIC should have taken a good look at education and science. Are not people in important respects the product of education?

The FCIC formulates its conclusions rather abstractly, imprecisely. In some cases it mentions only phenomena, not causes: (“collapsing...”, “contributed to...” “failures of credit rating agencies”). In spite of its terms of reference. Its conclusions therefore offer very much room for saying that something has been corrected or solved, without eliminating the deeper cause(s), and without preventing repetition.

With minor or unimportant³⁴⁴ changes, the above also applies to the reports of the CDW.

3. Lack of integrity and competence of CDW and FCIC, and its consequences.

The commissions were composed by politicians who were part of, and co-responsible for, the system which generated the crisis. The politicians had obvious and significant interests: to be exculpated or avoid being accused, and/or to be kept out of the limelight. The commission members were selected and appointed by means of procedures closely related to those used for the appointment of the persons who, apart from a quickly “corrected” exception, failed disastrously. The commission members were politician, political advisor, and/or administrator/manager. They are not representative for the populace or science/ academics. They do not come from all layers of hierarchical organizations, but only from the top. They have no demonstrable research competence. They have no reason to believe that the people by whom they were appointed could assess their ability to participate appropriately in an inquiry as proposed (rather the contrary). They do not explain why they can be relied on to do this inquiry properly.

Most commission members were either personally involved in developments related to the origin or development of the crisis, or had worked in an environment to which this applies. They must have had preferences, and/or interests in specific explanations. Something similar probably holds for their

³⁴¹ Even if the FCIC is far from explicit or clear about these responsibilities. The opinion of the FCIC can be attributed to its superficial and deficient analysis.

³⁴² However, the integrity of the principal persons in supervision and government is not put into question, but that of the principal persons of the major financial institutions in the narrow sense is, if only implicitly, by not mentioning good reasons they may have had for their conduct.

³⁴³ The “easily” indicates that they would not have had to turn the world upside down to avoid the crisis. It is plausible that no more than systematic subscribing to the 1994-1999 analyses of the GAO, and as good as possible implementation of its recommendations, would have been sufficient.

³⁴⁴ “Unimportant”= not affecting any of the main conclusions.

staff.³⁴⁵ The composition of the commissions themselves gives reason to doubt the competence and integrity of the commission staffs.³⁴⁶ Many of the staff members of the CDW are called “research staff member”. But a name says nothing about the competencies of the bearer. None of the staff members has a Ph.D.^{347, 348}

Those who composed and appointed the commissions, and the commission members themselves, could and should have known this.³⁴⁹ It attests to false pretensions or an essential lack of integrity and/or self knowledge to accept a job for which one should know that one does not have the necessary qualifications. To accept a job when there is nothing which reliably shows that one will be able to do it properly.

In short: a priori there was no reason to believe in the competence of the inquiry commissions. A posteriori their incompetence is shown by many methodological errors. Possibly the most important is the great weight they attach to interviews. Mostly interviews with persons who can be considered as suspects, or friends or colleagues of suspects. Their utterances are nevertheless rarely or never (explicitly) checked and compared with contemporary evidence. As if the commission members do not understand why utterances of suspects should not play a primary role in any process of truth finding. And this in a situation where it is beyond any doubt that the system managed by the interviewed persons has crashed completely, and caused immense damage for uncountable innocent people.

Without a competently reacting interviewer, interviews give the interviewed the opportunity to exculpate himself and to mislead. The principal persons seized this opportunity with both hands. Essential untruths of the interviewed have not been refuted by the commissions. Important examples are: the denial by Bernanke of the duty of the Fed to contain systemic risk, and the claims of Wellink about his warnings and the unforeseeability of the crisis. The utterances of the interviewed were not compared with their own contemporary reports. More examples will be given later on.

The commissions were asked to discover the causes of the subprime crisis. What they say about bonuses and “compensation” shows that they acknowledge the influence of the given remuneration system on behavior. And therefore the influence of financial consequences of misconduct. The historical facts show that those responsible had little or no reason to fear that inadequate or misconduct would be sanctioned. But the commissions say nothing about this. Neither do they say anything about legal (im)possibilities of proportional and effective sanctions. This shows incompetence and/or lack of integrity. It has serious consequences. For by means of the interviews and the masked reports fatal misconduct has been disguised and concealed. Which hampers or prevents sanctioning of misconduct in such a way as to discourage similar behavior in the future. Wittingly or unwittingly the commissions have made themselves instruments for the prevention of effective measures.

Although the commissions do not exonerate supervisors and governments, they are far too uncritical about their misconduct (and false pretensions). They don’t note that the crisis would not have occurred if supervisors and governments had only done their duty. In the case of the FCIC it is completely obscure what could or should be done to prevent repetition.³⁵⁰ In the case of the CDW it is clear that its recommendations are very insufficient. Both commissions were silent about the continuation in office of principal persons of whom they could and should have concluded that they are both insufficiently competent and honorable for their function.

³⁴⁵ If the experience with other cases is taken as representative of a general situation.

³⁴⁶ And apart from this: why can the commission members be expected to be able to select appropriate staff for their inquiry?

³⁴⁷ Which shows how members of parliament value these education programs.

³⁴⁸ This is not to deny that the staffs have done very much useful work. But the final reports are (very) inadequate. The commissions (CDW and FCIC) have not done what they were asked to do: find the causes. They did not find the causes which have to be eliminated to prevent repetition.

³⁴⁹ For the FCIC see the appendix about the Members of the FCIC; for the CDW see p. 29 of its first report. All members of the CDW were members of parliament. Its staff was composed of members of the staff of parliament, two temporary government employees, and an externally recruited staff member. (Terminology of the CDW report).

³⁵⁰ The FCIC had not been asked to formulate recommendations. But it is clear that their inquiry should help find measures for prevention.

All this can be explained, and only be explained, by a combination of incompetence and lack of integrity.

4. Methodological deficiencies of the CDW and FCIC inquiries and their consequences.

1. The FCIC assumes that telling the story will automatically uncover the causes.³⁵¹
 - a. The assumption is incomplete and/or incorrect because it is impossible to tell the whole story. The whole story is far too extensive. It consists of innumerable sub...substories and details of details etcetera. Selection is inevitable. A selection can only be made responsibly if the causes are known, and/or if it is beyond doubt what is relevant and what is not. But one can only know after completion of the study. The problem can be solved by critical questioning and iteration.³⁵² In this case the most important question is: does the report explain what needs to be explained, and what needs to be explained to find effective measures for prevention? Is the sequence of events logical, given the explanatory information provided by the commission? One should iterate until one gets a picture and a set of explanatory information which enables one to answer all relevant questions. The FCIC didn't do so. It did not note that the supervisors could have prevented the subprime crisis and why they failed to do so. The commission furthermore did not explain why the various governments failed fatally.
 - b. In principle, the assumption gives all attention to actions, and none to omissions. The assumption leads to underexposure of people and organizations who should have acted because it was their duty to act, but didn't. The FCIC story presents supervisors and government as actors. But the attention given to them is very much less than the attention given to the financial system in the narrow sense. The omissions (and misleading actions) do not get the attention they need in order to understand the crisis and to prevent repetition. Analysis and explanation of the dysfunctioning of supervisors and government are completely absent.³⁵³ The report would have given a very different picture if it had been structured according to groups of actors,³⁵⁴ and if both the actions and omissions of a given group had been investigated. And even in the given approach a separate chapter should have been devoted to supervision and government.

The assumption favors supervision and government. It draws disproportionately much attention to the financial system in narrow sense (the banks).

2. The FCIC draws its conclusions from a marginal analysis of its story of the events. Many of the conclusions are formulated metaphorically (see above). The conclusions overlap with those of the present study. But the FCIC presents them incoherently, as a whole that is difficult to understand, or not understandable at all. Which can be explained from the lack of appropriate analysis and a coherent vision of the financial system in the broad sense. But it can also be explained from the wish to belittle or conceal the role of the government.
3. CDW and FCIC give a dominant role to interviews of persons who played a responsible role in the preparation of the crisis. All these people have an interest in an incorrect picture of the history of the crisis.³⁵⁵ The commissions also use the interviews to get information which can also (better!)

³⁵¹ «This report is intended to provide a historical accounting of what brought our financial system and economy to a precipice and to help policy makers and the public better understand how this calamity came to be.» FCIC p. xi/11.

³⁵² Iteration is the repeated execution of a procedure which improves input data, the output of the procedure being used as input for the following execution of the procedure. The procedure is repeated until the results don't change any more. The existence of a single unchanging limit is not general but conditional.

³⁵³ Moreover, the picture the FCIC gives of the affordable housing policy is methodologically inadequate and incompatible with the facts. See the Chronicle and the notes about the FCIC report.

³⁵⁴ As the Irish reports do. See for example *Misjudging risk: causes of the systemic banking crisis in Ireland*, Report of the commission of investigation into the banking sector in Ireland, March 2011. In the dossier.

³⁵⁵ The sections about the subprime crisis in Sloman and in Gamble, Thompson & Peteraf prove that the efforts at misrepresentation were successful. They make no mention of failures of supervision and government.

- be obtained from contemporary documents.³⁵⁶ The reliability of the interviewed is not even discussed.³⁵⁷
4. Not all groups of actors investigated in some depth have been investigated similarly or proportionally. A whole day was spent on Moody's and ratings, but not a day (let alone days) on supervision, and not a day (let alone days) on government (especially Treasury).
 5. Principal persons, heads of organizations, were not interviewed about the (dys)functioning of their organizations, but as material experts: about specific subjects. Cox (SEC), Geithner (NYFed) and Paulson (Treasury) for example were interviewed in connection with shadow banking, and Bernanke and Bair about "too big to fail". Even though more than one subject was discussed with these people. But the (causes of the) dysfunctioning of their organizations was not discussed with them at all.
 6. The present study shows that contemporary documents contain much crucial information, and make interviews largely or completely superfluous. The CDW and FCIC say that they studied very many documents. But they don't say that they have noted significant incompatibilities between contemporary documents and statements of principal persons in commission hearings after the crisis.

Beside methodological incompetence, lack of integrity probably also played a role. Important deficiencies in the FCIC majority report seem only explicable by the influence of other aims than finding causes. Examples are given below. This can at least partly explain why the FCIC could not agree on a single report, and published a majority report and two minority reports. The minority report of Wallison is limited to the role of the government in the disproportional and dangerous growth of the number of poisonous mortgages. Contrary to the majority report, it is mainly based on contemporary documents.

5. The "Intermezzo: images of the Dutch Central Bank": an example of the inadequate approach of the CDW.^{358, 359}

In the first report of the CDW this intermezzo counts six pages. It consists almost entirely of opinions. In general opinions of people heard by the CDW. The images may be based on facts. But otherwise the intermezzo pays no attention to facts and historical documents.

It speaks anthropomorphically about "the bank", as if it is a single person. There is no attention at all for DNB as an organization of more than 1500 employees.³⁶⁰ Furthermore, none of the following questions was investigated by the CDW:

- How did DNB evaluate the financial system and its stability?
- How did it take account of minority opinions? Were they absent, or why did DNB's management decide to present only a single majority view?
- What were the procedures for annual reports, financial stability reports and other advisory documents?
- Were there no serious differences of opinion within DNB about required actions or policy changes? If such differences existed, what were they? What were the arguments for the actual policy/ actions/ inactions?
- Did nobody see serious risks or dangers that required serious action? What were the

³⁵⁶ This observation is the more amazing because of the assertions of the commissions that they studied an uncountable number of pages of source documents. See the first sentence of chapter 1 of the FCIC report, p. 3/31. For the CDW see p. 31 of its first report.

³⁵⁷ A rather ridiculous but serious example concerning the CDW can be found on p. 145 of its first report. Where after a quotation of Wellink in the hearings the commission asserts (without any check): «So DNB did warn publicly for the risks...». In fact what Wellink said was either very misleading or untrue.

³⁵⁸ INTERMEZZO: BEELDEN OVER DE NEDERLANDSCHE BANK, first report of the CDW pp. 169-75/165-71.

³⁵⁹ An example of (important) misunderstanding is given on p. 71/67 of the first report of the CDW: «A large part of the claims of banks consists of mortgages. As already mentioned in chapter 4, the credit risks of these claims are mostly covered by securitisation.» This is incorrect. Securitisation is no insurance, and doesn't really reduce risks. (It may transfer them). Note that the CDW mentions a publication of DNB of 2009 as its source.

³⁶⁰ In fact, the CDW says nothing that could give an idea of the size of DNB.

arguments for doing nothing?

And these are only the answerable questions. One cannot expect a meaningful answer for example to the question: why were no scenario's made for the sequences of events following the realization of each of the identified risks? One cannot expect a meaningful answer because all information about DNB (and other supervisors) shows that this was simply outside their field of imagination (and abilities). Even though such scenario's are necessary to see what supervisors have to do in order to keep the financial system sound and safe.

Maybe the CDW didn't ask any of these and similar questions because it was afraid to get untrue or otherwise unacceptable answers.

And last but not least: why didn't CDW (or FCIC) interview employees from outside the management?

6. The commissions don't eliminate the ambiguity of the concept "cause". They don't check completeness.

Subsection 7B1.2 discussed the concept of "cause". It explained its ambiguity, and noted that it is impossible and useless to look for causes in the abstract. It showed how the ambiguity can be eliminated when one tries to learn lessons from experience, and tries to avoid repetition of unwanted phenomena. The most important conclusions were, that an inquiry aimed at prevention of repetition of an avoidable disaster should look for man-made, changeable causes. It should check that the set of causes discovered explains the observed phenomena, and offers sufficient handles for changes that make repetition impossible (or at least implausible).

The FCIC was asked "to examine the causes of the current financial and economic crisis in the United States." It doesn't say what it understands a "cause" to be. Several formulations in the chapter *Conclusions* of the FCIC report suggest that the commission didn't really know how to go about the concept. The commission calls observed phenomena "avoidable", "proved devastating", "key cause", "put the financial system on a collision course with crisis", "[...] was ill prepared for the crisis", "added to the uncertainty and panic", "there was a systemic breakdown". She seems to beat about the bush. Obviously lots of things were deficient or wrong, and it is useful that the FCIC notes that. But what about the causes? They are not identified and enumerated. The FCIC doesn't tell us which causes can or should be eliminated to prevent similar crises in the future. Even though it is clear that the inquiry by the FCIC has a practical purpose: prevention of repetition of similar crises. But the FCIC does not use this purpose as a guide in its work, or as a criterion, to eliminate arbitrariness in the identification of causes.

For the misconduct in banking institutions, the FCIC mentions greed as principal or only cause. The causes of the failures of supervisors and government are 1) presumably supposed to be less important; 2) not investigated. The FCIC does not notice that its report shows that in a certain sense, the causes of the crisis can be brought under a single common denominator. Namely that of "false pretensions" of the heads of all organizations constituting the financial system: banks, rating institutions, supervisors, and government. False pretensions about both their integrity and (other) competences. The omnipresence of false pretensions can be seen as a consequence of the systematic selection of people with false pretensions for top management functions. As a consequence of co-optation by similar people.

Like the FCIC, the CDW doesn't ask itself the question about the level of abstraction of causes. The commissions don't seem to be aware of the ambiguity and the need to make a choice. At no level do they give a complete and unambiguous explanation. They ask themselves too few questions. They don't look for changeable causes, at least not systematically. They don't ask themselves questions of completeness. Like: "Do these causes explain the crisis and the phenomena inextricably bound up with it?", "Is a similar crisis impossible if these recommendations are implemented?"

The dysfunctioning of supervision can be said to be a cause, but as long as the causes of this dysfunctioning are not understood it is unclear what measures are necessary and sufficient to prevent it. For this reason it would have been wiser if the FCIC had tried to formulate proposals for correction or improvement, and if both commissions had tested their proposals as regards plausibility and effectiveness by means of thought experiments and the newly gained insights. The proposals should be able to withstand criticism. It should be plausible that implementation of the proposals makes similar

crises impossible or very improbable. This approach forces an inquiry commission to look much more critical for and at causes.

To be useful for prevention, the inquiry commissions should anyway have looked for changeable causes, and checked that it is credible that their elimination or suitable change will prevent new crises.

7. The inquiry of the FCIC has important gaps, serving specific interests.

The FCIC pays a lot of attention to the operation of the financial system in the narrow sense. It pays much less attention to the operation of the supervisors, and even less to that of the government (or Treasury). This is incompatible with the well-balanced treatment which is promised on pp. xi and xii of its report. There the commission suggests something which isn't true, without formally speaking untruth. For it is true that the report has something to say about all topics mentioned. But some topics get much more attention than others, and similar topics are treated rather differently. The influence of HUD on the GSEs is hardly studied or not at all. The FCIC notes that the supervisors have failed. But the supervisors have not been questioned about their annual reports and the (internal) operation of their organization. The commission does not try to explain their dysfunctioning. If the absence of supervision of the supervisors by administration or Congress is noted at all, it certainly isn't analyzed and explained.

The FCIC failed to evaluate the operation of the Presidents Working Group.³⁶¹ It has questioned members like Cox and Greenspan, but not about this.

The FCIC wipes the floor with the rating agencies and the risk management of the banks. But the disastrous (absent) risk management of the government is not even noted. Did HUD estimate the risks of its affordable housing policies in a way that could serve as an example for rating agencies and banks? The FCIC doesn't say a single word about it. And of course, the facts have given the lie to this supposition.

Contrary to the CDW (and the Irish investigators) the FCIC pays no attention to (external) auditors and accountancy firms like Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers. It does not investigate the role they played in the risk taking, in the accounting tricks to increase leverage and in the creation of transparency (or opacity) for supervisors and shareholders. In this connection the SEC "Form 10K" could (or should) have been evaluated too.³⁶²

It follows that the FCIC has only partly done its primary job: finding the causes of the crisis. Due to the omissions mentioned above, the causes of the dysfunctioning of government and supervisors remain hidden. Perhaps this was intentional. Or maybe the FCIC didn't find this important because it thought this has little to do with the causes of the crisis. (Which would be incompatible with its conclusions). Anyway the FCIC doesn't account for these omissions or opinions.

The gap precludes measures that could prevent repetition. For it is not sufficient to say that supervision should be corrected or improved without specification of what is needed, and without adequate periodic verification (i.e. supervision). The more so if one concludes that the management of the supervisors lacked the necessary integrity and competencies.

So the FCIC did its job by halves. Causes of important, possibly fatal, dysfunctioning were left covered. Since supervisors have a crucial function in the financial system it is therefore rather improbable that the FCIC report is a suitable basis for the formulation of a sufficient set of measures.

The political establishment failed decisively. The omission of the FCIC serves its interests. A clear exposition of its failure would undermine its power, and even the constitution.

8. Neither CDW nor FCIC tries to find causes of observed general misconduct.

From the histories presented by the inquiry commissions (as from the Chronicle) it can be concluded that all supervisors and governments systematically took wrong decisions with respect to

³⁶¹ Remember the answers to the GAO request for comment on their draft LTCM report. The answers claim that the PWG does all that is necessary. See the Chronicle, under 1999. Formally and theoretically the PWG could have been sufficient, but in practice it evidently wasn't. The "theoretically" means to indicate that the formal duties required a lot of constructive working-out and implementation.

³⁶² When completed, "Form 10K" is a kind of bare financial annual report.

the financial system.³⁶³ They did not do their duty. This had extremely harmful consequences for the people whose interests they were bound to protect. The commissions establish this phenomenon only implicitly. They don't conclude it explicitly. They seem to leave it up to the reader to draw this conclusion from what they do write. Since the phenomenon is not mentioned, it isn't analyzed either, and its causes are not looked for. In particular, the commissions don't ask themselves:

1. How it is to be explained that the dysfunctioning of responsible organizations can be a systematic phenomenon, and that no alarm-bell ever rang audibly anywhere;
2. How dysfunctioning can be corrected if the causes have not been established. This applies to government and supervision, but also to the rating agencies;³⁶⁴
3. Whether the people or organizations who have to devise, elaborate and implement measures are able and willing to do this appropriately.³⁶⁵ This needs investigation and/or substantiation and explanation, because all government organizations concerned have failed for a long time. If their ability and integrity cannot be proven credibly, they should be "renovated" first.

If the very good reports of the GAO of 1994 and 1999 were totally ignored, why not the reports of the CDW and FCIC? And indeed, the US Congress did not wait for the FCIC report to introduce new legislation. After more than a decade of laissez faire and passively looking on, there suddenly was an immediate need for new regulation, even before a foundation had been laid. One cannot reasonably expect organizations or a system that has been proven to be unable and/or unwilling to correct itself for at least about 15 years to suddenly operate properly. That is: fundamentally different.

9. The commissions ignore important facts, with fatal consequences for their conclusions.

Especially the FCIC has shown the systematic failure of the principal persons and organizations. But the character and depth of the failure have hardly been investigated or analyzed, if at all. Where "character of the failure" also refers to the failure of the management of organizations, the operation of organizations as organization, and the effect of codes of conduct and similar codes (or the absence of an effect). There was not just a single "mistake": the underestimation of the systemic risk. Very many errors were made, and not all errors concerned economics or finance. And not all misconduct can be characterized "error".

Nothing shows the depth of the errors more clearly than the annual reports of the supervisors. They show not only their dysfunctioning on a wide front, and their lack of integrity, but indirectly also the failure of the responsible government officials. These could and should have seen the inadequacy of the annual reports, and done something about it.

Please mark well: It is not alleged that the supervisors did everything wrong, and did no good, or that every supervisor employee dysfunctions. The problem is that a dike is as strong as its weakest part. And that this comparison is valid for quite a few human activities. So however good parts of the dikes are, as long as they are not uniformly sufficiently strong, much or most energy may be wasted.

As it is, in the annual reports the supervisors gave a far too rosy picture of themselves and the state of the financial system. Their reassurances were simply misleading, and may have invited more risk taking. The complacency radiated by the supervisors had no basis in reality.

Of crucial importance in this connection are the GAO reports of 1994 and 1999, and somewhat less the qualitatively inferior but still alarming reports of BIS-CGFS of 2003 and later. The FCIC writes that the first mentioned report was removed from the political table under pressure from lobbies. But it does not note that the reports gave well substantiated and clear warnings. It does not investigate what the Fed and other supervisors did with the reports. It does not investigate why not only politicians but the supervisors too threw them in the waste-paper basket. And if they met a better fate, why that

³⁶³ Systematically, during more than a decade.

³⁶⁴ The rating is an example of incomplete and therefore inadequate analysis, and doubtful measures. The problem of forecasting, the fundamental uncertainties of forecasts, and the communication about them, have been ignored completely. They are nevertheless of vital importance for usefulness and use. Improvement of supervision of rating agencies doesn't solve this, and can only improve the situation superficially.

³⁶⁵ By "measures" are meant: the measures intended to prevent repetition of crises.

wasn't noticeable in practice. Anyway, the supervisors should have evaluated the reports on their material merits, and henceforth taken them into account appropriately. Why didn't they do so? Why has the Fed done nothing about systemic risk in spite of these reports? Did nobody in the very large supervising organizations of the USA understand these reports?

Because of the number and quality of the employees of the supervisors this is not credible. Internal signals must have been ignored too.³⁶⁶ That nothing was done with them can only be explained by stupid, authoritarian and repressive management. By management that was arrogantly dogmatic, and unable to make professionally sound judgments. A management that was more of a political agent than professional supervisor, and gave priority to government policy at the cost of its primary mission of ensuring a safe and sound financial system. A management that left no room for opinions incompatible with its own. This may well be the reason why the FCIC doesn't look into the failure of the supervisors. And the reason why it didn't want to hear supervisor employees from outside the top management. They might show that the supervising organizations were run as dictatorships headed by repressive and irresponsible dictators.

The FCIC knows about the GAO reports. But it doesn't use them in its interviews or analyses (which don't go deep anyway, as noted before). The CDW ignores the GAO reports completely. Maybe it doesn't know them. But for an inquiry commission this is not an excuse: it should have found them. For the annual reports neither of the inquiry commissions shows any interest. This cannot have a good reason.

The commissions do not analyze the conduct of the relevant authorities. They do not specify their failings. Even though this is of decisive importance if the commissions' reports are to have the desired effects. Why would the FCIC report have more positive effects than the aforementioned GAO reports? Why would the report of the CDW have more positive effects than the report of 2002 of the commission Vos about the construction fraud?³⁶⁷ In this connection it may be important to note that the reports of the inquiry commissions are submitted to a government division (such as parliament). It is this government division that should do something with the report. In general only a good government has the motive and ability to do something with it. If it doesn't, nobody will do anything, except when it happens to seem profitable from a narrow individual point of view.

As a consequence of the failures of the inquiry commissions noted in this subsection, no improvements are to be expected with respect to the selection of heads of supervising organizations, and with respect to the operation of organizations as organizations.

10. A missing conclusion: for all key functions politicians had appointed inappropriate persons.

The reports of the inquiry commissions show, that none of the heads of the supervising and government organizations which are responsible for the safety and soundness of the financial system has fulfilled his function properly. But the commissions leave this implicit. Nowhere do they make integrity and competence subjects of investigation and analysis. They seem to have assumed tacitly that the principal persons are honorable and competent. That they made "human errors", erred in their judgments, saw no alternative. That they were honorable experts even though more than a decade of history shows that their bragging and dysfunctioning were systematic, and that none of their actions showed understanding of the system for which they bore part of the responsibility.³⁶⁸ And even though its annual reports show that the Fed consciously and systematically ignored its responsibility with respect to systemic risk.

³⁶⁶ As in the other cases, first of all those concerning the Dutch education ministry. Quite a few employees must have been able to produce similar arguments as those of GAO and CGFS. The OFHEO systemic risk report can be interpreted as proof. Even though OFHEO had only about 250 employees, some of them understood the risks, and could hardly have communicated them better. But their report was ignored even by their own management. (Around 2006, the Fed had about 2000 employees, and SEC 3500. Etcetera...).

³⁶⁷ The construction fraud is discussed in chapter 8. Vos was chairperson of a parliamentary inquiry commission.

³⁶⁸ Someone who understood the financial system understood the risks, including systemic risks, and had no reason to complain about the lack of (internal, external?!?) warnings. A principal person should not have remained passive.

One has to conclude that the appointments of the heads of the supervising organizations and the other principal persons were simply wrong. Those who appointed them made terrible errors of judgment.³⁶⁹ In this respect too their integrity and/or competence was a false pretension. For obviously these errors are not incidental. They were never quickly corrected (rather knowingly continued)³⁷⁰. It was a structural phenomenon; uncorrected, and without exception. The structural character is clearly seen in the reaction to the initiative of Brooksley Born of the CFTC. An “error” in the other direction; which was “corrected” as soon as possible.

There are plenty of grounds for the assertion that the crisis was caused by having the wrong people in all key positions in supervision and government. Or equivalently, that the crisis was caused by wrong appointments.

The inquiry commissions and their appointments are examples too. Wallison might be considered an exception (or mistake) if a good remark would mean a good report. Which it doesn’t.

The commissions can be blamed for sticking to the assumption of honorable and competent heads while a mountain of evidence showed the contrary. Professional investigators should at least have considered where dropping the falsified assumption would lead.

11. How the commissions enable the principal persons to retain similar functions.

The inquiry commissions seem to find that many of the principal persons should have behaved themselves differently, and should behave differently in the future. The problem is that the commissions suggest or recommend nothing that gives the principal persons reason to do so. And that they don’t ask themselves whether the principal persons really can behave differently, or are sufficiently honorable and competent.

By a stroke of luck the commissions complement each other nicely for this subject.

The FCIC minimizes the blameworthiness of specific persons or groups.

After the conclusions quoted in subsection 2 above, the FCIC makes the following remark:³⁷¹

«THESE CONCLUSIONS must be viewed in the context of human nature and individual and societal responsibility. First, to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis.

Second, we clearly believe the crisis was a result of human mistakes, misjudgments, and misdeeds that resulted in systemic failures for which our nation has paid dearly. As you read this report, you will see that specific firms and individuals acted irresponsibly. Yet a crisis of this magnitude cannot be the work of a few bad actors, and such was not the case here. At the same time, the breadth of this crisis does not mean that “everyone is at fault”; many firms and individuals did not participate in the excesses that spawned disaster.

We do place special responsibility with the public leaders charged with protecting our financial system, those entrusted to run our regulatory agencies, and the chief executives of companies whose failures drove us to crisis. These individuals sought and accepted positions of significant responsibility and obligation. Tone at the top does matter and, in this instance, we were let down. No one said “no.”

But as a nation, we must also accept responsibility for what we permitted to occur. Collectively, but certainly not unanimously, we acquiesced to or embraced a system, a set of policies and actions, that gave rise to our present predicament.»

These paragraphs excel in vagueness, half-heartedness, dubious generalizations and concealment. Clearly the FCIC doesn’t like openness and clarity.

³⁶⁹ Supposing they wanted to appoint a honorable and competent person. They may have had other priorities. Such as loyalty to presidential or partisan policy, or the need to reward a friend with a nice job. Perhaps integrity was the very last thing they wanted!

³⁷⁰ Examples: the appointments of Geithner and Summers by Obama after the crisis.

³⁷¹ FCIC report pp. xxii-xxiii/22-3.

Not everyone concerned had the same “societal responsibility”. With respect to the public, supervision and government had the greatest responsibility. Only they had a legal duty implying societal responsibility, and only they had the corresponding means and authority.

There are more “mortal flaws” than those mentioned. Because of their dominant and dangerous influence, false pretensions should have been mentioned prominently.

Everything that people do wrong can be blamed on (supposed? inevitable?) “human weakness”. In the context of the crisis this is a misleading observation, since not everybody has as many and as serious weaknesses, and because the consequences of weaknesses very much depend on one’s social position. But most of all it is misleading because the responsible positions were voluntarily accepted in spite of weaknesses which are incompatible with societal responsibility. (The initial irresponsibility). And finally, even if everyone had the same weaknesses, they still make one unsuitable for a responsible job.

In the second remark, the FCIC should have been much more explicit about the fact that the crisis has shown that vital pretensions of supervisors, governments and others were false. Not incidentally but systematically. The principal persons claimed abilities they didn’t have. They made assertions which could have been based on a job well done, but were actually based on wishful thinking. The FCIC should have added that false pretensions about one’s abilities do not make part of general human weaknesses. Indeed, people like Bos, Clinton, Greenspan and Wellink had false pretensions that made them fail. But none of the people working in my supermarket has. The formulations of the FCIC majority are much more vague than they need to be, and far too vague to be able to serve as a basis for corrective measures.

It is untrue that a crisis like this cannot be caused by just a few individuals.³⁷² It is the hierarchical political organization of society that makes this possible.³⁷³ It gives a few people so much power that all other people are effectively rendered powerless.³⁷⁴ Perhaps one cannot say that the subprime crisis was caused by less than ten people. But less than ten heads of supervising organizations certainly could have prevented it. They systematically deceived the public, and sabotaged vital democratic processes. For the purpose of correction the FCIC should have noted that the supervision, and the supervision of the supervision by the government, failed their duties and actively contributed to the development of (the size of) the crisis. Also by preventing correction through democratic processes. There are banks which did not contribute to the crisis, but among the supervisors there is no exception.

The third paragraph essentially concludes that the pretensions of all government agencies were false. But the suggestion that it was only a matter of tone and inability to say “no” is worse than misleading. The principal persons should have done much more than say “no” when their duty called for “no”. This kind of conclusions prevents effective measures. The supervisors, Treasury secretaries and the financial leadership of Congress simply misled the public. They actively broadcast nonsense about the safety and soundness of the financial system. They did not have the integrity and competence they claimed to have, and not by far. They could not and did not do what their duty required. They actively and fanatically obstructed efforts of other people to do what was later admitted to be necessary. In fact, the FCIC fails to note that for over a decade, “as a nation” we were systematically deceived by our representatives and elected officials in Congress and Administration. Not only accountability and ethics broke down, but the democratic system as such. The FCIC failed to conclude this, and failed to elicit reparation.

The last paragraph looks far too much like an effort to shift the ultimate blame on the public. It certainly further reduces the responsibility of the principal persons. The paragraph would have been justified if “the nation” had the means to change the “system, [and] a set of policies and actions” in such a way that the crisis would have been averted. Such means are not mentioned by the FCIC. According to the present author they don’t exist. And even if they existed, the structural misinformation would have prevented appropriate correction.

³⁷² Note that the commission gives no proof. It is supposed to be evident. But in modern “democratic constitutional states” heads of government organizations have absolute power in their organization, and play crucial roles in the system. Their incompetence and mutual support can be disastrous, as shown in both the subprime and government debt crisis.

³⁷³ Of course in the absence of effective checks.

³⁷⁴ Power includes the power to manipulate information. The power of appointment was already mentioned.

Since it has been shown implicitly that the political system, and therefore the Constitution, are inadequate, the last paragraph can be read as a call for revolution.

Of course it is misleading to speak anthropomorphically about the nation. According to the Constitution the nation is represented by the president. Because of the Constitution (and the powers it conveys), because of his actions and omissions, and because of his false pretensions, the president is the first to blame. All or almost all other principal persons in government and supervision were appointed or nominated by him.

The Commission De Wit sees irresponsible conduct everywhere, but makes no proposals to stop it.

In the chapter MAIN CONCLUSIONS AND RECOMMENDATIONS the CDW states:

«In its inquiry the commission noted that an appreciable part of those who had responsibilities in the financial system in the run up to the crisis hardly showed a critical look at their own role in the origin of the problems and their failure to prevent them.

The commission finds this lack of self reflection disturbing, because it mortgages the improvements which the commission proposes. It feeds the anxiety that the actors will return to “business as usual”.

In the opinion of the commission it is essential that those responsible for the present problems accept this responsibility and act accordingly.»³⁷⁵

But it makes no recommendations to ensure or increase the probability that they do.

Since no one has accepted responsibility for any serious failure, the first sentence is an understatement. All responsible actors claim that they did what they should and could. Without showing any doubt. Even if they claim a prominent role in the system, they simultaneously shirk their responsibility for the events. An important question seems to be, whether the softness of the commission serves any good purpose. Whether it helps prevention. As the commission itself indicates by the reference to anxiety for a return to “business as usual”, this is quite implausible. The principal persons still occupy vital social positions. Contrary to what happened to most people in the Western countries, the careers and incomes of almost all principal persons were left undisturbed by the crisis.

The commission is not explicit about its reasons for thinking that the responsible persons failed to evaluate their own pre-crisis conduct critically. Isn’t it possible that these persons really didn’t see themselves as responsible for what went wrong, even after thorough self reflection? That the hearings show what they really think? That they (unconsciously?) succeeded in finding an argumentation showing their innocence, at least in their own eyes? And if for some reason this is not plausible, then the commission should have tried to find the cause of the inability or failure of critical self-reflection. For this cause may be closely related to the causes of the false pretensions of the principal persons, and therefore of the causes of the crisis. Couldn’t self-delusion be a characteristic of people who claim (think?) to have competences which in fact they don’t have at all? If such people really could evaluate themselves critically or objectively, they would have done so already a long time ago, and have concluded that they are not suitable for functions in the top management of supervising or government organizations. Unless they are insensitive to the harm they cause for other people, and/or think they have to give absolute priority to I don’t know what. Such as compliance with political wishes which regrettably make victims, but necessarily and unavoidably.

The last sentence of the quote, “In the opinion...”, is an example of irresponsible wishful thinking. How is it possible to believe in fundamental change of the principal persons, given that the inquiry has shown that for many years all of them have acted irresponsibly, and given the lack of reliable self reflection? The more so since none of the recommendations of this commission forces people to act responsibly, or addresses the problem of irresponsible conduct directly. In other words: giving this opinion is the only thing the commission does about the problem. Obviously there is no reason to expect change.

Last but not least the commission nowhere asks the question whether the principal persons can act

³⁷⁵ First report of the CDW p. 4/8.

differently.

Instead of protecting those whom they find responsible, the commissions could and should have concluded that the pretensions of the principal persons were false. That these persons are insufficiently honorable and competent to occupy the kind of positions they occupied in the prehistory of the crisis. They should have mentioned names. Failure to do so means allowing these people to continue to function in top positions, and to remain a serious threat to the safety and soundness of society.

Implicitly the commissions manage to conclude that nobody is guilty. But the commissions do not infer from this that the principal persons and/or their organizations had missions they could not accomplish. And that therefore the missions should be adjusted. And that the system should be reorganized in such a way that (real) people can do what they are requested or supposed to do.

In the reports of both commissions it is assumed that bonuses affect behavior. Quite generally it is assumed that liability and punishability do so. Indeed, it is contrary to logic to deny such an influence. Therefore it is more than probable that shielding people who could and should have prevented the crisis, or could limit the extent of its consequences, prevents reduction of the probability of financial crises and other disasters in the future. Last but not least: their continuance in top management functions precludes their replacement by honorable and competent people.³⁷⁶

12. The FCIC, GSEs and the affordable housing goals.

An important example of a methodological failure is that of the “analysis” of the influence of the affordable housing policy (AH policy) of the US government. The investigation of this influence by the FCIC is hard to explain by incompetence only. It seems easier to explain as an effort to keep up appearances while keeping the AH policy, HUD and presidents in the background, and concentrating the blame for the “poisoning” of the mortgage pool on banking, and the blame for the GSE failure on the GSEs. The incredible analysis of the FCIC majority gave Wallison reason to write a minority report.

In section 9.7 of its report the FCIC majority explains why the AH policy played no significant role in the preparation of the crisis.³⁷⁷ The explanation is inadequately founded, and untenable. Untenable because it is a priori unbelievable that the policy had no influence. The policy was intended to substantially increase homeownership among people with low and moderate incomes. Especially by weakening conditions for obtaining a mortgage.

The crisis of 2007-2008 is sometimes called subprime crisis because it was triggered by subprime mortgages. That is: mortgages with a relatively high risk. Those who deny that the relatively large increase of subprime mortgages was caused by AH policy say that it was caused by greed. Greed undoubtedly played a role. But it did and does always and everywhere. Someone who claims that it caused this crisis has to explain why it didn’t cause crises at other times and places, and in particular why the crisis began (and was caused) in the US, and not in other countries. Such an explanation is wanting. Greed is everywhere; AH policy as described by Wallison (and for example the GSEs) was a US policy. As clearly shown by Wallison and Pinto, the AH policy and the reckless way it was pushed for many years by the successive US governments explains the relatively large increase of subprime.

On the other hand, the analysis supposedly showing that the AH policy had no significant influence is illogical and methodologically erroneous. This is shown in the following.

The FCIC claims that «The [AH]-goals were intended to be only a modest reach beyond the mortgages that the GSEs would normally purchase».³⁷⁸ This is incompatible with

³⁷⁶ Geithner, boss of the New York Fed, became secretary of the Treasury; Bernanke stayed at the Fed, Teulings stayed at the Dutch CPB, Wellink president of the Dutch central bank DNB. He was succeeded by Klaas Knot, participant of inadequate BIS-CGFS conferences, where he seems to have learned nothing that should have consequences for the DNB. For the Dutch ministers Bos, Balkenende, Kok and Zalm similar stories can be told. And these are only examples.

³⁷⁷ The takeover of Fannie and Freddie by the government is described in chapter 17 of the FCIC report.

³⁷⁸ FCIC p. 183/211, first paragraph of new section. The assertion seems to be based on interviews of the FCIC.

- the time series of quantitative goals (from 30 to 57%, see the relevant tables);
- the pressure systematically exerted by HUD to reduce the conditions for mortgages;
- common sense: is the FCIC saying that the policy wasn't needed?

How did the FCIC estimate what the “GSEs would normally purchase”? Because of its incredibility³⁷⁹ the assertion needs thorough substantiation. But this is not given.³⁸⁰

In its hearings in the beginning of 2010 the people questioned by the FCIC frequently say things they could have said years earlier in their annual reports.³⁸¹ But failed to say. The FCIC doesn't make any remark about this. It frequently quotes from the hearings, but never or nearly never from annual reports. In the hearings it is said that the AH goals were goals in a mix of goals. It is only natural that other goals played a role as well. But if the AH goals were no more than one set of goals among many, it is impossible to explain the fact that they were systematically realized very accurately.

The AH policy originated in the department of housing and urban development, HUD. Already long before the FCIC inquiry, there were good reasons to suspect AH policy to be the driving force behind the diminishing quality of mortgages.³⁸² In spite of this, the FCIC uses an employee of HUD as source of information about the effects of AH policy on GSEs. It suggests, implicitly and without argumentation, that this employee is reliable when he defends his own organization and accuses the GSEs:

«The former HUD official Mike Price told the FCIC that while the “GSEs cried bloody murder forever” when it came to the goals, they touted their contribution to increasing homeownership. In addition, Price and other HUD officials told the FCIC that the GSEs never claimed that meeting the goals would leave them in an unsafe or unsound condition.»³⁸³

This very much looks like a 100% misleading half truth (at best). For maybe the GSEs never asserted that “meeting the goals would leave them in an unsafe or unsound condition”.³⁸⁴ But their annual reports explicitly say that higher goals will reduce their expected profits, and increase their risks. The argumentation in the annual reports is correct, and the assertion that the profit goal got priority is not. And why doesn't Price explain why the “GSEs cried bloody murder forever when it came to the goals”? Why did the FCIC not ask for the explanation? The GSEs had good reason to cry bloody murder! The remark obviously contradicts the assertion of a “modest reach”.

In the sequel of the quoted paragraph the FCIC notes that the GSEs had the right to object against AH goals if these would affect their safety and soundness. And that HUD complied with a request for dispensation of... 12/12/07. When the crisis had already started. As if this proves the reasonableness of HUD, and the GSEs are left as the only possible culprits.

The allegation is incorrect because the AH policy of HUD was both reckless and risky. There is no evidence of reflection on risks or “side effects”. Wallison implicitly shows why for a long time the GSEs did not object openly against the goals. The reason was that HUD had created a climate in which cooperation with its AH policy was imperative, and lack of cooperation obstruction of the American dream.

In the meantime the GSEs did give well-argued signals. Just as an illustration a quote from the annual report 2006 of Fannie:

«Our efforts to meet the increased housing goals and subgoals established by HUD for 2007 and future years may reduce our profitability. In order to obtain business that contributes to our housing goals and subgoals, we have made significant adjustments to our mortgage loan sourcing and purchase strategies. These strategies include entering into some purchase and securitization transactions with lower expected economic returns than our typical transactions. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's

³⁷⁹ See the annual reports of the GSEs. The GSE appendix of the present study should be sufficient.

³⁸⁰ Neither in FHFA Note 10-2.

³⁸¹ Note that most of the people questioned had the power to do so.

³⁸² See for example the FCIC minority report of Wallison, and the reports of Pinto. They can be found in the dossier.

³⁸³ FCIC p. 185/213.

³⁸⁴ If only because “unsafe” and “unsound” are not defined measurably, if objectively.

goals and subgoals, which could further increase our credit losses.»³⁸⁵

Similar remarks were made in the annual reports of 2004 and 2005. They seem to have been ignored by HUD and OFHEO. There is at least no evidence of a reaction.

The AH policy can also explain the dysfunctioning of OFHEO. The more so since OFHEO was a part of HUD. Adequate supervision would have meant severe criticism of AH policy. If OFHEO wanted to support government (HUD) policy, it couldn't be independent and critical in any serious sense. In the conclusions of chapter 17, the FCIC majority alleges that OFHEO had to cope with (supposedly) insufficient authority and capacity, and political pressure from the GSEs. The FCIC should have noted that the GSEs could only exert pressure because of the support for the AH policy by HUD and Congress. And it should have explained why lack of authority and capacity justifies misleading annual reports to Congress.

On the other hand the FCIC gives no excuses for the conduct of the GSEs. It does not note that the GSEs contributed very successfully to the realization of the AH goals. If in the opinion of the FCIC the GSEs have taken too much risk, why doesn't the FCIC explain how the GSEs could have realized the AH goals without increasing risks? And did the FCIC ask itself how HUD and Congress would have reacted if the GSEs had resisted the goal hike in 2005?

Finally it should be noted that a thorough investigation would have studied the correspondence between GSEs and OFHEO, GSEs-HUD and OFHEO-HUD, and the minutes of conferences between these organizations.³⁸⁶

The conclusion can only be that the inquiry into the role of the AH policy by the FCIC majority is inadequate. With a lot of difficulty one can blame this on incompetence alone. Since the errors noted above are rather obvious, it seems much more probable that the "analysis" of the influence of the AH policy has to be explained otherwise. To wit: as an effort to stay away from any line of argumentation that would lead to the conclusion that Congress and government were the principal cause of the subprime crisis. Even if this could only be done at the cost of the integrity of the FCIC majority.

13. Supervision failed far worse than shown by the inquiry commissions.

FCIC.

In the subsection *Regulators*³⁸⁷ of chapter 16³⁸⁸ of the FCIC report, selected employees of supervisors are given the opportunity to explain failures of their organizations. The FCIC gives no comment or analysis. In this way they give suspects the opportunity to throw dust in the eyes of listeners and readers.

In the box at the end of the chapter the FCIC concludes:

«COMMISSION CONCLUSIONS ON CHAPTER 16

The Commission concludes that the banking supervisors failed to adequately and proactively identify and police the weaknesses of the banks and thrifts or their poor corporate governance and risk management, often maintaining satisfactory ratings on institutions until just before their collapse. This failure was caused by many factors, including beliefs that regulation was unduly burdensome, that financial institutions were capable of self-regulation, and that regulators should not interfere with activities reported as profitable.

[...]

The Federal Reserve realized far too late the systemic danger inherent in the interconnections of the unregulated over-the-counter (OTC) derivatives market and did not have the information needed to act.»³⁸⁹

³⁸⁵ Fannie Mae, Annual report 2006, p. 27/42. The losses were actually realized...

³⁸⁶ Instead of relying on an interview after the fact with one of the accused.

³⁸⁷ FCIC pp. 307/335 and following.

³⁸⁸ About the months March-August 2008.

³⁸⁹ FCIC-report p. 308/336.

The FCIC says nothing about the decade-long arrogant and complete lack of attention for the system as a system, and for the interactions between its parts and processes. This in spite of the warnings and recommendations of the GAO of 1999. The FCIC says nothing about the systematic misrepresentation of the state of the financial system and the false pretensions in the annual reports, and about the fatal lack of self knowledge demonstrated thereby. Which obviously can be explained by “many factors”, but not by the dogmas mentioned in the quote. Dogmas which were not listed as assumptions in the annual reports. So it was far worse than the FCIC suggests. The FCIC should have evaluated the accounting/ defense of the interviewed employees, if only to prevent misleading unsuspecting readers. It should have critically evaluated the suggestion that the failure should be explained by incorrect convictions, which by the way it fails to qualify as inexcusable for a professional supervisor.

The last sentence of the quote, “[The Federal Reserve...](#)”, is an example of a misleading half truth. Because the annual reports of the Fed show that the Fed ignored systemic risk completely and consciously. It rejected warnings by GAO, OFHEO and CGFS out of hand. The Fed simply did not do anything about one of its four primary duties. Presumably on the basis of an erroneous dogmatic belief of its chairman, his power and his intolerance of any other view. So the “too late” sentence hides facts which are very relevant if one wants to prevent repetition. The FCIC furthermore neglects to mention that the belief and late realization are inexcusable. Not in the last place because of the GAO and BIS reports, and the competencies which should be present in the Fed.

Regrettably the FCIC seems to assume that Greenspan and the Fed are one and the same. It ignores the fact that the Fed has about 1500 employees, and does not try to find out if Greenspan’s opinions reflect the (voluntary) consensus of his staff.

In short: the FCIC gives reasons which it suggests are excusable. It omits facts and analyses which show that the supervisor’s conduct is inexcusable.

The agenda of the hearings and the list of participants of the hearings³⁹⁰ show that only one day was spent with people from only one organization. Moody’s.³⁹¹ On that day the commission even paid serious attention to the internal operation of Moody’s. The disproportional attention to, and criticism of, the ratings cannot be accidental, and cannot be explained by their role in the preparation of the crisis. A much more probable explanation is that the rating agencies were the easiest scapegoat:

- They constituted the smallest subsector (and have less influence in Washington);
- They are not supervised, so that supervisors are not responsible, and the government “only” as the lawmaker.

Why did the FCIC not spend (at least) a similar day on the Fed? This is too inconsistent not to be suspect.

The misleading picture the FCIC gives of the supervisors can be blamed on a combination of lack of integrity and lack of research competence. The FCIC majority report can be explained if it is assumed that supervision (and government) had to be kept out of the wind, while remaining as credible as possible. Reproaches at the address of the supervisors were inevitable, but their character and seriousness had to be presented in such a way as to leave Congress and Administration, who are responsible for the supervision, unscathed as much as possible.

This also explains why the FCIC does not compare the duties and norms mentioned by the supervisors themselves in their annual reports 1995-2007 with their actual performance, and with its own explanation of the conduct of the supervisors.

CDW.

A similar analysis can be made of the CDW. It is undeniable that the CDW and its staff have done much useful work. But the commission seems to have recoiled from the conclusion of a general unacceptable lack of integrity and competence. The fear of coming too close to this conclusion seems to have had a dominant influence on its analyses. Witness curiously inadequate and misleading

³⁹⁰ See the file *Agenda en deelnemers hearings FCIC.rtf*.

³⁹¹ Warren Buffett was not on the staff of Moody’s, but an important shareholder. The FCIC may have seen him as supervisor. But he surely was very much interested as well.

analyses like the one quoted below. Analyses which exculpate the principal culprits. The same fear can moreover explain why some matters are, and others are not investigated, or only superficially.³⁹² Such as the annual reports of the supervisors and the GAO reports.

In its quasi analyses the CDW gratefully uses the representations of the events which had been given in the hearings. An example:

«The crisis showed that there was a worldwide lack of systemic supervision. That is: supervision directed at identification of risks for the financial system as a whole, and the solution thereof. In part, this is caused by the global character of many systemic risks, while supervision is national. In addition a large part of the activities within the financial system took place outside the reach of law or regulation, which reduced or precluded the possibilities of supervision. It is undeniable that the supervision of the financial system was too preoccupied with the evaluation and assurance of the health of individual institutions (micro-prudential supervision). Where it was assumed that the system would be healthy if the institutions were.

Shortcomings in system supervision could also be seen in the Netherlands. In general DNB, as responsible for systemic supervision, put the systemic risks that it increasingly perceived on the public agenda. Its warnings were either heard insufficiently or didn't convince policymakers and politicians. At the system level the systemic risks identified by DNB did not lead to subsequent action by the supervisor [= DNB itself]. The supervision of DNB was mainly directed at the management of individual institutions (micro-prudential).»³⁹³

This is misleading or plainly wrong in many respects. Examples are:

- Risks for the global financial system may have a national cause. As noted before, small causes can have large effects. Global spreading is possible but not always necessary. Countries may have better or worse supervision, may be more or less vulnerable. See the histories of earlier financial crises, such as the LTCM crisis and regional crises.³⁹⁴
- The suggestion that the global character was a problem (or excuse) for supervision is incorrect. National supervision was responsible for systemic stability. It was free to communicate internationally with other supervisors, and could report and advise freely to whomever it wanted. If it felt so, it could have reported that because of its (essentially) global character, it could not be held responsible for systemic stability. (It didn't).
- If activities threatening financial stability took place outside the reach of law or regulation, the supervisors could and should have reported this problem to the authorities, and should have made recommendations for changes in law and/or regulation. This is no more than part of its duty. They didn't. The clause “which reduced or precluded the possibilities of supervision” is incorrect and misleading.
- In fact, GAO, CFTC, OFHEO and others have warned of deficiencies in law and/or regulation. But the authorities did nothing. DNB never supported the efforts of GAO, CFTC, OFHEO and others.
- The sentence “It is undeniable...” is misleading. It is true that supervisors gave far too little attention to interactions and the operation of the system as a system. If only because these affect the safety and health of individual institutions. The commission should have noted that the supervisors failed even in micro-prudential supervision. It should have noted that it is logically impossible to evaluate the “health” of an individual institution without considering its environment- the system- and making assumptions about that. The more so if parts of the financial system are virtually invisible for supervision.
- This was shown in practice by the LTCM case. Everyone responsible, including CDW and FCIC, should have known this. That is what competence means.
- In fact the individual financial institutions were not healthy. (Don't forget the ridiculous (formal, arbitrary) capital requirements).

³⁹² At least in so far as becomes apparent from the reports. It is possible that material that didn't fit the (self imposed) boundary conditions has been left out, as in the case of the FCIC.

³⁹³ CDW1, section 7.5 *Conclusies*, pp. 166-7/ 162-3. After the quote the report goes on with another (sub)topic.

³⁹⁴ See for example the Wiki page Financial crisis. It can be found in the directory Encyclopedia.

- The assumption formulated in the last sentence of the first paragraph of the quote, that the system is healthy if the institutions are, is incompatible with the (untrue) assertion that DNB warned for systemic risks.
- Analysis of its annual reports shows that DNB did note certain risks. But in an inconspicuous way, and without appropriate explanation of consequences and dangers of inaction. It made no proposals for what had to be done. In the end, prior to the crisis it always suggested that an optimistic scenario was the most probable.
- It would be more correct and far less misleading to say that DNB did not warn for systemic risks.³⁹⁵
- CDW omits to note that the supervisors, including the Dutch, did not adequately cooperate internationally, and failed to react properly to signals and threats also in the international context. That not supervision had the priority of the supervisors, but subservience to government policies and fashions.
- CDW ignores the risks of basing its analysis on hearings of prime suspects like Wellink. To say that “**DNB put the systemic risks that it increasingly perceived on the public agenda**” is a ridiculous exaggeration. CDW fails to note that DNB agreed with Greenspan and Geithner that the new (poisoned!) instruments contributed to increasing the resilience of the system.^{396, 397}

CDW clearly did not study the annual reports of DNB. They are not mentioned in the list of documents consulted.³⁹⁸

The last two sentences of the quote are correct. They mean that DNB (and most other financial supervisors) failed fundamentally and disastrously. As underlined by the fact that a majority of Dutch banks needed taxpayers support for survival. But this conclusion is not drawn by the CDW.

14. A missing conclusion: the failure of supervision and government is unthinkable without repressive hierarchical organization.

All principal persons in supervision and government were head of a hierarchical organization. Organizations with at least hundreds and often more than a thousand highly educated employees. As noted earlier, it is unthinkable that none of these thousands of employees has given its managers well substantiated warnings.³⁹⁹ Employees could and should have seen reason for this in their own observations and analyses, reports of similar organizations, and gaps and/or nonsense in annual reports of supervisors and others. If the organizations operated properly as organization,⁴⁰⁰ or if there was an effective whistleblower regulation, then the idiocy⁴⁰¹ could never have lasted so long.

It has to be concluded that all these organizations were (and are) effectively repressive. That they have room only for the convictions and ideas of the top, and no room for meaningful open

³⁹⁵ Or that Wellink was misleading if not lying. The hearings of Wellink seem to be the only source of the CDW for the supposed “warnings”.

³⁹⁶ See DNB AR 2006 section 7.5 pp. 122-3.

³⁹⁷ The curious reader is recommended to search DNB AR 2006 for “systeemris” (= “systemic ris”), and to form an opinion about the “warnings”. Note next that the little you found is reflected only vaguely in the summarizing *Algemeen Overzicht* in the beginning of the annual report, on pp. 17-35. Is it correct to call this “warning”?

³⁹⁸ At the end of the first report of the CDW, on pp. 250-2/246-8. The list mentions only one *Overzicht financiële stabiliteit* in Nederland: that of 2009 (two thousand and nine!).

³⁹⁹ The Irish inquiries confirm this conjecture. See the Irish investigations appendix and below.

⁴⁰⁰ Here too there is coherence. Heads who put their signature under the given annual reports cannot be expected to be able to manage the production of sound reports. (Sound= able to withstand (consistent) criticism).

⁴⁰¹ Some quotes from the SEC Annual report 2006:

«The prosperity of 300 million Americans and six billion people around the world relies on trustworthy U.S. capital markets.»

«The U.S. Securities and Exchange Commission [= SEC] serves you by working to secure the trust in our markets that undergirds our nation’s continuing prosperity in an increasingly global economy. The level of trust in our markets has enormous economic consequences—affecting everything from the affordability of food, clothing, and shelter to the creation of new jobs, increases in wages, and the protection of our retirement security.»

discussions.⁴⁰² Such a (management) culture precludes correction, and is incompatible with effective, let alone optimal performance of the organization.

Repression by the management, combined with a slavish and unthinking attitude of subordinates, makes the observed (seemingly contradictory) phenomena understandable or more understandable. On the other hand the hypothesis of an open culture can only be upheld if it is simultaneously assumed that none of the thousands of employees of supervisors and ministries of finance saw and reported the deficiencies in supervision and the risk of collapse. That is: that their education was inadequate, and/or all of them were stupid and/or failed to do their duty.

The inquiry commissions entirely ignored the organization dimension of supervision and government. They say nothing about the quality of their thousands of employees and about the management of the supervision and government organizations. Or the operation of hierarchical organizations in general.

It follows that the principal persons were not only insufficiently competent as regards finance and economics, but also as regards (practical) management. They were dogmatically authoritarian and repressive (quite coherent properties by the way). As illustrated most clearly by the coordinated elimination of CFTC chairperson Born by persons who for many years in the run up to the crisis occupied the top positions in the financial economic system.⁴⁰³

15. The commissions pay no attention to the influence of liability and criminal law.

The importance of liability and criminal law for decision making has been discussed extensively in the sections 7B.3.4 and 7B.4.3. The present section can be very short because the CDW and FCIC give the subject no attention at all. The FCIC makes several remarks about the “compensation” of employees of financial institutions, and of the sometimes more than hundred million dollars given to departing CEOs. In session 3 of the hearings day devoted to Moody’s, the employees are unanimously of the opinion that liability would have an important and positive effect on the quality of the ratings. Which of course is no more than logical. In their reports, CDW and FCIC nevertheless pay no attention to the influence of liability law on the developments and behavior that caused the crisis. None at all. Why is compensation so much more important than liability?

Similar remarks can be made about the influence of criminal law and punishability.

Of course this is a rather amazing inconsistency. People’s behavior is not only influenced by compensation, but also by liability and criminal law.

16. After the outbreak of the crisis only appearances improved: with another man’s money everyone can solve almost any problem.

The Chronicle shows that the behavior of the principal persons in a rather long period before the crisis, including 1994-2008, was not accountable.⁴⁰⁴ When it became clear that the “theoretical” risks were going to be realized this seemed to change. But the change was more appearance than reality. Actions were taken, and perhaps people tried to do what they could. But their (in)competencies and character remained the same. As a consequence of lack of integrity and competence in the preceding period, necessary information, preparation and plans (scenario’s) were missing. This kind of circumstances helps to explain the inconsequent treatment of Bear and Lehman. A crisis does not suddenly make incompetent persons competent, and does not suddenly provide scenario’s which normally take years to prepare. It is no coincidence that supervision and government allowed Lehman to file for bankruptcy, and failed to apply the only remaining brake on the free fall of the system. The

⁴⁰² A meaningful open discussion is a discussion where everyone is free to say what (s)he thinks fit, where assertions are evaluated on their own merits (consistency, correctness, relevance and similar merits), and where existing ideas etcetera are replaced if the discussion shows that they are untenable. Tenable ideas etcetera are allowed to coexist.

⁴⁰³ And during or after the crisis were appointed in similar positions by president Obama.

⁴⁰⁴ With the (partial) exception of the GAO and many financial institutions, but including all supervisors and central governments.

consequences of the fall of Lehman seem to have been necessary to show the principal persons in supervision and government that the financial system was a coherent whole, and that the system was unstable, and out of control. Only then did they come with thousand and one terribly expensive remedies to save what could be saved.

Inquiry commissions were instituted which were composed of incompetent and unsuitable persons. The commissions were instituted by parliaments which evidently bore at least part of the responsibility for the crisis. In the US new laws for the financial system were introduced before the inquiry had been completed. Whatever was done was led by the same people who in the preceding years had convincingly proven their lack of integrity and competence. Nothing changed in the procedures for the appointment of the heads of the key organizations, and in liability or criminal law. Almost all people in supervision and government who were responsible for inadequate supervision and regulation kept their positions and powers⁴⁰⁵ during and after the crisis.⁴⁰⁶

It follows that their efforts to stop the fall do not show that the authorities are competent. Any fall will stop sooner or later, and with someone else's money and money printers⁴⁰⁷ everyone can solve almost any problem.

17. The interviews and parliamentary inquiries as cover up.

The inquiry commissions have questioned the principal persons about far fewer subjects and much less thoroughly than possible and desirable to find the causes of the crisis and to prevent repetition. The commissions moreover assume that the people they question are reliable: give true and complete answers. They don't discuss the problem of the value of interviews with people with great interests in specific answers and outcomes of the inquiry. In fact, the interviews were not necessary at all. As the Chronicle and the above analyses show, more than enough information could have been found in historical (contemporary) documents.⁴⁰⁸

The FCIC is completely silent about the methodology of the interview as an instrument. The CDW says the following about it:

«The public hearings of the commission had the following goals:

- increasing knowledge and understanding of the subject;
- public testing of findings and conclusions;
- publicly hearing the opinions of the different actors;
- offering the opportunity for public accounting.

The commission notes that the goal of the hearings was not to indict or exculpate persons. Public discussions are not public interrogations (after all it [= this CDW inquiry] is not part of a formal parliamentary investigation) nor sessions of a court, and for that reason not directed at, or suitable for, formal truth finding.»^{409, 410}

The difference between truth and formal truth is not explained. It is moreover necessary to find the whole truth, since half truths may give completely incorrect pictures.

At least the first two goals seem to assume that the people questioned speak the truth. But the (full) truth may be self-accusatory and unacceptable. The truth may be impossible to account for. In other

⁴⁰⁵ In particular their appointment power.

⁴⁰⁶ Such as: Bernanke, Balkenende, Bos, Geithner, Kok, Summers, Wellink, and Zalm.

⁴⁰⁷ To speak with Bernanke. See the remark about the "printing press" in his speech "Deflation: Making Sure "It" Doesn't Happen Here" for the National Economists Club, Washington, D.C., November 21, 2002. See the FCIC report, search for "Deflation".

⁴⁰⁸ In the end the interviews were useful and only useful to demonstrate (or rather confirm) the lack of integrity and competence of the principal persons. Although the commissions failed to conclude this clearly and unambiguously.

⁴⁰⁹ First report of the CDW pp. 32-3/28-9. There also were discussions behind closed doors. For more information see p. 32/28 of the same report.

⁴¹⁰ The original of the last sentence is just as questionable and/or inconsistent as this translation. The word discussion (in Dutch: gesprek) is incorrect: in the hearings the commission members asked questions, and there was at most an incidental semblance of discussion. This applies to the FCIC as well.

words: the consistency or credibility of the above goals is debatable, and the practical conduct of the interviews, and the use of the answers, require more explanation and reflection. Which are not given.

In some cases the problem of the reliability of interviews can be solved wholly or in part by comparison of answers with facts or documents. The present hearings are such a case. But the commissions made no such comparison. They even accepted declarations of ignorance and passivity which should be unacceptable given the responsibilities of the persons being heard. And which is even more unacceptable because these persons were supported by large organizations with many highly educated experts. A fact which is systematically ignored by the commissions.

Neither commission investigated the internal operation of the relevant supervisors or government departments. They did not question the heads of these organizations about it. Even more amazing is the fact that the commissions did not question heads about their own functioning or that of their organization. The commissions only questioned them as experts about specific subjects such as shadow banking or subprime lending. A few times the FCIC asked a head about the operation of his organization. But this happened only ad hoc, in exceptional cases. No head was questioned by either commission about his shameful annual reports.

The inquiries of the CDW and FCIC can have been meant to prevent other inquiries and hamper “similar” publications.⁴¹¹ By claiming the cooperation of all important experts and persons in the financial system, and due to the general abhorrence of (supposedly) double work, an official inquiry precludes other inquiries. In combination with the publicity about them, the large role of interviews means that the people interviewed get the opportunity to suggest that they did what they could and what was humanly speaking possible. And to suggest that it could hardly have been done better. In short: they get the opportunity to mislead the public (“public accounting”). While others are bereft of the opportunity to make investigations that may be necessary to show that these people lack the integrity and competence necessary for their function, and are playacting. That they could and should have prevented the crisis. That not the lack of warnings or authority, or unpredictability were the reasons they could not do otherwise, but their lack of integrity and ability.

The commissions have done little to correct the stories told by those responsible. Mainly by an insufficiently critical attitude and insufficiently thorough analysis. But also by imprecise and euphemistic formulations. The CDW “notes that the goal of the hearings was not to [...] exculpate persons”. But they actually do, namely by “offering the opportunity for public accounting”, without questioning dubious answers and correcting errors and lies. Obviously, the CDW was not trustworthy.

Conclusion. The Chronicle and analyses have shown that the inquiry commissions have systematically ignored essential contemporary information about supervision and government. The overly conspicuous interviews and irresponsible reliance upon these interviews must have helped the principal persons from supervision and government to retain their function or to obtain a similar function. The full truth would have shown their great and fatal lack of integrity and competence. It would have made their positions untenable. Neither commission exposed the half-truths and untruths of interviewed persons, even if misinformation was an essential element of their defense.⁴¹² For these reasons it has to be assumed that shielding responsible persons was an inviolable boundary condition of the inquiries.

18. Support for the hypothesis that a parliamentary inquiry is not meant seriously: eight years after recommendations of an inquiry commission for improvements of accountancy, accountancy turns out to have improved insufficiently or not at all.

Summary and conclusion.

A 2002 Dutch parliamentary inquiry commission made recommendations for accountancy similar to those made after the financial crisis. The evidence of the crisis shows that the earlier recommendations were insufficiently or not implemented. This can be explained by lack of cooperation from

⁴¹¹ Given the subservience and lack of competence of the media.

⁴¹² Which is compatible with their use of interviews as sources of information, and the assumption of reliability of the persons interviewed.

government and the accountants, and unprofessional conduct of parliament. There is no indication of any of this having improved.

In 2002, Dutch parliament instituted an inquiry commission to investigate large scale fraud in the construction sector. The fraud had been brought to light by a whistleblower.⁴¹³ One set of findings of the commission concerned the role of accountancy. This is of interest because the role of accountancy was questioned once again in connection with the subprime crisis.⁴¹⁴ The first quote summarizes the conclusions of the 2002 commission about the accountants:

- «Members of this group knew about forbidden [=illegal] operations;
- They did not take corrective action (even if required by regulation).⁴¹⁵
- There is hardly any indication that they were aware, let alone that they made their clients aware, of the need of a substantial reorientation in doing business in the construction sector, certainly after 1992.»⁴¹⁶

The next quotes are from chapter 8, *Recommendations of the Inquiry commission Construction Sector*, of the report of the commission. They give an impression of the state of affairs in accountancy.

«In the opinion of the inquiry commission the organizations of accountants have to rethink their functioning. They should not put their heads in the sand, but work on points where improvement of performance is possible.

The government has to take the initiative with respect to evaluation and upgrading of regulation. The present operation of the Directive Fraud Reporting is a thorn in the side of the commission. The operation of the private forensic accountants raised questions as well. According to the commission, legal norms for this “extralegal sleuth” are necessary. In the opinion of the commission it is furthermore undesirable that the same accountancy firm does both auditing and forensic jobs for the same client. This requires regulatory measures. The commission is also of the opinion that the government should no longer ask private forensic accountants to make certain investigations, for example regarding serious integrity violations.

The commission recommends appointment of a kind of public prosecutor for accountants. In this regard the commission sees no need to make a distinction in the treatment and guarantees between the two types of accountant, the AA’s and RA’s.⁴¹⁷ The analysis of the shadow administrations shows that both groups have clients in these circles.

In accountancy education more attention should be given to the subjects of fraud and money laundering. The commission points out that this also regards the permanent education of accountants with end responsibility, and especially dilemma training. The analysis of accountancy files shows “damping at the top”: auditing employees are more sensitive to fraud than the partners of accountancy firms.

The commission is very much aware of the fact that its observations regard only a part of the accountants. On the basis of this observation the commission was startled if not frightened by the culture and attitude among accountants. There is need for an inquiry to find out whether this is different in the parts of accountancy serving other sectors of the economy.

In the opinion of the commission the aspects mentioned should be taken along in the framework of current programs like the evaluation of accountancy law, and the discussion about independent supervision and independency. The inquiry commission does not consider it its duty to interfere with these programs. It does however recommend that these programs pay explicit attention to the conclusions of the present inquiry.»⁴¹⁸

⁴¹³ In section 5 of chapter 8 the case is described in some detail.

⁴¹⁴ Also by the Irish inquiry commissions. See below and their reports (in the dossier).

⁴¹⁵ Report Construction fraud, p. 290.

⁴¹⁶ P. 291 of the report (the version with photo’s). (Original and pdf paging agree).

⁴¹⁷ Details such as the precise meaning or specification of AA and RA are irrelevant in the present context.

⁴¹⁸ Construction fraud report (Rapport Bouwfraude) pp. 303-4.

The following is quoted from the list of recommendations on pp. 305-8:

21. «The government should take the initiative with respect to evaluation of the regulation of the functioning of accountants, and improve the regulation where necessary. Certainly where the Directive Fraud Reporting is concerned. But also as regards professional and permanent education. Aspects like fraud, laundering, dilemma training in professional ethics, and interaction with clients should not be absent. The institution of a public prosecutor accountancy should be contemplated.
22. Legal norms for the activities of accountants should be contemplated. Regulation is needed for the combination of auditing and forensic activities for the same client, a combination which according to the commission is undesirable. The government should be more careful in farming out forensic work, for example regarding serious integrity violations. Knowledge and know how in this field should be acquired more often within the government itself.»

The events, and the necessity of a new recommendation, show that these recommendations got insufficient follow up. The new recommendation of the CDW reads as follows:

«Recommendation 27: Improvement duties accountants.

The public accountant of financial institutions may in the first place be expected to check the annual accounts of the institutions adequately. This condition is only satisfied if both shareholders and other users of this financial information can be sure that the numbers give a reliable picture of the institution. It is the opinion of the commission that the financial crisis has shown that the accountancy has failed its social duty, to provide an understandable and sufficient explanation of annual reports of financial institutions, especially the explanation of the uncertainties in the valuation of financial assets.

The commission recommends that the accountants' organization and AFM [= the supervisor of the financial markets] together formulate quality criteria for annual reports of financial institutions. The purpose is that the annual report of a financial institution gives as clear a picture as possible of all relevant circumstances, including risks and uncertainties with respect to continuity. In combination with this, the commission recommends that the accountants' organization and AFM together take measures to bring about that accountants make more frequent use of explanatory sections about uncertain circumstances in financial institutions.⁴¹⁹

The commission supports, and has expectations with regard to, the initiatives taken by the accountants' organization to use the collective knowledge for early notification and monitoring of risks, problems and other points needing attention in financial institutions and the financial sector. With interest the commission has taken cognizance of the proposals of the tripartite consultations new style (the consultations of DNB, the financial institution and the accountant). These initiatives can contribute to restoration of confidence in the accountant as confidential agent in the financial sector and society in general. The commission sees no use in the suggestion to extend the duties of accountants to other duties in the field of corporate governance.»⁴²⁰

Because of the failure of the recommendations of 2002 and the defensive stance of Korf, the representative of the accountants in the financial sector, in the CDW hearings, it is to be expected that not much- if anything- of the recommendations will be implemented.⁴²¹ The need for new recommendations shows that not much was done with similar earlier recommendations in the report about the fraud in the construction sector, and that the accountants did not seriously evaluate and adjust their own role. The implementation of the recommendations of the fraud report seems not to have been

⁴¹⁹ Sic. The commission seems to mean: that accountants more often add explanatory sections, instead of keeping silent.

⁴²⁰ First report of the CDW p. 24/20.

⁴²¹ The attitude of Korf goes a long way in explaining the failure of the earlier recommendations. (Of course, since this attitude is very harmful for society, government and parliament should override him, or ensure that he is liable for his contribution to the causation of crises).

monitored, and parliament has not taken action when nothing was done with them. There is no indication that it will be otherwise this time.

19. Two Irish inquiry reports.

The two reports are:

- The Irish banking crisis regulatory and financial stability policy 2003-2008. A Report to the Minister for Finance by the Governor of the Central Bank. 31 May 2010.
- Misjudging risk: causes of the systemic banking crisis in Ireland. Report of the commission of investigation into the banking sector in Ireland (CIBSI). March 2011.

Summary and conclusions of the report of March 2011.

1. The commission was to find causes, not to make recommendations.⁴²²
2. The report is organized according to type of actors. Its attention is evenly distributed over banks, external auditors and supervisors. The ministry of Finance (DoF) may have got too little attention.
3. (Especially) Chapter 5 and the executive summary are very worthwhile reading. The reason being that this inquiry is remarkably more open than those of CDW and FCIC. It provides (additional) helpful information and views.
4. Contrary to CDW and FCIC, the Irish commission has taken a look inside banks, supervisors and DoF. It also looked at the practical relations between them.
5. The inquiry finds important if not fatal failures in the operation of the hierarchical organizations as organizations.⁴²³ Opinions deviating from that of the leadership are ignored without proper argumentation.
6. Implicitly but not explicitly the report establishes incompetency and lack of integrity of all managements concerned. Without exception they are too optimistic and take too much risk.⁴²⁴ And they fail in management too.
7. The commissions⁴²⁵ note systematically too optimistic/ positive assessments and outlooks of national and international supervisors. Including IMF and OECD.⁴²⁶ It is not noted however that this implies incompetence and lack of integrity. No effort is made to find causes and remedies.
8. The report lends support to the conclusion that hierarchical organization promotes repression: everyone has to follow the leader and accept his views, even if irrational, dangerous, etcetera.
9. The report lends support to the conclusion that strong countervailing forces are necessary to suppress unbearable risk taking and following bad but seemingly profitable examples.⁴²⁷
10. The report notes irrationalism, repression and intolerance, but does not reflect on this.
11. The report does not give solutions for all observed important failures, and does not check whether the remedies mentioned are sufficient to prevent repetition.
12. Its analyses are insufficient as a basis for finding a credible set of solutions.
13. Liability and criminal law are not mentioned.
14. The selection of the heads gets no attention.
15. The financial system is not explicitly considered as a system, and the GAO reports are not mentioned. The report thinks in terms of risks of banks; although these risks are supposed to include system-environmental and market effects.

⁴²² Terms of reference, p. 141/157.

⁴²³ This is the interpretation of the present author of its findings.

⁴²⁴ This includes, but is much worse than, the “Disaster Myopia” listed in the glossary of the report: «A tendency over time to underestimate the probability of low frequency shocks (i.e. “low probability / high impact risks”).»

⁴²⁵ The present commission and that of the earlier report.

⁴²⁶ See paragraph 1.15 in the May 2010 report (quoted in the Irish reports appendix). Paragraph 1.15 presents exactly the same conclusion as drawn above and in the appendices about the supervisors. Except that it is somewhat less outspoken.

⁴²⁷ Unbearable risk taking: unbearable for the risk taker.

Apart from what has been included in the above summary, the report of May 2010 does not give important additional information.

It will be clear that the Irish inquiries are fundamentally different from, and better than, those of the CDW and FCIC. They strongly support the present report. It does not seem to be necessary to spend more time on these reports. It would mainly cause repetition. The question about the explanation of the different character of the Irish inquiries lies outside the scope of this study.

7B.8. The principal persons.

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1. Conclusions about the principal persons.

By definition, the term “principal person” refers to people who had a function which could and should be fulfilled in relative independence, and who are co-responsible for conditions and events which are contributed to the causes of the financial crises.

Conclusions about the principal persons in supervision and government.

1. Without exception the heads of the organizations in supervision and government which were responsible for the safety and soundness of the financial system falsify history. Their most important line of defense is: nobody could have foreseen this, and nobody has. If true, this would indeed exonerate them. But it isn't. The risk of a crash could have been seen theoretically, even without knowledge of the LTCM mini crash. It had been foreseen and clearly explained by the GAO. Even by the title of a 1999 report the GAO had explicitly advised the supervisors to pay more attention to systemic risk. Those responsible for the safety and soundness of the financial system could and should have recognized and acknowledged the risks, and taken appropriate action. Instead they asserted wrongly and without adequate argumentation that there was no need for interference.
2. The Dutch parliamentary inquiry commission De Wit (CDW) has not refuted the line of defense of supervisors and government officials. The FCIC only in its final conclusions, in an aloof and incomplete manner,⁴²⁸ and without trying to understand why supervisors and government did not see or want to see what the GAO had clearly shown.
3. The inquiry commissions neglected to conclude unambiguously and explicitly that ministers, parliaments and supervisors⁴²⁹ could and should have prevented the crisis.
4. The members of the inquiry commissions were selected and appointed by what can be seen as principal suspects: the parliaments. From their CV's it follows that they had no proven competence for this inquiry. From their acceptance of the job nonetheless, and the absence of reservations in their report, it follows that they lacked necessary integrity.
5. The incorrect representation of the relevant historical facts precludes finding the causes of the irresponsible behavior of supervisors and government. If errors are not noted, one cannot learn from them, and cannot prevent repetition.

⁴²⁸ Without reference to the GAO or other reports (for example the OFHEO systemic risk report of 2003, or BIS reports).

⁴²⁹ Here meaning the heads of the supervising organizations.

6. The persons heard by the inquiry commissions are treated, and behave themselves, as if they were experts. Only rarely do they let shine through that they are or were head of an organization with hundreds or even thousands of employees.
7. None of those questioned by the commissions notes that there may be and were different opinions in his or her organization.⁴³⁰ They all do as if their own opinion is the only (relevant) one.
8. None of the principal persons was and is honorable and competent.
9. None of the organization heads acknowledges substantial failure of himself and/or his organization, and explains the failure.
10. None of them has communicated honestly about his functioning and failure.
11. The principal persons show no trace of modesty.
12. All of them behaved as if they had nothing to fear from malfunctioning.
13. None of the principal persons notes the serious failure of another organization (in supervision or government), and explains its failure.
14. None of the principal persons accounts for his conduct, or gives a trustworthy and acceptable account of his conduct. On the contrary: the principal persons use misleading half-truths and lies⁴³¹ to make everyone believe they did what they could and should, and could not have done better.
15. The impression of integrity and expertise which supervisors and government representatives tried and try to make, is false.
16. It follows that all top positions in the financial system were occupied by insufficiently honorable and competent people.⁴³²
17. It follows that the selection and appointment of the principal persons was inappropriate.
18. The presence of insufficiently honorable and competent people in all top positions in the financial system can be seen as a principal cause of the crisis.
19. The selection and appointment of insufficiently honorable and competent people in all top positions in the financial system can be seen as a principal cause of the crisis.
20. Readers who don't want to exclude the possibility that the principal persons did the good things they possibly did consciously and intentionally, while making their errors unconsciously and unintentionally,⁴³³ should be aware of the fact that the lack of ability to see what has to be done makes a person unsuitable for positions where errors can cause damage which can never be recovered by the responsible person.
21. The principal persons are 100% loyal with respect to each other and their organization. They strongly prefer to blame general facts or circumstances ("nobody could foresee"). If necessary, they blame (general) "human deficiencies", and if inevitable as wide categories of persons as possible ("as society we acquiesced..."). Rarely if ever do they mention deficiencies of specific persons or organizations. Often they praise the people with whom they collaborated. This attitude serves personal and group interests, hinders discovery of causes and prevention, and greatly harms the interests of the population.
22. The principal persons form a closed front against the population.
23. They left their code of conduct, integrity or professional code and/or similar codes a dead letter, showing that the codes are an instrument to mislead the population into thinking that it can rely on their organizations.
24. The principal persons frustrated the inquiries through selective and misleading information.
25. Neither supervisors nor inquiry commissions⁴³⁴ show that they understand the fact that competitors who can profit from activities which increase risks for their environment, and who will be held liable and punishable if risks materialize, benefit from external supervision with sufficient powers to force them to keep potential damages under a bearable maximum.

⁴³⁰ According to the Irish reports there positively were relevant other opinions.

⁴³¹ Including the omission of crucial information or facts.

⁴³² They even didn't listen sufficiently to their advisors, and/or didn't understand them, and/or overruled them for dogmatic and/or "political" reasons, or due to stupidity.

⁴³³ Unintentionally: not for political reasons either, or because Greenspan, Summers or someone else would make difficulties for them if they acted differently etcetera...

⁴³⁴ In fact, no one at all. But those mentioned should, because of their claim of inquiry-competence.

It would seem that the most important conclusions about the top of public administration can be summarized as follows.

The facts of the period 1994-2010 and their analysis show that:

- Almost all principal persons from supervision and government with responsibilities regarding the financial system have demonstrated a fatal lack of integrity and competence;
- They claimed that they did what they could and should, and that “humanly speaking” they could not have done more or better;
- None of them publicly gives any colleague the lie, although their main responsibility is towards the public;
- The inquiries have not resulted in any discharge, liability claims or criminal persecution, or conclusion about guilt.

If it is assumed that the conduct of the principal persons in the years before, during and immediately following the financial crisis is representative for the conduct of all principal persons in public administration, then one can conclude that these people:

- consider self interest and mutual loyalty inviolable norms, and (therefore) far more important than faithful and competent functioning and the interest of the population;
- do not feel accountable towards anyone.⁴³⁵

After an analysis of the financial crisis one can no longer assume that these people inform reliably, fulfill their duties properly, and/or work in the public interest (in the sense of Pareto or *The law of logic*).

Conclusions about the principal persons in private corporations.

1. As regards the subprime crisis, the principal persons in private corporations may not be representative of even the majority of heads of financial institutions in the narrow sense.
2. As regards the subprime crisis, the principal persons of private corporations were heads of a set of financial institutions which strongly affected the operations of all other (financial) institutions, and the financial system as a whole.
3. Like everyone, they could and should have known the (systemic) risk caused by some of their operations.
4. There is no evidence showing that they understood risk and risk management, or any better than supervisors and the responsible government officials.
5. The principal persons in private corporations took unbearable risks. They knew that they caused risks which their corporation would not be able to bear if they materialized. In other words: they didn't verifiably mind even seriously damaging interests of innocent outsiders.
6. They accepted excessively large bonuses and severance packages.
7. They did not give priority to the interests of their employees and shareholders.
8. They seem not to have done much illegal. They were liable nor punishable. None of them ended in jail, or lost a large part of his assets.
9. In other words: the law allowed these people to cause immeasurable damage, which neither they nor their corporations could ever recover. It follows that the law is seriously deficient. The same therefore applies to the makers of these laws: parliaments and administrations.⁴³⁶

Two remarks regarding measures to prevent repetition or other disasters.

The false pretensions of the principal persons have not changed.

The principal persons (implicitly) pretend to have the ability to reason about, and evaluate, financial economic phenomena. In addition they (implicitly) pretend to have the ability to lead and manage an organization with hundreds or thousands of highly educated employees. All of the principal

⁴³⁵ Or are unable to account for their conduct due to lack of self knowledge or the ability to critically evaluate their conduct. That is: not due to unwillingness, but due to inability.

⁴³⁶ And therefore the system by which they were selected/ appointed, and therefore the constitution. Which was made by people selected similarly, and in a similar “parliamentary” process.

persons failed substantially however. The question therefore arises whether there really exist people with both abilities, and to the extent required by the top jobs in supervision and government.

There may have been banks whose leadership had sufficient integrity and competence (and/or luck) to survive without extraordinary taxpayers assistance. This would not however prove either broad and reliable financial economic knowledge and understanding, or impeccable management abilities. Neither can financial economic expertise be proven by the apparent ability to talk about financial economic subjects. In the first place because most of what the top officials say or write is written by employees. In the second place because in general what they say or write cannot be checked reliably. It is not open to the public sceptis and independent criticism necessary to reliably evaluate its soundness, truth or value. And where criticism is seen to be valid, it is often simply ignored. It rarely has the consequences it requires.

In the hearings of the inquiry commissions the principal persons speak with the same self-assurance as they manifested before the crisis. Without showing any doubt. Chronicle and analysis show that before the crisis their speeches and writings were misleading at best, nonsense at worst. The hearings show that there is no reason to assume that in this respect anything has changed. The principal persons seem to have learnt nothing.

Structural human error. Why replacement by similar people won't help.

Logically speaking every changeable cause as defined earlier can be traced back to some kind of human misconduct.⁴³⁷ The relevant kinds of misconduct are identified in the course of this report. In the top of society they are found to be general and structural. They are found to stem from a great and fundamental lack of integrity and competence. This is a major problem since there is no empirical evidence whatsoever showing the feasibility of remedying a serious lack integrity and competence by re-education or otherwise. In other words: it is not reasonable to assume that solution of the problem can be found in correction of the principal persons. The empirical evidence does not allow one to assume that human beings are sufficiently changeable, and can be changed (corrected) as desired. Examples of significant correction should exist, but they don't. So in this report it will not be assumed that the people who were responsible for systematic misconduct can change to such an extent that the risk of similar misconduct in the future is eliminated. This conclusion is contrary to the corresponding assumption of the FCIC. The commission seems to assume that people are free to do what they want. That they can and will change as wanted or required. Upon request. The assumption remains implicit however, and is not discussed.

For the purpose of finding solutions of the repetition problem, this report makes the following assumption. If certain tasks are performed inadequately or worse for a long time, then there are at least three possible explanations:

1. The selection of the responsible actors was inadequate (the selection system must be thoroughly revised);
2. The system of rewards and punishments (the incentive system) is inadequate (and must be thoroughly revised);
3. The tasks exceed human capabilities (the tasks and or their distribution have/has to be revised in such a way that all tasks can be performed appropriately by real (as opposed to theoretical, ideal) people).

And combinations of these.

It cannot be stressed too strongly that it is simply unreasonable to expect fundamental change from people like the principal persons of the financial crisis. Suitable people should be honorable and competent, and (therefore) give priority to the interests of society over their personal interests and those of their likes. For many years the principal persons have shown a fatal lack these qualities. In the hearings of the inquiry commissions CDW and FCIC they did not admit their failings or false pretensions, and did not show understanding of the importance of these failings. They did not

⁴³⁷ Where "misconduct" is assumed to include well-intentioned actions and omissions which cause harm due to over estimation of one's (self) knowledge and abilities. In other words: arrogance. Thinking that one is honorable doesn't make one honorable.

acknowledge that they should have reacted very differently on the recommendations of the GAO of 1999 and the proposal of CFTC's Brooksley Born.

It is just as unreasonable to expect that the problem they created can be solved by replacing them by similar people from the same circles- characterized by false pretensions- or through the existing procedures for selection and appointment, executed by the same kind of people. There is a need for proven integrity and proven competence. This may very well be impossible for say 100,000 of the highest functions in the US. For the simple reason that these functions require competences which exceed human capabilities. "The best possible" may be insufficient, and create unbearable risk. In general a top manager cannot guarantee the safe and sound functioning of his organization. Someone with such a claim only shows a lack of integrity. In general "doing what one can" is insufficient, and may be dangerous for the organization and/or its environment.⁴³⁸

On the basis of the observations and analyses of this and the preceding chapters it has to be concluded that society is dominated by over-ambitious people who are insufficiently aware of, or knowingly ignore, the gap between their pretensions and the abilities required for the function under consideration, and lack the required respect for the population on whose behalf they do their job. They can afford to behave as they do because they know they will:

- At most be called to account by people of the same subculture (that is: people with the same norms and values);
- be allowed to cover errors with fairy-tales;
- never have to recover damages caused by themselves or their organization;
- never be punished (proportionately) for malfunctioning;
- get a nice follow-up job if they have to be sacrificed for the survival of the political establishment.

As long at least as they remain loyal to that establishment.

The list suggests what can or needs to be done to end a leadership that is a danger for society: serious accountability, and consequent liability and punishability. The least obvious may be the need of a reorganization of duties and responsibilities in society. As suggested in the preceding remark, they should be reorganized in such a way that all functions can be fulfilled properly by real people. Permitting impossible functions is asking for problems.

2. Introduction.

As everywhere in this study, the term "principal person" refers to people who had a function which could be fulfilled in relative independence, and who are co-responsible for conditions and events which contributed to the causes of the financial crises. In other words, the term includes all members of parliament, the heads of the relevant organizations, and the members of inquiry commissions.⁴³⁹ Because of practical and formal juridical differences in duties, and because of differences in the kinds of information which can be used to evaluate performance, it is useful to distinguish three categories of principal persons:

- Members of parliament and government;
- Supervisors and heads of organizations with a public function in finance or economics;
- Heads of private corporations.

For the investigation and evaluation of all three categories, use has been made of the factual information collected by the (staffs of the) inquiry commissions, or found in the literature.⁴⁴⁰ Including public reports and statements. For the evaluation of the second category of persons, the annual and other reports of their organization were a principal source of information.⁴⁴¹ The same reports could be used in the evaluation of parliaments and governments.

⁴³⁸ Apart from a very few exceptions, those in power in 1995-2007 did not even do what they could and should have done. Integrity may be the greatest problem.

⁴³⁹ The inquiry commissions because they are responsible for preserving conditions which make repetition possible or probable.

⁴⁴⁰ "Literature" refers to all written texts, including newspapers, and texts on the internet.

⁴⁴¹ Descriptions of the crisis events being the other principal source.

The historical documents have been organized and analyzed. They were compared with the answers the principal persons gave to questions asked by the inquiry commissions. And as regards the members of the inquiry commissions: with the questions they asked and did not ask, and the remarks they made and did not make.

Annual reports consider themselves as the principal documents for reporting and accounting. That is how they are seen here as well. This means that they are also considered as a manifestation of the vision and attitude of the principal person (organization) concerned, and as a sign of what he (it) considers important or not. What is absent is apparently not considered sufficiently important.

For evaluations of some of the principal persons the reader is referred to the appendices. With the understanding that appendices about persons should always be read in combination with those about the organization of which the person was the head.

Not all principal persons have been analyzed as extensively. A choice was made, or rather developed. The choice is not based on consequent application of criteria. It is the result of different time dependent subjective factors, such as personal interest of the author.⁴⁴² After reading some of these appendices, it will be clear that the principal persons are very similar as regards those qualities which are most important for their functioning. The observable qualities are listed in the summary and conclusions above.⁴⁴³ The reader may test the generalization (hypothesis) with the help of the Chronicle and the analyses given in this chapter, and with the documents in the dossier. One may moreover reflect that the hypotheses of the summary make the developments of 1994-2010 understandable, while the hypothesis of integrity and competence of even a minority of the principal persons makes the annual reports, the neglect of the GAO reports, and the crisis a complete mystery. Or even impossible.

If one assumes that the pretensions of the principal persons about their integrity and competence were false, and therefore also their pretensions about their understanding and priorities, then the events are easy to understand. This assumption is in agreement with all empirical evidence, its denial is not. Many documents in the dossier show that none of the principal persons has the slightest idea of the fundamental instabilities of the financial economic system. Nobody is seen to understand the concepts "stable" and "unstable", and the concepts "risk" and "risk management". Someone who understands his field only superficially can only blindly do what he is told, or choose what seems to suit his illusions best. Wishfully thinking that he can manage whatever happens, and/or that everything goes well of its own accord. And relying on friends and power if it does not.

3. The responsible persons were neither honorable nor competent.

A comparison of facts, annual reports and hearings of the inquiry commissions shows that almost none of the responsible people had the integrity and competence required by their function. Their pretensions were false. They only served the public interest with words, not by adequate fulfillment of their duties. They were interested only in appearances. Not in learning and improvement. Even if they professed otherwise.

They did not only lack competence in the quasi-scientific field of their degree, but also as manager. Before the inquiry commissions they acted like individual experts, not as team players, let alone as representative of hundreds or thousands of employees. None of them has been open about the existence of differences of opinion in his organization, and accounted for his management of them.

⁴⁴² Initially the author thought he would have to make a more or less complete collection. In that case the order of study does not matter. But it soon turned out that all these people are essentially the same. They are unreliable too. You don't know what their utterances mean, if anything. So it may even be better not to listen too much to these people. It would anyway be a waste of time to study more than any sample of these people beyond establishing that they are representatives of a rather uniform (and despicable) class.

⁴⁴³ "Observable" as opposed to inferred psychic and/or character qualities. The last will (also) be discussed in the final chapter of this study.

They showed no awareness of uncertainties and alternatives. They saw their own opinion as the only relevant or possible one. None of them acknowledged any form of failure or incompetence.⁴⁴⁴

None of the principal persons admitted that he should have acted differently and how. They did not account for their conduct, but tried to defend themselves, even if in the guise of explanations of causes of the crisis. They made it appear as if they had done what they could and should have done. Showing in this way that they put their personal interest above the interests of the millions of people for whom their function had been called into being. When asked, they will undoubtedly pretend that they respect these people. But their conduct, including that in the hearings, shows the opposite. They don't let themselves be led by a sense of duty and responsibility, but by self interest and false pretensions.

In the wake of the crisis and the inquiries they failed without exception to call those responsible responsible, or to accuse or blame anyone. In other words: the principal persons shielded one another, and thereby seem to form a group which denies accountability with respect to all the other people.⁴⁴⁵

The history of the crisis shows that so called political leaders frequently say things which they don't understand, and of which they see at most part of the consequences. Their statements often seem to be prompted by wishes or dogmas which have not been tested, and which they want neither to have tested nor criticized. They nevertheless want a maximum of support. If "necessary" they try to obtain this support by misleading information or rhetorical propaganda ("The American Dream"). The history of the crisis shows that even in the 21st century it is nonsense to suppose that these wishes or dogmas have a sound basis in terms of for example costs and benefits, and effects and side effects. It was not a matter of "political choices" either. In spite of the appearance of expertise by the use of financial economic terminology and rhetoric, the defense of the crisis-relevant policies was no more than gobbledegook of people who arrogate themselves far more than they can ever prove.

In the preceding section we saw that the inquiry commissions are a representative part of the given political system. A system that seems to have as its overriding goal: the retention of all important political administrative functions for the present occupants and their kindred friends. This would seem to be the only credible explanation of their strange selection of often far too kind questions. The accommodating questioning can already be inferred from a comparison of the facts of the Chronicle and the analyses of this chapter on the one hand, and the hearings on the other. But it becomes shockingly clear if the hearings are compared with the truly critical interviews in *Inside Job*. Which prove the corruptness of the principal persons beyond any doubt. An additional example is Frederic S. Mishkin, who was a member of the Board of Governors of the Fed from 2006-2008. When asked to explain misleading actions, he always starts answering with lies. Somebody who is credulous or sensitive for authority might leave it at that, and stop asking questions. This would explain part of the success of people like Mishkin, because they always seem to give reasonable and even knowledgeable answers to all questions, and in general without hesitation. *Inside Job* had done its homework however. The answers are not believed at face value, and questions are followed through. With the result that Mishkin is shown to have been lying and falsifying information about financial supervision in Iceland, thereby supporting fraud (initially perhaps unwittingly).⁴⁴⁶

Another and perhaps even more shocking example is Glenn Hubbard, dean of Columbia business school, and chief economic advisor of a Bush administration.⁴⁴⁷ He refused to acknowledge that conflicts of interest are incompatible with reliable (and therefore independent) science. He refused to acknowledge that mentioning relevant sidelines and payments in publications are necessary to enable assessment of the publication by the reader. The attitude manifested by such refusals is in full agreement with the analysis in the section Education and sciences above. It makes that analysis more understandable.

⁴⁴⁴ Perhaps Greenspan might be mentioned as an exception. But his incomplete recognition of a theoretical mistake seems to be extremely disproportional to his decade long neglect of systemic risk as chairman of the Fed, and his dishonest frustration of efforts at improvement of supervision by for example Born of the CFTC. As far as the present author knows, he did not acknowledge that he managed the Fed as a dictator, and that in the Fed he did not tolerate any other opinion beside his own. Did he apologize to Born?

⁴⁴⁵ Which is consistent with the hypothesis of a lack of respect for others.

⁴⁴⁶ Note that Mishkin was not one of the worst: he left the Fed board in 2008 instead of completing his term in 2014, and cooperated with *Inside Job*. Which is exceptional.

⁴⁴⁷ *Inside job*, starting around 81' (1h21).

It is of course highly significant that none of the people who are designated “principal persons” in this study was willing to be interviewed for *Inside Job*. This fact supports the above observation of selective questioning by the FCIC, and the hypothesis that they do not want to account for their conduct.

This should be a warning. For risks do not only exist in the fields of finance and economics. Because of the difficulty of many problems facing humanity, and the need of major changes to ensure its survival, integrity and competence, real care and interest are absolutely necessary for prevention of greater disasters than the financial crises. The analysis of the subprime crisis has shown that it was not caused by specific persons or problems, but by the general characteristics of the politicians in power. Honorable people cannot allow people who are a danger for everyone to keep responsible positions. The present politicians do.⁴⁴⁸ If they don’t understand what this means, then they are insufficiently competent. If they do understand, they lack integrity. The conclusion is that not only the laws and policies for financial and economic affairs were made by people lacking the required integrity and competence, but those in other areas as well. This must be considered the key to the solution of many other problems.

4. The heads of private financial corporations, supervision and government.

This subject needs only very simple analysis, and not many words. Many and especially the larger financial institutions took unbearable and irresponsible risks.⁴⁴⁹ CDW and FCIC give numerous examples of lack of understanding of the concept of “risk” in the top of financial institutions:⁴⁵⁰

«Charles Prince, the former chairman and chief executive officer of Citigroup Inc., called the collapse in housing prices “wholly unanticipated.”»⁴⁵¹

«Prince told the FCIC that even in hindsight it was difficult for him to criticize any of his team’s decisions. “If someone had elevated to my level that we were putting on a \$2 trillion balance sheet, \$40 billion of triple-A-rated, zero-risk paper, that would not in any way have excited my attention,” Prince said. “It wouldn’t have been useful for someone to come to me and say, ‘Now, we have got \$2 trillion on the balance sheet of assets. I want to point out to you there is a one in a billion chance that this \$40 billion could go south.’ That would not have been useful information. There is nothing I can do with that, because there is that level of chance on everything.”

In fact, the odds were much higher than that. Even before the mass downgrades of CDOs in late 2007, a triple-A tranche of a CDO had a 1 in 10 chance of being downgraded within 5 years of its original rating.»^{452, 453}

If the inadequate economy education and the widely shared (unnecessary) incomprehension and incompetence are taken into account it seems possible indeed that Prince failed to see that the odds for the 2 trillion were much higher. But this is no excuse.⁴⁵⁴ What he shows in the first place is that he should not have been CEO of a large bank.

In many financial institutions the risk management has failed completely. In spite of supposedly advanced models. It is extremely improbable that the higher management understood the models and the risk management, and could evaluate them. Checks were replaced by blind belief (“trust”). Even

⁴⁴⁸ As noted before, these politicians include the members of the CDW and FCIC.

⁴⁴⁹ Bearable risk may be irresponsible. Example: cooperation with Madoff.

⁴⁵⁰ Supposing these people are not lying.

⁴⁵¹ FCIC p. 3/31. If there is a risk, terminology like “unanticipated” is inappropriate, since it belongs to uniquely deterministic dynamics. Of course, one may wonder whether Prince speaks the truth, or says what he thinks.

⁴⁵² FCIC p. 260/88.

⁴⁵³ A specific example says nothing. But in general the risk certainly was more than 1 in a billion per year. A reversal of the upward trend of home prices within a century was 100% certain. And just as important: there were strong correlations, which put the whole 2 trillion at risk.

⁴⁵⁴ Although I do not exactly know what a banker can and may expect of supervision. A banker makes life difficult for himself by contributing to lobbying which undermines supervision, and makes it unreliable.

more reprehensible is the way some financial institutions treated well founded warnings, and the employees who dared submit them. Even if the employee had the duty to assess the quality and risks of products, and to report his findings. The FCIC gives several examples.⁴⁵⁵ Furthermore:

«Citi did have “clawback” provisions: under narrowly specified circumstances, compensation would have to be returned to the firm. But despite Citigroup’s eventual large losses, no compensation was ever clawed back under this policy. The Corporate Library, which rates firms’ corporate governance, gave Citigroup a C. In early 2007, the Corporate Library would downgrade Citigroup to a D, “reflecting a high degree of governance risk.” Among the issues cited: executive compensation practices that were poorly aligned with shareholder interests.»^{456, 457}

The FCIC gives several examples of incomplete or too late information of shareholder conferences when business took a turn for the worse.

The film *Inside Job* shows that the larger investment banks had a rather extreme decadent culture, without respect for human values. And that Barak Obama gave representatives of these institutions important jobs in his administration, even after the crisis.

The crisis has shown that the incentives, compensation and safeguarding from liability, work one way only: to the advantage of the institution and its higher management, and at the cost of the population outside the institution. There is no counterweight. The motivation of the (extremely) large compensation of the top managers, their “large responsibility”, has turned out to be fake. Their responsibility certainly doesn’t mean negative consequences in the case of malfunctioning. Even after bringing the corporation to or beyond the edge of bankruptcy they are paid amounts of the order of hundreds or thousands average yearly incomes. The supposedly terribly heavy responsibility does not mean the least personal risk.

The institutions in the private financial sector took collective action in the form of lobbying.⁴⁵⁸ According to the FCIC and *Inside Job* the banking lobby was very influential. It systematically obstructed efforts directed at safer rules and supervision. It helped spread the gospel that regulation and risk management could be safely left to the institutions themselves, and that derivatives made the financial system more resilient. The lobbying for such positions cannot be defended on the basis of insufficient knowledge and understanding on the part of the lobbyists or their commissioners. Propositions meant to be translated in binding regulation have to be reliably substantiated. The lobbyists could and should know that their more important propositions had neither empirical nor theoretical basis.⁴⁵⁹ That they (implicitly) claimed expertise shows at least that they lacked integrity.

This negative picture of financial institutions is not entirely representative.⁴⁶⁰ In part it is, because the lobbying took place in the name of the entire sector, and was not corrected by anyone represented. One cannot be a member of an organization involved in lobbying without becoming co-responsible for its positions and actions. Even if only by agreeing with the ways decisions are made. Still, not all financial institutions failed, and not all of them needed a proportional amount of taxpayers money to survive. The misconduct was not general:

«As standards fell, at least one firm opted out: PIMCO, one of the largest investment funds in the country, whose CDO management unit was one of the nation’s largest in 2004. Early in 2005, it announced that it would not manage any new deals, in part because of the deterioration in the credit quality of mortgage-backed securities. “There is an awful lot of moral hazard in the sector,” Scott Simon, a managing director at PIMCO, told the audience at an industry conference in 2005. “You

⁴⁵⁵ FCIC sec. 9.1, p. 157/85 (Countrywide), sec. 9.6 p. 176-8/204-6.

⁴⁵⁶ The Corporate Library LLC (Portland, Maine, USA, 1999-2010) provided independent corporate governance research and analysis. It was founded in 1999. In July 2010 it merged with GMI Ratings. In August 2014 GMI Ratings was acquired by MSCI ESG Research Inc. Further details can be found in the directory USA\Corporate Library.

⁴⁵⁷ FCIC p. 198/226. Note that not a supervisor but a private enterprise draws such a conclusion.

⁴⁵⁸ Note that “collective action” probably is determined by majority decision making.

⁴⁵⁹ The complete absence of knowledge and understanding of the prisoners’ dilemma situation has been noted before.

⁴⁶⁰ Contrary to that for supervision and government.

either take the high road or you don't—we're not going to hurt accounts or damage our reputation for fees." Simon said the rating agencies' methodologies were not sufficiently stringent, particularly because they were being applied to new types of subprime and Alt-A loans with little or no historical performance data.»⁴⁶¹

Whatever one says about the people in this category of principal persons, one should not forget that they worked within the given legal framework and under legally regulated supervision. Some legal action has been taken against some corporations. But there seems to be no legal basis for recovery of the overwhelming part of the damage they have done. It would seem that the financial institutions were not liable in a meaningful sense, and that there was no legal basis for action against any of the principal persons. None of them had to pay fines, or was forced to return bonuses or his severance package. None of them is behind bars, or excluded from public functions.⁴⁶²

The reason can only be that in general the financial institutions and their managers did nothing illegal. And therefore, if causing harm is to be illegal, that the law has to be thoroughly revised. At present it sets no limits on the risk financial (and other) institutions (or people) may take, and/or supposes effective supervision. The formal system assumes that unacceptable risk is precluded by supervision, that supervision guarantees safety and soundness. It assumes perfect regulation and perfect supervision. The risk of imperfect supervision is simply ignored. Even though there is no clear and effective sanction against dysfunctioning. As noted before, the situation is just one of many examples of absence of risk management by governments. Another, related, problem with the formal system is that liability has essentially been abolished for the private financial institutions, but was not shifted to the supervisors. Probably because supervisors can at most recover minor damages they cause. The conclusion is that the system is fundamentally deficient. It assumes perfect functioning supervision, without any provision for malfunctioning. The system is inconsistent: supervision is supposed to be necessary because of the possibility of misconduct in supervised institutions, while that possibility is excluded for supervisors.

The problem might be solved by perfect supervision of the supervisors. But the same people who are responsible for the faulty formal system and laws failed in this respect as well: parliaments and governments even encouraged supervisors to rely on nonsensical self regulation, and thereby fail their duty.

In general, if the law is deficient, then the same applies to the people who made it. Systematic misconduct in any sector of society is impossible without dysfunctioning parliament and government. Fundamental change is inevitable.

The yearly income of the top managers of 134 large corporations in the Netherlands is about 20 times that of the average income of their employees. On 15/6/13 one of the largest Dutch newspapers reported that in 2012 the total income of these managers was increased by 7.5%. The main point in the report is, that these people arrogate themselves a significant increase, while they kept the incomes of their employees unchanged. While the crisis has shown what their "heavy responsibilities" really mean. Permission to grab. Without any obligation to recover damages.

7B.9. Summaries and conclusions.

1. Explanatory summary of the subprime crisis.

The financial system is a collection of institutions, products, services, (vaguely defined) boundary conditions, procedures, and processes. The financial system is unstable. This means that relatively small causes can have relatively large or even extremely large effects. And that as a consequence risks, and the consequences of realization of risks, may be hard to estimate. And that for that reason certain

⁴⁶¹ The conference took place on 9/5/05 or before. FCIC p. 189/217. The FCIC gives several examples. P. 120/148 reports about the decision of bank-CEO Arnold Cattani to leave MBS because his CFO could not give understandable answers to his questions about them.

⁴⁶² On the contrary, as noted before, Obama appointed several of them to important positions. See *Inside Job*.

risks should be prevented or reduced even at high cost. This could and should have been known to all principal persons. Both from experience, reports, and reasoning about the financial-economic system.

But this knowledge was not acted upon. The present inquiry found no evidence showing that any principal person or organization except the GAO and the OFHEO under Falcon was interested in the workings of the financial system as a system, and understood the main mechanisms. The responsible supervisors and ministries showed neither interest nor understanding. Even though understanding and action were absolutely necessary for keeping the financial system and its institutions safe and sound. Or at least to avoid rapid and disastrous developments. Some people understood that some of the information necessary for a more precise evaluation of the stability or risks of the system was missing. But no effort was made to fill the gaps. On the contrary: the dominant supervisors claimed that self interest means self regulation, and that new financial products made the financial system safer. In the years preceding the crisis all supervisors claimed that they could vouch for the safety and soundness of the (ill-defined) part of the system for which they were responsible.

There was no realization of the sequence(s) of events which might follow stagnation or fall of the home prices. Scenario's had been sketched in the GAO report of 1994 and in the systemic risk report of OFHEO of 2003. Much would depend on the specific distribution of the various types of poisoned securities. This distribution was only partly known. And the reports and recommendations of GAO and OFHEO were ignored without sound argumentation. Neither supervisors nor government made contingency plans for the sketched type of scenario.

Mortgage buyers and sellers, and buyers of mortgage backed securities and other derivatives took risks they could not bear (and could only know in part). Important risks, and correlations between them, were strongly and systematically underestimated and/or ignored. Nobody tried to get the information and insight necessary to get reliable estimates of the risks, and to keep them within bearable bounds. Regulation and supervision gave the banks little or no reason to manage their risks in such a way as to avoid causing risk for their environment.

In the course of the years the risks and instability increased. The (relative) amount of money put at risk increased very substantially ("exponentially"). In fact, taking more risk was actively promoted by the US federal government. Its affordable housing policy was directed at increasing home ownership of people with moderate and low incomes. The ministry of Housing and urban development (HUD) dictated the GSEs yearly increasing quantitative goals for the percentage of mortgages sold to people with moderate and low incomes. Reduction of requirements for mortgages was the main instrument employed by the GSEs and other financial institutions for the realization of this goal. The risks increased more or less proportionally with time. Processes in the financial system mixed the "subprime" mortgages in all kinds of securities, making a significant part of assets vulnerable for a downturn in home prices. A downturn which sooner or later was inevitable.

The highest American authorities, including presidents, talked fantastic nonsense about the housing policy. The policy was said to be meant to realize The American Dream. Subservient officials took the words of their leaders as law, as the norm for their work, and let those words replace common sense and professional norms. In this way the authorities initiated the break down of the safety of the financial system.

For more than a decade before the eruption of the subprime crisis, not only the US, but almost all western countries had a policy of deregulation. It was based on the hypothesis that financial institutions have an interest in self-regulation, and that this obviates regulation by outsiders. It was not understood, neither by the institutions, supervision, or governments, that a self regulating group in general needs (will or should) institute supervision. Every lawmaker and true expert could and should have known this. They should have known that in many situations rules and supervision are necessary to optimize the results of the group. But none of them did. Neither did they try to test or check their hypothesis in any way. The deregulation policy must have had a demoralizing influence on the employees of the supervisors and governments. As a consequence, supervision steadily lost its relevance. An increasing part of the financial system became invisible and untouchable for supervision.

Supervisors may have done parts of their duty adequately. It is nevertheless an understatement to say that they failed. It was worse. Apart from very rare exceptions they have shown nothing that resembles understanding or critical thinking about the financial system. Neither did they show understanding of their own role, possibilities and limitations. They prevented necessary actions by others by

reporting that they could be trusted to stand guard over the safety and soundness of the financial system. They said that the system was safe and sound while it was not. They ignored vital parts of their duties. Without publicly accounting for that. They behaved as if they did not understand that exemption of the major part of liability and punishability can at most be justified by effective supervision.

The heads of the supervising organizations were selected and appointed by parliament and government. The crisis has shown that the heads lacked the necessary integrity and abilities. They have not done what they should have done. Parliaments and governments could have known this long before the crisis. They could have concluded it from an evaluation of the annual reports of the supervisors. But they didn't: there was no supervision of the supervisors. Political affinity must have been much more important in the selection and appointment of the heads than integrity and competence. And once in office, keeping silent about risk increasing laws and policies must have been much more important than reliable supervision.

Subprime mortgages in mortgage backed securities and other derivatives became poison when the home prices started to fall. Poisoned securities lost value at a rapidly increasing speed. After a time, nobody wanted them any more, and trade in them came practically to a halt.

It was the market value of securities that counted in book keeping, and determined whether a corporation was solvable.⁴⁶³ In the crisis situation this didn't help. Many financial institutions got liquidity problems, and maybe solvability problems. Important institutions depended on daily extension of loans. Loans which required collateral. Much collateral had lost value. Institutions which could not compensate the loss of value could not remain in business.

These are examples of the mechanisms that make the system unstable. They cause small problems to grow fast and uncontrollably. For numerous institutions the problems became unsolvable. The American dream had become a nightmare.

It slowly dawned upon central banks and governments that maybe more was going on than a temporary disturbance which would blow over in one or two months. In the beginning, when the problems seemed to affect only a few institutions, central banks and governments tried to solve the problem by organizing and supporting take overs by supposedly sound institutions. This was not enough however. For more and more institutions it became increasingly difficult to find the liquidity necessary to remain in business. Because of the risks and the increasing difficulty to cover costs, institutions lost interest in take overs. Only very large amounts of money could prevent a steadily growing number of banks to go bankrupt. In other words: tax payers' money. Important but difficult conditions for the distribution of this money were: minimizing costs for the tax payer and minimizing the benefit for the institutions and persons who had done worst.

Because developments took central banks and governments by surprise and fully unprepared, time posed a major problem. Central banks and governments had no plans or policy, and initially not even tenable ideas. Witness the in consequence of the saving of Bear Stearns and the almost forced bankruptcy of Lehman. The last acting as oil on the fire.

Thanks to the printing press, the financial capabilities of central banks and governments are virtually unlimited. But even unlimited power cannot change the fact that use of these capabilities costs time and has side effects. Time is needed to collect and digest information, understanding problems, developing and testing possible solutions, legal procedures, and obtaining political majorities. The crash itself didn't have such difficulties and obstacles. Delays would probably cost very much money. Therefore there was a fight against the clock too.

The tide was finally turned by the permission of Congress to make enormous amounts of tax payers' money available for supporting financial institutions in difficulties.

Strictly speaking, and in the first instance, there only was a problem with a part of the mortgages, the subprime mortgages. It was not a major problem at that. But through their integration in all kind of securities, and in combination with relatively large uncertainties about new products and processes, the use of which had grown tremendously, the extent of the potential problem had been multiplied

⁴⁶³ The prescription is: "mark to market". On p. 542/570 in the glossary of the FCIC-report one can read: «[mark-to-market: The process by which the reported amount of an asset is adjusted to reflect the market value.](#)»

very many times. Still, the (new) instruments were not intrinsically inadequate. But their value depended on markets and subjective valuation. Subjective valuations can change without good reason; rapidly and without hindrance. Combined with instabilities in the system, changes may cause crashes and crises. Subjective valuations change for 1001 reasons. An important cause of devaluation is the rather sudden general acceptance of the idea that markets (people!) have been too optimistic for too long. The optimism may or may not have had good grounds. Prediction is difficult. What is especially difficult to predict is the turnaround time of unsustainable growth trends in all kinds of prices. Such as the price of money (interest), houses and mortgage backed securities.

One lesson should be that risk management should take account of these possibilities. For if no fundamental changes are made- and in the years 2008-2018 no fundamental changes were made at all- then all of the risks outlined here will be realized again. And if history is a measure, in the 21st century too more than once.

2. Conclusions about the subprime crisis.

(and a few conclusions about both financial crises).

1. By deregulation policy and failure to supervise the supervisors, the central parliaments and governments allowed systemic risks to increase beyond control.
2. Central parliaments and governments are responsible for liability and criminal laws which fail to effectively restrict conduct that creates dangers for outsiders, and fail to ensure full compensation for avoidable man-caused harm.
3. Supervisors did not compensate for the lack of liability and punishability.
4. By its affordable housing policy, the US Congress and Administration caused a steady increase in the risks of mortgages.
5. Well substantiated reports and recommendations of the GAO of 1994-1999 were ignored. Implementation of the recommendations would most probably have prevented the subprime crisis.
6. With one or two incidental ineffective exceptions, supervisors lacked the necessary integrity and competence. They did not understand the financial system as a system, and didn't feel sufficiently responsible. They made themselves an extension of irresponsible government policies.
7. The supervisors nevertheless pretended to be trustworthy and authoritative.
8. All principal persons in government and its agencies were appointed through political processes. With one or two incidental and ineffective exceptions, none of these people turned out to be honorable and competent.
9. Hierarchical organizations can operate as dictatorships. In hierarchical organizations there is no separation of powers.⁴⁶⁴ There is no regulation providing for effective mechanisms for correction of systematic misconduct of the management. Such as preventive punishment of people who violate codes of conduct. Even good whistleblower regulations can at most be half of what is needed. Most attention should not go to whistleblowers but to the misconduct and the failure of the management to correct it.
10. The given whistleblower regulations, codes of conduct and similar codes, had no observable positive effects whatsoever.
11. Whistleblower regulations can only be effective if the regulatory, executive and judicial powers are separated. As it is, they only mislead the public by suggesting that organizations tackle misconduct effectively. (They don't).
12. The principal persons lacked knowledge and understanding which were necessary for adequate fulfillment of their duties. Quite generally there was insufficient knowledge and understanding of:
 - a. The concepts "risk" and "unstable";
 - b. The operation of the financial system as a system (as distinct from the knowledge and understanding of some separate products and services);
 - c. The instability of the system;
 - d. The prisoners' dilemma.
13. In particular, the heads of the supervisory and governmental organizations:
 - a. Did not understand the financial system as a system;

⁴⁶⁴ Reminder: law making, judiciary, and executive.

- b. Did not understand that they and only they could (and should) prevent that system failure would harm innocent people;
 - c. Sometimes were not even seriously interested in the financial system for which they were responsible;⁴⁶⁵
 - d. Pretended that they did understand the system;
 - e. Showed no trace of carefulness, in particular with respect to their own abilities;
 - f. Talked risk increasing nonsense;
 - g. Did not tolerate opinions differing from their own;
 - h. Implicitly pretended to be allowed to behave repressively with respect to subordinates and colleagues;
 - i. Assumed that they would not have to account for their conduct, or suffer consequences of misconduct.
14. If the top of a financial institution in the narrow sense had been competent, it would have lobbied for less permissive regulation, in particular with respect to leverage and risk management. Because this is in the interest of his institution and in the longer term interest of the shareholders.⁴⁶⁶
15. None of the supervisors and other relevant authorities knew how to handle, and communicate about, a future consisting of scenario's with probabilities. They did as if they only needed to take account of the most probable scenario.
16. Even if there had been sufficient knowledge and understanding for making reliable risk estimates, then there were still not enough incentives to actually make them, and to act upon them in such a way as to safeguard innocent people.
17. Several circumstances contributed to cause an enormous growth of the volume of mortgage related securities.
18. The safe and sound operation of the financial economic system gradually became more dependent on the stability of the value of mortgage related securities.
19. The subprime content of mortgage related securities gradually increased.
20. The value of all securities is subjective. It is therefore variable. The variability need not be proportional with objective risks or developments.
21. To a large extent, subjective changes are inestimable. That is: many risks must be considered unknown and in principle unlimited.
22. On the basis of experience it was to be expected that the inclusion of subprime mortgages in mortgage backed securities would cause disproportional value losses when home prices would start to decrease. (It being known that markets always overreact).
23. Due to the importance of MBS and related securities for the financial system, the prices of other securities and other valuations would follow their example.
24. Once a disturbance had brought the system out of its unstable equilibrium, developments outpaced the understanding of the responsible officials. There was insufficient knowledge and preparation for adequate management.
25. In other words: developments ran out of control.
26. However, not the new products were deficient or dangerous, but the fact that their value was subjective, and the fact that markets and important processes depend on subjective valuation. It is the combination of markets with subjective valuation- by people who fear continuation of falling prices- which makes the financial economic system unstable. This is the correspondence with past crises.
27. In the circles of the principal persons, the dysfunctioning and false pretensions were general.
28. None of the (responsible) principal persons has been held liable.
29. None of the (responsible) principal persons has been punished.

⁴⁶⁵ As demonstrated by a dogmatic and irresponsible attitude. Especially when this precludes serious study of relevant information (and therefore checking the operation of their own organization). For example by saying: "I don't read reports; if they contain something important, subordinates will tell me". Without ever checking this, and without proper accounting for the fact that on its way up from bottom to top in an organization, information may get mutilated and misrepresented. Which with a dogmatic head certainly will happen.

⁴⁶⁶ At least with strict or stricter liability and criminal law.

30. Possibly because prosecution can only be started with the support of the political establishment, and because this establishment understands that it could and should have prevented the crisis if it had done its duty. It could not accuse anyone without running the risk of being accused by the accused. Of even greater responsibility.
31. The Dutch and US parliaments instituted inquiry commissions which lacked the necessary integrity and competence. The commissions (or their staff) have collected and digested much useful information. But their analyses are inadequate, especially those regarding supervision, government, and the principal persons and their organizations.
32. Citizens have no possibility to sue dysfunctioning supervisors, members of parliament or the administration for liability, and/or to have them prosecuted under criminal law.
33. None of the circumstances, fundamental legal deficiencies, etcetera, mentioned in this list has changed until at least 2020.
34. Before, during and after the financial crises, the authorities fulfilled no duty with respect to the safety and soundness of the financial economic system with integrity and competence. The crises were nevertheless followed by sizable tax increases and reduction of the services provided for that money. Moreover, the tax increases are equivalent to more power for the politicians. That is: more power to those who failed.

3. Who could and/or should have prevented the subprime crisis.

It is evident that governments could and should have prevented the second financial crisis, the debt crisis. For years they did as if one can systematically spend more money than one receives without creating any problem. A ridiculous and falsified assumption. Which nevertheless is still acted upon.

The following conclusions are drawn from the study of the subprime crisis. Many could just as well have been drawn from the debt crisis. The debt crisis falsifies none of them.

Adequate risk management is understood to be: finding and analyzing risks, and making sure that the sum of the activities does not create unbearable risks, under the assumption of strict liability. The assumption of strict liability may be replaced by another restriction; but some legal (= generally binding) restriction is logically necessary. A well-defined legal restriction is necessary in order to have a "level playing field", equal rules for everyone. Strict liability is necessary if innocent outsiders are to be safeguarded. Without strict liability they are not. As seen after both crises.

1. Adequate risk management by all or substantially more mortgage buyers would have prevented the subprime crisis.
2. Adequate risk management by the financial institutions in the narrow sense would have prevented the subprime crisis. (This would have required strict liability).
3. By doing their duty the supervisors would have prevented the subprime crisis.⁴⁶⁷ Preferably by collectively pointing out that the government needs to take adequate (specified) action. For the communication of this demand they could have used their annual reports. In fact, the preceding points are valid for supervisors as well: adequate risk management by the supervisors would have prevented the subprime crisis. Even though their risk management would look somewhat different from that of banks. But actually they had no risk management at all.
4. By doing their duty, national governments, foremost that of the USA, would have prevented the subprime crisis.⁴⁶⁸ They fatally and blamably failed by:
 - a. Omitting to set limits to risk taking which preclude more than marginal harm for the world outside the financial sector;

⁴⁶⁷ The argument of judge Rothstein showing PricewaterhouseCoopers to be liable with respect to the FDIC/ Colonial Bancgroup is applicable here as well (without any substantial change). The argument shows the supervisors to be liable. The ruling supports the arguments presented in the present work. It shows that in some areas this argument does represent the law. Evidently not in all areas: as asserted before: the law is inconsequent. The ruling can be found in a file with date 20180702. The author is indebted to Reuters for an article about, and reference to, the ruling.

⁴⁶⁸ The previous note about the ruling re PwC-FDIC is applicable here as well.

- b. Retaining risk promoting laws, especially those regarding liability, criminal behavior and hierarchical organization;
- c. Deregulation and weakening supervision, in spite of warnings, the growth of the financial sector, and the introduction and growing use of new risky products. The policies were contrary to common sense and professional know-how;
- d. Dogmatic affordable housing (mortgage) policy, with quantitative 4-year plans that could only be realized by greatly increasing risks and undermining the safety and soundness of the financial system;
- e. Absence (or the wrong kind)⁴⁶⁹ of supervision of the supervisors;
- f. Appointment of people of insufficient integrity and competence in all functions relevant for the safety and soundness of the financial system;
- g. Allowing unrestricted lobbying;
- h. Absence of risk management.

The affordable housing policy of the US government (= Congress + Administration) is the best candidate for the denomination “main cause”. Because of its direct effects, and because it had a corrupting influence on many crucial processes regarding risk taking, safety and soundness.

4. Some general conclusions.

1. The subprime crisis has shown that the members of the parliaments and governments of the countries which were affected by the financial crises, and the heads of the organizations responsible for aspects of the financial economic system, lack the integrity and competence necessary for the adequate fulfillment of their duties.
2. Without significant exceptions. This was the cause of the crises. Not their unpredictability or the supposedly immoral conduct of banks. A competent public authority, the US GAO, had pointed out the danger. Its warning was well substantiated. Every expert should have been able to reproduce its reasoning and acknowledge its validity.
3. There is no reason whatsoever to assume that the lack of integrity or competence only concerns financial economic matters. Indeed, other chapters provide examples in a wide variety of other areas. The common denominator is: false pretensions about integrity and competence.
4. It must be doubted whether these people are able to evaluate candidates for responsible positions reliably. In any case people lacking integrity will not appoint honorable and competent people. Such people would try to eliminate them from positions of power.
5. In the present legal and political circumstances, people who take unbearable risks have insufficient reasons to fear a share in possible negative consequences.⁴⁷⁰ There is no limit to risk taking. As a consequence society and life on earth run unlimited risks. This is a consequence of inadequate laws and the dysfunctioning of parliaments and governments.
6. Hierarchical organizations do not correct themselves. This can be explained by the inadequate regulation of this kind of organization.
7. In combination with the selection of heads with a “positive attitude”, overestimation of personal abilities and underestimation of risks, repression in all hierarchical organizations involved in the subprime crisis precluded any positive effect from common sense and responsible thinking.
8. Codes of conduct and whistleblower regulations had no positive effect at all.
9. All education has serious deficiencies which contributed to the causation of the crisis. Education is insufficiently directed at preparation for the real world. It insufficiently teaches modesty and critical reflection. Sometimes, as in economics, it even teaches to ignore well-founded criticism. It

⁴⁶⁹ That is: making sure that supervision would not restrict the freedom of the financial institutions more than the irresponsible management of these institutions found acceptable. In other words: making sure that supervision was not really effective. The terminology “absent supervision” probably is an understatement. Government actively opposed effective supervision. The annual reports and the FCIC report provides evidence.

⁴⁷⁰ The “political circumstances” include the given occupation of higher functions in society. “Higher functions” are functions with relatively many subordinates and/or relatively much power/ influence.

- does not tell students how they can live in accordance with generally accepted norms and values without hurting themselves.
10. In science (as an activity) not the advancement of explanatory knowledge gets priority, but the personal interests of the scientific establishment. In general at the cost of the advancement of explanatory knowledge. The discussion in and about science as an activity is not open at all. Contributions are not evaluated only on their scientific merits.

There is a striking resemblance between the financial crises and the second world war. In both cases the danger (or risk) was known for many years, and allowed to grow unhampered. It was allowed to grow until it had by far outgrown all means of control. With innumerable victims and immeasurable destruction as a consequence. Afterwards the governments who could and should have prevented the disaster wrote history in such a way as to completely ignore their own complete failure to stop the evil and prepare for its attack. They put all the blame on a foreign evil which definitely played an important causal role, but could have done no major harm if (other) governments had done their duty.

This is consistent with the conclusion that most of the important causes (including the causes by omission) have nothing to do with the financial system, but concern the political system. And with the conclusion that no really effective lessons are learnt.

5. Early warnings by authoritative organizations.

People who are competent to head a ministry of finance or a supervising organization, or pretend to be an expert in finance or economics, should have seen and understood the main (systemic) risks without having to be warned by others. In their defense, many of the principal persons have said that the crisis came as a surprise for everyone. Thereby showing that they lacked crucial knowledge and understanding of the system they were supposed to keep safe and sound. And that they lacked the integrity needed in any responsible position. The denial of warnings being a lie. The warnings have been mentioned before. But because of their importance for the understanding of the crisis and of the responsible people, it may be useful to summarize them concisely.

In 1994, 1996 and 1999 the US Government Accounting Office (GAO) published clear and well substantiated reports with unambiguous warnings against system instability due to derivatives and other financial instruments. It is important to note that the GAO not only gave opinions, but explicitly pointed out mechanisms which constitute risks for the financial system. Everyone with some responsibility for the safe and sound operation of the financial system should have taken the reports to heart, and taken action according to its recommendations.

In January 2003 the Committee on the Global Financial System (CGFS) of the Bank for International Settlements (BIS) published a report *Credit risk transfer*. The report tries to give an understandable overview of the developments in the field of credit risk transfer. It draws attention to many obscurities, and points out many rather vague but potentially large risks. It is one of the very few systematic efforts at understanding the newer part of the financial system. The report mentions the systemic risk of concentration.⁴⁷¹ Implicitly it shows that in conceivable circumstances concentrations- or too much of the wrong types of assets- may cause markets to freeze to a standstill. The report discusses incentive issues. But the style of the report is extremely detached, even though it is written by supervisors. One can hardly speak of warnings. But the lack of logic in what should be a professional report is suspicious, and should alarm everyone interested. The report is simply too inconsistent. Someone who reads it against the background of the GAO reports can only conclude that in the meantime the risks have grown tremendously.

In February 2003 the GSE supervisor OFHEO published a report about GSEs, OFHEO and systemic risks. It sketched a scenario showing the possibility of a system breakdown as a consequence of falling housing prices, and made recommendations to mitigate risks.

⁴⁷¹ For “concentration” see IV.2 (with numbers), and VII.3.

Starting in 2004, Fannie and Freddie yearly drew attention to the risks of reduced mortgage requirements in their annual reports.⁴⁷² In the annual reports of Freddie the development is easy to follow. Realization of the ever higher HUD goals requires easing mortgage requirements, which affects profitability. This is purely logical, but contrary to the assertion of the FCIC that profit is the principal (and inviolable) goal of the GSEs.

In March 2005 there was a *Joint Forum on Credit Risk Transfer* in the BIS-framework. The report of this forum is just as strange and suspicious as the CGFS report of 2003. For an experienced reader it is nevertheless an unambiguous warning. For details see the appendix about the BIS reports.⁴⁷³

The BIS, GAO and OFHEO reports agree on all main points.⁴⁷⁴ The reports and recommendations were nevertheless largely ignored. In the annual reports of the supervisors they are not discussed or even mentioned.⁴⁷⁵ The inconsistencies and obscurities in the BIS reports were no reason for remarks or questions. The neglect is not accounted for. The reactions of the US supervisors on the GAO reports were defective if not shameless, and that of the US government at least as bad. Formally speaking some of these reports and recommendations could be ignored. However, because of the duties of the supervisors, the formal status of the publishing organization is irrelevant. The formal status is only important for people who think they have infallible knowledge and insight, or the power to ignore whatever doesn't suit them. Such people only listen to people with formal authority. They do not (and/or cannot) assess information as an expert, and from the point of view of their duties. The significance they attach to a report is determined only by the position and power of the author or commissioner.⁴⁷⁶ On the other hand, someone who takes his duties seriously and has a minimum of understanding of the financial system, studies every relevant signal, and acts accordingly.

After the crisis responsible authorities like Dutch central bank director Wellink and secretary of the treasury Bos denied that there had been authoritative warnings which required their (re)action. On Thursday, September 2, 2010, Bernanke told the FCIC under oath: «**What I did not recognize was the extent to which the system had flaws and weaknesses in it that were going to amplify the initial shock from subprime and make it into a much bigger crisis**». Something clearly described in both GAO and OFHEO reports. The reports mentioned above amply prove that these people lied.⁴⁷⁷

7B.10. By way of an epilogue: Trying to get Wellink prosecuted for perjury.

In 2016, when most of the present report was completed, it seemed impossible to get it published by a commercial publisher. Everyone of his acquaintances told the author that nobody nowadays is interested in books of more than a few hundred pages. The style moreover is too difficult, and the form too unconventional. Something short and simple might have a better chance. When thinking about a suitable subject, I realized that Nout Wellink, from 1997-2011 president of De Nederlandsche Bank (DNB, the Dutch version of the Fed), might have committed perjury in his hearings by the Dutch parliamentary inquiry commission, the CDW. For the present chapter I had made analyses of some of the hearings of Wellink, and of DNB annual reports. This had resulted in two appendices. I decided to review and supplement the appendices, and to check for violations of an oath to tell the truth, the

⁴⁷² In its AR of 2002 Freddie is still saying explicitly that «**We seek to purchase most single-family and multifamily mortgages in support of affordable housing through our standard mortgage purchase programs and under the same credit standards as our other mortgage purchases**». (On p. 15/24, in the section *Regulation and Governmental Relationships*). In AR 2003 uncertainty becomes noticeable, but the mortgage requirements remain unchanged. AR 2004 declares that the standards have to be lowered in order to realize the goals dictated by HUD.

⁴⁷³ Analysis suggests that there was much more anxiety in the forum than has found explicit expression in the report. At least from the point of view of research into the functioning of people under political pressure it would be very useful to be able to consult the drafts of the report and the minutes of this forum (and its committees).

⁴⁷⁴ This can also be seen in the appendices on these organizations.

⁴⁷⁵ An unforgivable omission. Supervisors should at least have mentioned and summarized them, and account for having done nothing with them. Differences of opinion are permitted, but in the case of authoritative reports on very important topics only when accounted for.

⁴⁷⁶ Note that nothing in this or any other case contradicts this hypothesis.

⁴⁷⁷ Quite apart from the fact that every competent person could have deduced the dangers from his knowledge of the system, just as GAO, OFHEO and CGFS had done.

whole (relevant) truth, and nothing but the truth, to the best of one's knowledge.⁴⁷⁸ It quickly became clear that Wellink never told the whole relevant truth, and lied whenever the truth would unmask him as being incompetent or having malfunctioned. It was not difficult to show that Wellink had committed perjury. But to prove and to prove in a formal juridical sense can be very different things.

In order to give a request for prosecution the best possible chances, I wrote a report presenting important declarations of Wellink in the hearings against the background of the (pre)history of the financial crises and the activities of DNB in that period. The report was meant to be self-sufficient. It has the following chapters:

1. Motivation and overview.
2. Concise history of the subprime crisis and the crisis of government debts.
3. Deeper causes.
4. The hearings of the CDW with Wellink.
5. The perjury and the constitutional state.
6. Dealing with the deeper causes.

Appendix. DNB reports 1998-2007.

Chapters 2, 4 and the appendix present most of the facts. The declarations of Wellink, and the questions of the CDW, can be compared with the facts presented in chapter 2 and with the appendix. The report provides all the information necessary for a reader to convince him- or herself. It also shows that the organizations of public administration established to evaluate and control the organizations of public administration failed in at least 1994-2010. In other words: the report does not only show the lack of integrity and competence of Wellink and DNB, but also that of crucial elements of public administration.

The chapter on deeper causes and chapter 6 are adaptations of similar parts in the present report.

At the internet I saw quite a few people accusing Wellink of perjury. But none of them made a serious effort to specify or prove it.

I had found out that any citizen can report a crime to the public prosecutor, and request prosecution. I had been told that in case of rejection of the request, the citizen can ask a court of appeal to order prosecution. So I sent the chief public prosecutor for the juridical region The Hague a copy of the report,⁴⁷⁹ and a letter requesting prosecution of Wellink for perjury.⁴⁸⁰ For proof the letter refers to the report. After two weeks, the chief prosecutor replied that Wellink had not lied on purpose, and that he would not prosecute him. He said that I could appeal to the court of appeal in The Hague. The letter gave no proof or arguments whatsoever, so I sent a letter asking substantiation. The chief prosecutor replied that he stuck to his argument showing that there was no perjury. Even though no argument was given. He had shown nothing. Both of the prosecutor's letters show more "errors" than this one. In fact, they seem to be written so carelessly as if nobody would ever have to answer for them. It would however be a waste of time to discuss them any further.⁴⁸¹ The conclusion being clear: a Dutch public prosecutor is free to act arbitrarily and irresponsibly. He need not give any argument showing he made a well-considered decision. He need not treat similar cases similarly.

The arbitrariness or malicious bias is underlined by declarations of the attorney-general, a high level public prosecutor, in a trial against former town councilor Van Rey on 14 November 2017. Van Rey was accused of corruption. Among other things, the attorney-general said:

«A corrupt civil servant signifies that public administration works better or faster for those who can pay for it. The citizen sees that public administration does not abide by the law, while especially public administration should give the good example: every citizen has the same possibilities and

⁴⁷⁸ This is the contents of the oath required by the US Financial Crisis Inquiry Commission (FCIC). The Dutch oath is less explicit.

⁴⁷⁹ This is where the perjury took place, and where I live.

⁴⁸⁰ The letter is dated 22 August 2017.

⁴⁸¹ The letters are appended to the (updated) Wellink report: rechtvandelogica.net/WM.pdf

everyone is treated equally. Especially the civil servant should stick to the rules. Public administration operates by the grace of the confidence of citizens in the objectivity of civil servants. Corruption undermines this confidence, and corrodes the foundation of the constitutional state. [...]

With the criminal prosecution of violations of integrity and official corruption, the office of the public prosecutor wants to firmly support all initiatives taken by the government to counter violations of integrity and official corruption. [...]

As town councilor Van Rey's conduct should be exemplary. Especially people like him cannot be honorable only partially. [...]

The essence of the case is not the financial benefit of Van Rey and [businessman] Van Pol, but the lack of integrity of Van Rey and the subversion of the public administration by Van Pol.»⁴⁸²

The attorney-general requested imprisonment of Van Rey for 2 years.

Obviously what is said about Van Rey applies at least as much to Wellink. But as we saw, in that much more important case the prosecutor refused to prosecute.

The misconduct of the public prosecutor with respect to Wellink's perjury should also be compared to its misconduct in the (Dutch) whistleblower cases described in the first part of chapter 8. There it can be seen that the prosecutor spares no efforts to harass innocent whistleblowers for as long as imaginable, and no inventiveness to show that it need not or cannot prosecute criminals who caused very much harm and obviously should be brought to justice. The simplest case is that of Ad Bos, section 8.5.

A copy of the letter to the public prosecutor, together with the report, was sent to the principal Dutch media and organizations of investigative reporters, to governmental advisory commissions whose mission statements or reports prescribed or suggested interest in the subjects treated by *Wellinks meeneed*, and for the same reason to the largest accountancy/ consultancy firms. In all, about 40 (forty) copies were sent. As far as I know, none of the media paid any attention to the prosecution request or the report. Even though this obviously was really "news".

Since parliament claims to supervise the proper operation of the Office of the Public Prosecutor, even if indirectly through supervision of the government, it seemed appropriate to inform it of the Prosecutor's refusal to prosecute Wellink, and- especially- his refusal to explain and defend his decision. The more so since in a month or two parliament would have to approve (or modify) the budget of the ministry of justice, which includes the budget of the Office of the Public Prosecutor. The answer was that parliament does not mingle in individual cases.⁴⁸³ Not only is this untrue, as will be shown in a minute, but the "policy" also means that parliament ignores an important if not essential source of information about the operation of an infinity of wholly or partially subsidized agencies. That parliament does mingle in individual cases is shown (for example!) by its reaction to the proposal to increase the salary of CEO Hamers of one of the largest banks in the Netherlands, ING. The increment was to consist of options, and was said to imply a 50% salary increase.⁴⁸⁴ Representatives of one political party after another said that this was unacceptable. One of the parties proposed a law requiring approval of salaries and/or salary increases by the minister of economic affairs.⁴⁸⁵ Haste was made in an effort to get the law approved before the shareholders meeting which was to decide about the salary increase. Some people suggested that by this action politicians meant to win votes in the coming elections for town councils. Whether this is true or not doesn't really matter: it doesn't change the conclusion that the behavior of the Dutch parliament is arbitrary and inconsequent. It is irresponsible: it makes a lot of fuss about something that doesn't hurt anyone, while covering up perjury and structural malfunctioning that guarantees catastrophe.

The rejection of the request to prosecute, though disappointing, did not come as a surprise. On the

⁴⁸² Press release of the Office of the Public Prosecutor (in Dutch: "Openbaar Ministerie") 14 November 2017.

⁴⁸³ The letter is an appendix of the webversion of WM.pdf.

⁴⁸⁴ Even after the increase, the salary is low as compared to the salaries of CEOs of US corporations with the same number of employees. Understandably this was given as the reason for the salary increase.

⁴⁸⁵ For the purposes of this work, details are completely irrelevant.

basis of the findings of the present report, a negative reply had seemed likely from the start. Prosecution, and a positive reply to my letter, would have justified serious doubts about the main conclusions of the report. If I wanted Wellink prosecuted, appeal would be necessary. But again, on the basis of the findings of this work, winning an appeal could not be taken for granted, irrespective of the solidity of the proof. I was particularly afraid of formal errors and juridical aspects unknown to ordinary citizens, but nevertheless essential for an appeal to be successful. It seemed to me that if I wanted to prevent unwilling people to kill the case without even having looked at the report, I would need competent legal assistance. That turned out to be much more difficult than expected. This surprised me, especially because (in the Netherlands) one often hears lawyers explain why even the worst "ordinary" criminals should be defended properly. The interest of the constitutional state, equality before the law, human rights and all that. After a few failed efforts, I came to expect reluctance. Since I didn't want to waste time and money, both being in short supply, I was quite explicit about what I wanted: competent help, of somebody believing in the merits of the case. After several "No"'s and unanswered mails, I struck a "Yes".⁴⁸⁶ However, a month later the lawyer's report showed that the firm should actually have said "No". The report argued that the appeal would almost certainly be rejected on formal grounds. It claimed that none of the allegations of the report could be proven objectively. It turned out that Article 12 of the law of criminal procedure does not allow citizens to appeal against a decision of a public prosecutor. Only a "moral person" whose purpose is involved by the alleged crime or prosecution can appeal. Which also meant that the assertion in the letters of the public prosecutor, that I could appeal, was simply untrue. I found this out by myself, at home, by reading the law (being amazed by the lawyer's report). I was quite a bit indignant about the absence of a remark in this vein in the lawyer's report. So I complained to the lawyer that her report did not indicate the possibilities, and that it failed to recommend establishing a foundation. Her answer was that making suggestions of that kind was not included in the assignment. Whereupon I noted that it was obvious from the beginning that I want Wellink prosecuted, and that I hired a lawyer in order to get all legal information that could be useful for the realization of that goal.

In support of its claim that *Wellinks meineed* provides no objective proof of perjury, the lawyer's report gives three examples. In my opinion at least one of them was incorrect. Objective proof seemed given or very well possible. The basic point however was, that a few (selected how?) examples prove nothing. The lawyer's report proved only one thing. Namely the inappropriate and unwanted attitude of the lawyer. The report should have shown efforts to find or construct proof. It should have shown the difficulties, and should have tried to overcome them. Find and indicate possible ways. I had researched the literature, and had seen how other lawyers go about and solve difficulties in similar cases. Perjury cases may be difficult, but they are not impossible to win.

So as regards the case, this firm made me none the wiser. Except that lawyers may cheat, and may bleed you rather badly before you can stop them.

⁴⁸⁶ Sjöcrona and Van Stigt, The Hague.

Chapter 7.

The financial crises of 2007-2013.

Part C. Appendices.

Principal persons and organizations in the (pre)history of the subprime crisis.

A litany of dysfunctioning and deceit.
With exceptions to prove the rule.

Table of appendices.

The table gives abbreviated appendix titles.

1. The Basel agreements
2. Bernanke
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19. OTS
20. SEC
21. Wellink

Note.

This Appendix complements the reports of the FCIC and its staff, the reports of the CDW, and the reports of Pinto. It presents information which enables the reader to evaluate the operation of the financial supervisors in the prehistory of the financial crises. Such information is missing in the reports just mentioned. The Appendix is meant to fill the gap.

A small number of appendices has another motivation. They are only meant to give background and other useful information.

In general, information has not been included in the Appendix because it is not sufficiently important to be included in Chronicle or Analysis. It is included in the Appendix in order not to burden Chronicle and Analysis with a relatively large amount of information about a specific subject.

The appendices are independent of one another. They can be read in arbitrary order.

1. The Basel agreements.

Table of contents of this appendix.

- Evaluative concluding remarks.
- *The Basel Capital Accords*. By Joe Larson, April 2011.
- The book *From Basel I to Basel 3* by Laurent Balthazar.
- The presentation sheets of Tamer Bakiciol, Nicolas Cojocaru-Durand, and Dongxu Lu of 15/12/08.
- *Not What They Had in Mind. A History of Policies that Produced the Financial Crisis of 2008*. By Arnold Kling, September 2009.
- The Wikipedia (of 26/3/12) on the BCBS.

For the Basel agreements, Larson seems to be the best source. The others can be used for clarification and checks.

Evaluative concluding remarks.

1. The sources do not mention personal liability and punishability. While it is clear that:
 - a. personal liability and punishability can have a positive influence on risk taking and the quality of risk management;
 - b. the Basel agreements offer no guarantee;
 - c. given the possibly disastrous consequences of a failure of the Basel agreements, there should be a safety net
2. The origin of the 8% is not explained. Neither is the increase with 2,5% (of Basel II to III), nor the counter-cyclical rise of 2,5% and the bottom of 3%. It is logical that more capital means greater safety, but it is completely unclear how much capital ensures how much safety, and what risks remain. There is not the least reliable (scientific) foundation for the percentages, not even anything resembling an explanation. Because of the historical events and the fact that the people responsible for the crises are the same as those responsible for the Basel agreements, it must be assumed that the percentages are only guesses, and unreliable compromises of political negotiations.¹
3. For the national states, the Basel agreements are recommendations. The agreements have no power of law. States are free to do with them as they please. In general they have translated the Basel norms in laws and regulations. It is remarkable that the annual reports of the financial supervisors do not give critical discussions of either the Basel agreements or the way national states implemented them in laws. Doesn't their responsibility require an independent and critical attitude? Or are they in actual fact not as independent as politicians and they themselves want us to believe? The evidence, their silence, shows that they find loyalty towards governments, other supervisors, and the banks (with whom they negotiated the agreements) more important than loyalty towards those they are meant to serve, the citizens.
4. Both the Basel process and its results, the agreements, show gross incompetence. Which can be seen as part of the explanation of the financial crisis. This conclusion is consistent with the conclusions of the analysis of the other activities (and omissions) of the financial supervisors 1994-2008 .
5. Incompetence is social and organisational respects too. Note that Basel I is dated 1988, that Basel II came into effect in 2008, and that Basel III dates from 2010. 22 years after Basel I, and still ill-founded and risky. There is an immense unwillingness and/or incompetence to reflect critically and to safeguard outsiders.

¹ And never forget: a compromise between safe and unsafe is unsafe (always).

The Basel Capital Accords. By Joe Larson, April 2011.

This seems to be a sensible description and modestly critical evaluation of the Basel agreements. The article is readable and understandable. An agreement is first described, then discussed.

An asset is the opposite and pendant of a liability. See p. 11.²

Basel I. (Pp. 8-15).

«Basel I was the first coherent international attempt at regulating bank capital»³

In capital, two tiers are distinguished. The tier-division corresponds with a difference in quality.⁴ For assets 4 risk categories are distinguished. The capital requirement is 8%. This percentage only applies to the risk category with the highest risk. Larson gives the following examples:

Risk-Weight Category	Types of Assets Included in the Risk Category
0%	Cash; assets involving the governments of OECD countries
20%	Assets involving banks located in OECD countries; cash items in the process of collection
50%	Loans secured by mortgages on residential property
100%	Assets involving businesses; personal consumer loans; assets involving non-OECD governments (unless the transaction is denominated and funded in the same currency)

On p. 13 Larson summarizes the essence of Basel I as follows:

«[...] the bank must then ensure that value of its total capital levels (tier 1 + tier 2) are equal to at least 8% of the bank's risk-weighted assets, with tier 1 capital equalling at least 4% of risk-weighted assets.»

An important criticism held that one and the same category might include assets with widely varying real risks. This gave rise to regulatory arbitrage:

«Essentially, regulatory arbitrage describes a situation where, if a bank is presented with two options, both of which receive the same regulatory treatment, but each of which result in differing profit-making opportunities, the bank will choose the more lucrative option.»

Where “the more lucrative option” in practical reality means the *potentially* most lucrative option... (It may simultaneously cause the greatest risks).

The evaluation of Basel I is concluded with:

«In sum then, the common theme running through the criticisms of Basel I was that Basel I's method to determine the proper amount of capital to be held by a bank was not sufficiently or

² Page numbers always refer to sources.

³ Larson p. 13. Note that capital only needs regulation if liability is insufficient or absent, and does not produce similar (or better) effects.

⁴ «Tier 1 capital consists of higher-quality forms of capital, in the sense that it is comprised of items that have lower priority of repayment in the event that a bank becomes insolvent, and therefore have the greatest ability to absorb asset losses. Tier 1 capital consists primarily of “core capital.” Core capital, also known as common equity, represents items arising from pure ownership in the bank and includes the paid-in value of common stock, as well as the amount of any reserves (i.e., retained earnings) that the bank has accumulated and disclosed. Because these items arise from ownership in the bank, they have the lowest priority of repayment in the event of insolvency, and therefore represent the highest quality capital. As mentioned above, for a bank to be considered sufficiently capitalized under Basel I, it had to maintain a capital ratio of 8%. However, Basel I also required that half of this 8% consist of tier 1 capital (i.e., tier 1 must equal at least 4% of the bank's risk-weighted assets). Tier 2 capital is considered less reliable and is comprised of items such as subordinated debt and reserves held for loan-losses. Subordinated debt is debt (e.g., bonds) issued by the bank that the bank need not pay back until it has paid all its other creditors. » Pp. 8-9 of The Basel Capital Accords.

accurately connected to the actual risks confronting the bank.»⁵

Basel II. (Pp. 15-24).

«Basel II still requires that a bank's total capital equal at least 8% of the bank's risk-weighted assets. It also still assesses banks' capital adequacy using the same capital adequacy ratio, which is equal to a bank's capital divided by the bank's risk-weighted assets. Basel II did not alter Basel I's definition of capital, i.e., the numerator of the ratio. However, as will be seen below, Basel II, or more specifically, Pillar I, does alter how a bank arrives at the denominator, i.e. the calculation for risk-weighted assets.»⁶

«Pillar I was specifically designed to redress the deficiencies identified in Basel I. As such, Pillar I focuses primarily on reforming the method of measuring credit risk, i.e., the risk inherent in the bank's assets. The goal of these reforms is to ensure that the calculation of risk in a bank's assets more accurately reflects the actual risk in those assets, which should reduce the opportunity for banks to engage in regulatory arbitrage»⁷

Regrettably the pillars 2 and 3 lie outside the scope of the article by Larson, because they have no “direct bearing” on the calculation of “capital adequacy”. Fortunately Balthazar fills the gap.

Credit risk is to be measured by one of three approaches. In the standardized approach the four categories of Basel I are replaced by 6 new ones. The four categories of Basel I are retained, and two new ones are added: those of 35 and 150%. The classification corresponds with the ratings of the rating agencies. Not rated means 100%.⁸ In Basel I the rating did not matter. The table of Basel I is replaced by the following:⁹

Credit Rating (S&P)	Government Risk-Weighting	Private Counterparty Risk-weighting
AAA to AA-	0%	20%
A+ to A-	20%	50%
BBB+ to BB-	50%	100%
Below BB-	150%	150%
Unrated	100%	100%

For smaller banks the standardized approach is the most important. In the other «two approaches, banks can use their own internal methodology to determine the risk level of their assets». These two are called internal ratings-based (IRB) approaches.

Explanation of IRB approaches requires the concept “unexpected losses”. Larson defines it on pp. 18-9. Expected losses can be inferred from the historical record [how long?]. The description of the things which have to be taken into account in the calculation of “unexpected losses” shows that these losses are not really unexpected or unpredictable, and do not necessarily have small probabilities. Which is not to say that they correspond with systemic risks. The important point is that a bank has some autonomy in estimating unexpected-loss-risks. A rather crucial question would seem to be whether a bank can be required, to be able to, to explain its calculation to supervisors (inspectors representing a supervisor), to their satisfaction.

Criticisms were:

- The dependence on rating agencies, together with the fact that these agencies are paid by those for whom they rate. And they make errors too. Optimistic rating pays.

⁵ Larson p. 14.

⁶ Larson p. 15.

⁷ Larson p. 15-6.

⁸ Larson p. 17. Note that this should be at least 150 or 200% if avoidance of rating is to be discouraged.

⁹ Larson p. 18.

- Lack of uniformity, even in the standardized approach. There are different rating agencies, which rate differently;
- Too much uniformity: unrated borrowers are considered of equal quality and given equal weight (100%);
- In the IRB approaches there obviously is no uniformity either;
- For supervisors the internal implementation of IRB is difficult to evaluate- there is a risk of self regulation;
- «Another shortcoming of the IRB approaches is their tendency to promote procyclical bank behavior. In short, Basel II's regulatory structure has the effect of inducing banks to maintain lower amounts of capital during good economic times, which forces them to take economically harmful action in bad times to maintain sufficient capital.»¹⁰

According to the present author this procyclical behavior simply means bad risk management. It is ignored or taken insufficiently into account that good times don't last. Risk management is not sound if the possibilities of a downturn and bad times are not properly taken into account.

Basel III. (Pp 24-29).

This agreement dates from September 2010.

«Basel III does not replace Basel II, but rather augments it. The primary goal of Basel III is to improve the ability of banks to absorb asset losses without affecting the rest of the economy. In terms of capital regulation [...] Basel III focuses mainly on the quantity and quality of capital held by banks.»¹¹

The following provides some more detail.

A more stringent definition of capital.

«Among the most important parts of Basel III is its new definition of regulatory capital, which is more restrictive, and emphasizes greater quality. Basel III retains the tier 1 and tier 2 distinction, but limits their composition to higher-quality capital that is better able to absorb losses. Under Basel III, Tier 1 capital must be mostly of “core capital,” which consists of equity stock and retained earnings. In addition, many items that were formerly included in a bank’s capital calculation under Basel II, including some forms of subordinated debt, will be excluded under Basel III. Those capital instruments that will no longer qualify as “capital” under Basel III will be phased out of a bank’s capital calculation over a ten-year period starting in 2013. This transition period will help those banks that do not currently possess the sufficient amount and types of capital comply with the new requirements.»¹²

The maximum capital requirement is raised from 8 to 10.5%.

«In addition to increasing the quality of capital, Basel III increases the quantity of capital that banks must hold. By the time participating countries fully implement Basel III in 2019, banks are expected to maintain a total capital ratio of 10.5%, an increase from the 8% requirement under Basel II. As with Basel I and Basel II, banks under Basel III must maintain a minimum total capital ratio of at least 8% of risk-weighted assets. However, under Basel III, after a bank has calculated its 8% capital requirement, it will have to hold an additional capital conservation buffer equal to at least 2.5% of its risk-weighted assets, which brings the total capital requirement to 10.5% of risk-weighted assets. The purpose of the capital conservation buffer is to ensure that banks have sufficient capital levels to absorb asset losses, especially during periods of financial and economic stress.»¹³

But what is the basis for the percentages, and the rules?

¹⁰ Larson p. 23.

¹¹ Larson p. 24.

¹² Larson p. 24.

¹³ Larson pp. 24-5.

The tier 1 requirement is raised from 4 to 6%. Moreover:

«Under Basel III, banks will have to hold an amount of core capital equal to at least 4.5% of risk-weighted assets, whereas in the previous Basel Accords, core capital had to represent only 2% of risk-weighted assets.»¹⁴

In addition a counter-cyclical buffer of 2,5% is required:

«The amount of the counter-cyclical buffer will range from 0%-2.5% of risk-weighted assets. The exact amount of the counter-cyclical buffer will be decided by national regulatory authorities and will generally be determined by the amount of credit in an economy, with more credit leading to a higher buffer.»¹⁵

The requirement tries to preclude banks reducing capital in better times when the risks seem to be smaller. [They aren't. It seems that "risk" is defined inadequately].

With a counter-cyclical buffer of 2,5% the total capital amounts to 13% of risk-weighted assets.

A further raise of the capital requirement?

When Basel III was published, the Basel Committee on Banking Supervision (BCBS) announced that it would consult the Financial Stability Board (FSB) about the need of a further raise of the capital requirement. Larson had not heard the outcome when he wrote this article.

Leverage ratio $\geq 3\%$.

«As opposed to the risk-weighted capital ratios, which compare a bank's capital to the bank's risk-adjusted assets, Basel III's leverage ratio will compare a bank's capital level to its total assets, regardless of their risk level. By requiring a leverage ratio, Basel III ensures that banks maintain at least some amount of capital at all times, and thereby limits the ability of banks to engage in practices designed to evade minimum capital requirements.»

Criticism of Basel III.

«Critics who say the amount is too high point to the impact it will have on lending.»¹⁶ Namely $(8/13) \times 100\% = 61,5\%$ of what could be lent under Basel II.

«A report produced by the Institute of International Finance (IIF) (an organization representing banks) concluded that Basel III's requirements would result in a 3.1% drop in a nation's gross domestic product (GDP) for every 1% increase in a bank's capital ratio. In contrast, a similar report produced by the Bank for International Settlements (BIS) concluded that GDP would decrease by only 0.09% for every 1% increase in the capital ratio requirement.»

«[...] with the higher capital requirements, not only will there be less lending, but the lending that does take place will be more expensive and riskier.»¹⁷

According to Larson the long implementation period will at least cushion any possible negative side effects.

On the other hand there are critics who find the requirements too low still:

«On the other hand, there are critics who hold the opposite view, that the capital requirements imposed by Basel III are too low to ensure a bank can absorb losses of the same magnitude as those experienced during the financial crisis. In support of their argument, those calling for even higher capital requirements point out that many of the banks affected by the financial crisis, especially those in the United States, already had capital levels at or above the Basel III levels. Some studies even suggest that the necessary minimum capital ratio should be closer to 15%-20%, which would effectively double Basel III's requirements.

¹⁴ Larson p. 25. As regards the explanation of the different percentages: core capital is a part of tier 1.

¹⁵ Larson pp. 25-6.

¹⁶ Larson p. 27.

¹⁷ Larson p. 28. Why riskier? Larson does not give the explanation of the economists.

Maybe the biggest criticism of Basel III is what it fails to do. Many of the criticisms of Basel II go unaddressed in Basel III. For example, Basel III does not address the problems associated with Basel II's methods of assigning risk to a bank's assets- it does nothing to change the calculation of the bank's risk-weighted assets and leaves in place the use of external rating agencies to determine risk. Nor does Basel III do anything to harmonize the IRB approaches to prevent vastly different risk-weighting methodologies from bank to bank. Thus, while Basel III has attempted to improve the numerator of the capital ratio, it has done nothing to improve the denominator, which many would argue was what needed the most reform.»¹⁸

Reminder: the numerator is the capital, the denominator the assets.¹⁹

«VII. Conclusion

The international regime for bank regulation has evolved considerably since the BCBS was established in 1974. Yet, as the global financial crisis made clear, after the first two Basel Accords, there is still room for improvement in the regulation of bank capital. While it's too early to tell with any certainty, Basel III seems to be a step in the right direction. Yet, if the criticisms already put forth are any indication, Basel III may be just one of many steps yet to come.»²⁰

Liability and punitive damages are not discussed. All Basel agreements address only the banks. Not their employees. No personal liability or penalties are introduced, and nothing is done with respect to skewed compensation plans. See the opinions of Warren Buffet and Moody's employees as voiced in the FCIC hearings of 2/6/10, and quoted in the Moody's appendix.

From Basel 1 to Basel 3 by Laurent Balthazar, 2006.

(The book is dated 2006, the pdf file is dated 19/9/08).

This is a valuable source of more detailed information. The subtitle is witness to an era of arrogance and quasi-science:

«From Basel 1 to Basel 3

The Integration of State-of-the-Art Risk Modelling in Banking Regulation»

The “Basel 3” can only be meant to seduce prospective buyers. What the book says about Basel 3 is no better than speculation, even if quite reasonable, to a certain extent.

It is evident that the book was written before the crisis. The first sentence of The Future on p. 284 (in the Conclusions) reads: «Basel 2 is a tremendous improvement on Basel 1.»

About Basel 1 and Basel 2 the book provides more and more precise information than all other sources studied (until 31/12/13). It provides useful historical overviews of crises and regulation. It is readable and understandable. A pdf file is available and well organized. It has linked bookmarks.

In connection with the assertion that Basel I reduced capital and increased leverage it is useful to know the situation before Basel I. Box 1.2, about the history of banking regulation, on pp. 9-10, gives some information about this:

«1981.

Seeing the banking sector deteriorating, US regulators for the first time introduced a capital ratio at the federal level. Federal banking agencies required a certain level of leverage ratio on primary capital (basically equity and loan loss reserves: total assets). [...]

1983.

¹⁸ Larson p. 29.

¹⁹ Larson p. 8, above.

²⁰ Larson p. 29.

The US International Lending and Supervisory Act (ILSA) unified capital requirements for the various bank types at 5.5 percent of total assets and also unified the definition of capital.»

P. 27 gives a useful definition of market risk:

«In the Basel Committee document, market risk was defined as “the risk of losses in on- and off-balance sheet positions arising from movements in market prices.”»

Follows an inventory of specific risks.

This is of interest in connection with the adjustment of Basel I for market risk in 1996.

Box 2.1 on pp. 24 and following concerns regulation of market risk.

The sheets of the presentation by Tamer Bakiciol, Nicolas Cojocaru-Durand, and Dongxu Lu of 15/12/08.

«Purpose of banking supervision is

- to ensure that banks operate in a safe and sound manner.
- to ensure that banks "hold capital and reserves sufficient to support the risks that arise in their business".
- sound practices for banks' risk management»²¹

Below on this sheet one reads the following cryptic phrase:

«Economic Capital: trade off between profitability and insolvency»

Sheet 6 has the title “What is the Basel Committee?”. The sheet says something about the purpose and role of the Committee, and the historical perspective:

- «Basel Committee on Banking Supervision was established by the central-bank governors of the G10 countries in 1974
 - Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, UK, US;
- Meets at the Bank for International Settlements in Basel;
- Its objective was to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide;
- Not a formal supranational supervisory authority and conclusions do not have legal force;
- Formulates broad supervisory standards and guidelines;
- First major result was the 1988 Capital Accord;
- 1997 developed a set of "Core Principles for Effective Banking Supervision", which provides a comprehensive blueprint for an effective supervisory system.»

The history of the Basel agreements is summarized as follows:

- «Basel I Capital Accord (1988)
 - Amendment to the capital accord to incorporate market risks (1996)
- Basel II Capital Accord
 - First Consultative Paper (1999)
 - Second Consultative Paper (2001)
 - Third Consultative Paper (2003)
 - Final Document (2004)
 - “Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework”
 - Amendment (2005)
 - The Application of Basel II to Trading Activities and the Treatment of Double Default Effects

²¹ Sheet 4.

- Final Version(2006)
 - “Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework -Comprehensive Version”
- Proposed revisions to the Basel II market risk framework (2008)»²²

Basel II was motivated by the following problems with Basel I:

- «Club-rule (being a member of OECD) is not meaningful in terms of riskiness;
- “Broad brush” and lacks risk differentiation: one size fits all;
- Divergence between Basel I risk weights and actual economic risks;
- Regulatory arbitrage (Solved?);
- Inadequate recognition of advanced credit risk mitigation techniques (securitization and CDS).»²³

The objectives of Basel II are revelatory:

- «Eliminate regulatory arbitrage by getting risk weights right;
- Align regulation with best practices in risk management;
- Provide banks with incentives to enhance risk measurement and management capabilities.»

This breathes the spirit of deregulating and belief in self control. This interpretation is confirmed by the following sheet.²⁴ It presents the following scheme:

Pillar 1	Pillar 2	Pillar 3
Minimum Capital Requirements: <ul style="list-style-type: none"> • Risk management incentives • New operational risk capital charge • Risk weighted assets (RWA) for credit more risk sensitive • Market risk largely unchanged 	Supervisory Review: <ul style="list-style-type: none"> • Solvency reports • Regulatory review • Capital determination • Regulatory intervention • Addresses risks that are not captured in Pillar 1 like concentration, interest rate, and liquidity risks 	Market Discipline: <ul style="list-style-type: none"> • Minimum disclosure requirements • Scope • Capital transparency • Capital adequacy • Risk measurement & management • Risk profiling

Basel I distinguishes 3 kinds (“tiers”) of capital. They are described in the sheets 15 en 16.

The following scheme shows the most important difference between Basel I and Basel II:

Credit Rating	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Basel I Risk Weight	100%	100%	100%	100%	100%
Basel II Risk Weight	20%	50%	100%	150%	100%

The next scheme illustrates an obvious improvement of Basel II with respect to Basel I:

²² Sheet 7.

²³ Sheet 9. Note that the objections are not independent.

²⁴ Sheet 11.

OECD Country	S&P Sovereign Rating	Risk Weight (Basel I)	Risk Weight (Basel II)
Turkey 	B-	0%	100%
Mexico 	BBB+	0%	50%
Korea 	A	0%	20%
Germany 	AAA	0%	0%

Ratings as of Sept. 2001

Sheet 31 shows how banks try to minimize capital requirements:

- «Just like you can buy life insurance, banks can protect themselves against defaults by buying Credit Default Swaps (CDS);²⁵
- This exposes them to counterparty risk however;
- They can also get rid of bad loans/risky exposure (even CDS) by repackaging assets in CDOs which are housed off balance-sheet.»

Under the heading “Regulatory arbitrage” sheet 33 reads:

- «In hindsight, SIV’s enabled banks to house risky assets outside the scope of Basel rules;²⁶
- Because of the diversification coming from the pooling of risky assets, the tranches issued had higher credit ratings;
- Limited provisions were made for the liquidity clause banks had with their SIV’s especially if they issued short-term assets (ABCP);²⁷
- Combined, this reduced regulatory capital to be held and enabled more risk-taking.»

Sheets 36 and 37 discuss problems with the value-at-risk-approach (VaR) for the management of market risk.

The idea of market discipline was that the market requires banks to behave properly. The market can only do this (in a reasonable way) if the banks are transparent in all essential respects, and if supervision works properly.²⁸ Under the heading “Market Discipline” sheet 45 says the following about this condition:

«The third pillar greatly increases the disclosures that the bank must make. This is designed to allow the market to have a better picture of the overall risk position of the bank and to allow the counterparties of the bank to price and deal appropriately.»

The last sheets present some evaluative remarks.

²⁵ In important respects, the comparison is false. For life insurances statistics really apply. Not so for the things “insured” by CDS. The value of assets insured by CDS probably vary in a correlated fashion. The orders of magnitude of the amounts of money involved differ enormously. Combined with correlations they may more easily bring the insurer (CDS issuer) in difficulties. Already by the end of 2008 this could have been understood, given the difficulties of the monolines.

²⁶ SIV= structured investment vehicle. It is a corporation in the sense of a body formed and authorized by law to act as a single person.

²⁷ ABCP= asset backed commercial paper.

²⁸ At least the note on supevision is made by the present author.

Not What They Had in Mind. A History of Policies that Produced the Financial Crisis of 2008. By Arnold Kling, September 2009.

Available on the internet as a pdf file.

On p. 40 Pinto refers to this book for an excellent discussion of the impact of the Basel Accords on the financial crisis.²⁹

Chapter 6 on pp. 22/24 and following discuss capital regulation. Among other things the chapter shows that the risk increasing effects of Basel had been foreseen by the Shadow Regulatory Committee, a group of economists offering independent opinion on bank regulation. It also shows that publications of Fed employees show that these employees understood that regulatory arbitrage took place. Kling presents their reasons for considering this positive:

«In essence, the author argued:

- The Basel risk buckets were arbitrary.
- The risk classifications may have been overly conservative for certain types of loans.
- Regulatory Capital Arbitrage (RCA) enabled banks to reduce the capital requirements for these loans.
- RCA was difficult to stop politically.
- RCA did not necessarily harm safety and soundness if it kept banks competitive in markets to make low-risk loans.

What is striking about the paper is the degree to which the regulator shows understanding and support for the banks' use of securitization and off-balance-sheet entities to reduce capital requirements. Because we know what happened subsequently (the paper was published in 2000), reading the Jones paper is like watching a movie in which we see how a jailer becomes sympathetic to the plight of a prisoner, while we know that eventually the prisoner is going to escape and go on a vicious crime spree.»

“The author”, Jones presumably, gives an excellent example of wishful thinking. Several arguments can be turned around, and the political “argument” is no argument at all.

The Wikipedia (26/3/12) about BCBS.

«[The Basel Committee on Banking Supervision (BCBS)] was formed in response to the messy liquidation of a Cologne-based bank (Herstatt Bank) in 1974. On 26 June 1974, a number of banks had released Deutsche Mark (German Mark) to the Bank Herstatt in exchange for dollar payments deliverable in New York. On account of differences in the time zones, there was a lag in the dollar payment to the counter-party banks, and during this gap, and before the dollar payments could be effected in New York, the Bank Herstatt was liquidated by German regulators.

This incident prompted the G-10 nations to form towards the end of 1974, the Basel Committee on Banking Supervision, under the auspices of the Bank of International Settlements (BIS) located in Basel, Switzerland.»

«[This] Committee consisted of representatives from central banks and regulatory authorities of the Group of Ten countries plus Luxembourg and Spain. Since 2009, all of the other G-20 major economies are represented, as well as some other major banking locales such as Hong Kong and Singapore. (See the Committee article for a full list of members.)

The committee does not have the authority to enforce recommendations, although most member countries as well as some other countries tend to implement the Committee's policies. This means that recommendations are enforced through national (or EU-wide) laws and regulations, rather than as a result of the committee's recommendations- thus some time may pass between recommendations and

²⁹ Pinto *Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study*. Dated 14/8/10. (Pdf file created and modified 12/9/10).

implementation as law at the national level.»

2. Ben Shalom Bernanke.

Table of contents of this appendix.

- Summary and conclusions.
- Biographical information.
- Bernanke in the film *Inside job*.
- The Morehouse speech of 14 April 2009.
- The hearing of Bernanke by the FCIC on 2 September 2010.
- Bernanke in the FCIC-report.

Summary and conclusions.

1. Bernanke was an economist, educated at the best universities of the USA. He was awarded a PhD, and became chairman of the economics faculty of Princeton University.
2. He was specialized in depression and crises.
3. But did not understand that the financial system is unstable.
4. He made a fatal error of judgment regarding the GAO reports of 1994-1999.
5. Was governor at the Fed as of 2002.
6. Was chairman of the Fed as of 1 February 2006.
7. In answer to a question of the FCIC asserted under oath that the Fed is not responsible for systemic risk.
8. Before the crises he ignored or grossly underestimated warnings.
9. His conduct during the crisis was unprepared and inconsistent.
10. In the light of his other conduct and assertions, his explanation of the management of the Lehman crisis lacks credibility.
11. Bernanke speaks as if he impersonates the Fed. He shows no awareness of the fact that he is head of an organization with more than 1500 employees with their own and in general different competencies and thoughts.
12. The facts indisputably show Bernanke to be insufficiently honourable and competent.
13. (Purported) Academic performance is not a reliable indicator of performance on the job.
14. On his way up Bernanke was never evaluated correctly. Those who recommended him either lacked integrity or competence, or both.

Biographical information.

The following biographical material is based on the Wikipedia page Bernanke of 6/3/12. The text has been edited slightly; sometimes on the basis of simple but not 100.00% certain assumptions: the wiki-page is not consequent as regards methods. Some dates are missing for example.

«Date of birth: December 13, 1953

Place of birth: Augusta (Georgia, USA)

Education:

Bernanke attended Harvard University, where he lived in Winthrop House with the future CEO of Goldman Sachs, Lloyd Blankfein, and graduated with a Bachelor of Arts in economics summa cum laude in 1975.

He received the doctor of philosophy degree in economics from the Massachusetts Institute of Technology in 1979 after completing and defending his dissertation, *Long-Term Commitments, Dynamic Optimization, and the Business Cycle*. Bernanke's thesis adviser was the future governor of the Bank of Israel, Stanley Fischer, and his readers included Irwin S. Bernstein, Rudiger Dornbusch, and Robert Solow of MIT and Peter Diamond and Dale Jorgenson of Harvard.

1979-1985: Bernanke taught at the Stanford Graduate School of Business.

?-?: visiting professor at New York University

?-1/7/05: tenured professor at Princeton University in the Department of Economics.

1996-2002: tenured professor at Princeton University and chairman of the department of economics. In September 2002 he went on public service leave.

2002-2005: member of the Board of Governors of the Federal Reserve System.
21/5/05-31/1/06 chairman of Bush's Council of Economic Advisers.
1/2/06->11/12/12: chairman of the Fed. Appointed by G W Bush, and 1/2/10 re-appointed by Obama.»

[At the Fed] «he outlined the Bernanke Doctrine and first spoke of the Great Moderation, where he postulated that we are in a new era, where modern macroeconomic policy has decreased the volatility of the business cycle. [This was the text of the wiki-page on 6/3/12. On 24/7/12 it said:] [...] “the Great Moderation”—the theory that traditional business cycles have declined in volatility in recent decades through structural changes that have occurred in the international economy, particularly increases in the economic stability of developing nations, diminishing the influence of macroeconomic (monetary and fiscal) policy.»

«In 2002, following coverage of concerns about deflation in the business news, Bernanke gave a speech about the topic. [The speech was entitled: Deflation: Making Sure "It" Doesn't Happen Here]. In that speech,³⁰ he mentioned that the government in a fiat money system owns the physical means of creating money.³¹ Control of the means of production for money implies that the government can always avoid deflation by simply issuing more money. He said "The U.S. government has a technology, called a printing press (or today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at no cost." (He referred to a statement made by Milton Friedman about using a "helicopter drop" of money into the economy to fight deflation.) Bernanke's critics have since referred to him as "Helicopter Ben" or to his "helicopter printing press." In a footnote to his speech, Bernanke noted that "people know that inflation erodes the real value of the government's debt and, therefore, that it is in the interest of the government to create some inflation." For example, while Greenspan publicly supported President Clinton's deficit reduction plan and the Bush tax cuts, Bernanke, when questioned about taxation policy, said that it was none of his business, his exclusive remit being monetary policy, and said that fiscal policy and wider society related issues were what politicians were for and got elected for.»

About “the Great Moderation” the FCIC-report says:

«“Recessions have become less frequent and less severe,” said Ben Bernanke, then a Fed governor, in a speech early in 2004. “Whether the dominant cause of the Great Moderation is structural change, improved monetary policy, or simply good luck is an important question about which no consensus has yet formed.”»

So maybe it was simply good luck. Note that one could only talk this kind of nonsense in 2004 if one ignored the reports with warnings, if one had no idea of the instabilities in the system (and therefore of previous crises), and no idea of the notion that small causes may have large effects.

In his hearing by the FCIC on 2/9/10 Bernanke nevertheless claims competence in the field of crises:

«WITNESS BERNANKE: So first of all there was of course, we were trying to arrange a private takeover over the weekend, and we wanted that to be done on the best possible terms that we could. And for that reason there was some benefit I think in the weeks prior to Lehman to keep our hands, you know, a little bit up to the vest in terms of what we were willing and able to do. So there was some of that going on in the week prior to the Lehman weekend. That being said, let me just state this as unequivocally as I can. As you know, **before I came to the Fed Chairmanship I was an**

³⁰ For the source see (also) FCIC p. 85/113.

³¹ Fiat money is currency which derives its value from government regulation or law. (From Wikipedia 24/6/15).

academic, and I studied for many years the Great Depression, financial crises, and this is my bread and butter. And I believed deeply that if Lehman was allowed to fail, or did fail, that the consequences for the U.S. financial system and the U.S. economy would be catastrophic. And I never, at any time, wavered in my view that we should do absolutely everything possible to prevent the failure of Lehman.»³²

But Lehman was allowed to fail nevertheless. Bernankes report of the decision making with respect to Lehman does not seem to be consistent, tenable, and credible. It seems permeated with convenient hindsight arguments. Bernanke had become a member of the Board of Governors of the Fed in 2002. But in the record of the Fed of the last decade no indication could be found of any of his insights or fears.

Bernanke in the film *Inside job*.

At about 55 minutes in the documentary, at the beginning of Part III, Bernanke is shown as saying in July 2005 that there has never been a nationwide fall in house prices. He refuses to consider the eventuality.

He declined to be interviewed for the film.³³

The Morehouse speech of 14 April 2009.

On 14/4/09 Bernanke gave a speech at Morehouse College, Atlanta, Georgia. He answered four questions:

1. How Did We Get Here?
2. What Is the Fed Doing to Address the Situation?
3. Does the Fed's Aggressive Response Risk Inflation Down the Road?
4. Why Did the Fed and the Treasury Act to Prevent the Bankruptcy of Some Major Financial Firms?

His answer to question 1 is an explanation of the (subprime) crisis:

«Saving inflows from abroad can be beneficial if the country that receives those inflows invests them well. Unfortunately, that was not always the case in the United States and some other countries. Financial institutions reacted to the surplus of available funds by competing aggressively for borrowers, and, in the years leading up to the crisis, credit to both households and businesses became relatively cheap and easy to obtain. One important consequence was a housing boom in the United States, a boom that was fuelled in large part by a rapid expansion of mortgage lending. Unfortunately, much of this lending was poorly done, involving, for example, little or no down payment by the borrower or insufficient consideration by the lender of the borrower's ability to make the monthly payments. Lenders may have become careless because they, like many people at the time, expected that house prices would continue to rise- thereby allowing borrowers to build up equity in their homes- and that credit would remain easily available, so that borrowers would be able to refinance if necessary. Regulators did not do enough to prevent poor lending, in part because many of the worst loans were made by firms subject to little or no federal regulation.

Mortgage markets were not the only ones caught up in the credit boom. The large flows of global saving into the United States drove down the returns available on many traditional long-term investments, such as Treasury bonds, leading investors to search for alternatives. To satisfy the enormous demand for investments both perceived as safe and promising higher returns, the financial

³² Text was bolded by the present author.

³³ The film was a one time only event. As opposed to interviews with newspapers and other periodicals. The last group has an interest in preserving good relations, a filmmaker has not. Indeed, most of the people responsible for the subprime crisis refused to be interviewed for *Inside job*.

industry designed securities that combined many individual loans in complex, hard-to-understand ways. These new securities later proved to involve substantial risks- risks that neither the investors nor the firms that designed the securities adequately understood at the outset.

The credit boom began to unravel in early 2007 when problems surfaced with subprime mortgages- mortgages offered to less-creditworthy borrowers- and house prices in parts of the country began to fall. Mortgage delinquencies and defaults rose, and the downturn in house prices intensified, trends that continue today. Investors, stunned by losses on assets they had believed to be safe, began to pull back from a wide range of credit markets, and financial institutions- reeling from severe losses on mortgages and other loans- cut back their lending. The crisis deepened last September, when the failure or near-collapse of several major financial firms caused many financial and credit markets to freeze up. Stock prices fell sharply as investors lost confidence in the financial sector and became gloomy about economic prospects. Declining stock values, a teetering financial system, and difficulties in obtaining credit triggered a remarkably rapid and deep contraction in global economic activity and employment, a contraction that has persisted through the first months of 2009. Both the ongoing financial crisis and economic contraction have posed major challenges to economic policymakers.»³⁴

In his answer to the second question Bernanke confirms the responsibility of the Fed for the stability of the financial system, though in ambiguous and misleading terms:

«Those challenges bring me to my second question: What has the Federal Reserve been doing to address the economic and financial crisis?

The Fed's mandate from the Congress is to promote maximum sustainable employment and stable prices. In addition, the Fed is expected to contribute to financial stability by acting to contain financial disruptions and prevent their spread outside of the financial sector. Thus, we have been serving as a first responder to the crisis.»³⁵

“The mandate is to promote”, vs. “the Fed is expected to”. This is a rather strange way of presenting and paraphrasing equivalent duties, see the first quote of the next section.

The last “thus” in the quote is misleading. Contrary to what the “thus” suggests, the Fed’s conduct in (at least) 1990-2008 was not guided by its duties, but mainly by wrongly arrogated dogmas. The crisis was very very bad for employment. In other words: both goals required prevention of the crisis. It should have been a first anticipator and preventor. It should not have been necessary “to serve as a first responder”.³⁶

The hearing of Bernanke by the FCIC on 2 September 2010.

According to the agenda’s of the hearings and the transcripts, Bernanke was supposedly questioned about “Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and The Role of Systemic Risk in the Financial Crisis”.

A. Proof of the assertion that the Fed had the duty to contain systemic risk.

In the hearing, Bernanke denies the responsibility of the Fed for containing systemic risk. This means that the chairman of the Fed either lies, or doesn’t know the duties of the organization for which he is responsible.

³⁴ The first paragraph is copied from the quote by Wallison in FCIC, p. 485/513. (Wallison speaks of Morehead, the text of the speech of Morehouse). At the time when this was copied, the speech was not available to the present author. The two other paragraphs were included later, directly from the file of the speech. The text of the speech can be found in the dossier, under 20090414.

³⁵ From the same speech.

³⁶ Whatever that may mean, and assuming it to be true, which seems open to doubt. See the Chronology and the FCIC report.

In the booklet *The Federal Reserve System- Purposes & functions* of 2005, the duties of the Fed are described as follows:

«Today, the Federal Reserve's duties fall into four general areas:

- conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system»³⁷

«The Federal Reserve System is considered to be an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive branch of government. The System is, however, subject to oversight by the U.S. Congress. The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government; therefore, the description of the System as “independent within the government” is more accurate.»³⁸

P. 5 of the Annual report 2006 gives an *Overview of the Federal Reserve*. It opens as follows:

«As the nation's central bank, the Federal Reserve System has numerous, varied responsibilities:

- a. conducting the nation's monetary policy by influencing monetary and credit conditions in the economy;
- b. supervising and regulating banking institutions, to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers;
- c. maintaining the stability of the financial system and containing systemic risk that may arise in financial markets;
- d. providing financial services to depository institutions, the U.S. government, and foreign official institutions.»³⁹

N.B. Bernanke himself submitted this Annual report in June 2007 to the Speaker of the House of Representatives.

B. Denial of this fact by Bernanke, and statements of his showing (lack of) understanding of systemic risk.

The quotes are from the official transcript of the hearing on 2/9/10.⁴⁰ The FCIC does not correct Bernanke. Not in the hearing and not in its report.

«CHAIRMAN ANGELIDES: [...] And one of the things that struck me as we reviewed our case studies is the failure of regulator supervisors to identify and contain systemic risk in too-big-to-fail institutions before the crisis hit. [...] Let me just ask you: Why such a big miss? And I want to put this in context, that some of your folks who have spoken to us here, like Mr. Alvarez and Mr. Cole, whom we interviewed, talked about the fact that, well, gee, we had- and I think it was maybe Mr. Cole who

³⁷ P. 1 of *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005.

³⁸ Pp. 2-3 of *The Federal Reserve System: Purposes and Functions*.

³⁹ For the purpose of easy reference, the dots in the original have been replaced by the letters a-d.

⁴⁰ This can be found on the FCIC website, and in the dossier under 20100902.

used the word "myopic look". "We looked at safety and soundness." But shouldn't have systemic risk been part of a safety and soundness regime, even in the 2000 period? Was this a substantial miss? How fundamental was the failure of proper supervision to the metastasizing of this problem?

WITNESS BERNANKE: [...] Now that being said, it is certainly true that the system did not sufficiently anticipate the systemic risks associated with these institutions. That was, frankly, partly due to the regulatory structure that was given to us by Congress. As you had mentioned, our charge was to focus on the safety and soundness of individual institutions. There was no provision, no authority to address systemic risk in an institution. In fact, when the Fannie and Freddie law was redone and there was additional regulation put on Fannie and Freddie, the Congress explicitly said that you are not allowed to consider systemic risks when you are looking at the safety and soundness of this institution. Now- and furthermore, there was no-

CHAIRMAN ANGELIDES: Was that part of the Gramm-Leach-Bliley-

WITNESS BERNANKE: No, that was part of the Fannie and Freddie's, of the law that created the FHFA, the new institution.⁴¹ And furthermore, there was no- there was no collective assignment, as there is under the more recent reform legislation, to look for systemic risks. Many of the risks that occur obviously are interactions of the size and complexity of individual firms, but features of the entire system.»

«WITNESS BERNANKE: [...] But what happened here was that the financial system had these vulnerabilities and weaknesses, which I talked about in my longer testimony, and what was a relatively small factor in the scheme of things triggered these weaknesses and led to a much bigger crisis. And so what I did not recognize when I thought and said that this crisis was contained was that it was based on my view that the losses were going to be, you know, manageable. What I did not recognize was the extent to which the system had flaws and weaknesses in it that were going to amplify the initial shock from subprime and make it into a much bigger crisis.

COMMISSIONER HOLTZ-EAKIN: And so if we then move to the crisis, I want to talk a little bit about too-big-to-fail institutions in both the history we have to investigate, and then going forward. So as it sort of bleeds into the broader financial markets, what institutions are you watching carefully? And by what criteria are you selecting the ones that you really are worried about?

WITNESS BERNANKE: You mean today?

COMMISSIONER HOLTZ-EAKIN: At the time. You know, as the crisis begins to unfold, what was the nature of the Fed's criteria for identifying institutions that they needed to be on watch against?

WITNESS BERNANKE: Well, again, to begin with it's important to remember that the Fed was not a systemic regulator at that time. We had some very specific responsibilities for bank holding companies, principally. We did not have responsibilities for AIG, or for the investment banks, or for Fannie and Freddie, or for mortgage bankers. So many of the areas where there were problems, we simply did not have an ongoing authority or supervisory presence.»

The bold assertions are incompatible with the duties as formulated in the Purposes & functions publication and the Annual reports. If Bernankes assertions about the Fed's supposed lack of authority to contain systemic risk were correct, he and/or the Fed should have informed Congress of its problems. Systemic risk clearly endangers the "the safety and soundness of the nation's banking and financial system", which the Fed is called upon to protect according to its duty b. So Bernanke and/or the Fed should at least have warned Congress for the danger this purported lack of authority implies. They Fed did no such things. In fact, what Bernanke says is simply untrue.

As argued in the Analysis, chapter 7B, the essential part of Bernankes remarks is untrue and misleading. Bernanke fails to reflect on what he could have done. The point is that the Fed (and Bernanke) didn't do what it could do and should have done. Responsibilities for AIG and the GSE's were not needed for prevention of the crisis. If Bernanke believes what he says, he simply doesn't understand the system and systemic risks. And leading an organization like the Fed.

⁴¹ Only created by HERA, signed into law by G. W. Bush on 30/7/08. See for example FHFA Strategic Plan 2009-2014 p. 4. (In the dossier).

The following quotes from the beginning of the hearing, where Bernanke is questioned by chairman Angelides, supplement and specify the above remarks:

«While potential subprime losses were large in absolute terms, judged in relation to global financial markets they were not large enough to account for the magnitude of the crisis on their own. Instead, the system's pre-existing vulnerabilities, together with gaps in the government's crisis response toolkit, are the primary explanation of why the crisis has such devastating effects on the global financial system and the broader economy.»

«Many of the key vulnerabilities of the financial system were the product of private sector arrangements, including, as just noted, overdependence of many financial institutions on an unstable short-term funding, poor risk management, excessive leverage of some households and firms, misuse of certain types of derivative instruments, mismanagement of the mortgage securitization process, and other problems. But important vulnerabilities also existed in the public sector, both in the United States and in other countries. These vulnerabilities included both gaps in the statutory framework, and flaws in the performance of regulators and supervisors. Important examples of statutory gaps were the absence of effective authority to regulate and supervise some important types of shadow banks such as special-purpose vehicles, and broker-dealer holding companies, the lack of authority or responsibility to take actions to limit systemic risks, and the absence of a legal framework under which failing systemically critical nonbank financial firms could be resolved in an orderly way.»

Don't forget that this is said by the person who was on the board of the Fed as from 2002, and chairman since 2006. Should he not have known and understood these things much earlier? Should he not have noted them in his annual reports, and done something about it? Why was nothing done to fill the gaps? In fact, most of what he says can be found in the GAO reports of 1994-1999. But all its recommendations warnings were rejected as being unnecessary.

In combination with these remarks and an earlier quote, the following shows that Bernanke doesn't understand systemic risk. He is still thinking in terms of separate institutions, and not in terms of processes and coherent systems of institutions.

«COMMISSIONER HENNESSEY: Good. Systemic risk. You hear a lot of people talk about it. I haven't heard a precise definition, other than people usually say it means risk to the system, which-
(Laughter.)

COMMISSIONER HENNESSEY: -doesn't- and I understand that there's always going to be discretion involved, and that it's been much more of an art than a science.⁴² Are there efforts underway, or has anyone done any good work in trying to turn this from an art to science to eventually some sort of engineering where you can measure this and analyze systemic risk?

WITNESS BERNANKE: Yes. There's right now an active academic research literature looking at some of these things, trying to identify, for example, what some of the criteria are; how big; how interconnected, those sorts of things. There is some criteria involving things like correlation. You know, how correlated is the stock of company X with other shares of other companies, and what does that say about its systemic importance, and things of that sort. So there is an academic literature underway. The Federal Reserve has to set up a set of rules that will govern how we recommend to the oversight council which companies are to be treated as systemically critical for the purposes of special oversight. And so we're going to have to write a rule which puts down on paper in a way that is legally sensible what are the criteria we're looking at. So to some extent it is going to ultimately remain subjective, and I think the systemic criticality of any individual firm depends on the environment. So our decisions vis-a-vis some of the firms we addressed might have been different in a more calm environment. So the overall economic and financial environment also matters, not just the characteristics of the firm. But we are cognizant that we need to be more specific. And as I said, there is a literature to draw on,

⁴² Of course, systemic risk is much more science than art, even if at present the science is in a very bad shape. See the sections on education and science in chapter 7B. Even if the course of events due to disruptions of unstable systems is only predictable in a crude sense.

and we have a project at the Fed right now trying to write this rule that will govern our recommendations.»

Of course, the first half of the “reply” is no more than empty tattle. To fill time, and to tire the Commission and the public. The second half is only slightly better. What does he mean: the environment, a calm environment? The GAO reports of 15 years earlier show very much more, and even true and useful understanding. Bernanke represents a big step backwards.

Note that if you cannot properly analyze a system yourself, you can still accept the results of someone who can.⁴³ The Fed didn’t. Worse: it arrogantly rejected the GAO proposals. Bernanke seems to be unaware of his lack of basic knowledge and competence.

The following remarks are quoted because they may shed some more light on Bernankes understanding of the crisis, its causes, and the role of supervision:

«**WITNESS BERNANKE:** I think it is very, very important. As I said before, the most important lesson of this crisis is we have to end too-big-to-fail.»

«**CHAIRMAN ANGELIDES:** [...] When you first testified to Congress I believe after the failure of Lehman, you had essentially said in your testimony- and I’m shortening this up- that Lehman was not rescued essentially because the market, the participants, had had time to prepare in the wake of market developments. And I say this, as I said yesterday, it seems to me the decision to allow Lehman to fail was a conscious policy decision.»

«**WITNESS BERNANKE:** [...] One of the sources of the panic was the subprime lending, which was something that was done both by banks and by nonbanks, and we all share some responsibility for that.»

«**WITNESS BERNANKE:** [...] So I believe very strongly that it wasn't subprime lending, per se- although obviously that was a bad thing and caused significant problems- but rather it was the fact that the system as a whole had structural weaknesses.»

Chapter 6 shows that this could and should have been known and understood since the LTCM crisis of 1998, but that supervisors and governments refused to learn the lessons. They haughtily ignored the warnings of the GAO and rejected its recommendations.

Bernanke’s denial of a Fed mandate contradicts an assertion of Greenspan in his FCIC-hearing on 7/4/10:

«**MR. GREENSPAN:** Yeah, statutorily we have a number of- we had a number, and still do, have a number of different authorities. Fundamentally, it's monetary policy, and that's what a central bank does. We had supervision and regulation as secondary but major issue. And we even, as we specify in the -- some of our written documents, the third one was systemic risk. So there's a very broad mandate that the Federal Reserve has, [...]»

It follows that at least one of them is lying under oath.

Bernanke in the FCIC-report.

(For this section the FCIC-report was screened in full).

N.B. There also was a closed-door session with the FCIC, on 17/11/09.⁴⁴

According to the FCIC, Bernanke and others thought that the course of events was manageable:

⁴³ One may be able to understand and judge someone else’s explanation without being able to generate an explanation oneself.

⁴⁴ FCIC p. 553/581, note 4.

«Although government officials knew about the deterioration in the subprime markets, they misjudged the risks posed to the financial system. In January 2007, SEC officials noted that investment banks had credit exposure to struggling subprime lenders but argued that “none of these exposures are material.” The Treasury and Fed insisted throughout the spring and early summer that the damage would be limited. “The impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained,” Fed Chairman Ben Bernanke testified before the Joint Economic Committee of Congress on March 28. That same day, Treasury Secretary Henry Paulson told a House Appropriations subcommittee: “From the standpoint of the overall economy, my bottom line is we’re watching it closely but it appears to be contained.”»⁴⁵

One wonders what the opinions of Bernanke and Paulson were based on. Trust in containability is incompatible with understanding of the concept of “unstable system”, and crashes like those of 1929 and LTCM.⁴⁶

«Throughout the summer of 2007, both Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson offered public assurances that the turmoil in the subprime mortgage markets would be contained. When Bear Stearns’s hedge funds, which were heavily invested in mortgage-related securities, imploded in June 2007, the Federal Reserve discussed the implications of the collapse. Despite the fact that so many other funds were exposed to the same risks as those hedge funds, the Bear Stearns funds were thought to be “relatively unique.”»⁴⁷

The same question: what were the opinions of Bernanke and Paulson based on? Taking into consideration that all of Bernankes quoted assertions were ill-founded, it seems probable that in the last analysis his comforting opinions were just wishful thinking.

Bernanke was informed personally, timely and emphatically about the large number of bad mortgages, and warned about its danger:

«To community activists and local officials, however, the lending practices were a matter of national economic concern. Ruhi Maker, a lawyer who worked on foreclosure cases at the Empire Justice Center in Rochester, New York, told Fed Governors Bernanke, Susan Bies, and Roger Ferguson in October 2004 that she suspected that some investment banks—she specified Bear Stearns and Lehman Brothers—were producing such bad loans that the very survival of the firms was put in question. “We repeatedly see false appraisals and false income,” she told the Fed officials, who were gathered at the public hearing period of a Consumer Advisory Council meeting. She urged the Fed to prod the Securities and Exchange Commission to examine the quality of the firms’ due diligence; otherwise, she said, serious questions could arise about whether they could be forced to buy back bad loans that they had made or securitized.»⁴⁸

«Consumer advocates kept up the heat. In a Fed Consumer Advisory Council meeting in March 2006, Fed Governors Bernanke, Mark Olson, and Kevin Warsh were specifically and publicly warned of dangers that non-traditional loans posed to the economy. Stella Adams, the executive director of the North Carolina Fair Housing Center, raised concerns that non-traditional lending “may precipitate a downward spiral that starts on the coast and then creates panic in the east that could have implications on our total economy as well.”

At the next meeting of the Fed’s Consumer Advisory Council, held in June 2006 and attended by Bernanke, Bies, Olson, and Warsh, several consumer advocates described to the Fed governors alarming incidents that were now occurring all over the country. Edward Sivak, the director of policy and evaluation at the Enterprise Corp. of the Delta, in Jackson, Mississippi, spoke of being told by mortgage brokers that property values were being inflated to maximize profit for real estate appraisers and loan originators. Alan White, the supervising attorney at Community Legal Services in

⁴⁵ FCIC p. 234/262.

⁴⁶ This remark is from the present author.

⁴⁷ FCIC p. xxi/21.

⁴⁸ FCIC p. 16/44.

Philadelphia, reported a “huge surge in foreclosures,” noting that up to half of the borrowers he was seeing with troubled loans had been overcharged and given high interest rate mortgages when their credit had qualified them for lower-cost loans. Hattie B. Dorsey, the president and chief executive officer of Atlanta Neighborhood Development, said she worried that houses were being flipped back and forth so much that the result would be neighborhood “decay.” Carolyn Carter of the National Consumer Law Center in Massachusetts urged the Fed to use its regulatory authority to “prohibit abuses in the mortgage market.”⁴⁹

With the support of Bernanke and Bies (and of the Board of Governors of the Fed) this resulted in “guidance”:

«More than a year after the OCC had began discussing the guidance, and after the housing market had peaked, it was issued in September 2006 as an interagency warning that affected banks, thrifts, and credit unions nationwide. Dozens of states followed, directing their versions of the guidance to tens of thousands of state-chartered lenders and mortgage brokers.»⁵⁰

Obviously this is a good example of (far) too little, (far) too late.

⁴⁹ FCIC pp. 21-2/49-50.

⁵⁰ FCIC p. 21-2/49-50.

3. BIS-reports 2003-2009.

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- Abbreviations.
- Conclusions.
- BIS according to BIS.
- January 2003: Report on Credit risk transfer. (BIS-CGFS-20).
- March 2005: Joint Forum on Credit Risk Transfer.
- January 2006: Housing finance in the global financial market. (BIS-CGFS 26).
- June 2006: BIS AR 2006.
- July 2008: Joint Forum on Credit Risk Transfer: Developments from 2005 to 2007.
- June 2009: BIS AR 2009.

Abbreviations.

AR= annual report

BIS= Bank for international settlements

CGFS= Committee on the Global Financial System.

CRT= credit risk transfer.

FCIC= Financial crisis inquiry commission (USA).

Conclusions.

1. The role of BIS in the run up to the financial crisis has been evaluated on the basis of the following reports:
 - CGFS 20: Credit risk transfer (CRT, January 2003);
 - Joint Forum CRT (March 2005);
 - CGFS 26: Housing finance in the global financial market (January 2006);
 - BIS AR 2006 (June 2006);
 - Joint Forum CRT (July 2008);
 - BIS AR 2009 (June 2009).
2. The reports can be characterized as follows:
 - CGFS 20 on CRT (2003). Notes important risks and obscurities, but handles them unprofessionally and irresponsibly. Makes no recommendations, but restricts itself to outlining issues;
 - Joint Forum CRT (2005). Gives a defective analysis. Implicitly, and only implicitly, shows an utterly unacceptable and very risky state of affairs in and among market participants. Presents valuable recommendations. However, implementation is entirely noncommittal, and governments are not addressed;
 - Housing finance (2006). Lacks involvement and shows irresponsible wishful thinking. Makes very soft and non-binding recommendations;
 - BIS AR 2006 (2006). Inadequate as an annual report, because it ignores a large part of the activities of central banks. Analytically it is inadequate too, because of restriction to global/macro aspects, without proper regard for the (potential) influence of micro on macro;
 - Joint Forum CRT (July 2008). There is no evaluation of the implementation of recommendations of the 2005 report. The earlier recommendations are supplemented with a few new ones. In spite of recent events there is no substantial change with respect to 2005. No vigorous action. Nothing was learned;
 - BIS AR 2009 (2009). Contains useful information about the crisis, but is analytically defective. Like the former annual reports, this one is written as if BIS has perfect knowledge and understanding. There is no trace of awareness of having failed. There is no sign of correction.

3. None of the BIS reports mentions the GAO reports of 1994-1999, acknowledges the correctness of its analyses, and supports its recommendations. Even though there is much overlap in subject matter;
4. The Housing finance report (CGFS 26) mentions neither OFHEO nor “systemic risk”;⁵¹
5. In spite of overlapping duties, the annual reports of BIS do not mention specific or groups of supervisors, shared opinions or generally supported recommendations;
6. The reports suggest that they tell the one and only true story. They suggest that no other interpretations, points of view, and opinions are possible and actually exist;
7. Both ethics and risk management require reports like those of financial supervisors to contain all relevant opinions, judgments etcetera, together with arguments for and against.⁵² Publishing a single (compromise) opinion, conclusion, etcetera is a demonstration of lack of openness. It is unrealistic, misleading, and potentially dangerous;
8. As regards the BIS reports it would seem that deviating argumentation and opinions were not judged on their intrinsic merits, but ignored or left unmentioned for unexplained reasons, or modified in a compromise. This is incompatible with professionalism and the mission statement of BIS;⁵³
9. To a certain extent the reports can be understood as a compromise between material and dogmatic or political motives. To a certain extent, because such compromising is contrary to BIS’ mission statement;⁵⁴
10. Some reports frequently express uncertainty. The supervisors do not conclude however that this requires risk management by themselves. That is: by the supervisors. In this regard, they actually assume certainty (about safety, adequacy of self-regulation, etcetera);
11. What BIS calls annual reports are no annual reports. They do not give an account of what BIS did in the given year. Instead they present macro-economical reviews, similar to those found in the “annual reports” of most other supervisors, IMF and OECD. A (too) short annual report can be found in the appendices of the “annual report”;
12. The reports can only be explained as results of insufficient integrity and professionalism, inadequate management (including absent coordination), and compromises with dogmatic and/or stupid authorities.⁵⁵ It is not a matter of lack of information and underestimation of risk, but of intolerance for opinions which differ from those of the top, and refusal to reason and discuss on the basis of arguments. And of the subservience and cowardice of those who understand that this is an unprofessional and unethical practice, and increases the systemic risks;
13. The reports show that the reality of BIS is incompatible with its mission, and that the mission statement is misleading. Examples:
 - “Excellence”: because of very unprofessional and unexplained conduct in vital matters this is plain nonsense;
 - “BIS aims at promoting monetary and financial stability”: Although “promoting” is elastic, and BIS did promote a little bit, it did not do by far what it could and should have done;
 - “BIS staff emphasize highest ethical standards”: the reports show a complete lack of openness,⁵⁶ and actually are misleading. High ethical standards require openness, for example about compromises;
 - Failures of BIS are not acknowledged, and nothing is done to show the public that the defects indicated in the present conclusions will be repaired, and integrity and competence fundamentally improved.

⁵¹ The other reports have not been checked for these terms.

⁵² Unless convincingly refuted of course.

⁵³ It is incompatible with the “highest ethical norms”: other opinions and people are not respected. Due care requires openness and respect for other opinions and arguments, except when it can be (rigorously) proven that they are wrong. In economics this is rarely possible, if at all.

⁵⁴ In other words: the mission statement omits mention of norms and values which in practice are more important than those mentioned.

⁵⁵ Of course this can all be seen as management failures (too).

⁵⁶ In this study openness means: (timely) reporting everything that may be of importance in the given context. It is a form of completeness, and the opposite of secrecy.

14. Instead of working in accordance with its mission statement, BIS seems to have worked under the inviolable boundary condition, that nothing is to be said or done that is incompatible with the policy of any of the major supervisors (especially the US Fed). In other words: BIS operated as a political organization;
15. If BIS would consider its mission statement as no more than a noncommittal ideal, and that it cannot and need not respect the norms and values it incorporates, for example because compromises have to be made with central banks and/or others beyond its control,⁵⁷ then it could and should say so in the mission statement. Otherwise it gives rise to the suspicion that the mission statement is primarily meant to mislead the public;
16. The recommendations in the reports are noncommittal. There is never a sense of urgency. Members, participants or supervisors are not asked to report progress. Neither is implementation monitored by BIS (CGFS);
17. None of the reports informs outsiders in a clear way. Texts often are political and/or cryptic.

BIS according to BIS.

The following is quoted from AR 2006.

«The BIS is an international organization that fosters international monetary and financial cooperation and serves as a bank for central banks. Its head office is in Basel, Switzerland, and it has two representative offices, one in the Hong Kong Special Administrative Region of the People's Republic of China and one in Mexico City. The Bank currently employs 554 staff from 49 countries.»⁵⁸

«BIS Mission Statement

Excellence in service to central banks and financial authorities

The BIS

- Aims at promoting monetary and financial stability
- Acts as a forum for discussion and cooperation among central banks and the financial community
- Acts as a bank to central banks and international organizations

BIS staff emphasize

- excellence in performance
- highest ethical standards
- professional discretion»⁵⁹

The analyses of the reports show that the reality of BIS is incompatible with these norms and values. The following concerns the organization of BIS as an office:

«The Bank has three main departments: the Monetary and Economic Department, the Banking Department and the General Secretariat. These are supplemented by the Legal Service, the Compliance, Internal Audit and Risk Control units, and the Financial Stability Institute, which fosters the dissemination of standards and best practices to financial system supervisors worldwide.

There are three main bodies for governing and administering the Bank:

- the General Meeting of member central banks. [It] is held within four months of the end of the Bank's financial year, 31 March. [...]
- the Board of Directors, currently comprising 17 members. Its main tasks include determining the strategic and policy direction of the Bank and supervising the Bank's Management. The

⁵⁷ Even though these may have nice codes of conduct too.

⁵⁸ BIS AR 2006 p. 155/165.

⁵⁹ <http://www.bis.org/about/mission.htm>, 13/8/12.

Board is assisted by the Audit Committee and the Consultative Committee, composed of selected Directors; and

- the Executive Committee, chaired by the General Manager and comprising the Deputy General Manager, the Heads of Department and other officers of similar rank appointed by the Board. The Executive Committee advises the General Manager on all important matters affecting the Bank as a whole.»⁶⁰

«As of 1 July 2005, the annual remuneration of senior managers before expatriation allowances is based on the following salary structure:

- General Manager 718,370 Swiss francs
- Deputy General Manager 607,850 Swiss francs
- Heads of Department 552,590 Swiss francs

In addition to the above, the General Manager receives an annual representation allowance and enhanced pension rights.»⁶¹

The expatriation allowance is “14-18% of the salary, depending on family status, subject to a ceiling”.⁶²

«An Extraordinary General Meeting held in conjunction with the Bank’s 2005 Annual General Meeting decided to revise the BIS Statutes to streamline the governance of the Bank. This followed a review undertaken by the Bank the previous year to enhance the transparency of its operations and structure. As a result, the position of President of the BIS was abolished, effective 27 June 2005. The positions of Chairman of the Board and President had been vested in one person since 1948. The review also recognized terms of reference for the Executive Committee as an advisory committee to the General Manager, and Charters for the Board of Directors and several operational committees were drawn up.»⁶³

Nout Wellink, president of the Dutch Fed, was chairman of the Basel Committee on Banking Supervision from 1/7/06-30/6/09.⁶⁴ The term is 3 years.⁶⁵ Wellink had been preceded by Jaime Caruana, Governor of the Bank of Spain.

The Bank hosts the secretariats of a number of committees and organizations which should seek to promote financial stability. The classification below is that of the AR. For each of the groups mentioned, the AR gives a (more elaborate) elucidation.

«Promotion of financial stability through the permanent committees

⁶⁰ BIS AR 2006 p. 156/166.

⁶¹ BIS AR 2006 p. 180/190.

⁶² BIS AR 2006 p. 179-180/189-190.

⁶³ BIS AR 2006 p. 156/166.

⁶⁴ BIS AR 2002 p. 173 (for 1/3/02). BIS AR 2006 p. 185/195:

«Changes among the Board of Directors and senior officials

At the Extraordinary General Meeting held on 27 June 2005, it was decided to abolish the position of President of the BIS. Nout Wellink, President of the Netherlands Bank, who had been re-elected as Chairman of the Board of Directors and President of the BIS with effect from 1 March 2005, continued to serve in his capacity as Chairman of the Board before stepping down on 28 February 2006. At its meeting in January 2006, the Board elected Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, as Chairman of the Board of Directors for a period of three years commencing on 1 March 2006.»

At p. 166/167 of the same AR:

«Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision, chaired by Jaime Caruana, Governor of the Bank of Spain, strives to strengthen banking supervisory frameworks and to promote risk management best practices in the banking industry. With effect from 1 July 2006, Jaime Caruana will be succeeded as Chairman by Nout Wellink, President of the Netherlands Bank.»

⁶⁵ DNB AR 2006 p. 93/91.

- Basel Committee on Banking Supervision
- Committee on the Global Financial System.
The members of the CGFS include senior officials from G10 central banks and the ECB, and representatives of a number of central banks from major economies and financial centers.
- Committee on Payment and Settlement Systems
- Markets Committee
- Central Bank Counterfeit Deterrence Group

BIS contributions to broader international financial cooperation

- Group of Ten
- Financial Stability Forum⁶⁶
- International Association of Insurance Supervisors
- International Association of Deposit Insurers

Financial services of the Bank

- Banking services
- Operations of the Banking Department in 2005/06
- Functions as agent and trustee»⁶⁷

Finally there is a:

«Financial Stability Institute

The mandate of the Financial Stability Institute (FSI) is to assist financial sector authorities in strengthening their financial systems and to promote financial stability globally. The FSI follows a two-pronged approach designed to disseminate standards and sound practices primarily to the banking and insurance supervision sectors.

The first prong of the FSI approach is the long-standing series of high-level meetings, seminars and conferences both in Basel and at venues around the world. In 2005, the FSI organized a total of 51 events on a broad range of financial sector supervision topics. [...]

The second prong is FSI Connect, an online information and learning resource for banking supervisors.»^{68, 69}

Compare these fantastic investments and (paper) efforts with the results and analyses below, and the facts presented in the chronicle of the financial crises.

January 2003. Report on Credit risk transfer. (BIS-CGFS-20).

Conclusions.

1. There is an *Executive summary*. It is more a table of contents than a summary;

⁶⁶ From p. 171/181 of BIS AR 2006: «The Financial Stability Forum (FSF), established in 1999, promotes international financial stability through enhanced information exchange and cooperation in financial supervision and surveillance. Its principal remit is to assess conjunctural and structural vulnerabilities affecting the international financial system and to encourage and coordinate action to address them. The FSF comprises senior officials from finance ministries, central banks and financial regulators in key financial centres, as well as representatives of international financial institutions (the BIS, IMF, OECD and World Bank), international supervisory and regulatory standard-setting bodies (Basel Committee, IAIS, IASB and IOSCO) and central bank expert groupings (CGFS and CPSS). The Forum's Secretariat is based at the BIS. More information on the FSF is available at www.fsforum.org.»

⁶⁷ BIS AR 2006 pp. 166-177/176-187.

⁶⁸ BIS AR 2006 p. 165/175.

⁶⁹ It is remarkable that “FSI Occasional Paper” number 8 was not published. It must have been meant for publication in 2008 or 2009. Number 1 was published in 2000, number 7 in 2007, number 9 in 2010, and number 11 in 2015. A note on the website said that number 8 was not published. (This footnote was added 21/6/16).

2. The terms of reference ask for a “preliminary assessment of the financial stability implications [of CRT developments]”. The report fails to provide it;
3. The report lists issues. But it says nothing about the significance of the issues for the stability of the financial system;
4. There are no explicit recommendations, but many (valuable) implicit suggestions (the terms of reference ask for options and policy responses where necessary);
5. The report is detached. Because of the mission statement of BIS it is insufficiently involved and concerned. It points to all kinds of obscurities and matters implying risks. But its efforts at improvement are half-hearted at best;
6. A systematic inventory and description of vulnerable mechanisms and aspects is missing;
7. The report shows that since 1995 nothing has been done about the risks noted by the GAO reports, and that regulation is still behind developments in the financial system.
8. It seems to be assumed that the given risk management is sufficient to prevent destabilization. But norms for risk management are not discussed. Nothing is said about how to evaluate the given risk management of a given financial institution. Good risk management does not seem to mean that no risks are left. A question is therefore: what risks remain?
9. Without mentioning the GAO and its reports of 1994 and 1998, the working group nevertheless draws the same conclusion: conceivable circumstances and concentrations can cause a standstill of markets.
10. The working group could and should have concluded: *conceivable circumstances and concentration of CRT-instruments will lead to the freezing of markets. Due to lack of information the possibilities of control are insufficient.* It should have recommended explicitly to collect more relevant information, and where necessary improve regulation to make this possible.
11. Instead of remaining vague and undecided, the working group could better have admitted differences of understanding and opinion.
12. It is not noted as a problem that important parts of the financial system lack regulation and supervision.
13. There is no recommendation or agreement about the monitoring of the implementation of suggestions and to report about progress publicly and periodically.
14. In sum: the report is very insufficient, but nevertheless very valuable. For an expert, the warning and what is to be done are clear.
15. The report implicitly supports the conclusions of the GAO reports of 1994-1999.

The terms of reference.

The report was written by a Working Group of the Committee on the Global Financial System (CGFS). The working group was composed of employees of central banks and of BIS.⁷⁰ It had been given the following terms of reference:

«Terms of reference of the CGFS Working Group on Credit Risk Transfer.

Global credit risk transfer markets have emerged in recent years. These markets are being used to transfer credit risk within the banking system and from banks to non-banks, such as insurance companies and investment funds. They represent a significant development in financial markets and warrant heightened interest by central banks because of the possible implications for the functioning of the international financial system and for financial stability. The Working Group should review these developments in techniques for credit risk transfer and make a preliminary assessment of the financial stability implications. Specifically it should:

- provide a brief description of the various instruments and techniques used for credit risk transfer - including loan trading, conventional and synthetic securitization and credit derivatives - assess the driving forces behind recent market developments and identify the major participants in the markets for these instruments;

⁷⁰ P. 53/57 of BIS CGFS 2003 gives the names of the members.

- assess in qualitative and, as far as available, quantitative terms the extent and direction of risk transfer and the impact on risk distribution in the financial sector effected through use of these instruments;
- identify areas in which currently available information is inadequate to give a reliable picture of market developments and consider options for addressing any such gaps;
- make a preliminary assessment of the potential implications of recent developments in credit risk transfer techniques for financial stability and consider, as necessary, possible policy responses.

[...]

The Group is asked to begin its work immediately with a view to producing an interim report, which can be considered by the CGFS in early 2002. The Group should produce a final report in late 2002 for consideration by the CGFS at its last meeting in 2002.»⁷¹

The Executive Summary.⁷²

The summary has the character of a table of contents. It doesn't give clear answers to the questions asked in the terms of reference. Answers to some of the questions of the first set of questions can be found later in the report. But the answers to the other, most important questions are absent, both in the summary and the rest of the report. In particular a judgment about the influence on stability is missing.

On balance, the working group is positive about the developments:

«Innovation in financial markets, and within that the development of new financial instruments such as credit derivatives, is generally to be welcomed as increasing market efficiency, enabling better diversification of portfolios and providing a wider range of techniques for risk management. However, there are a number of aspects of CRT which raise policy issues and which, at least in some cases, might point to the need for a policy response (Section VII).»⁷³

The “generally” in the first sentence is unproven. The statement is biased, and given its mission statement, unbecoming of BIS. Not all innovation increases efficiency and provides a wider range of techniques for risk management.⁷⁴

Market efficiency premises full and correct information, including information about risks. What information specifically? Is it assumed that a counterparty can always fulfill his obligations, provide extra collateral on demand, and in the case of CDS: pay in case of default? Or are these treated as risks (and how)? In many places the report indicates a lack of information. So the conclusion seems premature, creating a risk.

The report doesn't tell how it added pros and cons, and risks, in order to be able to conclude that the net result is positive. Nothing shows that the “positive” is more than an unfounded conviction.

That efficiency can be increased is plausible (“as having the potential to increase market efficiency”). But that is a fundamentally different statement. Asserting without proof that something is beneficial is called wishful thinking. This is incompatible with BIS' mission statement.

The above quote continues as follows:

«Some of the main ones are as follows:

- **Transparency** - financial firms' disclosure of their CRT activities is patchy at best. In a fast developing market with a potentially significant effect on the distribution of risks this lack of disclosure is a concern. The Report suggests that the issue might best be addressed by lending support to existing initiatives on disclosure (eg Fisher II) and by flagging the specific concerns in relation to CRT.
- **Aggregate data** - the relative dearth of information at the level of the individual firm is paralleled by an incomplete picture of how CRT markets are developing in aggregate.

⁷¹ P. 30/34 BIS CGFS 2003.

⁷² BIS CGFS 20 (2003) pp. 1-3/4-7.

⁷³ P. 2/6, second text block.

⁷⁴ In fact it could better have been welcomed *conditionally* instead of generally. Conditions should include information enabling supervisors to detect systemic risks. See the GAO recommendations.

Central banks and others are currently exploring how to improve their database related to CRT instruments without imposing an undue reporting burden on market practitioners.

- **Rating agencies** - the Report notes the critical role of rating agencies in various CRT markets and the implicit reliance on the risk assessment techniques which they use. Although the Report does not formulate any view on the desirability or otherwise of this state of affairs, the CRT dimension should be taken into account in the various reviews of the rating agencies' activities which are at present in progress.
- **Diversification and concentration** - one of the principal potential benefits of CRT is that it facilitates the wider dispersion of risk and allows risk profiles to be adjusted more flexibly. At the same time, some elements of the CRT market appear to be highly concentrated, which might give rise to market disruption if the firms concerned were to come under pressure.
- **Contract design** - as previously noted, the formulation of restructuring clauses in credit derivatives contracts has proved to be particularly problematic. It remains to be seen whether the difficulties can be resolved; if not, it could act as a significant brake on the further development of this part of the CRT market.
- **Risk management** - although in many respects CRT involves familiar risk management issues, it does sharpen questions about counterparty risk in relation to unfunded risk transfers, given the speed and scale of possible changes in exposures, and also raises technical questions about the reliability of pricing of portfolio instruments. In addition, there are a number of issues related to documentation on which further work is needed. More fundamentally, there has been concern that CRT could lead to a weakening in overall credit risk monitoring if those who end up holding the credit risk have less information about the borrower than the original lender. Market practice has, however, evolved in a number of ways to mitigate this risk.
- **Accounting** - divergences in accounting rules have had a restraining effect on certain parts of the CRT market. As credit risk (at least vis-à-vis larger borrowers) becomes more readily tradable, it may also increase the tension between book value and mark to market valuation. Although the Report did not explore this (contentious) issue it is clear that it is attracting increasing attention from practitioners.
- **Regulation** - CRT has the potential to highlight more clearly differences in the regulatory treatment of credit risk as between different kinds of institution and is, therefore, likely to work towards a more integrated approach to regulatory capital standards. The International Association of Insurance Supervisors and the UK Financial Services Authority have recently reviewed the regulatory implications of CRT.»⁷⁵

With respect to risk management the working group raises a number of important questions. In the last sentence- that can but should not be read as a conclusion- it nevertheless backslides into wishful thinking. “Mitigate” is an elastic concept. It can mean everything between all and nothing, including almost nothing. It certainly doesn’t mean “eliminate”. The important question is: what risk remains? And how reliable is the information about market practice, given the indicated lack of information?

Several of the most important problems and risks are mentioned. (An important missing problem is that of the lack of attention of supervisors to the interrelationships between subsystems of the financial system).⁷⁶ But there is no indication of the size or seriousness of the problems or risks, and the formulations breathe the opposite of a sense of urgency.

With respect to transparency and aggregate data, the working group notes that central banks try to improve their information “without imposing an undue reporting burden on market practitioners”. But what is an undue burden? How does the working group, or how do the central banks estimate this? And what does the burden really matter if at least the regulation is the same for all “market practitioners”? Shouldn’t exactly this international working group have noted this, and made recommendations?

⁷⁵ P. 2-3/6-7, not abbreviated.

⁷⁶ As noted by the GAO report of 1999.

The quote concludes the executive summary. In other words: there is no final conclusion, and no unambiguous recommendation. The final conclusion could or even should have been: "Present market circumstances may very well precipitate a market crash. The information necessary to estimate this (systemic) risk, and to control or to exclude it, is not available. It can only be acquired after regulatory improvements according to the following recommendations: (to be supplied)."

The following quotes are from chapter VII of the report. The observation of the existence of different opinions, even within the working group, is remarkable. But the optimistic and agnostic views are treated quite differently (biased in favor of wishful thinking). The introduction concludes with a wait-and-see attitude, not a call for action.

«VII. Policy issues.

The development of CRT has a potentially important impact on the functioning of the financial system. It provides opportunities for more effective risk management, promises the relaxation of some constraints on credit availability and allows more efficient allocation of risk to a wider range of entities. The pricing information provided by new CRT markets is also leading to enhanced transparency and liquidity in credit markets.

At the same time, concerns have sometimes been expressed that CRT instruments, while capable of improving the dispersion of risk, equally have the capacity to concentrate it. Similar concerns have been expressed in relation to other new instruments in the past. Although information about the redistribution of credit risk by CRT is limited, there are no obvious signs that CRT has in fact led to a concentration of risk.⁷⁷

One view expressed in the Group was that the experience of financial institutions in recent years illustrated that CRT mechanisms had worked successfully to disperse credit risk more widely. Most members, however, thought that, although the general signals were positive, it was too early and there was insufficient information to reach firm conclusions on the financial stability impact of CRT. Regardless of this difference in view, Working Group members believe that there are a number of issues related to CRT worth highlighting, without implying that a policy response is necessarily indicated for all of them.

VII.1 Transparency

The analysis of various private and public data sources showed that the information available at present is adequate neither to track the redistribution of credit risk through the use of CRT instruments nor to identify any resulting risk concentrations.»⁷⁸

The working group fails to analyze the implications for financial stability. It had been asked to do so, but what is said under "Concentration" answers the question implicitly at best. It indicates primary risks, but doesn't examine consequences of their realization. And the working group clearly doesn't particularly clamor for action.

«VII.3 Diversification and concentration [...]

Concentration

As pointed out in Section IV.2, some parts of the CRT market are concentrated in a few institutions. In particular, intermediation of CDSs is dominated by a handful of large universal banks and securities dealers; and risk taking on the most senior ("super senior") unfunded tranches of CDOs is limited to the monolines and a few banks.

Although most intermediaries claim to have balanced books or only small structural positions, concentration in the intermediation of credit risk could itself be a problem. Even with a matched book - and achieving full matching may be difficult for a variety of reasons - institutions are still exposed to basis risks if contractual terms are not identical. It is, moreover, questionable whether a large number

⁷⁷ This is an example of wishful thinking, and a rosy presentation of the state of affairs. IMF does the same as the Working group. Note that there is no information which shows spreading, and shows that the fear of concentration is misplaced. In addition, there are other risks besides concentration. Search for "intermediation".

⁷⁸ P. 25/9.

of contracts is effective in diversifying such risk. Market risks can also be difficult to hedge in this area given patchy market liquidity. If intermediation remains highly concentrated, operational failings in dominant firms could disrupt markets. Any deterioration in the creditworthiness of large intermediaries- for example, as reflected in rating downgrades- could also reduce market liquidity by making counterparties less willing to trade without collateralisation.»⁷⁹

Doesn't the Working group know that there are structured investment vehicles (SIV⁸⁰), and that quite a lot is booked off-balance?

And even apart from that, the text sketches the start of a scenario of a breakdown of market operation. Only the trigger is left to be specified.

Remember that the Working group consists of employees of central banks. They seem to lack all kinds of important information, and have to rely on "claims" of financial institutions. But even though the risk seems evident, the group makes no recommendations for substantial improvement of its information base.

«VIII. Concluding comments

This Report has described recent development in CRT markets and has reviewed some possible implications for financial institutions' behavior and financial risk. It has not, however, been possible to provide a definitive answer to the question "How much does all this matter from the point of view of overall financial stability?" This is partly because of the currently incomplete statistical coverage of CRT; it is also because many CRT markets are still young and are evolving rapidly. In the light of the dynamic nature of these markets and changes in the surrounding financial and economic environment, central banks will continue to monitor developments closely. This Report provides a starting point for such monitoring.

Although beyond the scope of this Report, CRT clearly has monetary and macroeconomic as well as financial stability implications. CRT may, for example, help to ameliorate capital constraints on bank lending, thereby modifying the monetary transmission mechanism. Appendix 6 of this Report provides a glimpse of such possible structural impacts. Central banks will want to consider how far they merit further study.»⁸¹

The "statistical" probably does not mean statistical in the sense of phenomena with probabilistic aspects, but data about the state of affairs. As collected by for example the US Census Bureau, and the Dutch Central Bureau of Statistics.

It is remarkable that it is asserted that the implications for stability are not clear due to a lack of data about the state of affairs. As regards accurately specified implications this may be true. But lack of data also means uncertainty, hence more risk. In other words: the situation requires additional risk management.

Therefore the first paragraph of the quote is inadequate. That lack of information means risk is simply logical. An unknown risk is a potentially great, dangerous risk. In other words: the Working group could and should have understood and noted this. Under "Concentration" it showed that there is a risk of a market freeze. Due to lack of appropriate information the exact probability is unknown. Given the formal duties of the central bankers, the Working group should have concluded that this requires

1. active risk management by the central bankers.
2. (as part of that:) collection of the necessary information (to be specified).

Since it is obvious that the probability of a market freeze is nonzero and just as obvious that the consequences of such a freeze are tremendous, the Working group should have recommended the highest possible priority.

March 2005. Joint Forum on Credit Risk Transfer.

On top of each page of this report is printed in red type:

⁷⁹ P. 27/31.

⁸⁰ Not mentioned in CFGS 20. See the FCIC report, search for "SIV". See also the Basel appendix.

⁸¹ P. 29/33.

A later final paper on this topic has been published in July 2008. <http://www.bis.org/publ/joint21.htm>

Colored type is used nowhere else in the report. The report of 31/7/08 is not just a corrected version of the 2005 report however, but an entirely different report, that takes account of the developments from 2005 to 2007. It will be discussed later in this appendix.

Participants and terms of reference.

The “Joint Forum” refers to the participation of the:

- Basel Committee on Banking Supervision
- International Organization of Securities Commissions
- International Association of Insurance Supervisors

The report was written by a Working group:

«The attached report responds to a request by the Financial Stability Forum (FSF) for the Joint Forum to undertake a review of credit risk transfer (CRT) activity. The report was prepared by the Joint Forum’s Working Group on Risk Assessment and Capital on the basis of a number of interviews and discussions with market participants.»⁸²

Klaas Knot of DNB, who in 2011 would succeed Wellink as president of the Dutch central bank, employees of the UK’s FSA and BoE, and the US Fed, NY Fed, FDIC, OCC and SEC, were members of the Working group.⁸³ The IMF and the European commission were represented in the group as well.⁸⁴

The summary says the following about the development of the report:

«The report was issued on a consultative basis in October 2004. This final version reflects comments and suggestions received during the consultation process, but does not seek to provide a comprehensive update of the market information contained in the report. The key points raised during the consultation process are described at the end of this Summary.

The September 2003 FSF discussions noted the importance of considering the financial stability issues that could be associated with CRT activity and highlighted three issues in particular:

- (1) whether the instruments/transactions accomplish a clean risk transfer,
- (2) the degree to which CRT market participants understand the risks involved, and
- (3) whether CRT activities are leading to undue concentrations of credit risk inside or outside the regulated financial sector.

Additionally, the FSF asked whether there is a need for enhanced reporting to supervisors and improved public disclosures by regulated institutions, as well as whether there is a need for further information on credit risks that are transferred to nonregulated institutions. These questions are addressed below.»⁸⁵

Conclusions.

1. The report makes many very valuable observations about facts which clearly represent serious risks for the stability of the financial system.
2. The recommendations premise or show the existence of great risks, and lack of vital knowledge about them. However, there is no sense of responsibility, uneasiness, or urgency. The recommendations are rather noncommittal, and do not credibly try to remedy the lack of information.
3. The analysis is very inadequate. It doesn’t match the recommendations. The incompatibility can be explained by the assumption that powerful members of the Working group refused to accept

⁸² P. 1 of the report.

⁸³ The financial stability publication OFS of DNB of December 2005 mentions “BIS” only in connection with deposits of oil-exporting countries, while “CRT” is not mentioned at all. The Conclusion entirely ignores the risks mentioned in the Joint Forum report.

⁸⁴ P. 97 of the report.

⁸⁵ P. 1/7 Joint Forum CRT (BIS 2005).

- any conclusion showing systemic risk. The effectivity of their obstruction may be due to the generally accepted fiction that a working group has only one opinion.⁸⁶
4. No effort is made to sketch scenario's following realization of risks, or to estimate the size of the risks. The forum doesn't even seem to know the concept of scenario.
 5. In spite of substantial overlap, the conclusions of CGFS 20 (2003) and GAO (1994-1999) are ignored, or interpreted incorrectly, without argumentation.
 6. There is no recommendation for periodic reporting about the implementation of the recommendations, for example beginning end 2005. This is unprofessional, and compatible with the hypothesis that the recommendations meant to go halfway only.
 7. The Working group shows great risks and must understand that its recommendations do not eliminate them. But it fails to show how the (remaining) risk is to be managed.

The summary.

There is a summary which would deserve the name if it wouldn't be so long.

The section *Are undue concentrations of risk developing?* implicitly shows an important lack of vital information, and, as a consequence, serious risks of unknown extent. Due to the lack of information, the question cannot be answered. Suggestions for filling the information gap are not mentioned.

The section *Financial Stability Implications* does not describe implications for stability.

It opens with a paragraph with unsubstantiated wishful thinking opinions of interested parties. The risk of disruption of the liquidity of CRT markets, mentioned in the section *Are undue concentrations of risk developing?*, does not return in this one.

The last and longest of the four paragraphs of the section is quoted in full:

«With regard to the role of unregulated market participants, the Working Group believes that market discipline as evidenced through effective counterparty risk management is an essential element of a well-functioning marketplace. Market participants should seek to ensure that sufficient measures are taken to address these risks with respect to all counterparties, whether regulated or not. In addition, supervisory authorities have a legitimate basis for seeking to understand the aggregate amount of credit risk that is being transferred outside of the regulated sector. While greater information sharing among supervisors, including developing a common understanding of key concepts and terms, as well as improved analysis of existing and planned reports provided by regulated firms should provide an increased ability to assess such developments, it will be important to monitor progress in this area closely.»⁸⁷

How?

The first two sentences are another way of saying that nothing will go wrong if everyone (except the supervisors) is careful. But what if market participants lack necessary information, and accept the ensuing risks, as they are known to do? Does the Working group know what risks can be taken safely, without endangering others? (No, it doesn't). The Working group accords the supervisors a limited basis for understanding part of the processes in the system. Is this sufficient for what their duties require? (No, it isn't). The Working group says nothing about the possibilities of understanding with the given information. It does not specify the additional information needed for this understanding. And what information is needed to get a reliable picture of the stability situation.

Please keep in mind, that the market knows less, not more, than the supervisors.

The amazing and objectionable of this report is that it says nothing substantial about the risks, and about the management of these risks by the supervisors (and governments, where necessary). It is clearly shown that risks are present, and even that they can have far reaching negative effects. But no effort is made to analyze or quantify them further, or to reduce them. Scenario's- sequences of events

⁸⁶ Even if this opinion is incompatible with earlier opinions of almost the same group..

⁸⁷ P. 5/11 Joint Forum CRT (BIS 2005).

following realization of a given risk- are not investigated.

The next and last section of the summary has the title *Recommendations*. The recommendations are quoted in full because they clearly outline the state of affairs and thinking in 2005, and show that the supervisors assume that many practices in the financial system leave much to be desired, and by implication, embody risks:

«Recommendation 1: Role of Senior Management

- Market participants should use CRT instruments in a manner consistent with the overall risk management framework approved by their board of directors or equivalent senior management body, and implemented by their senior management.

Recommendation 2: Credit Risk

- Market participants transacting in CRT instruments should have the capacity to understand and assess the credit-related risks inherent in these instruments.
- Aggregation of credit risk: Market participants should seek to ensure that their measures of credit exposures to individual obligors are as comprehensive as possible;

Recommendation 3: Credit Model Risk

- Firms that rely on models to assess the valuation and risks of CRT instruments should have sufficient staff and expertise to properly understand the assumptions and the limitations of those models, and to manage their usage appropriately.
- Correlations: Firms should thoroughly understand the sources for and roles of correlation assumptions in models used for valuation and risk management of CRT instruments.
- Extent of risk capture: Firms should assess the extent to which trading/hedging approaches in CRT instruments may leave the firm exposed to risks that are not routinely captured in the firm's risk management calculations (eg, "jump to default" or other issuer-specific risks and basis risks).

Recommendation 4: External Ratings

- Market participants should understand the nature and scope of external ratings assigned to CRT instruments, particularly CDOs, how these differ from external ratings assigned to other types of instruments, as well as how ratings methodologies differ across the rating agencies.
- Supplementary measures: Market participants should encourage the rating agencies to continue their efforts to provide information that supplements the ratings themselves.

Recommendation 5: Dynamic Management of Structured Transactions

- Market participants investing in dynamic structures should evaluate carefully the record of the manager, the nature of the manager's discretion, and the potential for conflicts of interest.

Recommendation 6: Counterparty Credit Risk

- Counterparty credit risk arising from unfunded CRT transactions should be managed actively, at least to the same standards applied to other OTC derivatives.

Recommendation 7: Legal Documentation Risk

- All market participants need to pay careful attention to the legal documentation relating to CRT instruments, such as the range of credit events covered by the instruments and to the clear and unambiguous identification of underlying reference entities.
- Standardisation: To reduce legal risk arising from CRT transactions, market participants should aggressively continue their efforts towards standardisation of documentation, including for CDOs and other more complex products.

Recommendation 8: Legal Risk and Appropriateness of Transactions

- Before entering into a CRT transaction, market participants should undertake the due diligence necessary to clearly identify their legal responsibilities to the counterparty or customer, based on their role in the particular transaction, and to determine that their counterparty or customer has the

- legal authority to enter into the transaction.
- Marketing: When marketing structured CRT products, originators and dealers should seek to foster a complete understanding of the nature and material terms, conditions, and risks involved and should not encourage exclusive reliance on external ratings as a measure of risk associated with the transaction.
- Investor Information: Before entering into a CRT transaction, investors should ensure their ability to obtain, both at the outset and on an ongoing basis, the necessary information to properly evaluate and manage the risks associated with their investment.

Recommendation 9: Use of Material Non-Public Information

- Market participants, especially banks that lend to firms referenced by CRT instruments, should take care to ensure compliance with all relevant laws and regulations as well as industry recommendations concerning the use of material non-public information (MNPI) as it relates to their participation in CRT transactions.

Recommendation 10: Documentation and Settlement Risk

- Market participants should execute confirmations and any other documentation associated with a CRT transaction promptly after the transaction has been agreed.

Recommendation 11: Operational Risk

- Market participants should ensure that their CRT activities are undertaken by professionals in sufficient number and with the appropriate experience, skill levels, and degrees of specialization.

Recommendation 12: Market Liquidity Risk

- Market participants should understand the liquidity characteristics associated with the CRT positions they have taken on, including those positions used for hedging purposes.

Recommendation 13: Disclosure

- Market participants should continue to work to improve the quality of material public disclosures concerning CRT transactions and the resulting distribution of credit risks. While disclosures of CRT-related risks need to respect the frameworks within which individual firms present their risk profiles, there is room for improvement in a number of areas. [Five areas are mentioned]

Recommendation 14: Aggregate information

- The efforts of the Committee on the Global Financial System to develop mechanisms that better identify aggregate information on credit risk should be strongly supported by supervisory authorities and market participants.

Recommendation 15: Supervisory Efforts

- Supervisory authorities should undertake the steps necessary to enhance their understanding of evolving market developments in relation to CRT transactions.

Recommendation 16: Supervisory and Regulatory Review

- Supervisory authorities should periodically review regulations, supervisory guidance and reporting mechanisms that are pertinent to CRT transactions.

Recommendation 17: Supervisory Information Sharing

- Supervisory authorities should continue efforts to share information on CRT activities with the objectives of strengthening their mutual understanding of developments, promoting further improvements in risk management practices by market participants, and enhancing supervisory and regulatory approaches.⁸⁸

⁸⁸ Explanations have been dropped. The pointwise ordering is of the present author. Sometimes a comma has been replaced by a semicolon.

Note that both models and ratings are considered to be imperfect, and that blind faith is considered a risk.

It is obvious that these recommendations include many valuable observations. Weak points seem to be: the utopian character of many recommendations (given the occupation of the various jobs in the given initial situation), and the lack of more energetic and effective action by the responsible supervisors. Their absent risk management. Isn't it ridiculous to assume that these recommendations will be adopted without any more ado? Why doesn't the Working group give any recommendation to ensure compliance by financial institutions? Why doesn't the Working group recommend the supervisors to report twice yearly about the implementation of the recommendations, beginning in October 2005? The presence of recommendations without an adequate recommendation about the monitoring of progress is unprofessional, and/or an indication of bad faith.

There is at least one important gap in the set of recommendations. To wit, recommendations that address the information gap in an effective instead of non-committal way. Compare the 2003 report, under "Transparency". Given the fate of the CFTC initiative of 1998, recommendations 13 and 14 seem to be somewhat hypocritical or suspect in their neglect of powerful opposition.

Why is nothing said about the adequacy or non-adequacy of the legal possibilities of supervisors? Why is there no recommendation about the duties and authority of supervisors, similar to that made by the US GAO?

Remember that the report and its recommendations are written by and for supervisors. That is: the people responsible for the safety and soundness of the financial system. The report shows that there is a risk of a crash scenario, and that the safety and soundness is uncertain and cannot be guaranteed. The supervisors nevertheless fail to manage this risk, and to make firm recommendations, where necessary also to governments. They do not explicitly acknowledge that they cannot guarantee the stability of the system as long as the recommendations are not implemented. While implicitly this is very clear.

What the report shows in the first place is that the supervisors do not take their duty seriously, and act irresponsibly.

Remarks.

The following paragraph shows that Bernanke and others ignored important warnings, and/or had managed their organizations too badly, especially when allowing Lehman to fail:

«There is clearly some degree of concentration in the market-making activities associated with credit derivatives transactions. Many market participants expressed the view that the default or exit of one of the large dealers would be disruptive to the liquidity of the CRT markets, while noting that the same is also true of other OTC derivatives markets. Importantly, dealer firms clearly seek to operate their market-making activities in a manner that leaves them hedged to the greatest extent possible.»⁸⁹

In the SEC AR 2005, signed by chairman Cox in November 2005, the word "stability" and combination "credit risk" do not occur.

The report of the Joint Forum is mentioned on p. 73/78 of the Fed AR 2005. It says nothing about the recommendations or their implementation.

The two DNB-reviews of financial stability in the Netherlands of 2005, and the DNB AR 2007 (published 4/4/07) say nothing about this Joint Forum, the report or its recommendations.

Note that recommendation 3 premises correlations. This (too) is incompatible with declarations of Wellink in his hearing by the inquiry Commission De Wit. See the appendix Wellink, search for "correlation".

The report is discussed and quoted by the FCIC-report:

«Regulators did take note of the potential risks of CDOs and credit default swaps. In 2005, the Basel Committee on Banking Supervision's Joint Forum, which includes banking, securities, and

⁸⁹ P. 4/10 Joint Forum CRT (BIS 2005).

insurance regulators from around the world, issued a comprehensive report on these products. The report focused on whether banks and other firms involved in the CDO and credit default swap business understood the credit risk they were taking. It advised them to make sure that they understood the nature of the rating agencies' models, especially for CDOs. And it further advised them to make sure that counterparties from whom they bought credit protection—such as AIG and the financial guarantors—would be good for that protection if it was needed.

The regulators also said they had researched in some depth, for the CDO and derivatives market, the question “Are undue concentrations of risk developing?” Their answer: probably not. The credit risk was “quite modest,” the regulators concluded, and the monoline financial guarantors appeared to know what they were doing.

The [Joint Forum's Working Group on Risk Assessment and Capital] has not found evidence of ‘hidden concentrations’ of credit risk. There are some non-bank firms whose primary business model focuses on taking on credit risk. Most important among these firms are the monoline financial guarantors. Other market participants seem to be fully aware of the nature of these firms. In the case of the monolines, credit risk has always been a primary business activity and they have invested heavily in obtaining the relevant expertise. While obviously this does not rule out the potential for one of these firms to experience unanticipated problems or to misjudge the risks, their risks are primarily at the catastrophic or macro-economic level. It is also clear that such firms are subjected to regulatory, rating agency, and market scrutiny.⁹⁰

The regulators noted that industry participants appeared to have learned from earlier flare-ups in the CDO sector: “The Working Group believes that it is important for investors in CDOs to seek to develop a sound understanding of the credit risks involved and not to rely solely on rating agency assessments. In many respects, the losses and downgrades experienced on some of the early generation of CDOs have probably been salutary in highlighting the potential risks involved.”»⁹¹

January 2006. Housing finance in the global financial market. (BIS-CGFS 26).

This report was written by a Working group composed of employees of central banks and BIS.

Conclusions.

1. The report is international. It refers not only to housing in the USA, but also in other countries.
2. It gives useful information about the state of affairs and developments in housing markets in many countries.
3. Important risks are mentioned, but detached, qualitatively and absolutely: “there is a risk? (Yes or no)”.
4. The analyses are superficial. Scenario's are not considered.
5. The size of the risks is not investigated.
6. Sequences of consecutive consequences of realization of risks are not investigated. As a consequence, systemic breakdown (and disaster) upon the realization of certain risks is not seen.
7. In general the thinking of the Working group is irresponsibly wishful: “It may go well”. For a supervisor responsible for stability this is unacceptable.
8. The statement that the report underestimates the risk is an incorrect understatement. The Working group handles risks irresponsibly, recklessly and unprofessionally.
9. Issues are mentioned, and some very modest recommendations are hesitantly made.
10. There is no agreement or recommendation about the monitoring of the implementation of the recommendations, and to report periodically on progress.
11. The report can be explained as the result of debatable and irresponsible compromises. It would have been far better to present the different points of view with their arguments. Only this solution seems to be in accordance with the highest ethical principles BIS says to emphasize.

⁹⁰ The FCIC quotes from p. 4/10 of the Joint Forum report.

⁹¹ FCIC pp. 205-6/233-4.

12. Apart from information about a few factual developments this report has no added value with respect to the GAO-reports. It may even be considered a step backwards: the necessity of action stressed by the GAO-reports is completely missing in this leisurely BIS-report.
13. The report is an example of irresponsible detachedness.
14. This could have been seen already at the time of publication.

Remarks about the contents of the report.

Note. P. 15/19 concerns securitization. It mentions Fannie and Freddie and numbers.

The following is quoted from the Executive Summary:

«What are the possible implications for housing finance market participants?»

Several recent developments in global housing finance systems have contributed to an improved functioning of housing finance markets, and have enhanced financial and macroeconomic stability. Risk-priced lending and credit scoring have made credit more efficiently priced and allocated.⁹² Securitization has allowed a higher degree of specialization in financial markets and improved the allocation and pricing of risks in the global financial system.^{93, 94} It has also allowed investors to diversify into other high-quality asset classes.⁹⁵

The significant growth of household borrowing and higher house prices in many economies in recent years have coincided with a period of low interest rates and improved access to credit. These developments have prompted central banks, rating agencies and others to assess whether new risks to the stability of the financial system have arisen. However, stress tests conducted by central banks and other authorities suggest that the level of indebtedness is broadly affordable and that the majority of borrowers are able to absorb both declines in house prices and higher interest rates. Furthermore, financial institutions, notably banks, appear sufficiently capitalized to withstand a substantial deterioration in household credit quality.

Nevertheless, it is also clear that new, more complex, types of mortgage contract have increased the choice of products available to households, potentially raising household welfare, but may also have allowed some households to overstretch themselves in the purchase of homes that otherwise would be unaffordable, perhaps adding to the risks in a housing market downturn. The strong growth in subprime lending might also be a potential source of risk if credit defaults turn out to be larger than expected.

For financial institutions, increased housing debt and new loan types raise the need for careful management of credit, operational and reputational risks. Furthermore, although increased reliance on capital market funding should on balance increase liquidity available to lenders, it also exposes them directly to financial market volatility.

For investors, lenders' increased reliance on capital market funding is likely to provide access to a potentially very large asset class in the form of mortgage-backed bonds. This should improve diversification opportunities and risk allocation - provided that the pricing of risks is sound.⁹⁶ More broadly, the emergence of a new asset class linked to housing finance may create stronger links between global financial markets and domestic policies affecting housing markets. One possible implication is that this introduces a new source of market volatility.»

«What are the possible policy concerns and recommendations?»

The Working Group has identified several important possible policy concerns and recommendations for central banks:

⁹² If the risks and scores are estimated correctly. Why does the Working group believe this to be the case? In fact she doesn't: see the last paragraph of this quote!

⁹³ Here too, goal or purported intention is identified with reality, without evidence.

⁹⁴ Note that the report neglects to remark that government policies and subsidies may have corrupted the pricing of risks.

⁹⁵ And into assets of bad quality. Isn't exclusively mentioning "high-quality" rather strange?

⁹⁶ This is misleading, since "sound pricing" in practice does not make risks bearable, and "sound pricing" is therefore not sufficient to avoid crashes, crises, etcetera.

- Households may not completely understand their mortgage contracts or how their payments could change in response to interest rate shocks or other developments. In particular, the introduction of negative amortization loans and a number of other new loan contracts has led households to assume more, and increasingly complex, risk. This is part of a broad global trend in financial markets to shift risk towards households.
- The increased use of adjustable rate mortgage loans and other new mortgage instruments has increased households' sensitivity to changes in mortgage interest rates.
- Lenders, investors and regulators may find that older risk monitoring systems, which worked well when almost all borrowers were of high credit quality and used fixed rate loans, may not be adequate in an environment with significant numbers of sub-prime borrowers, and in which variable rate or other, more sophisticated, loan products have become increasingly common.
- Central banks and other policymakers need to ensure that they have access to a broad array of disaggregated data, particularly for more vulnerable subgroups of households. Furthermore, policymakers need to ensure that house price data are of high quality.
- Central banks could consider conducting their own stress tests as well as encouraging other authorities and market participants to engage in stress testing. The focus of these tests could be on household vulnerability, house prices and retail loan portfolios as well as liquidity risks from increased market funding.
- The trend towards increased globalization, particularly in the investor base, will require more international information exchange. An important question for policymakers and market participants is how to discern who ultimately bears the housing finance risks and whether there are concentration risks.
- There are differences in the recent developments in household indebtedness and house prices, as well as in the institutional setups between countries. It is important to recognize that public policies are often one of the main factors explaining the contrasting recent developments. An important issue for policymakers is how changes in different regulations, taxes and subsidies might affect housing markets, and in turn the real economy through the housing finance system, with possible feedback effects from global financial markets.»⁹⁷

Note that it is presented as a fact that “recent developments [...] have enhanced financial and macroeconomic stability”. No proof is given,⁹⁸ and as the facts would show, could not be given. Note furthermore that one does not need to be an expert to observe that no proof is given.

The recommendation about stress tests gives rise to the question what the statement about macroeconomic stability is based on.

Note that the section about the possible implications as a whole breathes a spirit of optimism, or rather wishful thinking and one-sidedness. The sentence about risk if credit defaults in the third paragraph is the only exception.

The report goes a long way in the direction of a crisis-scenario. See p. 27/31, and, especially, pp. 30-33/34-37. But it remains ambiguous. It fails to note the seriousness of the risk engendered, and provides half-wits and lazy-bones with quasi-excuses for doing nothing. Only quasi, because facts and analysis do not truly justify an excuse. They require much more urgent action than recommended by the Working group. The following is from p. 32/36:

«Fourth, lenders increasingly rely on capital market funding, which may be due to a combination of rapid growth in housing finance combined with a reduction in the volume of deposits, which compels lenders to seek alternative means of funding. It may also reflect the fact that capital market access has lowered the funding costs for housing loan providers, thereby increasing the incentive to securitise mortgage loans. Greater reliance on securitization means that the risks relevant to financial institutions are changing. Lenders can dispose of interest rate and credit risk, and concentrate instead on income from mortgage servicing rights (so-called “packaging fees”). Hence, in principle, institutions that

⁹⁷ Pp. 2-3/6-7 of the CGFS working group report *Housing finance in the global financial market* (CGFS Papers No 26, January 2006). It can be found in the dossier under 20060117.

⁹⁸ Not in the summary, and not in the main text of the report.

package and sell loans do not need to manage credit and interest rate risks, but are instead exposed to liquidity, operational and reputational risks. Growing dependence on financial markets has also increased the exposure to market turbulence. One aspect of this is that, in periods of severe market unrest or uncertainty, a whole group of housing finance lenders may suddenly find it difficult to obtain funding. Thus, although internationally active financial institutions build up exposures to non-domestic mortgages to diversify risks, spillover effects from foreign housing markets could become a source of concern. Housing finance-related risks may thus ultimately be transferred back to households, for instance via pension funds.»

Which is what actually happened.

The following quote is from the beginning of section 4.4. on p. 33/37. It raises several disconcerting questions:

«The rapid growth of sub-prime lending in new markets, combined with the introduction of new and complex loan types, could raise some issues for financial markets. One question is whether lenders and investors are able to assess accurately the risks of this lending, given a lack of previous experience. Another question is whether the risk of contagion from larger domestic housing finance markets via bond markets has increased. This aspect has until recently mainly been an issue for the US market, but could become a broader concern as this form of lending grows in other markets.

As investors create diversified global housing finance-based portfolios, it is likely to become less clear who ultimately bears which risks and whether new risk concentrations are emerging. For central banks, regulators and policymakers more broadly, assessing linkages as well as potential build-ups of risk will become more challenging. It is possible, though unlikely, that these risks, if not checked by prudent oversight, could offset the diversification benefits from having access to a broader set of mortgage bond markets.»

Risks are not only dangerous when concentrated or built up.

Why unlikely? The article of Rajan, which is referred to in a note, claims that the system has become more risky. Why not openly (ethically!) admit differences of opinion, and present their respective arguments?

Note that there is no attention whatsoever for consequences and sequences of the realization of risks. (As noted in the Analysis, consequences can better not be included in the risk concept, if only because in general they depend on circumstances).

The second paragraph is incorrect in suggesting that this is a recent development. Reality is that it played a role in the LTCM crisis, and that the GAO had warned already in the previous century. The “more challenging” is recklessly unspecific.

The following is from chapter 5, *Policy issues*:

«There have been a number of episodes in which a recession has been exacerbated by adverse developments in housing markets. It is therefore natural to ask whether recent increases in household borrowing and house prices could unwind in ways that severely affect overall economic activity. The risk of such a development might be higher today than just a few years ago, for instance because subprime borrowers and households that have used new exotic mortgage contracts to finance their houses have become particularly vulnerable. On the other hand, so far the recent experiences in the United Kingdom, Australia and elsewhere suggest that changes in macroeconomic conditions, including in the stance of monetary policy, need not trigger sharp reactions in housing markets.»⁹⁹

This is true, but imprudent to count on. Especially for supervisors. They should eliminate at least the risks for the world outside the financial sector, and account for the risks they consider inevitable or good for the economy.

So the Working group gives an example of a happy ending, without noting that this is no guarantee, without analysis of possible (other) courses of events, and without proper risk management. This is

⁹⁹ P. 34/8.

utterly unprofessional and irresponsible. One can even win a hundred million dollars by buying a lottery ticket, and survive crossing a street with eyes and ears closed. But these are no more than good luck.

June 2006. BIS AR 2006.

The BIS reporting year runs from 1 April until (and including) 31 March.
This is the 76th BIS AR. It is dated 9/6/06.

Conclusions.

1. There is no concise summary and there are no conclusions.
2. The annual report is exclusively macro-financial-economical. And even as such it is deficient. It only tells about (central banks) policy, not about regulation. It says nothing about for example capital requirements¹⁰⁰ or transparency¹⁰¹;
3. The chapter financial markets says a lot about risk management. The BIS-authors seem to believe that the risk management is adequate. They do not explain what their claims are based on. The claims look like illusions.
4. The AR seems to have been written by people who did not or insufficiently communicate with the authors of the reports CGFS 20 and 26, and those who attended the Joint Forum.
5. Only the appendix "Organization, governance and activities"¹⁰² is an annual report in the usual sense of the concept.
6. Even apart from the question whether the name "annual report" is justified, the report concerns only part of the supervisory activities of the central banks.¹⁰³ Namely the most detached or abstract part. The selection and treatment are not accounted for.
7. The essential incompleteness makes the AR inadequate as a report, both annual and otherwise.
8. The lack of integration, coordination and cooperation could have been noted and corrected already 2006. It is a missed opportunity and/or additional risk.

Remarks about the contents of the report.

General.

The report does not have a concise summary and/or conclusions. The chapter Conclusion covers the pages 140-152/150-162.

On the pp. 171-2/181-2 one finds a concise summary of the Financial Stability Forum.¹⁰⁴ It was chaired by Ferguson of the Fed. On 1/5/06 Ferguson was succeeded by Draghi of the ECB.

The Introduction.

The Introduction¹⁰⁵ of the AR outlines the financial-economic state of affairs. In the first half the

¹⁰⁰ "capital require" can only be found on p. 166/176.

¹⁰¹ "transparen" occurs six times, but not in connection with for example ABS, CDS, CDO, financial markets, hedge funds or risk concentration.

¹⁰² BIS AR 2006 pp. 152-185/162-195.

¹⁰³ Compare the BIS AR with the AR of the central banks, for example the Fed and DNB. Note that if BIS does not cover all central banks/ supervisors, nobody does. For comparison, observations about weaknesses and risks in the world of supervision as a whole, the world is dependent on BIS. Although of course individual national supervisors should be aware of risks created by dysfunctional supervisors in relevant countries, and report about this in their AR. Maybe BIS' internal organization is inadequate and badly coordinated (empirical evidence for this was noted earlier). Maybe some or many supervisors or governments do not permit evaluation by BIS. Whatever the explanation may be, the situation says a lot about the lack of care of supervisors and governments for a safe and sound financial system.

¹⁰⁴ Succeeded in April 2009 by the Financial Stability Board (or just renamed).

¹⁰⁵ BIS AR 2006 pp. 3-4/13-4.

word “surprise” is used three times. The surprise is that the sun is still shining. But:

«A number of signs have emerged that some kind of turning point might have been reached. Long bond rates have finally begun to rise, more sharply since the turn of the year, and evidence has been accumulating that other financial markets are increasingly being affected (Chapter VI). Moreover, in the United States and a number of other countries, house price increases (Chapter VII) and construction activity have recently become less vigorous. Evidently, the wish of policymakers must be that this orderly deceleration will continue, and that a smooth adjustment to a sustainable rate of growth will be the eventual outcome. Indeed, this is the consensus forecast, as well as that of the IMF and OECD.

Yet, even if this is the expected outcome, how sure of it can we be? Perhaps the principal point to make is that the cycle of policy tightening globally, as opposed to that in the United States, is not well advanced. Moreover, it is only since early 2006 that long rates, which play a key role in so many financial markets, have risen noticeably. More disruptive effects could still materialize. The recent historical experiences of Japan, Germany and Southeast Asia all indicate that costly economic downturns are possible, even after long periods of exceptional performance. The same examples also suggest that long periods of price stability are no guarantee of future robust growth.

Prudent policymakers today should still be thinking about remaining risks, and how they might respond to them. In advance, what steps might they take to minimize both the likelihood of difficulties and the scale of the losses that could be incurred should they arise? During and after the emergence of problems, what could be done to reduce the collateral damage? The Conclusion of this Annual Report addresses these forward-looking and more normative issues.»

The question “Yet, even if …” shows some awareness of the unreliability of a “consensus forecast” which says neither how probable it is with respect to alternative scenario’s, nor what kind of events could lead to realization of another scenario.

The texts seem to try and sail a middle course between a macro economic theory of cycles, and common sense reasoning in terms of a more or less detailed picture of the financial system. The text remains very superficial, and fails to identify the remaining risks it wants policy makers to respond to. If the central bankers cannot answer the questions asked here, who can? In other words: the central bankers/ supervisors fail to do their duty.

In spite of the reminder of historical experiences the tone of the text does not exactly give the impression that the authors are aware of the existence of realistic catastrophic scenario’s.¹⁰⁶ They seem to be victims of the incorrect hypothesis that they can do their job properly by looking only at the macro-numbers, without knowing and understanding the products and operation of the financial system.

The Conclusion.

The tone of the introductory paragraph of the Conclusion suggests insecurity, and distrust of the forecasts of OECD and IMF. Words like “seem” and “hope” occur more frequently than one would like. The first sentence of the section *What risks do we currently run?* reads: «**Hopefully, the markets are right in their relatively optimistic assessment.**» But the section actually discusses the monetary response and inflationary pressures. In other words: it is thinking in conventional macro-economic terms. The section mentions several supposedly inexplicable macro phenomena. Such as the high dollar exchange rate in spite of the bad balance of payments. The AR is suspicious. It searches in vain for a trigger for «a “bang” of market turbulence». ¹⁰⁷ In the following paragraph it gets “warm”:

«There are, moreover, several market-specific reasons for concern about a degree of disorder should a process of price adjustment towards more normal levels begin. In the main industrial countries, there are many new participants in financial markets and many new financial products, of

¹⁰⁶ It is remarkable that on p. 3/13 the AR does mention “concerns about global inflationary pressures”. A luxury problem! BIS (= the top of the world of supervision) obviously has no idea of the proportions of the risks and their consequences.

¹⁰⁷ It only sees, or looks for, macro economic triggers. Nothing shows acquaintance with the operation of the financial system.

increasing complexity and opacity. Market liquidity in this environment has yet to be put to the test. The fact that carry trade speculation seems to have intensified in recent years also implies the potential for crowded trades that could, in the limit, lead to an interactive deterioration of market risk, credit risk and liquidity risk. We have in fact seen such interactions before.»¹⁰⁸

True, but beside the point. The complexity is mentioned very often, too often, because hardly relevant. Cars are complex too. The AR seems unable to ask itself the question: what if one or more of these risks is or are realized? BIS seems to be unaware of the relevant literature.

The section concludes with the following paragraph:

«We are, of course, currently not in a situation in which we have to confront such problems, and the likelihood of their occurring remains low. The consensus forecast is still the best bet. Yet the potential economic costs, should such risks materialise, would seem great enough to warrant some reflections on how policymakers might best respond. Such reflections do not constitute a forecast, but rather an exercise in prudence. There is nothing inconsistent in expecting the best but planning for the worst, particularly if the costs of the unexpected might well be high.»

Indeed, that is part of sound risk management.

What is the basis for the claim “the likelihood of their occurring remains low”? And again: what are the consequences of realization of the risk with a small likelihood? “Best bet”? Are the supervisors gambling? “Planning for the worst”: how? And can nothing be done to eliminate the risk of disaster, to prevent the worst? Neither the consensus forecast nor the worst are expected or unexpected. Both are possible, both have a probability.

The section *How might current risks be reduced?* is 100% formulated in macro terms. Nothing about capital-requirements, leverage, risk management, or ratings.

Because of the remarks in the preceding sections, the answer should have been: by making scripts for the different possible scenario’s. For even disasters take time. They don’t happen instantaneously, and early braking means (much) less damage. But if you cannot think in terms of a future consisting of several possible scenario’s, then you cannot properly prepare yourself.

The section *What to do if risks materialise?* is full of sensible remarks and tips, and discussions of pros and cons of measures.

The title of the last section of this chapter, *Can we avoid similar risks in the future?*, is rather dubious, because it suggests that the preceding sections have identified the relevant risks, and that realization cannot be avoided. But the existing risks have been identified neither clearly nor completely. The question can therefore not be answered in a normal way. It can only be answered after adequate specification. And even then the relevance of the answer is debatable, since the risks left out of consideration may still cause disaster. Furthermore it is not explained why nothing can be done about the risks now. Shouldn’t supervisors rather have urged immediate action? The incompleteness is just one manifestation of thinking in terms of a too limited conceptual and analytical framework,¹⁰⁹ which in its turn manifests a lack of interest in a part of reality that is of crucial importance for financial supervisors. The ensuing irrelevance is illustrated by the closing paragraph of this section:

«To reflect such possibilities, the Keynesian analytical framework, which remains the workhorse in the stable of most central bankers, needs modification. A much richer set of indicators is now needed to guide the setting of interest rates, in particular indicators of financial imbalances, both internal and external. Over longer time periods, such imbalances can pose an even greater and more dangerous threat to price stability, on the downside, than shorter term and more conventional inflationary “pressures” such as output gaps. Recognizing this fact implies that we should lengthen the horizon over which we assess the success of monetary policy in stabilizing prices, in order to see its full effects. Raising interest rates in some circumstances might temporarily push inflation below desired levels, but this might still be preferable to a boom-bust scenario in which the eventual undershooting

¹⁰⁸ BIS AR 2006 p. 142/152.

¹⁰⁹ Greatly helped if not caused by a one-sided and dogmatic economics education, far away from the reality of the financial world. See also the section on education in the analysis of the financial crises.

of the inflation target is both larger and more lasting. Alternatively, there could be scope for reducing this trade-off dilemma by using other instruments, of a more regulatory nature, to help reduce the build-up of credit-financed imbalances in the first place. Such suggestions would, however, require a significant change in both the regulatory culture and the nature of the relationship between central banks and other public agencies.»¹¹⁰

July 2008. Joint Forum on Credit Risk Transfer: Developments from 2005 to 2007.

(The pdf file was (last) modified on 31 July 2008).

Conclusions.

1. The report gives a deformed picture of the developments in 2005-2007.
2. The report subscribes to the recommendations of 2005. The new recommendations are to be seen as supplementary.
3. There is no report of the implementation of the recommendations of 2005, and the results of the implementation.
4. What is said about a survey among supervisors suggests that the recommendations of 2005 produced no significant effect.
5. The issues noted by supervisors are largely the same as those mentioned in the report of 2005. This supports the hypothesis that the supervisors did little or nothing with the earlier recommendations.
6. Neither the text, including the supervisor-issues, nor the recommendations say anything about the adequacy of the formal possibilities of the supervisors.
7. Just like the report of 2005, the update does not mention an agreement or recommendation about the monitoring of the implementation of the recommendations.
8. There is no sense of urgency, and a fatal lack of credible or effective recommendations.
9. At the same time it is obvious that people who read this report could not be surprised by the events in the months following this forum and the publication of its report.

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¹¹⁰ BIS AR 2006 p. 152/162.

¹¹¹ In the present report, and especially in chapter 7C, Appendices, tables of content are given both to give an impression of the contents of a report, and to enable the reader to check whether the report might say something about a subject he or she is interested in. In other words: they are given to show what is included and (probably) excluded.

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The Summary.

The summary is not a summary but an introduction. It gives a concise and deformed explanatory picture of the developments in 2007. It does not summarize the (new) recommendations, and gives no conclusions.

The beginning of the summary suggests that since 2005 essential new things have happened. As if in the period between 2005 and the problems of 2007 the world has changed in essential respects.¹¹²

The forum finds it necessary to misrepresent the facts: «Since 2005, CRT activity has become significant in two new underlying asset classes: asset-backed securities (ABS) and leveraged loans.»¹¹³ This representation is incorrect. For a graph of ABS 1985-1999 (!) see p. 45/73, and for the volume of ABS commercial paper 2001-2010 see p. 251/279, both in the FCIC report.¹¹⁴ For leveraged loan statistics 1995-2006 see Figure A4 on p. 35/43 in the present BIS-report. There is no significant discontinuity in 2005 or in any year. In general there is strong growth.

Another untruth on the same page is the following: «The 2005 report discussed in some detail the complex risks of CDOs, with a particular focus on investment-grade corporate CDOs.» Perhaps something like this is said in the 2005 report, but certainly not in a prominent place.¹¹⁵ Nothing is anyway done with it, or about it.

It is quite inconvenient that there are no conclusions, and that the chapters are not concluded with a summary or conclusions. As a consequence the report gives the impression of a haphazard collection of remarks (copied from responses in the survey?), with which little more was done than group them under a number of headings.

The section "About this report".

This section covers about two thirds of a page. The method of inquiry is described as follows:

«The analysis in this report is based on interviews that Working Group members conducted with regulated firms in their respective jurisdictions, on meetings between a small subgroup and nearly two dozen market participants, and on a survey of Joint Forum members to identify supervisory concerns.»

This is only necessary and useful if the recommendations of 2005 had little or no positive effect. Including the recommendations for the supervisors. This is confirmed by remarks in the chapter *Issues raised in Survey of Supervisors*.

Note that unregulated (parts of) firms play a very important role in the financial system, but are not mentioned explicitly.¹¹⁶ Whether they are covered adequately by the other instruments seems open to doubt.

Isn't it remarkable that supervisor reports about the implementation of the earlier recommendations and related developments are not sufficient, and not even mentioned?

Chapter 9: Issues raised in Survey of Supervisors for Update of 2005 Paper.

«Supervisors expressed concern that the complexity of some CRT products and activities challenges the ability of boards of directors and senior management to understand and evaluate the

¹¹² Of course, if true, it would excuse the absence of more urgent warnings and recommendations in the 2005 report.

¹¹³ P. 1/9 of the forum of 2008.

¹¹⁴ For graphs of the volume of MBS see for example the report SECURITIZATION AND THE MORTGAGE CRISIS of the FCIC staff. For OTC see p. 299/327 of the FCIC report.

¹¹⁵ “corporate CDO” does not occur in the 2005 report.

¹¹⁶ Not in the remainder of the section either.

risks of these products and activities and to set appropriate risk limits. Supervisors also observed that some firms' internal risk reporting practices did not provide sufficient information regarding the volume and nature of their CRT activities, hindering their ability to monitor the firms' risk profiles against approved risk tolerances.

In addition, many market participants appeared not fully to appreciate how one type of risk (eg liquidity) can quickly evolve into another type (e.g. market and credit risk) in CRT.¹¹⁷ The lack of liquidity and corresponding drop in market value of highly rated CDO tranches, which was not anticipated by most market participants, provides an important example.»

There is an important difference between "anticipate" and "take into account" in risk management and scenario analyses.

Similar observations had been made already in 2005. For example the recommendations 2 and 12 (quoted above) were made to tackle this. Apparently the recommendations were implemented insufficiently.¹¹⁸

As regards liquidity, one can compare the above with section 5.1 of the report of the Joint forum of 2005.¹¹⁹ It is amazing that on the one hand it is obvious that the risks noted here are large, while on the other hand there is no serious reaction. Neither in words nor in deeds. Supervisors are concerned, and some of them worry. But what do they do?

«Liquidity

The importance of market liquidity in CRT is highlighted by recent credit market events, with one supervisor noting that "derivatives have created the tools to manage every risk except liquidity."

Supervisors are concerned that the "originate to distribute" business model makes a firm more dependent on market liquidity. A drying-up of market liquidity can impact a firm's ability to move credit assets off the balance sheet, disrupting the "pipeline" business model of a firm that originates or purchases credit assets with the expectation that they will be quickly sold. In this way, the "originate to distribute" model can generate unintended and large credit exposures to names, industries, asset classes and geographic regions in times of stress. It can also cause a firm to retain its market risk exposure for a much longer period of time than originally intended. Finally, it can lead to unanticipated funding difficulties for firms. These market liquidity risks also apply to CRT products purchased as investments for asset managers and insurers. These risks can become acute when firms fund such investments with short-term liabilities and rely on the market liquidity of the CRT assets to avoid asset/liability mismatch problems.

Some supervisors further worry that a decline in market liquidity can be exacerbated by leveraged transactions and participants, creating the potential for a vicious cycle of unplanned asset sales and margin calls driving prices lower, necessitating further sales and weakening of prices.»¹²⁰

Which is what happened. But the recommendations did not address the most crucial problems, and the time for effective action was passing rapidly.

The new recommendations.

Most of the recommendations are variants or supplements of those of 2005. But recommendation 5 is really new, even in style:

«Concentration Risk. Market participants should identify and avoid undue concentrations of risk through using CRT products and evaluate carefully their risk tolerance for, and ability to assume, liquidity risks associated with CRT activities.»

How are they supposed to do that? What are the boundary conditions (acceptable risks)? They

¹¹⁷ The subjects of interrelatedness of risk factors and second-order effects are treated in more detail in the Joint Forum report: *Cross-sectoral review of group-wide identification and management of risk concentrations – March 2008*. [Note of the original. The March 2008 report is included in the BIS-directory]

¹¹⁸ Had the recommendations been sent to those concerned?

¹¹⁹ Cited by the FCIC.

¹²⁰ Joint forum CRT 2008 p. 25-6/32-3.

depend on other market parties, and on the safety and soundness assurance of supervisors. If the supervisors cannot see the concentrations, how can market parties be supposed to see them? And finally: what if- due to their business model- a relatively large need of liquidity depends essentially on falling market-valuations of derivatives?

Considering the warnings that concentration can cause systemic risk, it is rather strange that a similar recommendation is not directed at the supervisors. Instead, recommendation 18 asks them to monitor compliance by the market participants:

«Supervisory requirements. Supervisors should evaluate the capital requirements for structured credit exposures, especially those based upon external credit ratings. Additionally, supervisors should ensure that institutions have well-developed frameworks for identifying concentration risks, and assess the need for capital requirements for such risks.»

Are the market participants supposed to make enquiries amongst one another? That doesn't seem efficient, if feasible.

The first part of the recommendation is remarkable as well. What exactly does it mean? Isn't it far better to do this in a coordinated or cooperative way? And what are the boundary conditions for the capital requirements? What risks are permissible, and why? Without unambiguous answer to these questions, there are thousand and one different capital requirements.

Once again there is no agreement or recommendation about monitoring the implementation and results of the recommendations, and about the rapid exchange of findings. Even though risks in one country strongly affect those in other countries.

June 2008. BIS AR 2008.

This is the 78th BIS AR. It is created 24/6/08 and modified 26/6/08.

There is a valuable timeline on pp 95-6/103-4. The report gives much relevant information about the onset of the subprime crisis.

June 2009. BIS AR 2009.

This is the 79th BIS AR. It is dated 29/6/09.

There is a valuable timeline on pp. 18-9/26-7.

Conclusions.

1. There is no concise summary and there are no (concise) conclusions.
2. As before the subprime crisis, the BIS AR writes in a style suggesting that it is omniscient. Its failure is evident, but there is no trace of modesty or awareness of any shortcoming. There is no awareness of the necessity of correction.
3. The section Warnings presents the warnings and context in such a way as to make it appear that inaction was inevitable. It does not try to find out how this inaction can be prevented, and appropriate action promoted.
4. The analysis has essential shortcomings, and the conclusions and recommendations are useless.
5. Chapter 2 gives a useful description of the course of the subprime crisis from June 2007-May 2009.
6. There is no explanation of the failure to adopt the GAO recommendations of 1994-1999, and the inadequate reactions to these recommendations. Something similar applies even more to the BIS CGFS reports 20 en 26 discussed above.
7. BIS could have distanced itself (somewhat) from the work of the commissions and working groups which it only hosted and provided with secretarial support. By means of this annual report it shows that it identifies itself with these commissions and working groups.
8. From the preceding points it follows that this AR is a manifestation of unlimited arrogance and unacceptable dysfunctioning.
9. There is no evidence showing that BIS has learnt anything positive from the crisis.

10. This is a shameless report. It greatly helps explain the occurrence of a crisis. With people like those of BIS in responsible positions, catastrophe is unavoidable.

Chapter 1, Rescue, recovery, reform.

Chapter 1 gives a very interesting evaluation of the subprime crisis. Interesting especially in the light of the duties and responsibility of the central banks and BIS. And because of the implicit pretension to be competent to evaluate the crisis, and the lack of self-evaluation.

The chapter is nevertheless written very well, with a rather unique sense of humor. It gives valuable supplementary insight. It also contains lies however. In this respect already the second sentence is a perfect hit: «No one thought that the financial system could collapse.». Everyone knowing the GAO reports, the nonsensical supervisor reactions to these reports, the LTCM crisis, the elimination of CFTC boss Born by her colleague-supervisors, and lastly the OFHEO systemic risk report, or any single one of these, must have been aware of the risk of a crash.

The section *What went wrong?* distinguishes macro- en micro economical causes, and within the last: incentives, risk measurement and regulation. The macro economical causes are summarized as follows:

«One set of macroeconomic causes of the crisis were global imbalances: the persistent and large current account deficits and surpluses resulting in capital flows from capital-poor emerging market countries to capital-rich industrial economies, especially the United States [...] combined with export-led or leverage-led growth [...] and low interest rates [...] which caused a credit boom. The boom caused distortions that need to be unwound.»¹²¹

Logic is entirely absent, both in the quote and the complete text. That the phenomena which are mentioned must result in a crisis is neither self-evident nor explained. If it were true, it would be all the more blamable that the central banks didn't warn earlier and more seriously, and failed to take measures or propose them to their governments. For contrary to the intransparant derivates markets and processes, these phenomena were well-known (from the economics textbooks and statistics bureaus). It seems that the author presumes the correctness of economical theories, and that these theories explain the crisis. So he concocts an explanation in the terminology of economics textbooks. Which after the fact is always easy.

The micro economical causes are summarized as follows:

«Microeconomic causes involved incentives, risk measurement and failings of the regulatory system. [...] The crisis has revealed distorted incentives for consumers, for financial sector employees and for rating agencies.»¹²²

Pp. 9-10/17-18 are devoted to the difficulty of estimating the tails of risk distributions, the lack of information about infrequent events, especially for new products [and processes]. «With no history, their riskiness cannot be statistically measured at all.»

This was well-known of course. But in practice supervisors assumed the risk to be zero, and did not manage risks anyway. The present BIS AR does not say how this kind of risk is to be treated, and gives no reference.

«Risk management in financial institutions has of course improved over time in addressing the incentive-related problems that arose during previous booms. But while there had been progress, it was based on a world with less leverage and risk-taking than we saw in the latest boom.»

“Of course improved”? What evidence underlies this statement? Why is this more than an often aped hypothesis? An obvious and essential fact is that the risks and/or their consequences increased more rapidly than the precautions to prevent or manage realization. Whatever “improvements”.

About inadequate capital requirements and regulation:

«Beyond the problems with incentives and risk measurement was the fact that financial institutions found it relatively easy to move activities outside the regulatory perimeter. Inside the supervisors’

¹²¹ This sentence is composed of the headings and the first sentence of p. 5-6/14-5 (BIS AR 2009).

¹²² BIS AR 2009 p. 7/15. Note that neither politicians nor policies are mentioned. While it is obvious that they play an important role.

sphere of influence, banks are required to hold capital in order to engage in risky activities. While it may be hard to believe, the regulatory capital requirement did limit the build-up of leverage on bank balance sheets. However, lower leverage meant lower profitability, so bank managers found ways to increase risk without increasing the capital they were required to hold. That is the story of the structured investment vehicle. More generally, the crisis showed that the enlarged financial sector – comprising both traditional banks and an increasingly important parallel financial system composed of non-bank intermediaries and off-balance sheet entities – had become much riskier than in the past.¹²³

Shouldn't this have been known? Shouldn't supervisors have done something about it? Noted the additional, possibly large, risks? (Where necessary informed their governments and asked for improved regulation?)

The discussion of the warnings on pp. 11-2/19-20 is utterly inadequate, if not scandalous. The arguments are of the most extreme passivity type. They seem to be biased in order to prevent, weaken or reduce complaints about supervision.

«Many of these warnings turned out to be accurate, but obviously they were issued in vain. While people agreed on the general nature of the stresses that were building in the system, there was little agreement on the details. The implications of the porous regulatory perimeter – through which firms could easily move activity beyond the view of officials – and the build-up of financial leverage – in which the capital structure shifted to one with relatively more debt and relatively less equity – were simply not well understood. Although some people called for effective regulation of hedge funds, they were much less vocal about the need to keep intermediaries from shifting loans to conduits and structured investment vehicles that had virtually no capital. Finally, almost no one realized that the US assets being spread around the world would turn out to be toxic.

It is not surprising that government officials and market participants were largely deaf to the alarms.»

Especially if supervisors and politicians believe in dogma's which allow them to remain passive, and to keep waiting and hoping for the best, instead of sounding the alarm and taking action. The last sentence is simply misleading or fraud. The systematic passivity of the supervisors as shown by all of their reports, and the inadequacy of their reactions to the warnings of the GAO and others, are both amazing and incompatible with their duties, and only explicable on the basis of utter incompetence, including dishonesty.

Details were completely irrelevant. If they had been relevant, the supervisors should and could have tried harder to acquire the necessary information and insight.

“Not well understood” only means additional risk, danger. One never can know and understand everything. It could and should moreover have been noted by the supervisors, at least in their annual reports, that important things were not known or understood. They should have advised about consequences, and about action to be taken.

The sentence **Although...** suggests that a warning for danger 1 can be ignored if it is not coupled with a warning against danger 2. Which is evident nonsense. And of course, only the supervisors are to be blamed for the lack of calls for effective regulation of both hedge funds and SIV's.

The sentence **Finally...** is at best a misleading half truth. This representation of the state of affairs is simply incorrect. It suggests that nobody realized that assets can devalue, even much. But that is obvious nonsense. There was plenty awareness of risks, and this was what the risks were about. The risks may have been underestimated, but that is a different matter. Risks may have been ignored because they seemed to be very small and hard to estimate. There certainly was no due regard for the consequences of realization of (any) risks. Nowhere did the present author see scenario's, except in the GAO and OFHEO reports. The problem was not the ignorance of risks, but the dogmatic rejection of supervisory “meddling”. It was the failure to trace and analyse scenario's following realization of risks. Undoubtedly at least in part because the ruling dogma's decreed that self-regulation took care of risks. While contrary to what the supervisors said, the risk management of major institutions was simply inadequate. Supervisors nor governments had set bounds on acceptability of risk. An observation by the way that is not found in any of the reports, before or after the crisis.

¹²³ BIS AR 2009 p. 10/18.

P. 12/20 gives a few examples of insignificant actions by mostly irrelevant supervisors.¹²⁴

The section concludes as follows:

«In the industrial economies – especially the United States, where the problem was becoming the most severe – there was little discussion of what types of tools policymakers might try to use to combat the property and credit booms, and the consequent build-up of systemic risk. And it is easy to see why. Making what would have been wholesale changes to the monetary and regulatory policy frameworks in many countries would have presented nearly insurmountable political and intellectual difficulties. Why would anyone risk such a move when the existing apparatus appeared to be working so well?»¹²⁵

This too is a misleading representation of the situation and history. As an explanation it does not pass muster, and the text does not answer the question why nothing was done about the other problems mentioned earlier in the AR. It furthermore does not explain the inadequate reactions to the GAO reports and the intolerant and foolish repression of the CFTC/Born efforts to improve regulation of OTC. It does not even explain the weakness of the analyses and recommendations in the above mentioned BIS reports, and their failure to propose more decisive action. (The reports do not mention these “insurmountable difficulties”). It does not explain the absence of open discussion of the risks and situation by the supervisors in their AR. In fact, the text completely fails to address the question of the responsibility of the supervisors. Did they do what they could do and should have done? Of course not. Why? Are they only to do what is politically and intellectually acceptable? (Whatever that “politically and intellectually acceptable” may mean or hide) Do the intellectual difficulties include those of nonsensical dogma’s and the economic quasi-science?

No mention is made of the absence of even the idea of a need of risk management by the supervisors, of the lack of openness of the supervisors (for example in their publications), and the absence of evidence of their feeling responsible,

Chapter 1 concludes with the following advice:

«The redesign of the financial system must be comprehensive. Ensuring financial stability requires a redesign of macroeconomic as well as regulatory and supervisory policies with an eye to mitigating systemic risks. For macroeconomic policies, this means leaning against credit and asset price booms; for regulatory and supervisory policies, it means adopting a macroprudential perspective. Importantly, reform must focus on identifying systemic risks arising in all parts of the financial system – risks that arise from the complexity, opacity and ownership concentration of financial instruments; from the counterparty risk and margining practices in financial markets; from the risk of joint failure created by interconnections and common exposures; and from the procyclicality that is inherent in financial institution management and can be compounded by microprudential regulation.»

This is so vague as to offer not the least guarantee of improvement. Comprehensive redesign can mean everything, both good and bad. It will not help if it is based on the BIS analysis, or a macroprudential perspective (which can be seen as a symptom of complete misunderstanding). Explicit attention to systemic risk is obviously necessary,¹²⁶ as noted by GAO in 1999, but “focus” should not mean neglect of other aspects.

Fake measures will increase the danger, because they give an feeling of security that leads to underestimation of risks in all kinds of decisions.

Why doesn’t BIS explicitly acknowledge and support the GAO recommendations, or remind and improve upon those of BIS CGFS 20 en 26? Because it would show incompetence and failure? It would. But it would also show openness, and willingness to admit errors and learn. It would reduce the fear that the words about reform are no more than words, only meant as a sop for the public. After all, BIS has by now amply proven that it cannot be trusted.

Some of the remarks in this AR are completely ridiculous, and misleading. An example:

«For all their enduring virtues, markets have failed in some very important ways. It is now apparent that as the financial system has grown and become more complex, it has come to need a more

¹²⁴ Without dates and references.

¹²⁵ BIS AR 2009 p. 12/20.

¹²⁶ BIS does not explain its neglect in the past > 15 years.

comprehensive set of rules to ensure that it functions smoothly.»

The remark refers to the following footnote:

«As John McMillan notes, individual incentives and self-regulation go only so far. The existence of an underground economy proves that markets can self-organise but only when transactions remain small and simple. Moving beyond the black market requires rules and a rule-maker. That is where the government steps in to protect property rights and ensure that people live up to their promises. See J McMillan, *Reinventing the bazaar: a natural history of markets*, W W Norton, 2002.»

Take note: of 2002. Why didn't BIS or any supervisor listen and act in 2002? That is the first and foremost problem. Why doesn't BIS explain how it could neglect McMillan, and before him the far more important GAO reports and the analysis of the LTCM crisis?¹²⁷

The remark “For all their enduring virtues...” is completely ridiculous because everything it says (except the enduring virtues) was already known for many years, if not centuries. It is misleading because it suggests new insight, that could not have been obtained without a crisis.

It is a pity that BIS does not enumerate the “enduring virtues” of “markets”, and show how the costs can be compared to the benefits (“virtues”).

¹²⁷ In fact, the reference to McMillan seems exceptionally arbitrary, inadmissible.

4. The CFTC annual reports 2006 and 2008.

Table of contents of this appendix.

- (Acting) chairpersons 1996-2010.
- CFTC AR 2006.
- CFTC AR 2008.
- The FCIC report on the history of the CFTC and the (de)regulation of OTC.

(Acting) chairpersons 1996-2010.¹²⁸

- John E. Tull, Jr. (Acting Chairman 1/27/96-8/25/96) 4/15/93 – 4/15/98, 11/24/93 – 2/27/99
- Brooksley E. Born (Chairperson 8/26/96-6/1/99) 4/15/94 – 4/15/99, 8/26/96 – 6/1/99
- David D. Spears (Acting Chairman 6/2/99-8/10/99) 4/15/95 – 4/15/00, 9/3/96 -12/20/01
- William J. Rainer (Chairman 8/11/99 – 1/19/01) 4/15/99 – 4/13/04, 8/11/99 – 1/19/01
- James E. Newsome (Acting Chairman 1/20/01 – 12/27/01) (Chairman 12/27/01 – 7/23/04) 6/19/96 – 6/19/01, 6/19/01 – 6/19/06 8/10/98 – 7/23/04
- Sharon Brown-Hruska (Acting Chairman 7/24/04 – 7/10/05) 4/13/99 – 4/13/04, 4/13/04 – 04/13/09, 8/7/02 – 7/28/06
- Reuben Jeffery III (Chairman 7/11/05 – 6/27/07) 4/13/02 – 4/13/07, 7/11/05 – 6/27/07
- Walter L. Lukken (Acting Chairman 6/27/07-1/20/09) 4/15/00 – 4/15/05, 4/15/05 – 4/15/10, 8/07/02 -7/1/09
- Gary Gensler (Chairman 5/26/09 -)

In spite of their long presence at the CFTC, in important years, Jeffery and Lukken do not appear in the list of persons heard by the FCIC. Lukken has no Wiki page.¹²⁹ Contrary to Jeffery III, see the dossier. (Lukken is a politician). Gensler has been heard.

CFTC AR 2006.

The pdf file was created 15/12/06, and modified 10/1/07.

The pdf file has no bookmarks, and the table of contents is not linked.

The page numbering is complicated. Here (only) the numbers are given which appear on the pages.

Conclusions.

1. The main conclusion is: there is no indication of anything being amiss. Nothing in the report suggests that 2006 was very different from 2005, or that 2007 may be very different from 2006.
2. The report does not outline the position of the CFTC in the financial system or in the supervision system. It gives no idea of the duties of the CFTC with respect to the duties of other supervisors. It does not explain that parts of the financial system are less supervised than others, or not at all, and what that means for the safety and soundness of others and the whole. It does not describe its possibilities or limitations, or assumptions, one should keep in mind when reading this annual report.
3. The report does not explain the significance of its results (measurements). It suggests that its goals were attained. Even though logic obviously forbids to conclude safety and soundness from even perfect results of all performance measurements mentioned. The annual report expresses no doubts as to the ability to measure the performance of the CFTC and the safety and soundness of the CFTC part of the financial system with the listed indicators. There is no discussion about the relevance of the indicators (performance measures).

¹²⁸ Wikipedia 31/3/13. It does not explain the notation. Possibly the period of (acting) chairmanship is placed between brackets, while the other periods refer to common membership. But there is reason for doubt about the accuracy. Some dates do not agree with dates mentioned in CFTC AR 2006 on pp. 133 and following.

¹²⁹ At the time of writing. That is, around 3/13.

4. There is no trace of awareness of, or interest in, the performance of the financial system as a whole.
5. The annual report completely lacks any critical attitude. As implied by the above, it is extremely self-centered.
6. There is no list of publications.
7. The CFTC may very well do a lot of useful work, and prevent a lot of misconduct and dangers. But it also may be no more than cumbersome overhead. The point being that this annual report does not enable the reader to form an opinion about the effectiveness of the CFTC. Obviously, the quality of its work leaves a lot to be desired. But how much can only be guessed.
8. The prizes for the AR 2006 and 2007 are entirely misplaced.¹³⁰ They are indications of a corrupt, dysfunctional social system.
9. No crash or crisis was needed to conclude the inadequacy (unprofessionality) of the CFTC annual reports. Application of common sense suffices.

In 2008, the CFTC had a formation of 448 fte.¹³¹

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The following is taken from “A Message from the Chairman” on p. 1:

«The Commodity Futures Trading Commission (CFTC or Commission) oversees the commodity futures and option markets in the United States (U.S.). These markets are the key source of commodity price discovery and are used as a tool by participants in the global economy to offset price risk. In recent years these trillion dollar markets, with massive economic force, have grown faster than almost any other asset class. The markets are expanding steadily in both volume and new users and their

¹³⁰ The AGA prize for AR 2006 is reported on one of the first pages of AR 2007. The pdf file of CFTC AR 2007 has no bookmarks or linked table of contents. CFTC AR 2007 has an interesting list of “historical events” in the history of the CFTC. The listed events are non controversial: 1998 is absent.

¹³¹ P. 42 of CFTC AR 2008.

complexity is rapidly evolving with new technologies, globalization, product innovation, and greater competition.

The Commission accomplishes its mission through three strategic goals, each focusing on a vital area of regulatory responsibility. They are:

1. to ensure the economic vitality of the commodity futures and option markets;
2. to protect market users and the public; and
3. to ensure market integrity in order to foster open, competitive, and financially sound markets.»¹³²

The chairman concludes his message as follows:

«Although these [= the above mentioned] accomplishments are very significant in themselves, they are only part of the important contributions made daily by the dedicated staff of the Commission. We hope you will join us in applauding their efforts, which are highlighted in the pages to follow using data, both financial and performance, that is reliable and complete.»¹³³

The following is the conclusion of “CFTC History and Transformation” on p. 7:

«In recognition of this changing environment, Congress and the President reauthorized the Commission through FY 2005 with the passage of the Commodity Futures Modernization Act (CFMA) in December 2000. [...] It also brought legal certainty to the trading done in bilateral, over-the-counter derivatives transactions and clarified the CFTC’s jurisdiction over the retail, off-exchange foreign currency market. It gave the CFTC authority to regulate clearing organizations in a way that enables the CFTC more effectively to foster open, competitive, and financially sound markets.»

This section could have been used to outline the development of the duties and authority of the CFTC, and to explain the limitations of the supervision by the CFTC. To describe what is and what is not regulated or supervised. The CFTC did not use this opportunity.

The following is the beginning of “Keeping Pace with Change” on p. 7:

«In February 2004, the Commission issued Keeping Pace with Change, a strategic plan for FY 2004-FY 2009. This plan reflects the new direction of the agency, driven by the CFMA, including three key objectives:

1. modernizing regulations affecting trading platforms and market intermediaries;
2. permitting futures based on single stocks or narrow-based stock indices; and
3. providing legal certainty for over-the-counter derivatives.»¹³⁴

The left graph on p. 8 shows the number of staff of the CFTC in 1996-2006. In 2006 it was 490 fte. In 1999 it was 567, the maximum for these years. In the same period trading volume increased about fourfold.

P. 9: «The Commission regulates the activities of over 70,000 registrants».

The tables on the pp. 10-13 suggest that quite a few markets and organizations are not supervised by the CFTC for one reason or another. The legends of the tables leave something to be desired. The history of the CFTC and (de)regulation of OTC, as given in the FCIC report, may explain at least part of the tables.

The section “Performance Highlights for Goal One” on p. 17 can be summarized by “In 2006, it was business as usual”. The pages mentions nothing remarkable.

The same applies to goal 2.

¹³² The numbers 1-3 have been added for clarity by the present author.

¹³³ On the same p. 1. The signature is dated 15/11/06.

¹³⁴ In the original the items are presented consecutively, instead of each on a new line.

The section “Performance Highlights for Goal Three” on p. 24/28 includes the following subsection:

«Capital Computation and Risk Models.

The Commission adopted amendments to its regulations that recognize the growing use by FCMs of internally developed mathematical models for value-at-risk (VaR), especially in light of SEC regulations that permit well-capitalized broker-dealers to incorporate VaR measurements in the market risk and credit risk capital deductions that are required for their proprietary trading assets.¹³⁵ FCM/broker-dealers who are registered with both the Commission and the SEC, and who have received SEC approval for their VaR-based market risk and credit risk deductions, are permitted to use the same deductions when calculating their capital under amended Commission Regulation 1.17. When compared to the capital deductions that Commission Regulation 1.17 (or similar SEC regulations) otherwise would require, capital deductions based on VaR measurements are aligned more specifically to the risk characteristics of the firm’s trading portfolio. FCMs using such market risk and credit risk capital deductions are required to provide to the Commission, on a periodic basis, information related to their VaR models.»

Although the present author does not claim to understand this for the full 100%, one suspects that SEC and CFTC believe that capital requirements can be reduced if supposedly improved models are used. Where do they prove this? Has this been approved internationally? Where? No references are given.

No other remarkable things are reported.

P. 25 has a section “Forward Looking”. Nothing is reported about any serious problems or risky developments. Nothing about important risks or their growth. Nothing suggests that 2007 might differ substantially from 2006.

Pp. 133-135 presents the biographies of the commissioners. Chairman Reuben Jeffery III has worked 18 years for Goldman Sachs.

The word fragment “self-regulat” is found 25 times in this annual report. The report frequently uses the abbreviation SRO for self-regulating organization.

The performance section of the CFTC annual report is discussed under AR 2008 below, because it is much easier to evaluate this section of the AR when there is clear observational evidence, as provided by the events of September 2008.

CFTC AR 2008.

The pdf file was created and modified on one and the same date: 8/1/09.
The pdf file has a linked table of contents.

Conclusions.

- If you don’t read very carefully, you wouldn’t be able to infer from the report that anything abnormal had happened in 2008, and that a crash had occurred and a crisis arisen.
- In particular, there is no discussion of “CFTC and the crisis”. On pp. 2-5, AR 2007 had given a kind of timeline.¹³⁶ If the CFTC would repeat that exercise in say 2020, what would it report under 2007 and 2008?
- With obvious changes, what was said about AR 2006 applies here as well.
- The performance section and its performance measures are purely theoretical. Their relation with the relevant phenomena is unclear and not discussed. Neither is it discussed in the light of the

¹³⁵ FCM= futures commission merchant.

¹³⁶ To give an indication of the level of detail: there are 20 entries (events) for 2001-2007.

crisis.¹³⁷ Formulations about performance often are misleading, if not plainly incorrect.

One of the first pages of AR 2008 is called the “CFTC Awards Page”. It is devoted to two prizes awarded for AR 2007.

**Association of Government Accountants (AGA) Awards the
CERTIFICATE OF EXCELLENCE IN ACCOUNTABILITY REPORTING**
*In recognition of your outstanding efforts in preparing the
Commodity Futures Trading Commission Performance and
Accountability Report for the fiscal year ended September 30, 2007*

**League of American Communications Professionals (LACP) Awards the
GOLD 2007 VISION AWARD**

*In recognition of your outstanding efforts in preparing the Commodity Futures Trading
Commission Performance and Accountability Report for the fiscal year ended September 30, 2007.
Awarded GOLD in the Government classification, and received overall ranking of 140 out of 3,161
total entries.*

In this annual report, the *Message from the Chairman* covers pp. 2 t/m 5.¹³⁸ The length of the message is not caused by the crisis. Hardly a trace of the calamitous events can be found. The only sentences vaguely suggesting that something may be amiss are quoted below. Crash or crisis related phenomena are hardly mentioned. What the CFTC has to do with them is discussed even less. Although this is an annual report, it does not report about the CFTC’s reactions to the exceptional events. Several paragraphs of the annual report nevertheless suggest that the CFTC did have a role in the events.

The next quote seems to concern the legal basis of the CFTC:

«A major step in the Commission’s evolution came in May, after years of work and bipartisan effort, when Congress enacted the CFTC reauthorization legislation as part of the Food, Conservation, and Energy Act of 2008 (Farm Bill), making critical improvements to the Commodity Exchange Act (CEA or the Act) and the Commission’s authority. Specifically, the new legislation reauthorized the Commission through FY 2013, closed the so-called “Enron Loophole” by allowing enhanced Commission oversight of exempt commercial markets (ECMs) that trade contracts linked to regulated U.S. futures contracts, increased CFTC penalties for manipulation, clarified CFTC anti-fraud authority for off-exchange principal-to-principal energy trades, and clarified CFTC retail foreign currency fraud authority.» (pp. 2-3)

What is the importance of ECMs? Who supervised them before 2008, if anyone? Under 2006, p. 12 of CFTC AR 2006 mentions “17 ECMs having filed notices with the Commission”. In 2001 only 3 had. See also the critical evaluation by the Inspector General of the CFTCs FY 2007 performance regarding ECMs on p. 137 of CFTC AR 2008.

A little bit farther on:

«As a result of [...] public hearings and meetings, the Commission focused on a number of critical initiatives, including:

- 1) providing a detailed report to Congress recommending legislative changes relating to oversight of trading on ECMs (recommendations that were enacted in large part as part of the Farm Bill); [...]

¹³⁷ This is not to say that the measures are entirely irrelevant. They may be relevant for part of the CFTC’s duties. The problem is that the relevance of the measures is completely unclear, and that the relation between the measures and the real goals is not discussed. The present author does not understand how it is possible that nothing in the performance section lets transpire that the financial system went amok.

¹³⁸ Signed 17/11/08.

- 4) requiring production of more detailed trading information from index traders and swap dealers; reviewing whether index traders and swap dealers are properly classified for regulatory and reporting purposes; [...] and
- 7) issuing an unprecedented special call for information from commodity swap dealers and index funds trading in OTC markets to quantify the amount of this trading and evaluate its potential effects on the regulated markets.»¹³⁹

What was the motivation for these questions? Phenomena related to the crisis? The questions suggest that the CFTC has something to do with the crisis. But what exactly? Explanation is missing.

P. 4 presents the start of self-evident cooperation with other financial supervisors as extraordinary accomplishments.

P. 5 mentions “the credit crunch and overall market distress over the last year”, and the bankruptcy of Lehman.

Only the closing paragraph uses the word “crisis”:

«The year ahead will be a busy one for the Commission. In the wake of the financial crisis, Congress will likely turn to broad financial reform. Volatility in the energy and agricultural markets will continue to be the focus of policymakers as we work to ensure the proper functioning of our price discovery and risk management markets. I am confident that the Commission’s dedicated staff and the flexible principles-based authority provided by Congress will help this agency to forcefully police these ever-changing markets in order to uphold the CFTC’s important mission and the public’s trust.»

The paragraph is quoted in full, to show that except for this one sentence it says nothing about the crisis.

The section *Forward Looking—Future Business Trends and Events* reports problems with staff. Quantity and quality are insufficient to fulfil the CFTC duties :

«Without a staffing increase, Commission efforts will be scaled back to the extent increased productivity cannot offset resource deficits.»¹⁴⁰

Pp. 38-9 of the section list developments, problems and risks.

The performance section of CFTC AR 2008.

The performance regards four goals:¹⁴¹

1. Ensure the economic vitality of the commodity futures and option markets.
2. Protect market users and the public.
3. Ensure market integrity in order to foster open, competitive, and financially sound markets.
4. Facilitate Commission performance through organizational and management excellence, efficient use of resources, and effective mission support.

After an introductory title page, the first page of this section defines Goal One:

«Goal One: Ensure the economic vitality of the commodity futures and option markets.

Outcome Objective 1.1: Futures and option markets that accurately reflect the forces of supply and demand for the underlying commodity and are free of disruptive activity.

Annual Performance Goal 1.1: No price manipulation or other disruptive activities

¹³⁹ CFTC AR 2008 pp. 3-4. The hearings were held “In order to increase transparency and better inform the regulatory responses to the challenges of today’s markets”. The “challenges” can hardly be unrelated to the crisis and/or its causes. But this is not stated explicitly, and the challenges are not specified.

¹⁴⁰ CFTC AR 2008 p. 37.

¹⁴¹ The descriptions of the goals are taken from the first pages of the corresponding sections: pp. 46, 56, 74 and 91 respectively.

that would cause loss of confidence or negatively affect price discovery or risk shifting.

Outcome Objective 1.2: Markets are effectively and efficiently monitored to ensure early warning of potential problems or issues that could adversely affect their economic vitality.

Annual Performance Goal 1.2: To have an effective and efficient market surveillance program.»¹⁴²

(In CFTC AR 2006, the above and following subdivisions of goals is given not in the performance section, but on pp. 15-24).

The following pages present results of measurements of performance with the help of "performance measures". They are listed here to show them, and because the annual report does not give a listing or an overview of them. They are important because they embody the self-evaluation of the CFTC. They are:

1. «Percentage growth in market volume.
2. Percentage of novel or innovative proposals or requests for CFTC action addressed within six months to accommodate new approaches to, or the expansion in, derivatives trading, enhance the price discovery process, or increase available risk management tools.
3. Percentage increase in number of products traded.
4. Percentage of new exchange or clearinghouse organization applications completed within expedited review period.
5. Percentage of new contract certification reviews completed within three months to identify and correct deficiencies in contract terms that make contracts susceptible to manipulation.
6. Percentage of rule change certification reviews completed within three months, to identify and correct deficiencies in exchange rules that make contracts susceptible to manipulation or trading abuses or result in violations of law.
7. Percentage of derivatives clearing organization applications demonstrating compliance with CFTC Core Principles.
8. Ratio of contracts surveilled [sic] per economist.
9. Percentage of contract expirations without manipulation.»

The first 6 belong to goal 1.1, the last 3 to goal 1.2. One page is devoted to each measure. Results are given for the years 2005-2008. For 2008 both the actual and plan value are given. Whatever the percentages say about the CFTC's performance, it seems rather strange to claim that they measure the success of the CFTC's efforts to ensure the economic vitality of the commodity futures and option markets.

Note that measure 2 suggest that more risk management tools means better risk management. But it is not explained how the implementation of the (new) risk management tools is evaluated. Something similar applies to other items in the list.

Especially in 2008, goal 2 would seem to be very much to the point. It is defined as follows:

«Goal Two: Protect market users and the public.

Outcome Objective 2.1: Violations of Federal commodities laws are detected and prevented.

Annual Performance Goal 2.1: Violators have a strong probability of being detected and sanctioned.

Outcome Objective 2.2: Commodity professionals meet high standards.

Annual Performance Goal 2.2: No unregistered, untested, or unlicensed commodity professionals.

Outcome Objective 2.3: Customer complaints against persons or firms registered under the Act are handled effectively and expeditiously.

Annual Performance Goal 2.3: Customer complaints are resolved within one year from the date filed and appeals are resolved within six months.»

¹⁴² CFTC AR 2008 p. 46.

Note that the goal suggests that this is possible. That is, that law and regulation are adequate. After 2008, with events suggesting a terrible lack of protection of users and public, one would expect the CFTC to explain the discrepancy between appearances (= reality) and the suggestion of this annual report, that at least the CFTC protection was effective.

[Regarding objective 1:]

1. «Number of enforcement investigations opened during the fiscal year.
2. Number of enforcement cases filed during the fiscal year.
3. Percentage of enforcement cases closed during the fiscal year in which the Commission obtained sanctions (e.g. civil monetary penalties, restitution and disgorgement, cease and desist orders, permanent injunctions, trading bans, and registration restrictions).
4. Cases filed by other criminal and civil law enforcement authorities during the fiscal year that included cooperative assistance from the Commission.

[Regarding objective 2:]

1. Percentage of self-regulatory organizations that comply with CFTC Core Principles.
2. Percentage of derivatives clearing organizations that comply with CFTC Core Principles.
3. Percentage of professionals compliant with standards regarding testing, licensing, and ethics training.
4. Percentage of self-regulatory organizations that comply with requirement to enforce their rules.
5. Percentage of total requests receiving CFTC responses for guidance and advice.

[Regarding objective 3:]

1. Percentage of filed complaints resolved within one year of the filing date for Voluntary Proceedings.
2. Percentage of filed complaints resolved within one year and six months of the filing date for Summary Proceedings.
3. Percentage of filed complaints resolved within one year and six months of the filing date for Formal Proceedings.
4. Percentage of appeals resolved within six months».

«Goal Three: Ensure market integrity in order to foster open, competitive, and financially sound markets

Outcome Objective 3.1: Clearing organizations and firms holding customer funds have sound financial practices.

Annual Performance Goal 3.1: No loss of customer funds as a result of firms' failure to adhere to regulations. No customers prevented from transferring funds from failing firms to sound firms.

Outcome Objective 3.2: Commodity futures and option markets are effectively self-regulated.

Annual Performance Goal 3.2: No loss of funds resulting from failure of self-regulated organizations to ensure compliance with their rules.

Outcome Objective 3.3: Markets are free of trade practice abuses.

Annual Performance Goal 3.3: Minimize trade practice abuses.

Outcome Objective 3.4: Regulatory environment is flexible and responsive to evolving market conditions.

Annual Performance Goal 3.4: Rulemakings issued and requests responded to reflect the evolution of the markets and protect the interests of the public.»

Note that “Commodity futures and option markets are effectively self-regulated”, and that this is a very far reaching objective. There seems to be no measure for the effectiveness or adequacy of “their rules”.

The performance measures are:

[Regarding objective 1:]

1. «Lost Funds: Number of customers who lost funds.

2. Number of rulemakings to ensure market integrity and financially sound markets.
3. Percentage of clearing organizations that comply with requirement to enforce their rules.

[Regarding objective 2:]

1. Percentage of intermediaries who meet risk-based capital requirements.
2. Percentage of self-regulatory organizations that comply with requirement to enforce their rules.

Both percentages are found to be 100. (From 2005 onwards even). Obviously this does not imply “effective self-regulation”. As every attentive reader could have noticed. Already in CFTC AR 2006 (on p. 22).

[Regarding objective 3:]

1. Percentage of exchanges deemed to have adequate systems for detecting trade practice abuses.
2. Percentage of exchanges that comply with requirement to enforce their rules.

[Regarding objective 4:]

1. Percentage of CFMA Section 126(b) objectives addressed.
2. Number of rulemakings, studies, interpretations, and guidances to ensure market integrity and exchanges’ compliance with regulatory requirements.
3. Percentage of requests for no-action or other relief completed within six months related to novel market or trading practices and issues to facilitate innovation.
4. Percentage of total requests receiving CFTC responses for guidance and advice.»

Goal Four is: Facilitate Commission performance through organizational and management excellence, efficient use of resources, and effective mission support. This goal was missing in CFTC AR 2006. It is not discussed here, because it is relatively unimportant, and cannot reasonably be expected to yield important new insight.

The conclusion is that the performance measures do not measure the safety and soundness of the supervised system. The report does not discuss the limitations of the performance measures. A critical attitude is lacking.

The FCIC report on the history of the CFTC and the (de)regulation of OTC.

The following unabridged quote includes all relevant occurrences of “CFTC” in the FCIC report. The quote is given because it seems to be a valuable supplement to the annual reports.

The quote starts on p. 46.

«The derivatives markets are organized as exchanges or as over-the-counter (OTC) markets, although some recent electronic trading facilities blur the distinctions. The oldest U.S. exchange is the Chicago Board of Trade, where futures and options are traded. Such exchanges are regulated by federal law and play a useful role in price discovery—that is, in revealing the market’s view on prices of commodities or rates underlying futures and options. OTC derivatives are traded by large financial institutions—traditionally, bank holding companies and investment banks—which act as derivatives dealers, buying and selling contracts with customers. Unlike the futures and options exchanges, the OTC market is neither centralized nor regulated. Nor is it transparent, and thus price discovery is limited. No matter the measurement—trading volume, dollar volume, risk exposure—derivatives represent a very significant sector of the U.S. financial system.

The principal legislation governing these markets is the Commodity Exchange Act of 1936, which originally applied only to derivatives on domestic agricultural products. In 1974, Congress amended the act to require that futures and options contracts on virtually all commodities, including financial instruments, be traded on a regulated exchange, and created a new federal independent agency, the Commodity Futures Trading Commission (CFTC), to regulate and supervise the market.

Outside of this regulated market, an over-the-counter market began to develop and grow rapidly in the 1980s. The large financial institutions acting as OTC derivatives dealers worried that the

Commodity Exchange Act's requirement that trading occur on a regulated exchange might be applied to the products they were buying and selling. In 1993, the CFTC sought to address these concerns by exempting certain nonstandardized OTC derivatives from that requirement and from certain other provisions of the Commodity Exchange Act, except for prohibitions against fraud and manipulation.

As the OTC market grew following the CFTC's exemption, a wave of significant losses and scandals hit the market. Among many examples, in 1994 Procter & Gamble, [transition to p. 47] a leading consumer products company, reported a pretax loss of \$157 million, the largest derivatives loss by a nonfinancial firm, stemming from OTC interest and foreign exchange rate derivatives sold to it by Bankers Trust. Procter & Gamble sued Bankers Trust for fraud—a suit settled when Bankers Trust forgave most of the money that Procter & Gamble owed it. That year, the CFTC and the Securities and Exchange Commission (SEC) fined Bankers Trust \$10 million for misleading Gibson Greeting Cards on interest rate swaps resulting in a mark-to-market loss of \$23 million, larger than Gibson's prior-year profits. In late 1994, Orange County, California, announced it had lost \$1.5 billion speculating in OTC derivatives. The county filed for bankruptcy—the largest by a municipality in U.S. history. Its derivatives dealer, Merrill Lynch, paid \$400 million to settle claims. In response, the U.S. General Accounting Office [GAO] issued a report on financial derivatives that found dangers in the concentration of OTC derivatives activity among 15 major dealers, concluding that "the sudden failure or abrupt withdrawal from trading of any one of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole." While Congress then held hearings on the OTC derivatives market, the adoption of regulatory legislation failed amid intense lobbying by the OTC derivatives dealers and opposition by Fed Chairman Greenspan.

In 1996, Japan's Sumitomo Corporation lost \$2.6 billion on copper derivatives traded on a London exchange. The CFTC charged the company with using derivatives to manipulate copper prices, including using OTC derivatives contracts to disguise the speculation and to finance the scheme. Sumitomo settled for \$150 million in penalties and restitution. The CFTC also charged Merrill Lynch with knowingly and intentionally aiding, abetting, and assisting the manipulation of copper prices; it settled for a fine of \$15 million.

Debate intensified in 1998. In May, the CFTC under Chairperson Brooksley Born said the agency would reexamine the way it regulated the OTC derivatives market, given the market's rapid evolution and the string of major losses since 1993. The CFTC requested comments. It got them. Some came from other regulators, who took the unusual step of publicly criticizing the CFTC. On the day that the CFTC issued a concept release, Treasury Secretary Robert Rubin, Greenspan, and SEC Chairman Arthur Levitt issued a joint statement denouncing the CFTC's move: "We have grave concerns about this action and its possible consequences. . . . We are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives." They proposed a moratorium on the CFTC's ability to regulate OTC derivatives.

For months, Rubin, Greenspan, [SEC-chairman] Levitt, and Deputy Treasury Secretary Lawrence Summers opposed the CFTC's efforts in testimony to Congress and in other public pronouncements. As Alan Greenspan said: "Aside from safety and soundness regulation of derivatives dealers under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary."

In September, the Federal Reserve Bank of New York orchestrated a \$3.6 billion recapitalization of Long-Term Capital Management (LTCM) by 14 major OTC [transition to p. 48] derivatives dealers. An enormous hedge fund, LTCM had amassed more than \$1 trillion in notional amount of OTC derivatives and \$125 billion of securities on \$4.8 billion of capital without the knowledge of its major derivatives counterparties or federal regulators. Greenspan testified to Congress that in the New York Fed's judgment, LTCM's failure would potentially have had systemic effects: a default by LTCM "would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM."

Nonetheless, just weeks later, in October 1998, Congress passed the requested moratorium.

Greenspan continued to champion derivatives and advocate deregulation of the OTC market and the exchange-traded market. "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," Greenspan said at a

Futures Industry Association conference in March 1999. “The fact that the OTC markets function quite effectively without the benefits of [CFTC regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives.”

The following year—after Born’s resignation—the President’s Working Group on Financial Markets, a committee of the heads of the Treasury, Federal Reserve, SEC, and Commodity Futures Trading Commission charged with tracking the financial system and chaired by then Treasury Secretary Larry Summers, essentially adopted Greenspan’s view. The group issued a report urging Congress to deregulate OTC derivatives broadly and to reduce CFTC regulation of exchange-traded derivatives as well. In December 2000, in response, Congress passed and President Clinton signed the Commodity Futures Modernization Act of 2000 (CFMA), which in essence deregulated the OTC derivatives market and eliminated oversight by both the CFTC and the SEC. The law also preempted application of state laws on gaming and on bucket shops (illegal brokerage operations) that otherwise could have made OTC derivatives transactions illegal. The SEC did retain antifraud authority over securities-based OTC derivatives such as stock options. In addition, the regulatory powers of the CFTC relating to exchange-traded derivatives were weakened but not eliminated.

The CFMA effectively shielded OTC derivatives from virtually all regulation or oversight. Subsequently, other laws enabled the expansion of the market. For example, under a 2005 amendment to the bankruptcy laws, derivatives counterparties were given the advantage over other creditors of being able to immediately terminate their contracts and seize collateral at the time of bankruptcy.»

5. CVs of the members of the FCIC.

This appendix is included to present evidence about the competences of the members of the FCIC, and because the source, the FCIC website as of 20/2/12, includes the following acknowledgement of Brooksley Borns efforts to improve regulation of OTC, one of the very few encountered in the present study:

« Ms. Born is a 2009 recipient of the John F. Kennedy Library Foundation's Profile in Courage Award "presented annually to public servants who have made courageous decisions of conscience without regard for the personal or professional consequences." She received the award in recognition of her efforts as chair of the CFTC to urge that the over-the-counter derivatives market should be subject to federal oversight and regulation. The failure to regulate that market is now seen to be a major cause of the recent financial crisis.».

According to page 9, "Commission staff", of the FCIC report, the commission was assisted by a staff of 87 persons.

General summary and conclusions.

The CVs look like those submitted by people who apply for a job. That is: they are one-sidedly self serving. They present the candidate in as favorable a light as possible. So the reader is warned. Crucial information is probably simply left unmentioned. There is not the least semblance of objectivity.

The principal conclusion is that the CV's of most members show no or hardly any evidence of research competence or research experience, or of the competence to produce a report like that asked of the FCIC. In the prehistory of the crisis several of them played political roles which possibly interfered with policies relevant to the financial crisis.

The CVs lead to the same conclusion about the FCIC as the report: though the commission does have competencies, it lacks the integrity and competence to adequately analyze the history of the financial crisis.

Note that suspicions of interference with personal interests (exculpation) are unavoidable when people were somehow involved in the history of the case to be investigated. Moreover, it might seem that the competencies needed for making a good inquiry in general go together with some kind of involvement. In the case of the financial crises however, the present report hopes to show that this assumption is wrong. (The most important competencies may be openness, independence, and plain common sense).

At the same time, the generalist manager hypothesis claiming that a good manager can do everything without any specialist knowledge or know-how has been falsified, both by the FCIC and CDW.

In the eyes of the present author it is highly amazing that an inquiry commission into the financial crisis is not composed of university scientists (where "science" is meant in the general sense, the open endeavor to find reliable, summarizing, explanatory knowledge). And that after the FCIC report university scientists did not come together to produce a single reliable report instead of three more or less biased, but largely unprofessional reports.

Where it should be noted that political science seems to be fatally hampered by, among other things, a fear of the truth about politics and government. And as noted elsewhere, it is not the only science failing to do what it claims to be and do.

Summaries of the CVs.

Phil Angelides (chairman).

Nothing in the biography¹⁴³ of Angelides shows scientific or research competence or experience. It does show that he may have contributed to the preparation and size of the crisis. It does not show opposition to AH or CRA policies, or their quantitative goals.

The biography seems to contain contradictions. On the one hand:

«As early as 2002, he warned of excesses and abuses in the nation's financial markets, mobilizing pension funds and investors across the country to push for reforms, fight fraud, curb egregious executive compensation, and expand shareholder and investor rights. He was a consistent and forceful voice against California's deficit spending and excessive borrowing».

On the other:

«he was a widely respected policy leader in affordable housing»

and

«as Treasurer, Mr. Angelides [...] financed over 100,000 units of affordable housing».

It obviously suits him that the FCIC majority concludes that affordable housing policy played no significant role.

It follows from the above that he should not have been chosen chairman of the FCIC. On the other hand, he may have been chosen to prevent AH getting the blame.

Brooksley Born.

Born is a lawyer. She has been chairwoman of the CFTC, and definitely deserves praise for her conduct in that role. (With some reservations though: why did she give in and leave? Furthermore, she may just have tried to do what the organization asked her to). She did not fall in with the foolish policies of Greenspan, Rubin, Summers etcetera. It follows however that she is not really independent. There is no evidence of scientific or research competence or experience.

The annual reports of the CFTC about the years when Born was chairwoman were just as insufficient as the others.

But she does have useful competencies, and if her integrity is not beyond doubt, there is much less reason for doubt than for most of her colleagues.

The above is in agreement with her joining the majority of the FCIC, which rejected the AH and CRA policies as main cause of the crisis.

Byron S. Georgiou.

Georgiou has had a long career in the private and public sector in government service, business and law, and has spent most of the last decade investigating and prosecuting financial fraud. He is said to have played leadership roles in the historic litigations on behalf of victimized investors at Enron, WorldCom, AOLTimeWarner and other corporations.

The CV may mean that Georgiou has analytical and research competencies, and in important matters chose the right side (= in favor of respecting outsiders, safeguarding).

Bob Graham.

Graham appears to have spent his life in politics. He was governor of Florida for two terms, and senator for 18 years. As a politician he may have been OK, and even relatively good. There is no evidence of scientific or research competence or experience. He was part of the FCIC majority.

¹⁴³ Which, like those of the other members of the FCIC, and because of the unbridled praise, may have been supplied by himself.

Keith Hennessey.

«Before coming to Washington in 1994, he spent two years developing software at Symantec Corporation and two years at Harvard where he received a Master in Public Policy degree from the John F. Kennedy School of Government. He earned a BAS degree in math and political science from Stanford in 1990.»

For many years, Hennessey was economic advisor of G. W. Bush. In other words: he is a suspect, but cannot be suspected of integrity and competence in economics:

«From his West Wing office beginning in August 2002 through the end of 2007, Mr. Hennessey served as Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council. In 2008 and 2009, he was Assistant to the President for Economic Policy and Director of the National Economic Council. [...] In addition to advising the President on his Administration's response to the financial crisis of 2008, Mr. Hennessey helped design, enact, and implement the President's most important economic policies, including reforming the regulation of Fannie Mae and Freddie Mac, and international economic issues such as several free trade agreements.»

There is no evidence of scientific or research competence or experience.

Douglas Holtz-Eakin.

Holtz-Eakin is an economist. The CV suggests research competence and experience. In economics: not a recommendation. He has had prominent positions in Washington politics.

Heather H. Murren.

Murren is a graduate of the Johns Hopkins University. The CV does not say in what discipline(s). The CV shows a success story:

«In April 2002, she retired as a managing director, Global Securities Research and Economics, of Merrill Lynch where she was Group Head for the Global Consumer Products Equity Research effort. Ms. Murren was a highly ranked analyst. She was chosen six consecutive years as a member of The Institutional Investor's All-American Research Team. Her multi-year inclusion in the Greenwich survey and repeated designations by the Wall Street Journal as an all-star analyst underscored her other notable achievements in the economic and financial services community. In addition, while at Merrill Lynch, she was profiled in Fortune magazine as one of Wall Street's all-star analysts for her independent thinking, sometimes controversial, and often accurate.»

«She is the [? A, it would seem] cofounder and served as the Chairman of the Board and Chief Executive Officer of Nevada Cancer Institute (NVCI) from its founding in 2002 until June 2009, and remains a member of its board of directors.»

She obviously excels in advertising (for an American public). But the CV presents no evidence of scientific or research competence or experience.

Bill Thomas (vice chairman).

Thomas «graduated from Santa Ana Community College and obtained both his bachelor and master degrees from San Francisco State University. Prior to being elected to Congress in 1978 to represent Bakersfield, CA, he began serving as a California state assemblyman in 1974. He was a Professor of Political Science at Bakersfield College from 1965-1974». So it seems he studied political “science”.

«A member of the U.S. House of Representatives for 28 years, Bill Thomas has spent his career strengthening health care legislation, reducing tax burdens, advocating free and open trade and protecting workers' pensions».

«Bill has been recognized by the National Federation of Independent Business as a "Guardian of Small Business" and has received the "Spirit of Enterprise" award from the U.S. Chamber of Commerce. The League of Private Property Voters has honored him as a "Champion of Private Property."»

It follows that he is a suspect, and without scientific or research competence or experience.

John W. Thompson.

«Thompson completed his undergraduate studies at Florida A&M University and holds a master's degree in management science from MIT's Sloan School of Management.»

For 10 years John W. Thompson was CEO of Symantec, the computer security firm.

The CV suggests management competence. There is no evidence of scientific or research competence or experience.

Peter Wallison.

«He received his undergraduate degree from Harvard College in 1963 and law degree from Harvard Law School in 1966.»

«Wallison has held a number of government positions. From June 1981 to January 1985, he was General Counsel of the United States Treasury Department, where he had a significant role in the development of the Reagan Administration's proposals for deregulation in the financial services industry. During 1986 and 1987, Mr. Wallison was White House counsel to President Ronald Reagan.»

Wallison [is a member of the Shadow Financial Regulatory Committee](#) (mentioned by Kling).

His minority report helps to diminish the relative role of deregulation (especially under Reagan). Because of his publications and minority report he can claim research competence and experience.

Without knowledge of the publications it is hard to say more. His minority report may be somewhat one-sided, (may be not). It certainly is rather thorough and to the point, and definitely fills an important gap in the majority report. So even though his suitability may not have been clear in advance, he has played the best role in the work of the inquiry commission.

FCIC CVs of the members of the FCIC.

As presented by the FCIC website on 20/2/12.

Phil Angelides (Chairman).



Phil Angelides has earned national acclaim as an effective public and private sector leader with broad expertise and accomplishments in the fields of investor protection, finance, housing, and corporate and financial market reform. He has won widespread praise for his innovative work in urban reinvestment, smart growth and green investment.

Mr. Angelides was elected as California's State Treasurer and served from 1999-2007. The Associated Press reported that he made "the sleepy treasurer's office a policy powerhouse," and The Sacramento Bee praised Treasurer Angelides as "the most effective and dynamic state treasurer in a generation."

During his eight years in elected office, he transformed the State Treasurer's Office into a force for progress. As early as 2002, he warned of excesses and abuses in the nation's financial markets, mobilizing pension funds and investors across the country to push for reforms, fight fraud, curb egregious executive compensation, and expand shareholder and investor rights. He was a consistent and forceful voice against California's deficit spending and excessive borrowing. He put the weight of the state's pension funds behind investment in clean energy and the fight against global warming – seeding the "green tech" investment revolution. And, Mr. Angelides launched groundbreaking initiatives to promote smart growth and to spur urban revitalization.

During his tenure as Treasurer, Mr. Angelides served as a trustee for California's two major pension funds, managed the State's \$57 billion investment fund, financed over 100,000 units of affordable housing and \$150 billion in schools, transportation, parks and other public projects, and earned record returns on state investments.

Mr. Angelides is a graduate of Harvard University and a Coro Foundation Fellow. He served from 1975 to 1983 in California government, where he was a widely respected policy leader in affordable housing, urban planning, and public finance. He entered the private sector in 1984 and, in 1986, formed his own real estate investment business, which pioneered the planning and building of smart growth communities and helped spark a national dialogue around building more livable, environmentally responsible communities. Mr. Angelides is currently President of Riverview Capital Investments which focuses on sustainable urban development and clean energy projects.

Mr. Angelides has been active in the civic life of his community, state, and nation for more than three decades. He was the Democratic nominee for Governor of California in 2006. He currently serves as the National Chairman of the Apollo Alliance, a coalition of business, labor, environmental and community leaders committed to building a clean energy, good jobs economy for America's future. Mr. Angelides has received numerous awards for his work, including the National Inner City Leadership Award from the Initiative for a Competitive Inner City; the California League of Conservation Voters' Environmental Leadership Award; the Congress for the New Urbanism's Lifetime Achievement Award; and induction into the California Housing Hall of Fame.

Mr. Angelides and his wife, Julie, have three daughters – Megan, Christina and Arianna.

Brooksley Born (Commissioner).



Brooksley Born practiced law for many years in Washington DC. She joined the firm of Arnold & Porter in 1965, became a partner in the firm in 1974 and retired from the firm in 2002. She was the head of the firm's derivatives practice and represented domestic and international clients in legislative, litigation, regulatory, and transactional matters involving derivatives and financial markets.

From 1996 to 1999 she was chair of the US Commodity Futures Trading Commission (CFTC), the federal government agency that oversees the futures and commodity option markets and futures professionals.

While at the CFTC, Ms. Born served as a member of the President's Working Group on Financial Markets and the Technical Committee of the International Organization of Securities Commissions.

Ms. Born is a 1961 graduate of Stanford University and a 1964 graduate of Stanford Law School where she was president of the Stanford Law Review and received the Outstanding Senior Award. She is a member of the Order of the Coif and the District of Columbia Bar. She served as law clerk to Judge Henry W. Edgerton of the United States Court of Appeals for the District of Columbia Circuit. She has served on the Boards of Governors of the American Bar Association, the American Bar Foundation, and the District of Columbia Bar. At the ABA, she has chaired the Section of Individual Rights and Responsibilities, the Standing Committee on Federal Judiciary, the Consortium on Legal Services and the Public, and the Council of the Fund for Justice and Education. Ms. Born is a founder of the ABA Women's Caucus and chairs the board of the National Women's Law Center. She has taught Women and the Law at Georgetown Law Center and the Columbus School of Law of Catholic University of America.

Ms. Born is a 2009 recipient of the John F. Kennedy Library Foundation's Profile in Courage Award "presented annually to public servants who have made courageous decisions of conscience without regard for the personal or professional consequences." She received the award in recognition of her efforts as chair of the CFTC to urge that the over-the-counter derivatives market should be subject to federal oversight and regulation. The failure to regulate that market is now seen to be a major cause of the recent financial crisis.

Among other awards, she was recognized as a "Champion" in Legal Times' list of "The 90 Greatest Washington Lawyers of the Last 30 Years" in 2008 and was a recipient of The American Lawyer Lifetime Achievement Award for her career-long leadership in private practice and public service in 2005. Ms. Born lives in Washington DC. She is married to Alexander E. Bennett, and they have five children and four grandchildren.

Byron S. Georgiou (Commissioner).



Byron Georgiou has had a long career in the private and public sector in government service, business and law, and has spent most of the last decade investigating and prosecuting financial fraud.

He currently oversees Georgiou Enterprises, with wide ranging interests including the manufacture of a broad range of lithium ion iron phosphate all electric powered vehicles; the development of information technology and electronic health records for physicians and other healthcare professionals; the manufacture of custom parts for the aerospace and defense industries; partnerships in several private equity firms; a portfolio of carbon emission reduction projects in Central America that generates carbon credits under the Kyoto protocol; environmental cleanup and resource recovery at coal mining sites; development of nationwide fiber optic networks for broadband transmission; development and management of commercial and residential real estate and golf courses; and the provision of customer services at regional shopping centers throughout America.

Mr. Georgiou has served since 2005 on the advisory board of the Harvard Law School Program on Corporate Governance which hosts the world's leading blog on corporate governance and financial regulation.

Since 2000, Mr. Georgiou has been affiliated Of Counsel to the national law firm of Robbins, Geller, Rudman & Dowd, the world's largest plaintiffs' securities practice, and has spent much of the last decade investigating and civilly prosecuting financial fraud, with leadership roles in the historic litigations on behalf of victimized investors at Enron, WorldCom, Dynegy, AOLTimeWarner, and UnitedHealth.

In 1994, he co-founded and served as President of American Partners Capital Group, which served the needs of institutional investors and investment managers through capital formation programs in a variety of alternative asset categories.

From 1983-1994, he was Managing Partner and co-founder of the law firm of Georgiou, Tosdal, Levine and Smith, a general civil practice, with emphasis on litigation and appearances before executive and legislative governmental bodies, and representation of labor organizations and their members, including contract negotiations and enforcement for many public and private sector labor organizations.

From 1980-1983, Mr. Georgiou served as Legal Affairs Secretary to California Governor Edmund G. Brown Jr., responsible for litigation by and against the Governor, judicial appointments, liaison with the Attorney General, Judiciary and State Bar, legal advice to the Governor and members of his Cabinet, and exercise of the Governor's powers of extradition and clemency.

In 1982 Mr. Georgiou was honored as Public Official of the Year by the California Trial Lawyers Association and served as chair of the Governor's Task Force on Alcohol, Drugs and Traffic Safety, one of the nation's first vehicles for enacting tough drunk driver legislation, sponsored by Mothers Against Drunk Driving (MADD).

Mr. Georgiou served from 1975-1980 in various capacities with the California Agricultural Labor Relations Board, defending the constitutionality of the law up through the United States and California Supreme Courts, and prosecuting unfair labor practice cases enforcing the collective bargaining rights of farm workers, who had been excluded from protection under the National Labor Relations Act.

He received his undergraduate degree with Great Distinction from Stanford University, attending on a full Alfred P. Sloan academic scholarship, and his Juris Doctor degree magna cum laude from Harvard Law School.

Mr. Georgiou and his wife, Dr. Therese Collins Georgiou, live in Las Vegas, Nevada with their daughters, Ariadne Christina (born 10/19/08) and Athena Theodora (born 12/14/10).

Senator Bob Graham (Commissioner).



Senator Bob Graham is the former two-term governor of Florida and served for 18 years in the United States Senate. This is combined with 12 years in the Florida legislature for a total of 38 years of public service. He was recognized by the people of Florida when he received an 83% approval ranking as he concluded eight years as Governor. Senator Graham retired from public service in January 2005, following his Presidential campaign in 2004.

Senator Graham is recognized for his leadership on issues ranging from healthcare and environmental preservation to his ten years of service on the Senate Select Committee on Intelligence - including 18 months as chairman in 2001-2002. Following the release of the Joint Inquiry's final report in July 2003, he steadfastly advocated reform of the intelligence community and sponsored legislation to bring about needed changes. In the fall of 2004 Senator Graham authored "Intelligence Matters" based upon his experiences gleaned during the joint inquiry and his analysis of the run up to the Iraq war.

After retiring from public life, Senator Graham served for a year as a senior fellow at the Harvard Kennedy School of Government where he lectured to undergraduate, graduate and executive management students.

Senator Graham is currently Chairman of the Commission on the Prevention of Weapons of Mass Destruction Proliferation and Terrorism whose mandate is to build on the work of the 9/11 Commission and complete a critical task: to assess our nation's progress in preventing the proliferation of weapons of mass destruction and terrorism, and to provide a roadmap to greater security with concrete recommendations for improvement. The Commission's report, "World At Risk," was published in the Fall of 2008.

Additionally, Senator Graham is also the author of a new book about civic participation, entitled "America: The Owner's Manual." The goal of the book is to provide ordinary people with the means and motivation to go out and influence decision makers in order to achieve positive change in their neighborhoods and communities.

Senator Graham serves as the Chair of the Board of Overseers of the Graham Center for Public Service. This Center, with a home at the University of Florida, commenced programs in the fall of 2007 in the areas of Public Service, Homeland Security, and The Americas, subjects in which he has been deeply involved during his public career.

He and his wife Adele have returned to their home in Miami Lakes, Florida, and are enjoying more time with their four daughters and eleven grandchildren.

Keith Hennessey (Commissioner).

(The website biography has no photograph of Hennessey).

Keith Hennessey most recently served as the senior White House economic advisor to President George W. Bush. Mr. Hennessey coordinated economic policy for the President, including financial market issues, tax policy, energy and climate change, health care, Social Security and Medicare reform, housing, technology and telecommunications, and agriculture. He now writes about American economic policy at www.KeithHennessey.com.

From his West Wing office beginning in August 2002 through the end of 2007, Mr. Hennessey served as Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council. In 2008 and 2009, he was Assistant to the President for Economic Policy and Director of the National Economic Council.

Mr. Hennessey analyzed economic policy problems and coordinated design of the President's economic policies. He framed strategic decisions and policy options for the President, integrating economic and other policy analysis with legal, legislative, and political constraints. He acted as an honest broker among the various Cabinet secretaries and senior White House advisors, resolving conflicting views when possible, and structuring and chairing Oval Office meetings at which issues and options were presented to the President. After a Presidential policy decision, Mr. Hennessey was part of the core White House team that wrote the speech, communicated the policy to the public, worked with Congress to enact a new law, and oversaw the implementation of the policy.

In addition to advising the President on his Administration's response to the financial crisis of 2008, Mr. Hennessey helped design, enact, and implement the President's most important economic policies, including reforming the regulation of Fannie Mae and Freddie Mac, and international economic issues such as several free trade agreements.

Before the White House, Mr. Hennessey spent eight years on Capitol Hill, most of it working as Economic Policy Advisor to Senate Majority Leader Trent Lott. He also worked for Senator Pete Domenici on the staff of the Senate Budget Committee, and on the staff of the 1994 Bipartisan Commission on Entitlement and Tax Reform.

Before coming to Washington in 1994, he spent two years developing software at Symantec Corporation and two years at Harvard where he received a Master in Public Policy degree from the John F. Kennedy School of Government. He earned a BAS degree in math and political science from Stanford in 1990. Mr. Hennessey is single and lives in Arlington, Virginia.

Douglas Holtz-Eakin (Commissioner).



Douglas Holtz-Eakin has a distinguished record as an academic, policy adviser, and strategist. Currently he is the President of American Action Forum.

Since 2001, he has served in a variety of important policy positions. During 2001-2002, he was the Chief Economist of the President's Council of Economic Advisers (where he had also served during 1989-1990 as a Senior Staff Economist). At CEA he helped to formulate policies addressing the 2000-2001 recession and the aftermath of the terrorist attacks of September 11, 2001.

From 2003-2005 he was the 6th Director of the Congressional Budget Office. The CBO provides non-partisan budgetary and policy analysis to the U.S. Congress. During his tenure CBO assisted as Congress addressed numerous, notably the 2003 tax cuts (JGTRRA), the Medicare prescription drug bill (MMA), and Social Security reform. During 2007 and 2008 he was Director of Domestic and Economic Policy for the John McCain presidential campaign.

Dr. Holtz-Eakin has held positions in several Washington-based think tanks. He was Senior Fellow at the Peter G. Peterson Institute for International Economics (2007-2008), and the Director of the Maurice R. Greenberg Center for Geoeconomic Studies and the Paul A. Volcker Chair in International Economics at the Council on Foreign Relations (2006). He has also been a visiting Fellow at the American Enterprise Institute, Heritage Foundation, and American Family Business Foundation.

Dr. Holtz-Eakin built an international reputation as a scholar doing research in areas of applied economic policy, econometric methods, and entrepreneurship. He began his career at Columbia University in 1985 and moved to Syracuse University from 1990 to 2001. At Syracuse, he became Trustee Professor of Economics at the Maxwell School, Chairman of the Department of Economics and Associate Director of the Center for Policy Research.

Dr. Holtz-Eakin serves on the Boards of the Tax Foundation and the National Economists Club, and the Research Advisory Board of the Center for Economic Development.

Heather H. Murren, CFA (Commissioner).



Heather H. Murren, CFA, is the cofounder and served as the Chairman of the Board and Chief Executive Officer of Nevada Cancer Institute (NVCI) from its founding in 2002 until June 2009, and remains a member of its board of directors. NVCI is a non-profit 501(c)(3) organization and the official cancer institute of the state of Nevada as established by the State Legislature in 2003. On July 15, 2009, United States Senate Majority Leader Harry Reid appointed Heather Murren to the Financial Crisis Inquiry Commission.

In 2002, Ms. Murren and other community leaders began an effort to build a comprehensive cancer center, as defined by the National Cancer Institute, in a young state that previously had nothing of its type. So far this effort has raised more than \$200 million to build, equip and staff a research and care center which opened its doors in 2005.

In April 2002, she retired as a managing director, Global Securities Research and Economics, of Merrill Lynch where she was Group Head for the Global Consumer Products Equity Research effort. Ms. Murren was a highly ranked analyst. She was chosen six consecutive years as a member of The Institutional Investor's All-American Research Team. Her multi-year inclusion in the Greenwich survey and repeated designations by the Wall Street Journal as an all-star analyst underscored her other notable achievements in the economic and financial services community. In addition, while at Merrill Lynch, she was profiled in Fortune magazine as one of Wall Street's all-star analysts for her independent thinking, sometimes controversial, and often accurate.

In 2004, she was recognized as one of the Influential Businesswoman of the Year by Las Vegas magazine of the Las Vegas Review-Journal. She has received both Congressional recognition and commendation from the U.S. Senate for her work at Nevada Cancer Institute. In addition, she has received numerous awards for philanthropy. In 2006, she was cited as a Nevada Healthcare Hero by Nevada Business Journal.

She is a graduate of the Johns Hopkins University and has served in the past as a member of the Board of Trustees of the Johns Hopkins University; sitting on the committees for audits and insurance, academic affairs, and trusteeship, nominations and by-laws. She was also a member of the Johns Hopkins University Zanvyl Krieger School of Arts and Sciences Advisory Council and founder of the Jochebed Scholarship. Fluent in Spanish and French she has served as a volunteer translator for the Nevada Health Centers Inc., a nonprofit organization that provides healthcare to the community of Nevada regardless of the patient's ability to pay. She has held a gubernatorial appointment to the Nevada Academy of Health and has served in the past as a member of the board of directors for Mannkind, a biopharmaceutical company, and Service First Bank of Nevada, a community bank in Southern Nevada. She is married to James Murren, Chairman and Chief Executive Officer of MGM.

Hon. Bill Thomas (Vice Chairman).



A member of the U.S. House of Representatives for 28 years, Bill Thomas has spent his career strengthening health care legislation, reducing tax burdens, advocating free and open trade and protecting workers' pensions.

Mr. Thomas continues his examination of substantial economic issues in search of coalition-building solutions through his work as a visiting fellow at the American Enterprise Institute (AEI), a national think tank that brings together some of the country's most accomplished public policy experts.

As former chairman of the House Ways and Means Committee, Mr. Thomas was responsible for reforming Medicare legislation, nearly \$2 trillion in tax relief and reforms to the U.S. pension system. During his six years as chairman, Mr. Thomas helped the President attain trade promotion authority and guided seven free trade agreements through Congress, as well as leading efforts to implement international tax reforms to make U.S.-based companies that operate abroad more competitive. He also created an energy tax package aimed at strengthening the nation's existing energy infrastructure while promoting alternative energy sources.

Prior to his election as Chairman of the Ways and Means Committee, Mr. Thomas served as Chairman of the Ways and Means Health Subcommittee where he was instrumental in the passage of the "Health Insurance Portability and Accountability Act of 1996," as well as the author of the "Medicare Preservation Act." In 1998, he was appointed Administrative Chairman of the National Bipartisan Commission on the Future of Medicare. He was also Chairman of the House Administration Committee from 1995-2001.

Throughout his congressional career, Mr. Thomas has been recognized for his fiscal conservatism.. He is a multiple recipient of the Golden Bulldog Award for fiscal restraint and has been honored by the National Tax-Limitation Committee for his fight against waste in government spending. Bill has been recognized by the National Federation of Independent Business as a "Guardian of Small Business" and has received the "Spirit of Enterprise" award from the U.S. Chamber of Commerce. The League of Private Property Voters has honored him as a "Champion of Private Property."

Mr. Thomas and his wife, Sharon, have two grown children, Christopher and Amelia. He graduated from Santa Ana Community College and obtained both his bachelor and master degrees from San Francisco State University. Prior to being elected to Congress in 1978 to represent Bakersfield, CA, he began serving as a California state assemblyman in 1974. He was a Professor of Political Science at Bakersfield College from 1965-1974.

John W. Thompson (Commissioner).



John W. Thompson is chairman of the board of directors of Symantec Corporation. During his 10-year tenure as chief executive officer, he helped transform Symantec into a leader in security, storage and systems management solutions delivered to a broad base of customers, from individual consumers to the largest enterprises in the world. From 1999 to 2009, Symantec's revenues grew from \$632M to \$6.2B and its worldwide workforce reach over 17,000 employees.

Since 2009, Thompson has been an active investor in early-stage technology companies in Silicon Valley. He recently became the chief executive officer of one of the portfolio companies, Virtual Instruments, a privately held company focused on optimizing the IT infrastructure for today's cloud computing environments. He also serves as a director on the boards of UPS, the world leader in global logistics, and Seagate Technology, the world leader disk-drive development and manufacturing.

He has served on the national board of Teach for America, an organization dedicated to eliminating educational inequities for all children and was recognized in 2010 by Silicon Valley Education Foundation for his commitments to improve the educational opportunities of all children. In addition, in 2008 he was inducted into the Junior Achievement Business Hall of Fame.

Thompson completed his undergraduate studies at Florida A&M University and holds a master's degree in management science from MIT's Sloan School of Management. In addition, in May 2008, he received an honorary doctorate degree from Notre Dame University.

Peter J. Wallison (Commissioner).



Peter Wallison holds the Arthur F. Burns Chair in Financial Policy Studies and is co-director of the American Enterprise Institute (AEI)'s program on Financial Policy Studies. Prior to joining AEI, he practiced banking, corporate and financial law at Gibson, Dunn & Crutcher in Washington, D.C. and New York.

Mr. Wallison has held a number of government positions. From June 1981 to January 1985, he was General Counsel of the United States Treasury Department, where he had a significant role in the development of the Reagan Administration's proposals for deregulation in the financial services industry. During 1986 and 1987, Mr. Wallison was White House counsel to President Ronald Reagan.

Between 1972 and 1976, he served first as Special Assistant to New York's Gov. Nelson A. Rockefeller and, subsequently, as counsel to Mr. Rockefeller during his term as Vice President of the United States.

Mr. Wallison is admitted to practice before the courts of the District of Columbia, and he is a member of the District of Columbia Bar Association. He received his undergraduate degree from Harvard College in 1963 and law degree from Harvard Law School in 1966.

Mr. Wallison is the author of *Ronald Reagan: The Power of Conviction and the Success of His Presidency*, published in December 2002 by Westview Press. On financial or regulatory matters, he is the author of *Back From the Brink*, a proposal for a private deposit insurance system, and co-author of *Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac; The GAAP Gap: Corporate Disclosure in the Internet Age*; and *Competitive Equity: A Better Way to Organize Mutual Funds*, all of which were published by AEI. He is also the editor of *Optional Federal Chartering and Regulation of Insurance Companies*, and *Serving Two Masters, Yet Out of Control: Fannie Mae and Freddie Mac*, also published by AEI. On campaign finance, he is the author (with Joel Gora) of *Better Parties, Better Government* (AEI Press 2009).

He is a frequent contributor to the op-ed pages of New York Times, Washington Post, Wall Street Journal and Financial Times. He has also been a speaker at many conferences on financial services, accounting, and corporate governance, and is a member of the Shadow Financial Regulatory Committee, the Council on Foreign Relations, the SEC Advisory Committee on Improvements to Financial Reporting (2008), and co-Chair of the Pew Financial Reform Task Force.

6. DNB- the Dutch central bank & financial supervisor (DNB) 1999-2008.

Results of an analysis of Annual reports and Overviews financial stability 2003-2007.

Table of contents of this appendix.

- Preliminary remarks.
- Summary and conclusions.
- The annual reports.
- The Overview financial stability (OFS).
- Quotes with “derivat” from DNB annual reports.
- Quotes with “intransparant products” from DNB annual reports.

1. Preliminary remarks.

Abbreviations.

AR= annual report.

CDW= Parliamentary inquiry commission De Wit, named after its chairman Jan de Wit.

DGAO= Dutch general accounting office (in Dutch: Algemene rekenkamer).

DNB= De Nederlandsche Bank, the Dutch central bank and supervisor.

OFS= the DNB-publication Overview financial stability.¹⁴⁴

In references, in a page indication M/N, M is the page number printed on the page, and N the page number of the pdf-file.

Publications of DNB.

At least around 2013, the website of DNB presented a list of publications. The first seven are:

1. DNB Magazine
2. OFS
3. Economical developments and expectations.
4. AR
5. DNB quarterly bulletin
6. DNB Statistical bulletin
7. Newsletter banks.

DNB and Wellink.

1. From 1 July 1997-30 June 2011 Nout Wellink was president of DNB. He was very important for the international financial system. The present appendix is about DNB. A separate Wellink appendix provides the information which in combination with the DNB appendix shows his lack of integrity and competence, and his perjury before the parliamentary inquiry commission De Wit.
2. The reason being, that given the regulation and operation of hierarchical organizations, and his long presidency, Wellink was responsible in every sense of the word.
3. A short list of important “feats of arms” of DNB can be found in section *Miscellaneous* of the Wellink appendix. The DNB appendix is restricted to DNB’s activities and omissions with respect to the financial crises only.
4. When reading the present appendix the reader should keep in mind that more than half of the Dutch financial system had to be saved by the tax payer, and that DNB also failed very seriously in several cases having nothing to do with the crises.
5. The second report of CDW gives useful additional information about DNB. The information confirms the incompetence and false pretensions of DNB.

CDW and DGAO about DNB.

In its first report, on p. 141/137, in section 7.3.1.1, *General problems systemic supervision*, the CDW notes that:

«The DGAO too concludes that in the period preceding the crisis regulation and supervision paid

¹⁴⁴ In Dutch: Overzicht financiële stabiliteit.

insufficient attention to the financial system as a whole. Regulators and supervisors thought that the stability of the financial system would be ensured sufficiently by taking care of the stability of the individual institutions.»

As the source a note mentions: DGAO, *The system for supervision of the stability of financial markets*,¹⁴⁵ 2009, p. 31. This report has been included in the dossier.

Analytical note. The stability of the financial system would indeed be ensured sufficiently by taking care of the stability of the individual institutions. But this has to be done properly, by taking adequate account of environmental influences: of other institutions, markets and whatever maybe relevant, including “the system”. It is logically impossible to evaluate an institution separate from its environment. In other words: not only the attention for the system was insufficient, but the supervision of the separate institutions too. The conclusion of DGAO and CDW is misleading or incorrect.

On p. 142/138, in the section 7.3.1.2, *Execution systemic supervision in the Netherlands*,¹⁴⁶ one reads:

«In the Netherlands, the systemic supervision of the financial system is one of the duties of DNB.»

CDW also quotes from self-evaluative remarks of DNB about its systemic supervision, in the quarterly bulletin of June 2009.

Methodological remark.

The quotes were selected for the insight they provide in the operation of DNB in the prehistory of the financial crises, and for information which may be relevant for other parts of the present report.

2. Summary and conclusions.

1. As reports about the activities, the annual reports of DNB leave much to be desired. The DNB annual report is first of all a discussion of the state of affairs in the financial sector, in the Netherlands and the world. Activities of DNB are indicated, but embedded in a sector wide discussion. Overviews of (the most important) activities and a list of (the most important) publications are missing.¹⁴⁷
2. The descriptions and analyses would be useful if something very similar would not be published by many other institutions (other central banks and supervisors, IMF, OECD), and if the quality would at least be sufficient. As for all similar institutions, this is not the case.
3. The reports manifest an arrogant attitude. They betray no doubt about the understanding, competence and opinions of DNB. No serious doubts are raised about the operation of the financial system, regulation, supervision, or DNB.
4. The annual reports manifest a detachedness and passivity which are not accounted for, and which are incompatible with the duties of DNB.
5. The annual reports mention risks, but in the end are always reassuring. Emphatic warnings are absent. Which is underlined by the absence of any decisive action or recommendation.
6. Like similar institutions, DNB shows no understanding of the coherence of parts and developments in the financial system.
7. Like similar institutions, DNB shows no understanding of the concept “risk”. Risks are mentioned without specification, and without reflection on the consequences of realization. There is no attention to scenarios.
8. Like similar institutions, DNB shows no knowledge or understanding of the concept of “instability” and of the instability of parts of the financial economic system.
9. There is no trace of knowledge or understanding of the GAO reports of 1994-1999.

¹⁴⁵ *Algemene problemen systeemtoezicht*.

¹⁴⁶ *Uitvoering systeemtoezicht in Nederland*.

¹⁴⁷ Even if the publications were mentioned on the website, that is insufficient reason to leave them unmentioned in the AR. An AR is a management instrument that is especially suitable to orderly present activities. In 2012 it was in actual fact unclear whether the publications were on the website. The website certainly did not give an accessible overview.

10. Even though DNB employees were involved in the writing of the CGFS report about Credit risk transfer (CRT) of 2003 and the report of the Joint Forum on CRT of 2005, and these reports mention several risks which require action of supervisors, the reports are ignored by the DNB AR and stability reports.
11. OFS 2004 sees only interest developments as source of risks.
12. The ministers of finance and economics and parliament could have seen the essential deficiencies of the AR already at the time of publication. They could and should have taken corrective action.
13. A clear and important example of the passivity of DNB is the incorrect suggestion, repeated for several years in successive annual reports, that certain developments were new, and not only have positive effects, but also cause risks.¹⁴⁸ Risks which DNB only mentions, and otherwise leaves undisturbed.
14. DNB is not aware and explicit about its assumptions, and does not manage the risks caused by uncertainty about the correctness of its assumptions.
15. The CDW could and should have seen the inadequacy of the DNB AR, and taken corrective action. It didn't. It even failed to compare the declarations of DNB president Wellink with the AR.
16. The annual reports and the financial stability reports of DNB are incompatible with essential declarations of Wellink in the hearings of CDW. The conclusion is that Wellink is a liar, and guilty of perjury.
17. DNB AR 2006 mentions risk caused by government debts. Without adequate explanation or urgency.
18. The reports show that DNB does not have the integrity, knowledge and abilities to do its duty properly.
19. The financial crises have shown that the complacency and optimism of DNB about the Dutch financial system, as shown until 2007 by the annual and stability reports, were erroneous.
20. The inadequacy of the DNB reports and the thinking reflected thereby is consistent with the events. The events would be incomprehensible (and impossible) if DNB would have given unambiguous well-founded warnings and shown an active attitude.
21. This appendix can be interpreted as an important part of the explanation of both the subprime and debt crisis.
22. This appendix shows that the reports mentioned give all the information CDW needed for the evaluation of DNB in the run-up to the crisis, and that the hearings of Wellink were superfluous at best.

3. The annual reports.

Introduction.

The present investigation of the subprime crisis began with the reports of the hearings of the parliamentary inquiry commission De Wit. The declarations of DNB president Wellink in these hearings raised questions. To answer the questions, Wellink's declarations were compared with the annual reports of DNB. The year 2004 was chosen because it was well before the onset of the crisis, but not too much. Somewhat later the annual report of 2007 was studied as well, to see whether it differed, and in what respect(s). Only after having studied many (other) reports it became clear that many institutions in the periphery of the financial system contributed to the crisis either actively or by omission, and that their annual reports testify to this. Since there are many relevant institutions and since time is limited, it was decided to study at least the annual report about 2006 of every relevant institution. Which caused DNB AR 2006 to be added to the list of annual reports to be studied. The findings show that the choice of the year doesn't matter much. There are no substantial differences (in character) between the annual reports of different years. The conclusions are stable for a change in the

¹⁴⁸ DNB even doesn't seem to understand that in case of exponential growth one can speak of a strong or explosive development every successive year. Conversely, from explosive growth alone the reader should never conclude that something new is happening.

year or years. Of course this is a necessary condition for reliability.¹⁴⁹

According to the annual reports 2006 and 2007, the average number of employees of DNB in these years were 1630 and 1566 full time equivalent respectively.¹⁵⁰ The costs of personnel in 2006 and 2007 were 146 and 169 M€ respectively.¹⁵¹

The annual reports of DNB do not include a list of publications or actions, or of the most important ones. It is almost impossible to get a meaningful picture of the activities in the year under review, let alone the size of the various activities expressed in fte.

The members of the management team have salaries of more than 312 k€. That of Wellink is 391 k€. This was approximately twice the salary of a cabinet minister.

According to AR 2006 DNB sees its mission as follows:

«DNB champions ‘financial stability’. In this way it contributes actively to the prosperity of the Netherlands. For this purpose it:

- cooperates with other European central banks in keeping the purchasing power of the euro stable (‘monetary policy and implementation’);
- aims at a flexible, reliable and efficient payment system;
- sees to it that financial institutions have enough capital to meet their obligations and manage their business in a sound and honorable way (‘prudential supervision’);
- contributes to good national and international decision making by ‘economical advice’ in the fields mentioned.

DNB furthermore advises the Minister of Finance about ‘export credit- and investment insurance’. Excellent knowledge and ‘statistical data’ are very important for the work of DNB. DNB wants to implement its role as a knowledge institute by sharing the knowledge with society (‘research’). The organization does its work effectively and efficiently.»^{152, 153}

The annual reports show that these pretensions are false. The actual performance of DNB requires a much more modest attitude. The annual reports show no excellent knowledge. They do show that, like all other financial supervisors, DNB advised inadequately. They show that it wrote far too ambiguously and insufficiently about risks. Perhaps in part because DNB does not understand the concept of “risk” correctly. It certainly does not betray more than the most superficial understanding. The concept is nowhere defined, discussed or explained.

AR 1999.

The pdf-file of this annual report was created 3/5/00 and modified 18/5/00. It has a linked table of contents.

Introduction. The 1999 CRMPG report.

This AR is considered because 1999 was a unique and crucial year for supervision. It was the year of the elimination of Brooksley Born and of the GAO report *Regulators Need to Focus Greater Attention on Systemic Risk*. It was also the year of a report *Improving Counterparty Risk Management Practices* of the Counterparty Risk Management Policy Group (CRMPG). The CRMPG was composed of representatives of the larger internationally active commercial and investment banks.¹⁵⁴ Its «formation was endorsed by Chairman Greenspan, Chairman Levitt and Secretary Rubin. The

¹⁴⁹ For the report *Wellinks perjury* (in Dutch: Wellinks meined) the annual reports 1998, 2000, 2003, and 2005 were studied as well.

¹⁵⁰ DNB AR 2006 p. 183/194, DNB AR 2007 p. 175/182.

¹⁵¹ DNB AR 2007 p152/143.

¹⁵² DNB AR 2006 p. 133-4/131-2. On p. 125 of AR 2007 DNB calls this its mission.

¹⁵³ The terms between ‘ and ’ may be those of the relevant law.

¹⁵⁴ Among them: Goldman Sachs, Bear Stearns, Deutsche Bank, Morgan Stanley, Citigroup, J P Morgan, Barclays, Credit Suisse, Merill Lynch, Lehman Brothers, Chase Manhattan.

objective of the Policy Group [...] has been to promote enhanced strong practices in counterparty credit and market risk management. [... The] report sets forth the Policy Group's review of key risk management issues, its evaluation of emerging strong practices, and its recommendations for action».

After the list of recommendations the CRMPG notes:

«The recommendations flowing from the first two parts of the Policy Group's work can be largely, if not completely, acted upon by individual firms. Many of the recommendations for changes in industry practices and standard documentation will require concerted industry follow-up, to which the firms in the Policy Group commit their support. The suggestions for regulatory reporting improvements obviously require evaluation by the authorities. The Policy Group believes there should be extensive practitioner input to, and coordination with, the regulators in evaluating these and other proposals for improved reporting, as well as possible new public disclosure requirements. The firms in the Policy Group stand ready to provide assistance to those efforts.»

The group does not note that each bank has an interest in compliance by all of its counterparties, or even needs this compliance to be able to implement recommendations. In practice this means that compliance is in the interest of all. The group does not recommend monitoring the implementation of the recommendations.

DNB AR 1999 does not mention the CRMPG report.¹⁵⁵ Even though the CRMPG report explicitly asks for the opinion of the authorities, and offers assistance to efforts at improvement. And even though this AR shows awareness of the importance of financial economic events elsewhere for those in the Netherlands, and, much more, of the need of international cooperation to ensure financial stability.

DNB AR 1999 does not include the terms "OTC", "counter", or "Born".

DNB AR 1999 does not include the terms "LTCM" (the name of the hedge fund at the center of a mini-crisis of 1999), "PWG", or "GAO".

The overview (Report of the President).

The overview is not a summary of the report.

Most of the overview is devoted to the financial economic developments and situation in 1999/2000. Except for the last two sections, which discuss supervision and payment and settlement systems. The last part of the supervision section shows that the international cooperation of supervisors leaves almost nothing to be desired.¹⁵⁶ A working group led by one of the DNB directors has concluded that there is no need to change the European supervision system. The Basel Committee is bringing capital requirements in accordance with the true banking risks, and a new Financial Stability Forum will act as an early warning system for weak spots in the financial system in order to prevent crises like the dot-com crisis. What more can one want?

Financial stability in DNB AR 1999.

The annual report has a chapter *Financial stability*. It has the following table of contents:

- 4.1 Introduction 107
- 4.2 Institutions 108
 - (4.2.1 IMF 108/ 4.2.2 Group of Ten 109/ 4.2.3 Financial Stability Forum 111/ 4.2.4 Group of Twenty 111/ 4.2.5 The role of the Eurosystem 111)
- 4.3 Developments in the financial sector 112
 - (4.3.1 Consolidation, internationalization and the abrogation of restrictions on the combination of different types of banking business 112/ 4.3.2 Hybrid enterprise capital 115)
- 4.4 Crisis prevention and -management 115

¹⁵⁵ At least the terms "CRMPG", "Corrigan" and "counterparty risk" are missing.

¹⁵⁶ Almost, because in connection with European supervision it is noted that the system assumes cooperation and information exchange. The AR does not say whether this assumption is realistic, and does not report about the actual state of affairs or plans for improvement.

- (4.4.1 Transparency 116/ 4.4.1.1 Transparency private sector 116/ 4.4.1.2 Public sector 117/ 4.4.2 Review of Capital agreement 118/ 4.4.3 Hedge Funds 118/ 4.4.4 Involvement of private sector 119/ 4.4.5 Standards for payment systems 121)
- 4.5 Other forms of international financial cooperation 122
 - (4.5.1 Debt reduction and the war on poverty 122/ 4.5.2 Financial position of the IMF 124/ 4.5.3 The role of the IMF now and in the future 124)

The chapter seems to make a lot of wise observations. But it is very bad in reporting about the acts of DNB, especially the changes it has made or is planning to make in supervision. And how the supervisor tackles changes in the financial sector, new products and processes.

The chapter suggests that the given developments create the need for various improvements. But DNB AR 1999 says nothing or almost nothing about actions to realize these improvements.

Very irritating is the juxtaposition of quasi sophisticated arguments and the absence of reports of what has been done, or what improvements in safety and soundness have been realized. The report communicates no sense of involvement or responsibility.

The following is quoted from the introductory section 4.1:

«The supervision of the financial enterprises is meant to keep the risks in this sector within bounds which are socially acceptable.»¹⁵⁷

There is no discussion of the question what is socially acceptable, and who is authorized to answer that question, and on what grounds.

Section 4.2.3. has the title *Financial Stability Forum*. The opening sentence of the section is:

«The Financial Stability Forum (FSF) was installed in February 1999 for the purpose of strengthening the financial stability»¹⁵⁸

This shows that DNB does not understand that the financial economic system is not stable but unstable. The section does no more than elucidate the goal(s) of the FSF, and mention the studies which are being made or planned by the FSF. No action is mentioned which may reduce the instability of the financial system. (Or reduces the harmful consequences of realization of a risk).

Section 4.3, Developments in the financial sector.

Subsection 4.3.1, *Consolidation, internationalization and the abrogation of restrictions on the combination of different types of banking business*, makes the following observations:

«1999 clearly showed the efforts of the financial sector towards further consolidation. [...]»

Consolidation reduces the number of institutions to be supervised; but at the same time their complexity increases. [...]

Another trend is the intertwining of banking and insurance. [...]

In the US the combination of different types of financial business was facilitated by the Gramm, Leach, and Bliley Act. This was adopted by Congress in November 1999. The new law abolishes the strict separation between insurance, investment banking and other banking activities created by the Glass-Steagall Act of 1933»¹⁵⁹

Nothing is said about the reasons for keeping the activities separated. (Glass-Steagall was an effort to prevent crashes like that of 1929 (and their terrible consequences). By keeping activities separated the law tried to exclude some kinds of risk).

The term “internationalization” refers to the consolidation of financial enterprises from different countries. In this connection the internationalization of the market for financial products, crucial for the spread of crashes and crises, is not mentioned.

Subsection 4.3.1 concludes with a discussion of the recommendations of a report on financial stability of a working group of the Economic and Financial Committee, a committee which prepares

¹⁵⁷ DNB AR 1999 p. 107/105.

¹⁵⁸ Original text: «Het Financial Stability Forum (FSF) werd opgericht in februari 1999 met als doel het versterken van financiële stabiliteit». DNB AR 1999 p. 111/109.

¹⁵⁹ DNB AR 1999 pp. 112-3/110-1.

meetings of the ministers of finance of the European Union. Only the report is discussed. No mention is made of the results of its discussion by the ministers.¹⁶⁰

Section 4.4, Crisis prevention and -management.

According to the introductory sentences of section 4.4, the developments in the financial sector “increase the importance of financial stability”, but make it more difficult to realize it. In 1999 financial authorities reacted to the development by concentrating on crisis prevention. Their efforts are directed at improvement of the operation of market mechanisms and market discipline.

The introduction of subsection 4.4.1 on transparency asserts that the crisis in the emerging economies in the 90s was made worse by a lack of financial transparency. This had hampered risk estimation, and in good times led to over-optimism, and in bad times to over-pessimism.¹⁶¹ More transparency supports the proper operation of market mechanisms, and therefore financial stability. But transparency is no goal in itself. And the goal is optimal transparency, not maximal transparency. Nothing substantive is said however about the weighing of the costs and benefits.

Subsection 4.4.1.1 reports about international discussions about transparency of the private banking sector. It neither tells what has been realized in the year under review, nor what is to be realized in the coming years. It does not say whether more than recommendations is to be expected, and whether supervisors will depend on voluntary cooperation. The role of accountants is mentioned, but no specifics are given.

Subsection 4.4.1. would have been the place to mention the CRMPG report. But as noted before, it isn't.¹⁶²

Subsection 4.4.2 asserts that Basel I includes a minimal capital of 8% of risk weighed assets. Formally this may be correct, but it is also misleading, because the weight factors are at most 100%. For mortgage backed securities the weight is 50%, for example. The requirements of Basel I are said to correspond insufficiently with real banking risks. Therefore proposals are being written for a revised accord. It is discussed in more detail in section 5.5.

Subsection 4.4.3 on hedge funds opens with the observation that it has turned out that with respect to highly leveraged institutions (HLIS), banks did not take counterparty risk properly into account. «The supervisors chose an indirect approach, in which it is tried to influence [unregulated!] HLIS by means of regulated institutions. This indirect approach conforms the market better, and circumvents a large number of practical objections of direct regulation, such as the difficulty of defining a hedge fund.» What follows is plainly inconsistent. It assumes suitable transparency of hedge funds. But without regulation such transparency need not exist. No critical remarks are made about the indirect approach. Instead, the subsection concludes with the supposedly reassuring remark that it seems (!) that the banks have reduced their exposure to HLIS substantially.

Subsection 4.4.4 about the involvement of the private sector in crisis resolution begins with a very obscure paragraph. The next paragraph, a discussion about policy principles, suggests that systemic risk can only be reduced at the cost of more moral hazard. The reason being that the perspective of government help creates trust, and reduces the probability of contamination. However, the report neglects to mention that the perspective of government help can encourage risk taking by an amount that more than cancels the positive effect.

As regards The Netherlands, the subsection only mentions discussions and even vaguer proposals. That is: no decision, policy change or other action is mentioned.

The chapter says nothing about events that might initiate a crash or crisis.

AR 2004.

¹⁶⁰ Let alone of voluntary adoption by the supervisors. Note that in general they must have room to do so.

¹⁶¹ This is supposed to be human. But it is not logical, and not in agreement with experience.

¹⁶² The January 2000 BIS report (BCBS 68) does mention the CRMPG report, but is not specific. It also shows that the international cooperation of the supervisors is a mess. Very much discussion, very little agreement and action.

This annual report is more than enough to prove that the most important declarations of Wellink are untrue. The report is not full of forebodings and warnings, but of reassurances.

The section *Developments in supervision* of the General overview includes the following paragraph:

«For the banking sector 2004 was a good year, in spite of an only moderately performing economy. Profitability increased to more than 13%, which exceeds the average of the 50 largest EU-banks. The resilience– national and international– of this part of the financial sector turned out to be surprisingly strong. This was also found in the Financial Sector Assessment Program executed in the Netherlands by the IMF. A number of factors contributed to this, such as continuous further professionalization of the management of these institutions (especially in the field of risk management), the increased possibilities to spread risks, and, not the least, substantial cost reduction measures.»¹⁶³

In the hearings of the CDW, Wellink said to have been worried for years about the large risks inevitably coupled to high yields.

The crisis would show that risks had indeed been spread, indeed fatally so, but also that risk management and resilience were utterly insufficient. The same therefore must apply to the assessments by IMF and DNB.

The following is the conclusion of the General overview:

«At present the expectations are that the European, but also the Dutch growth will accelerate smoothly until in 2006 the normal trend will be reached. The foundation for this has by now been strengthened sufficiently. In spite of the moderate growth, more progress could be realized in the Netherlands in 2004 in the field of structural reform of government finances than in most other euro countries. In the private sector profits recovered further, while the moderate development of labor costs laid a sound basis for future exports. Taking everything together the perspectives are not unfavorable, though the risks in the macro-economic forecasts, as indicated earlier, are not negligible either. However, the financial system is sufficiently robust to meet potential set-backs.»¹⁶⁴

What is one to do with such an evaluation? Has the “not negligible either” only been included to be able to say afterwards that warnings had been given?

In the report, the claim of robustness was defined and substantiated insufficiently. The events have convincingly shown that it was false.

For the Netherlands, DNB is the main supervisor. Practically speaking it was a monopoly. It was the foremost authority in its field. It had to be assumed to be reliable. So although formally this may not be read as a guarantee, it cannot really be read differently. No conditions are mentioned, no actions or corrections are said to be necessary. Notwithstanding the doubts and worries DNB president Wellink wants us to believe he had always shown.

That the Netherlands need not worry with a supervisor like DNB is underlined by an external evaluation by the authoritative IMF:

«*The IMF evaluation of the Dutch supervision is good.*

With this cumulative balance [of 5 times GDP, of the Dutch financial institutions] the Netherlands occupies the seventh position on an international list. Which means that it has one of the largest financial sectors in the world. A strong financial sector benefits from eminent supervision. In 2004 the International Monetary Fund (IMF) has evaluated the quality of the Dutch supervision. According to the IMF the supervision of the financial institutions satisfies the international norms very well, and belongs to the best practices in the world.»¹⁶⁵

No deficiencies or points for improvement are mentioned.

This evaluation conclusively disqualifies the IMF. The question remains whether financial supervision in other countries is really even worse, and by how much and in what senses.

The following concerns the assessment of new top managers of financial institutions by DNB:

¹⁶³ DNB AR 2004 p. 30/28.

¹⁶⁴ DNB AR 2004 p. 31/29.

¹⁶⁵ DNB AR 2004 p. 66/64.

«The integrity and expertise of executive officers and policymakers are an important part of the license requirements, beside criteria for the enterprise plan, solvability and internal organization. Therefore DNB assesses executive officers of new institutions, and new executive officers of existing institutions. In the year under review, a total of 2,083 policymakers were evaluated (table 4.3). In eight cases the result stood in the way of an appointment. Five of them concerned the Wtv, two the Wgt, and a single one the Pension- and Savings-law (PSW).»¹⁶⁶

How is "integrity" to be reconciled with a compensation scheme which rolls losses off to customers, shareholders and the public, and gives large bonuses for profits? And how is "expertise" to be reconciled with the inability to assess the suitability of people, and the need to trust subordinates blindly?

The text creates illusions. There is no indication that these assessments take place only since the year Y, and that the integrity and expertise of people appointed before that year is actually unclear. An observation like this, supplemented by an indication of Y, could prevent misleading illusions. And how about CEO Scheringa of DSB, a bank which would fail due to mismanagement?

The chapter Financial stability is introduced as follows:

«The International Monetary Fund (IMF) published a positive evaluation of the Dutch financial sector. The Fund also judged positively about the new structure of the supervision in our country and about the intention of the Nederlandsche Bank (DNB) to strengthen macro-prudential supervision.»¹⁶⁷

About the role of the IMF the same chapter writes:

«The IMF plays a key role in maintaining worldwide financial stability. It follows and evaluates the policy of all member countries (surveillance), (conditionally) supplies credit to countries having difficulties with their balance of payments, and provides technical assistance to low-income countries. Every year the Fund furthermore evaluates the financial sector in a number of member states in a Financial Sector Assessment Program (FSAP), as it did for the Netherlands in 2003-04 (see section 6.5.3).»¹⁶⁸

How the IMF can properly evaluate the Dutch financial sector with very limited means and in little time, or just as well as DNB, is not explained.

AR 2006.

(The paper version is dated 4 April 2007, the pdf version 13 November 2007).

In the annual reports of DNB the General overview plays the role of a summary. Something with a title like "summary" is absent. The section *Risks* of the General overview of AR 2006 includes the following paragraph:

«Asset prices— at exchanges and home markets— run the risk to grow too much. As a consequence of low interests and reduced risk awareness, both households and investors may take financial risks and debts too lightly. In such circumstances a sudden reversal in sentiment may have serious repercussions on financial markets and the real economy. Such a reversal might be caused by fading trust in the US dollar. Though this is not a new risk, it is a yearly increasing risk for the worldwide financial system, due to the very longstanding deficit on the current account of the American balance of payments. To get a feel of the exact location of the risks, the seriousness of the risks, and the remedies to be considered, more and more stress tests are held. Internationally, but also by DNB.»¹⁶⁹

Much of this analysis is correct,¹⁷⁰ but the action taken was marginal in comparison with the threatening danger. (A danger that was underestimated terribly, contrary to what Wellink told the CDW). The stress tests are not described or discussed. No indication is given of the stress an institution or the system can withstand if it passes the test. The tests premise knowledge and understanding of the financial system. Nothing shows that DNB and IMF possessed this knowledge

¹⁶⁶ DNB AR 2004 p. 70/68.

¹⁶⁷ DNB AR 2004 p. 95/93.

¹⁶⁸ DNB AR 2004 p. 101/99.

¹⁶⁹ DNB AR 2006 p. 19/17.

¹⁷⁰ The risk did indeed increase, but even a diminishing risk may be realized.

and understanding. On the contrary: the silence about the GAO and OFHEO reports, the lack of analyses resembling those of the GAO and OFHEO, and the facts of the crises show that they don't. That one can only design and implement meaningful stress tests if one understands the system is only logical. The text anyway gives no convincing explanation of the reliability of the stress tests. One has to believe the AR. Therefore the AR cannot be considered as a form of accounting.

One wonders how DNB reconciles this with the claim in its mission statement "The organization does its work effectively and efficiently." This is only compatible if the risk and its consequences are negligible. The quote suggest the opposite.

The stress tests do not reduce any risk. DNB nevertheless only tested. It says nothing about reducing the risks.

The present author finds it very remarkable that here and in most publications of other financial supervisors the shortage on the US balance of payments gets much attention, while the government debts of the US and many other countries are hardly mentioned. He cannot explain it theoretically, except for political reasons incompatible with a supervisory mission. Practically it shows a fatal blindness: not balance problems but government debts would cause a crisis, and a serious one at that.

DNB AR 2006 did warn against the excessive government debt however. The General overview of AR 2006 has a section Budget development. It only mentions shortages or surpluses in the current budget. Section 3.3, "Government finance: economical circumstances and gas receipts cause improvement", is more extensive. There one reads:

«**Notwithstanding the improvement of the budget situation, further consolidation is warranted, since the Dutch government finances are still on an impracticable trajectory. In its study of the ageing of the population, [economic advisory organization] CPB shows that due to demographic developments like ageing of the population various costs will increase. The depletion of the stock of natural gas will further worsen the emu-balance. If no action is taken, the government debt will increase to untenable levels.»**¹⁷¹

The annual report does not explain why this is untenable, and what may or will happen if no action is taken. The deficits and debts are not mentioned as risks, or in a prominent place.

The term "government debt" is also mentioned in connection with Japan¹⁷² and the admission of states to the euro area.¹⁷³ Not in connection with other states, such as the USA, Greece, Italy, or Ireland.

The General overview of DNB AR 2006 concludes as follows:

«**Globalization once more made a strong mark on growth and inflation worldwide, but it also affected other areas, such as the representation in international financial institutions and fora, supervision and payment systems. Once more the consequences of globalization were very clearly visible in financial market, and the behavior of the players [sic¹⁷⁴] in these markets, who innovate on a unprecedented scale.¹⁷⁵ In the past few years as a consequence, markets and institutions have become much more efficient. But some developments nevertheless cause worries, such as the ample liquidity proportions, the increasing debt proportions, the low long-term real interest, and the low risk premiums. These phenomena increase the vulnerability of the financial system. They do not make monetary policy easier to design.**

«**All in all 2006 was a good year. But because of the many vulnerabilities and uncertainties one should beware of euphoria and straightforward extrapolation of present trends.»**¹⁷⁶

What is one to do with such "advice"? Why no mention of measures DNB will take, and of the plans it has for 2007? Why no discussion about what can or should be done? DNB writes as if it is an

¹⁷¹ DNB AR 2006 p. 66/64

¹⁷² «as a legacy of serious stagnation of its economy in the nineties, [Japan] has a budget deficit of 4,2% GDP and a government debt of 175% GDP. These are problematical percentages [...].» DNB AR 2006 p. 21/19.

¹⁷³ DNB AR 2006 p. 57/55.

¹⁷⁴ DNB could also have used words like participant.

¹⁷⁵ DNB says "innovative product renewal", showing it doesn't know that innovation already implies something new.

¹⁷⁶ DNB AR 2006 p. 35/33.

observer on a distant planet, instead of a supervisor responsible for the safety and soundness of the Dutch financial system.

«4.1.2. Regauging supervision strategy: more risk orientation and integrity.

On the basis of the actual developments in the financial world and the merger with the Pension- and Insurance Council (PIC) in 2004, DNB has regauged its supervision strategy. In the new strategy more stress is laid on risk orientation, integrity supervision and openness.¹⁷⁷

Supervision is more emphatically applied where the risks are largest. The supervision approach will be matched systematically with the risk profile of the institutions to be supervised. Managing with emphasis on risks requires a sharp up to date picture of the risks and a flexible employment of supervision capacity. In practice this means that the involvement of the supervisor scales proportional to quality of the financial and organizational management and control of the institutions under supervision.¹⁷⁸ The given risk situation determines the way in which DNB communicates with an institution or makes an inquiry in that institution.

Integrity supervision is given more emphasis too. Important subjects are: reliability-evaluation of policymakers and self-assessments, where financial institutions are asked to compare the compliance structure with the compliance norm. New is furthermore the choice of relevant themes as spearhead in supervision and communication. The themes are chosen on the basis of sector-wide risk analysis.¹⁷⁹

The compensation and bonus policies which after the crisis will be strongly and gratefully reviled and even get part of the blame for the crisis, are not mentioned. It must be assumed that DNB sees no incompatibility with integrity. The word “bonus” does not occur in DNB AR 2006.

P. 72/70 shows that the loan to value ratio for mortgages in the Netherlands too has increased substantially: from 104% in 2002 to 114% in 2006. This means that the risk that people will not be able to pay back their loan has increased.

The Corrigan-report, CRMPG II.

The so-called Corrigan-report, CRMPG II, of 27/7/05, gives analyses of parts of the financial system. The analyses are aimed at recommendations meant to increase the stability of the financial system. The report notes several weak points, and makes numerous recommendations. The report shows that there are many new, rather obscure, risks. A pessimistic reader might conclude that we live on a volcano. The report is written by the sector itself, and asks action first and foremost from the sector (in the narrow sense). It asks little action from the supervisors. But because of the risks which it reveals, it implicitly requires reaction and action from those who are charged with the care for the stability of the financial system. The report is mentioned in DNB AR 2005.¹⁸⁰ A conclusion is given, and it is said to be important that the recommendations of the report are followed-up. The annual report of the following year, DNB AR 2006, mentions monitoring by DNB. No more. A summary or evaluation of the findings is not given, and nothing is said about any follow up activities. Even though there is a risky gap in information:

«The limited information provided by hedge funds and private equity-houses hampers the estimation and management of risks [of, and caused by, their products and services] by financial enterprises.»¹⁸¹

DNB leaves it at that. No remarks are made about deficiencies in laws or regulation, and the need to repair them. Notwithstanding the following recommendation by CRMPG II, one of the few directly addressing the supervisors:

«CRMPG II recommends that the private sector, in close collaboration with the official sector, convene a high level discussion group to further consider the feasibility, costs and desirability of

¹⁷⁷ The source continues with: (see the publication ‘Vision DNB on supervision 2006-2010’ at www.DNB.nl, under ‘News and publications’ and ‘Publications DNB’).

¹⁷⁸ The AR probably means: *inversely* proportional.

¹⁷⁹ DNB AR 2006 p. 69/67.

¹⁸⁰ The text is quoted below, in the section on quotes with “deriv”, at the end of the subsection on AR 2005.

¹⁸¹ DNB AR 2006 p. 123/121.

creating an effective framework of large exposure reporting at regulated financial intermediaries that would extend — directly or indirectly — to hedge funds. Using the indirect method, regulators would collect and aggregate large exposure data from traditionally regulated institutions and, through those institutions, collect data on hedge fund activity. Under the direct approach, hedge funds would, on a voluntary basis, provide large exposure data directly to the appropriate regulator.»¹⁸²

Nothing is said about this in DNB AR 2006.

In AR 2006, the word-fragment “warn”¹⁸³ is only used in connection with a warning system for the fight against terrorism.¹⁸⁴

AR 2007.

(Both the paper and pdf-version are dated 2 April 2008).

The summarizing General overview of DNB AR 2007 concludes with the following section:

«Conclusion.

Substantial risks for the world economy can at present be found in the development of the American economy, the rising inflation, and the restructuring process of the financial sector.

This will take some more time, and it will require expert navigation to follow a safe course in these turbulent waters. On the one hand the necessary adjustment processes – with the accompanying unpleasant side effects – should be continued, on the other hand the process should remain under control, and risks reduced as much as possible. At present, the business model of banks and the environmental factors which are relevant for this model (such as the risk management of banks, the operation of the ratings industry, and the valuation of complex financial products) are being audited fundamentally.¹⁸⁵ This should lead to tangible improvements. Monetary and budgetary authorities will furthermore have to watch the danger of continuing acceleration of the inflation carefully. The Netherlands has had good years, but will also experience the consequences of international developments. At this moment the macro-indicators for our economy are still looking good as compared with other countries, but in some fields (labor market, healthcare sector, housing market) substantial improvement is possible.»¹⁸⁶

Note that the first statement is simply wrong. It doesn't mention any of the causes of the subprime and debt crisis.

Chapter 7 of AR 2007 has the title “Financial stability”. It gives both relevant and useless information.¹⁸⁷ It suggests that the phenomena are understood. It seems reassuring. As compared to other parts of the chapter, doubts are expressed most strongly in the following paragraph:

«In many respects the developments can be seen as a correction, after a long period of high risk tolerance and debt accumulation in financial market parties, enterprises and households. Similar ‘boom-bust’-patterns have occurred more often in history. A difference with earlier cycles is that, more than in the past, the problems were caused by the complexity and opaqueness of risk positions. In combination with progressive integration and globalization of the financial system this also makes effective crisis management by the authorities more difficult.»¹⁸⁸

“More difficult” doesn't sound alarming. “Difficult to manage” would be more to the point, While “unmanagable” would have been the best signal, a real warning.

¹⁸² CRMPG II p. 40/58.

¹⁸³ In Dutch: “waarschuw”.

¹⁸⁴ DNB AR 2006 p. 106/104.

¹⁸⁵ What does this refer to? The improvements obviously never came, not even after the crash & crisis. See the Chronology.

¹⁸⁶ DNB AR 2007 p. 29/26.

¹⁸⁷ As if it doesn't understand, and cannot distinguish what is important and what is irrelevant. For examples of irrelevant information see section 7.5.2 on p. 123/115.

¹⁸⁸ DNB AR 2007 p. 117/109.

Do I understand correctly that DNB considers crises inevitable, and thinks that its main duty is to “manage” crises? (There is no mention or discussion of the DNB assumptions anywhere in the studied documents).

Section 7.5, *Policy of the authorities*, is surprisingly uncritical (if not unthinking). There is no trace of doubt about the adequacy of the measures taken, and no questions are asked.

Remarkable in AR 2007 is the implicit assumption that the Dutch and US systems are largely independent. DNB seems to believe that it has done its duty if the Dutch supervisory system is approved by the IMF.¹⁸⁹ The problem is that supervision requires more than paper. DNB should at least have read (IMF and other) reports about the UK and US financial systems to get a better picture of the risks they pose for the Dutch (European, world) system. At least as regards the safety and soundness of the (Dutch) financial system and economy, DNB underestimated the influence of the US on the Netherlands very very badly. The DNB annual reports show no interest in any supervisory activity anywhere outside the Netherlands, and its ineffectiveness. The following quote is an example of irresponsibly simplistic optimism (= blindness), which moreover is a misleading half-truth:

«In the Netherlands there is no reason to fear the occurrence of an American scenario, since there is no Dutch version of the American subprime mortgage market.»¹⁹⁰

Somewhat further down DNB contradicts itself:

«In the second half of 2007 the market turbulence has also affected the Dutch banks. The buffers are adequate, but profitability has come under pressure. With respect to their subprime related securities Dutch banks had to accept limited losses.»¹⁹¹

There may not have been a “Dutch version...”, but Dutch institutions did have subprime dependent securities.

Also in section 4.2.4, *Implementation Basel II*, reflection is missing. In the course of the crisis the norms of Basel II were nevertheless generally considered to be insufficient.

Critical notes about Basel II are missing. The section even suggests that the financial world already does what it has to do, and does it well:

«In the standard approach banks use, among other things, external credit ratings of for example Moody’s Investor Service and Standard Poor’s. In the internal-model approach the banks use their own risk estimates. The application of the internal-model approach is subject to the high norms for risk management.»¹⁹²

And more of the kind. Reassuring phrases everywhere. There is no indication of the meaning of the “high norms” for risk management. Take note that the crisis showed that such phraseology of even a high authority means absolutely nothing.¹⁹³

DNB does not conclude the section with a list of remaining risks in the Netherlands, and, in so far as the Dutch financial sector depends on them, risks in the relevant other countries.

4. The Overview financial stability (OFS).

Introduction.

In December 2004, DNB started publishing half-yearly Overviews financial stability (OFS).¹⁹⁴ Until OFS 13 of “Spring 2011” (inclusive), the OFS don’t advise. OFS 14 does. Because of the concurrence with the publication of a report of CDW, this may be a result of CDW’s work, though this isn’t noted in the OFS.

¹⁸⁹ See above, under AR 2004.

¹⁹⁰ DNB AR 2007 p. 69.

¹⁹¹ DNB AR 2007 p. 70.

¹⁹² DNB AR 2007 p. 72/66. There is no reference for the “high norms”, or normative risk management.

¹⁹³ Of course, unless convincingly explained and proven. DNB (and other supervisors, and the inquiry commissions) never did.

¹⁹⁴ The pdf file of number 4 does not allow copying.

DNB is not clear about its definition or interpretation of “financial stability”. In the brochure *Watchdog financial stability*¹⁹⁵ of December 2008 the following quote comes nearest to a definition:

«A stable system can absorb external shocks without disrupting financial markets, financial enterprises or the economy. Pillars for financial stability are sound and honorable financial enterprises, a stable euro, liquid financial markets, a safe and efficient payment system, and a balanced financial-economical policy.»¹⁹⁶

This betrays a lack of understanding. A financial system can collapse, crash, and enter a crisis entirely of its own, without any external “shock”. A financial crisis in general is caused by internal developments. This is true for the crisis of 1929 and the LTCM crisis for example.

If a “shock” is meant to indicate something rather severe, this is wrong too: even smooth developments (such as of interest rates) can trigger disastrous developments. The general word “disturbance” is better.

In April 2013 the DNB-website said the following about financial stability:

«DNB guards financial stability by concentrating on three main goals:

- stable prices;
- a smoothly operating payment system;
- sound financial institutions.»¹⁹⁷

OFS nr. 1 of December 2004. (In English!).

The introduction begins as follows:

«This overview focuses on financial stability in the Netherlands, analyzing the main developments and risks for the financial system. It is the first reflection of the more systematic manner in which De Nederlandsche Bank (DNB) has started monitoring financial stability as from this year. The analysis confirms the stability of the Dutch financial system, even when downside risks are taken into account. In the base scenario, of a gradual interest rate rise, these risks remain limited, because debt ratios remain manageable. Thanks to a sound solvency position, the banks can withstand a stress scenario of rapid interest rate rises or sharp falls in asset prices. The recovery of their financial position notwithstanding, the institutional investors remain vulnerable to new shocks; life insurers are affected by the continuous decline of policy sales and non-life insurers by the increased insurance for own account. The adjustments at the pension funds do not present contagion risks for other financial institutions; they do, however, affect the economy and potentially bond yield volatility.»¹⁹⁸

If you please: “even when downside risks are taken into account”, and “banks can withstand [...] sharp falls in asset prices”. Clearly, DNB was not aware of all relevant risks and literature. It seems to see only interest developments as a source of danger, and traditional economics textbook mechanisms. It sees no need to tell the reader what it means (quantitatively) by “sharp falls in asset prices”.

DNB was nevertheless represented with two employees in the Working Group on Credit Risk Transfer which published CGFS-report 20 of 2003.¹⁹⁹ It is therefore clear that the necessary knowledge and understanding were present in DNB, and that the employees or management failed to take appropriate action. As the chapters 2-5 and 8 show, this is what happened at the ministries of education, defense, and agriculture too.

The most important claims in the text were already untenable in 2004 anyway, and were falsified by both crises.

The report concludes as follows:

«**In conclusion.**

¹⁹⁵ The pdf file of this brochure does not allow copying.

¹⁹⁶ P. 4, *Hoedster van financiële stabiliteit*, DNB 2008.

¹⁹⁷ DNB website 19/4/13: <http://www.dnb.nl/over-dnb/taken/financiele-stabiliteit/index.jsp>

¹⁹⁸ OFS 2004 p. 1/2

¹⁹⁹ BIS CGFS 20 2003 p. 53. The employees are Lidwin van Velden and Tom van Veen.

The downside risks for financial stability in the Netherlands remain limited in the base scenario providing for gradually rising interest rates. This overview also sets out the possible consequences of stress scenarios, such as a faster-than-expected interest rate increase, and a worldwide confidence crisis. Thanks to a sound solvency position, the banks can withstand a stress scenario; the institutional investors remain vulnerable to sharp declines of asset prices. The stress scenarios and the downside risks do not reflect expected developments, but their analysis is a way of identifying risks to the financial system before they arise. Taking into account possibly unfavourable outcomes is essential to a proper assessment of financial stability.»²⁰⁰

So? Should something be done? What? What is DNB going to do about it? And what should the minister of finance, the cabinet do? Nothing? They should at least have asked less ambiguity, and more clarity.

The principal and major error of this OFS seems to be the absence of a survey of the relevant literature. Nothing shows however that DNB is aware of the analyses and recommendations of the often mentioned reports of GAO, OFHEO and CGFS. It shows no awareness of a lack of important information, including information about the reliability of foreign financial supervisors. In a first OFS, all this should have been discussed thoroughly. Of course, for a professional and responsible financial supervisor, ignorance of these reports, or failure to reproduce their findings is inadmissible. DNB does not know its limitations, lacks necessary competence, but arrogates perfect knowledge and understanding.

OFS nr. 5 of March 2007.²⁰¹ (In Dutch).

«Conclusion.

With increased potential imbalances in the world-wide financial system, due to the continuing search for yield and risen debt ratios, the judgment about the financial stability in the Netherlands remains predominantly positive. The OFS shows that the Dutch financial institutions in general have adequate solvability buffers to protect them against a strong increase of credit and interest risks under a number of simulated, unfavorable scenarios.

Although the flattening of the interest curve led to downward pressure on the interest profits of the Dutch banks, their solvability position is sound to such a degree that the most unfavorable scenario ('world-wide correction', with an abrupt and chaotic dollar depreciation, rising capital market interest rates, and falling share and home prices) can be met. That also applies to life insurers, who saw improve their asset position with the recently increased capital market interest rate. They seem to be able to withstand both the world-wide correction-scenario and the slump-scenario, with a lower capital market interest rate and an inverse interest curve. Of the three types of financial institutions distinguished, the pension funds, which also profit from the increasing capital market interest rate, are found to be the most vulnerable to the unfavorable market developments assumed in the stress tests. Structurally the financial position of the pension funds has nevertheless improved due to the establishment of cost-covering contributions and reduction of the interest mismatch.

In this connection it is important to note however that the dynamics and the impact of uncontrolled adjustments, as may happen in a financial crisis, can never be completely quantified in scenario-analyses and stress tests. In any case the results underline the importance of adequate capital buffers and prudent risk management. In their risk management, financial institutions should also take account of second-round effects which shocks in the financial sector can cause in the economy and in financial markets. If this is done, institutions will be better prepared for a real stress situation.

Because of the reservations regarding quantification of stress scenarios, vigilance and control of financial stability risks remains necessary. In several areas DNB contributes to guarding financial stability, among other things by recent initiatives in prudential supervision, which for example follow from the identification of risks in the last OFS-publications. Together with foreign central banks and

²⁰⁰ OFS 2004 p. 13/14. Boldface italics from the original.

²⁰¹ The pdf-file of OFS nr. 5 is dated 27/2/2007.

supervisors, DNB continues to exert itself to keep the institutional framework for supervision, crisis management and payment systems and securities trade adapted to the progressing financial integration in Europe and elsewhere; in dialogue with the private sector. In these policy areas the OFS can play a catalyzing role by considering risks in relation to each other.»²⁰²

Contrary to the claim in the first paragraph, most of the important Dutch banks were not able to withstand the consequences of the fall of the American housing prices. For logical-theoretical reasons the claim was too pretentious. DNB made serious methodological errors. There is not the least proof of the adequacy of the norms for the solvability buffers. They would only be if disruptions, and the total effect of disruptions, were limited, and sufficiently small. A ridiculous assumption, since in general nothing really limits subjective valuations. Neither is there any proof of the adequacy of the test method used. The paragraph assumes the ability to aggregate risks, and therefore sufficient specific knowledge of risks, their interference, and their consequences.²⁰³ None of the studied DNB publications shows any trace of knowledge and understanding of this. On the contrary: DNB and other supervisors are systematically surprised by events.²⁰⁴ An example of lack of understanding of before the subprime crisis is the course of events surrounding the bankruptcy of Van der Hoop on 16/12/06.²⁰⁵ The difficulties with the DSB bank too began well before the publication of OFS nr. 5.

Without the knowledge indicated, the kind of conclusion which DNB draws can actually not be drawn. As long as risks have not begun to be realized, they are only probabilities. As long as they are dormant, the development, for example of the growth of GDP, is positive, otherwise it is negative. The “expected” and “most probable” outcome may be either positive or negative, but people or organizations should be adequately prepared for all possible outcomes by risk management adapted to their situation and responsibilities.

A supervisor should be much more careful and modest. He should not pretend to be able to measure and aggregate risks. He should do everything possible to uncover and list possible risks, and trace and estimate their consequences. If only descriptive, qualitatively. Nothing like this can be found in any of the studied reports of any supervisor, in the Netherlands, US, or anywhere else.

To this should be added the complete lack of understanding of the fundamental instability of the financial-economic system as described in the analysis of the financial crisis. As regards the concept “risk”, DNB may have heard bells ringing in the far distance, but as regards “instability” the ringing was evidently too far away.²⁰⁶ Deficient understanding, inadequate application of available knowledge, both supported by arrogance, can explain the incorrect positive results of scenario-analyses and stress tests, and the failure to give a useful and understandable indication of the assumptions. The terminology “the dynamics and the impact of uncontrolled adjustments” in the third paragraph suggests that DNB may have an intuitive inkling of instability. But DNB seems to take the cause for the consequence. It sees the crisis as an instability, while instabilities are always present, and cause a crisis if appropriate developments take place. Where the developments need not even be “shocks”.²⁰⁷

What specific activities does DNB refer to by “vigilance and control of financial stability risks” in the fourth paragraph? It sounds nice, but how does DNB mean to implement this vigilance and control? Is it possible at all, at this late stage? DNB’s plans are indicated only vaguely; and DNB can hardly expect its vague indications to be reassuring. Given the supervisors failure to convincingly react to the events and warnings in the past 15 years, and the lack of understanding manifested in the annual reports and reports like this OFS, it is highly improbable that they will- or can- (re)act adequately now. And indeed, they didn’t.

²⁰² OFS nr. 5 p. 31.

²⁰³ Compare the reaction of Wellink to a remark by Docters van Leeuwen. Search for “multiplied” in the Wellink appendix.

²⁰⁴ As DNB AR 2007 amply proves.

²⁰⁵ See DNB AR 2006 p. 81/79.

²⁰⁶ In OFS nr. 5 and DNB AR 2007 the word fragment “instabi” does not occur; in AR 2006 once, in the word “premie-instabiliteit”; and in AR 2005 also once, now in the combination “politieke instabiliteit”.

²⁰⁷ The English language does not make communication on this topic easy. In English, the concept “instability” is too wide or ambiguous. One needs at least two different words to indicate “liable to disproportionate changes upon relatively minor disturbances”, and “absence of constancy”.

The clearest and most decisive proof of lack of knowledge of the financial system and lack of understanding of the coherence of phenomena in that system is the following paragraph:

«As a new scenario a world-wide correction of housing markets has been added. This scenario corresponds with recent developments in the USA, where in the second half of 2006 the home prices entered a downward cycle, and possibly weakened an important pillar of private consumption. It is assumed that an initial increase of capital market interest, amplified by a negative confidence spiral, will cause a drop in home prices of 30% in three years, beginning in the USA, and followed by the euro-area. Beside the assumed common interest and confidence factors, the increased boundary crossing investments in mortgage products, and the real (consumption) effects may contribute to the assumed cross-Atlantic correlation of home prices. Consequence of the housing market correction is a world-wide fall in growth, which will also affect the Dutch economy. If it is assumed that the policy interests react mechanically to GDP growth and inflation developments (according to the Taylor rule), then these will initially decrease in the direction of the zero-level. This subsequently softens the initial negative effects on economic growth and the securities markets.»²⁰⁸

The fatal effect on the value of derivatives and on the operation of repo-markets is completely ignored, or of course simply unknown.²⁰⁹ As a consequence, the upcoming need for central banks and governments to support a majority of the banks is unforeseen.

By the way: the use of the concept “cycle” in the second sentence is both superfluous and unfounded. Fact is that home prices decreased. Whether this has anything to do with a cycle remains to be seen, and is completely irrelevant in the present context.

5. Quotes with “derivat” from DNB annual reports.

This part of the investigation was made to check assertions of Wellink in the hearings of the CDW.

Summary and conclusions of an analysis of the quotes with “derivat” and “intransparant”.

1. The quotes show DNB as a passive pedant.
2. DNB uses very many words to say far less than the GAO in 1994-1999.
3. Implicitly the reflective reader is warned, also for DNB. But DNB gives no explicit warnings
4. No proposals for action are made. No mention is made of measures taken or to be taken.
5. Parliament and government must be irresponsible sleepy-heads. The annual reports show that the risks increase (strongly), and that at least DNB does nothing about them. And that it quite generally takes an irresponsibly passive stand. This could have been seen all of the years 2003-2007 considered here.

Some statistics.²¹⁰

The number of occurrences of respectively “derivat”, “intransparante”, “intransparantie”, and “repo” (excluding report):

2003...70011
2004...10011
2005..10109
2006..131112
2007...50113
2008..170010
2009..190015

²⁰⁸ OFS nr. 5 van mart 2007, p. 12.

²⁰⁹ Note that DNB talks mainly in macro economic terms, not in terms of financial system processes.

²¹⁰ These numbers are given not because of their importance but to obviate the need to count the occurrences once more.

AR 2003.

P. 93/87:

«The improvement of the risk management of the individual institutions goes together with increasing use of instruments like securitization and credit derivatives. With these instruments banks can transform risks, and exchange them amongst themselves, or transfer them to other financial institutions. In this way risks are spread better in the system, promoting its stability.²¹¹ Drawback of these instruments is the reduction of the transparency of the system, and thereby the manageability in crisis situations. As a consequence, many policy initiatives are aimed at improvement of transparency (see section 4.5.4).»

As regards the first sentence: the crisis has shown that the supposed improvements in risk management did not keep pace with the growth of the risks taken by the financial institutions.

The sentence “In this way...” lacks any serious substantiation. It may just have been copied from American supervisors. (Who don’t supply proof either). The crisis has shown that it is untrue, and that the net effect has been worsening of instability.

Less transparent, but nevertheless better risk management and more stability? Doesn’t that need explanation, and at least an indication of the evidence on which this claim is based? What is the evidence for better risk management and greater stability? How can DNB be sure that there are no dangerous concentrations of risk?

P. 96/90, in section 4.5.4, beside the marginal “heading” “Much attention for risk transfer...”:

«Supervisors moreover spend explicit attention to cross-sectoral developments, such as the transfer of risks within and between (not always supervised) sectors. Especially the transfer of credit risk with instruments like credit derivatives and securitization takes a high flight. Points of worry are that it is not clear where the credit risks finally end up, and whether the risk management of the institution accepting the risk is adapted to it. Both in Basel and in the European framework one tries to get a better view of risk transfer activities, for example by means of interviews with European banks. The first results will be published in the middle of 2004.»

What does the attention to cross-sectoral developments yield, if not insight in where the risks end up? Is it possible at all to get the insight necessary to make sure that the financial system is safe and sound? Is regulation adequate, notwithstanding the fact that part of the system is outside the scope of supervision, and “unregulated”? Are the risks so small that the supervisors can afford such a leisurely approach as witnessed by this paragraph?

If opaqueness is a dangerous risk, which the text clearly suggests, why doesn’t DNB say anything at all about the desirability of creating transparency as soon as possible? Because Greenspan or the banking lobby object to transparency? So what? Why not openly say so? What about the mission and law instituting DNB?

AR 2004.

The word-fragment “derivat” is only found in the table on p. 145/143. This table has nothing to do with supervision. It is part of the annual account of DNB as an organization.

The word “risk transfer” (in Dutch: “risicotransfer”) is not found. P. 77/75 mentions “transfer of risks” (in Dutch: “overdracht van risico’s”), but only as an example, about which nothing substantial is said. In other words: nothing seems to be said about the results published in the middle of 2004 referred to by DNB AR 2003.

So everybody could check for himself that as regards this subject of care (in Dutch: “punt van zorg”) DNB is negligent.

AR 2005.

P. 20/18:

²¹¹ Note that here “stability” means resilience, the ability to absorb shocks, and not constancy or smooth development.

«New instruments like credit derivatives increase the intertwining of credit and market risks, and create new forms of liquidity risk. For the Netherlands, with large and complex financial conglomerates, a large pension sector, and a private sector with many assets but also much debt, it is of essential importance that the finger is kept on the pulse in such a way that in case of threatening contrary developments it is possible to interfere timely.»

Unbelievable, this “New”! For an outline of the history see for example the 1994 (nineteen ninety four) report of the US GAO.

The “keeping of the finger on the pulse” doesn’t inspire confidence either. A metaphor like that may very well be meant to hide the fact that for the time being nothing is done at all.

Note furthermore that DNB assumes that it is sufficient (“timely”!) to start acting when “threatening contrary developments” have become clearly visible. None of this is argued, and none of this is correct.

P. 94/92:

«In a few years, the world-wide market total of credit derivatives and structured credit products has increased manifold.»

The importance of the accompanying risks may have increased proportionally, and maybe more, because when grown sufficiently large, risks start to threaten the whole system. (Remember: “Too big to fail”). Reason for action!

Don’t forget that already in its AR 2003 DNB had said that the use of the new instruments had taken a high flight. In the following quote DNB repeats this:

P. 96/94:

«In the last years the tradability of credit risks, for example via ‘credit default swaps’, has taken a high flight. This has loosened the relation between credit providers and buyers, and further spread the risks in the financial system. If they are spread to parties which can bear them better, then the risks in the financial system are shared more efficiently. It also improves the resilience of the system, because with new instruments the risks can be measured and managed better.²¹² This is one of the reasons why banks increasingly use credit derivatives and other instruments in their risk management. With a few large securitization transactions Dutch banks too have reorganized their balance position in 2005.²¹³

The rise of new financial instruments causes new risks as well. The instruments have hardly been tested in a crisis situation, where market prices and risk positions derived from them may develop in another way than expected by investors. As a consequence of the complexity of these instruments investors may accept risks which are difficult to model in advance.²¹⁴ If the underlying risks are not clear for the parties concerned, then the sale of complex financial products may hurt reputations.

Finally the year under review turned up operational risks in the form of arrears in the unwinding of credit derivatives. In July the Counterparty Risk Management Policy Group II- an initiative of a large number of market parties- published a report, CRMPG II, the so-called ‘Corrigan-report’, with recommendations intended to make the various risks of new financial instruments more understandable and transparent. It concluded that this introduces new requirements for the risk management of the financial institutions, the financial infrastructure, and supervision of this. It is important that the recommendations are followed-up, in the first place by the institutions. Supervisors and regulators can play a stimulating role, for example by pointing out the [sic] risks, and promoting ‘best practices’ to manage them.»

Again “new financial instruments”.

GAO and CGFS are not mentioned, but CRMPG is. Because it fits the dogma of self-regulation, and doesn’t require much of supervisors and regulators?

But neither CRMPG nor the dogma can change the duties of DNB. Is stimulation what CRMPG recommends, and is it reasonable to assume that it is sufficient? If the recommendations deserve support, or are even necessary, why didn’t supervisors make them long ago?

²¹² Note the error in the reasoning: something is a fact because of something hypothetical.

²¹³ The lack of clarity is shared by the original.

²¹⁴ But easy to model afterwards? What does DNB mean?! What does it mean, to model a risk?

Note that DNB doesn't summarize or discuss the recommendations CRMPG addresses to the supervisors.

Note that DNB AR 2005 implies that since 2003 nothing has been done about the “new” risks and for example transparency. Although DNB itself notes that the volume of derivatives has taken a high flight, it forgets that something that flies high can fall deep.

AR 2006.

Pp. 120-1/118-9:

«7.4. Structural changes in the financial system.

The growth of the role of private equity and hedge funds is the exponent of structural changes in the financial system which in the past years have accelerated. As a consequence of the continuous process of financial innovation, boundary crossing activities of financial enterprises increased, while capital moves easier between sectors and economies. For this reason the financial systems begin to look more and more like a world-wide system.

Through these forces the competition in the financial sector has increased strongly. The traditional activities of banks and other financial institutions, such as insurers and investment funds, have become more blended. The use of derivatives and other complex instruments thereby has grown explosively. The last years especially the instruments for credit transfer, such as structured credit products and credit derivatives, took a high flight (see graph 7.5). New risk-oriented supervision frameworks, such as Basel II, stimulated the use of instruments for credit risk transfer, because they encouraged institutions to manage risks more actively. [Perfect past? DNB AR2007 says that Basel II was introduced in Europe only 1/1/08...] Banks consider their credit risks ever more on a portfolio basis, and with the new credit instruments they can diversify their credit portfolio better.²¹⁵ In the year under review the low premiums for credit risk in the financial markets and the great demand of investors for this gave the banks an additional incentive to transfer credit risk. The trade in credit enables banks to generate additional income. These developments gave rise to a process of ‘re-intermediation’, in the form of a changing role of banks. They are still the most important providers of credit, but trade an ever growing part with other market parties, and therefore don’t keep it (fully) on their balance. Partly for this reason the fraction of interest income in the total of banking income has decreased from more than 70% to about 50% in the past twenty years, to the benefit of brokerage and other income.

The financial innovations contributed to ample availability of liquidity. Attracted by the new financial instruments and stimulated by the ‘search for yield’, investors have appreciably expanded their deposits in the credit markets. The total amount invested in Europe in credit titles with a high risk profile reached about 66 billion euros (in a total of credit titles of enterprises of more than 1.000 billion euros). The increased tradability of credit provided the banks with additional liquidity for selling new loans. This has made them more dependent on the operation of markets where (credit) risk is traded. A market turnaround for example could confront banks with credit risks which were supposed to be transferable. These risks for the banks have not yet been tested by a real crisis situation, and have the attention of DNB.²¹⁶

The financial innovations have large consequences for the operation of the financial system. The increased risk transfer and rise of new market parties, which trade in these innovative instruments, has made the system more complex, and their positions less transparent. Because the new instruments decouple the risks from the underlying financial products, it is less visible where they precipitate ultimately. It may be true that risks are mainly transferred between banks (see graph 7.6), but more and more they are also traded with investors such as hedge funds, which don’t inform supervisors. DNB and some other supervisors think that the risks of hedge funds can best be managed in an indirect way (via supervised institutions).²¹⁷ For the major part, the hedge fund-emissions of Dutch financial institutions concern foreign entities. According to various estimates for 2006, the share of hedge funds

²¹⁵ Note that once more DNB is speculating about what is possible, (“can”), and is not reporting about what is.

²¹⁶ Wow! Attention! Great! A group of children is playing with fire. Don’t worry, they have the attention of their parents.

²¹⁷ Why? And how to manage invisible risks? What assumptions does DNB want banks to make, and why?

in world-wide credit trade was 20% to 60%.²¹⁸ In this way risks move outside regulated [= supervised] sectors, so that the emissions of supervised institutions provide [relatively?] less information about the total positions put out in the financial system. To an increasing extent, risks end up not only in unregulated financial enterprises, but also in households. Most often indirectly, for example via (investment) mortgages, pensions and insurance (see section 7.6).»

Note that DNB talks about derivatives just as it did in 2003, three years earlier. As if it has been asleep. Already for a number of years there are no new instruments. Only their use has grown, and very much indeed. On the average more than 25% per year for 5 years. See graph 7.5 (or similar graphs in the FCIC report or the studies of its staff). In spite of all the risks, DNB says nothing about actions to control them. It says nothing about making hedge funds more transparent, and the elimination of a dangerous weak point in the financial system. It mentions no proposals at all. Not from itself, nor from other supervisors or institutions like BIS or IMF.

The remainder of section 7.5 (too) indicates growing risks for the financial system. But no action. DNB suggests that Basel II means improvement, makes the system safer. This was not the case. As a consequence of Basel II, risks could and did grow.²¹⁹

Section 7.6.2. reports about “successful” stress tests:

«In year under review DNB has mapped the resilience of the Dutch financial sector for extreme scenarios by means of macro stress tests (see the DNB Quarterly of December 2006). For this purpose the largest banks, pension funds, and insurers have calculated the effects of a further decreasing capital market interest and of a disorderly correction of world-wide imbalances in balances of payments on their financial positions.»²²⁰

As far as can be inferred from the text, DNB concludes that the institutions passed the test reasonably well. According to DNB, «with the macro stress tests DNB has stimulated that the institutions become better aware of the possible effects of shocks in the financial sector on the economy and the financial markets.»²²¹

Note that DNB speaks of “extreme scenarios”.

AR 2007.

Pp. 22-24/19-21:

«Causes of financial turbulence

The serious unrest in the financial markets since August 2007 came as a cold shower. For until late spring, the trees seemed to grow into heaven. For years the profits of banks had not been so high, turnover at the derivatives markets exploded, hedge funds and private equity financiers were extraordinarily active, share prices continued their strong growth, and mergers and acquisitions were the order of the day. In short, the financial climate was a tropical temperature and the attendant risks got far too little attention. The availability of plenty liquidity undoubtedly contributed to this. Subsequently cracks in the building became visible. A few institutions came into difficulties, and the financial rot in the American subprime sector became clearly visible, after which everything accelerated.

Imperfections in the ‘originate-to-distribute’-model are an important cause of the present problems. When this model started to falter (after all, everywhere responsibility had to be taken for securitized products which had been transferred off the balance), more and more certainties started to evaporate in the financial markets. Have the rating agencies done their job properly? Could there be more subprime-like segments in the market? Can products for which there is no market be reliably priced at all? What is the position of individual banks? Does the banking sector have the risks in its grasp? Do supervision rules and compensation schemes elicit perverse incentives in banking? How large are the

²¹⁸ Indeed, twenty to sixty percent. Quite a margin of uncertainty! Is this symptomatic of what supervisors glean via supervised institutions? Can the supervisors guarantee a sound and safe financial system notwithstanding such uncertainty?

²¹⁹ See the dossier, for example the reports of the first set of hearings of CDW.

²²⁰ DNB AR 2006 p. 124/122.

²²¹ DNB AR 2006 p. 124/122.

write-offs going to be? What is the influence on the solvability position of the banks? To what extent will the bond insurers be hit by these developments? What will be the consequences of this becoming known? What is going to happen with the hedge fund sector? What is the influence of these developments on the real economy and how does this in its turn affect the financial sector?

Many of these questions could not be answered, or only partially. This increased the uncertainty. The development was furthermore characterized by sequentiality. Old questions were answered, new problems arose. Although in a number of fields there is by now more clarity, the developments are not yet fully crystallized, and the adjustment process in the financial sector is not yet completed. Although definitive analyses and answers will therefore have to wait, it is worthwhile to reflect somewhat longer on a number of questions which have particular relevance for the supervision of the financial system.

Measures to be taken.

The financial system changed that fast, that serious deficiencies in the infrastructure have been created.²²² These were discovered mercilessly by the present crisis.²²³ The authorities in the US will have to ask themselves fundamental questions as to the supervision of the mortgage sector. After all, that is the sector where the trouble began, even though it could have started elsewhere. But the problem is wider. In essence the crisis in the market for subprime mortgages has shown that the financial system as such is extremely vulnerable in important points.²²⁴

In their frequent international conferences, the banking supervisors have made a plan.²²⁵

In the first place the rapid introduction of the new Basel Capital agreement (Basel II) is called for. Those who blame this agreement for the present crisis don't realize themselves sufficiently that Basel II only became effective in Europe on 1 January 2008, and will become effective in the USA only next year.²²⁶ Many of the impulses in the banking sector which resulted in irresponsible risk behavior came from Basel I, or were at least not opposed by this antiquated agreement.²²⁷ Basel II is a risk oriented capital framework, and as such better adapted to parry consequences of financial innovations. Which is not to say that this framework is perfect. Recent experience has taught that further refinements and reinforcements are necessary, though the framework as such should be retained. The Basel Committee on Banking Supervision is energetically working on this.

A second priority is the further improvement of the liquidity risk management of banks. Already in the year 2000 guidelines had been issued for this, but these were badly or not observed.²²⁸ This got too little attention from the supervisors. A liquidity crisis like the present one was considered highly improbable, so that banks were surprised by the total size of their obligations. The Netherlands is among the very few countries where the supervisor prescribed that obligations which are not visible in the balance (for example related to 'conduits') are nevertheless taken account of in liquidity management. In the course of this year the Basel committee published a new, much sharpened version of the liquidity guidelines of 2000. Whereby it is of great importance that supervisors enforce compliance.²²⁹

The next [third] priority lies in the field of the valuation of complex financial products. The great uncertainty which arose in the markets about this was one of the most important causes of the wide dissemination of the crisis. In the past years financial institutions have to a large extent adopted market

²²² Nothing was created. The deficiencies existed already for over a decade, and were known. Long existing risks were realized. Nothing else, nothing more.

²²³ No, not discovered. The risks were realized, not discovered.

²²⁴ The LTCM crisis had shown the same. The GAO concluded as much, but the financial supervisors claimed to know better. Including DNB.

²²⁵ May be the Dutch text can also be translated as: "plan of approach". This doesn't mean more however, since it is not explained and not self-evident what the plan is about. Given history, there is no ground for illusions.

²²⁶ DNB itself gave rise to this idea: in DNB AR 2006 it suggested that Basel II had already been introduced. Search for "perfect past". And does DNB claim that Basel II is good and sufficient?

²²⁷ Why didn't DNB note its inadequacy before?

²²⁸ If it can say so now, why didn't DNB note this in earlier annual reports? And do something about it?

²²⁹ Note that either the guidelines or the enforcement were insufficient: the crisis of September 2008 was a liquidity crisis. DNB never reported on enforcement of the guidelines. (That is what an annual report is for).

Note that the supervisors, DNB included, did not expect any crisis at all. The DNB text is falsely suggestive and misleading in more respects than noted.

valuation [“mark to market”]. In this situation it turned out that for many complex products there was no market (any more), and the products had to be valued according to prescribed models. The models have imperfections and uncertainties, with large consequences for the size of write-offs. Supervisors united in the Basel committee work on methods to strengthen the market practice. In this connection mention should also be made of the role of what are called the ‘rating agencies’. Apart from ‘moral hazard’ questions— they give for example a rating to products which they develop in consultation with their customers— there is the question of quality and extent of the information transparency of the ratings which they give. Important changes which are in the pipeline and will be adopted by the industry on a voluntary basis, try to address these points.

A fourth priority of the supervisors lies in the field of stress tests. Present experience shows that they should become more realistic and comprehensive than hitherto, and that at the same time they should be sufficiently adapted to the specific profile of the individual institution.²³⁰ This point too is under consideration by the supervisors, and is being discussed with the sector. More lessons can be learned from the recent developments, also for the central banks. It has also become clear, on the basis of the experience in two countries, that, for the accomplishment of their stability duty, central banks need appreciably more detailed information about national banking systems and in some cases individual institutions than available at present. In the Dutch situation information exchange is no problem, since the central bank and the supervisor are one and the same. In countries with a different model the information-exchange between both institutions will have to improve, and the ‘mindset’ changed in such a way too, that in the fulfillment of one’s duties, everyone is constantly aware of mutual dependence. The coordination between central banks of different countries will have to be improved further. Here by the way good progress has been realized, given the good cooperation in the past few months of the most important central banks in providing more liquidity.

The next [fifth] lesson, especially drawn from the problems around the British bank Northern Rock, is that the existing systems guaranteeing bank deposits should be reviewed. The maximum insured amount, the presence of own risk, and the speed of payment in case of appeal to the system turn out to be important factors for the effectivity of this instrument. It seems that in a number of respects the Dutch system too can be improved. It is positive that the sudden, strong increase of the number of transactions confronting the settlement systems of the central banks could be processed without disturbances. This underlines the importance of the proper operation of the payment system in turbulent times. Further growth of the efficiency and resilience of the payment system will soon be realized, as a consequence of the adoption, by all central banks in the euro area, of the same system for interbank payments (target2). Consumers and enterprises too will, after the introduction of the Single Euro Payments Area (SEPA) in the beginning of 2008, begin to pay more and more according to harmonized European standards.^{231»}

Pp. 116-7/108-9:

«In the financial markets a clear turnaround has taken place. The ‘search for yield’-phenomenon, which strongly determined the sentiment in the past years, made place for a strongly increased risk-awareness, and a ‘flight to quality’. The risk tolerance of market parties has decreased, so that especially the risk premiums for financial enterprises have increased (see graph 7.2). This particularly affected specific categories of financial institutions, such as obligation insurers (‘monoliners’). These are specialized insurers which almost exclusively insure risks of obligations, derivatives and related services. In 2007 these institutions, which traditionally have a very good creditworthiness, for the first time saw a downward adjustment of their ratings. This contributed to the deteriorating risk profile of a large number of obligations, and increased the system-wide uncertainty. Which was furthermore

²³⁰ Note that DNB now says that the stress tests were not realistic. If true, earlier annual reports and OFS were misleading.

²³¹ Sounds nice, but contrary to the old account numbers (9 digits), the new ones are impossible to memorize (18 characters). Something similar applies to the euro coins of 10, 20 and 50 cents, which look alike, and much more than the preceding coins of the national currencies. Which were much more practical. Common sense seems to have vanished.

amplified when related markets are affected, such as that for ‘Credit Default Swaps’ (CDS) for transferring credit risks between parties.

Much uncertainty has also arisen about the size and distribution of the losses in individual financial institutions. Since a number of market parties indicated that they had been hit directly or indirectly by the crisis, some financing channels dried up, such as the market for ‘asset-backed commercial paper’ (ABCP). A large number of banks was hit by this via credit lines to entities—‘Special Investment Vehicles’ (SIV’s) and conduits— which were unable to roll over the short financing with similar paper.²³² Due to the grown uncertainty, banks became more restrained with accepting obligations in the money market. In the beginning of August this resulted in tensions in this market, and a rising money market interest. The Eurosystem reacted on 9 August with a temporary liquidity injection of 95 billion euro. This action was especially intended to restore the operation of the money market, and was expressly not intended to ease monetary policy, nor to react to the situation of individual banks. In the subsequent months the Eurosystem has taken various preventive measures to facilitate the money market.»

In the light of the earlier DNB reports, the ironical remarks and questions in the first quoted section are entirely misplaced. Consider for example:

“the attendant risks got far too little attention”, and
“Does the banking sector have the risks in its grasp?”

and compare them with texts in reports of recent years. What about the improved risk management, the spread of risks making them easier to bear and improving stability, the stress tests, and the positive evaluation of the IMF? The texts are simply incompatible.

The incompatibility is exacerbated by the observation that DNB does not explain why it did not notice the insufficiency of the attention earlier, and did not answer the question as to the adequacy of the banks’ risk management (and many more questions!) long ago, and in the negative.

Nothing in these quotes makes one suspect that for many years the author (DNB) has failed utterly, will continue to fail utterly, and thereby caused and cause immeasurable disaster. On the contrary: the text seems to be written by someone who sees everything, knows everything and understands everything. And seems not to have any responsibility for what is going on.

One of the things that are missing in this seemingly reasonable report is a list of measures and actions taken in the course of the past decade by the supervisors, especially DNB, in order to keep the innovations and their effects under control. Probably they are missing because no (adequate) actions or measures were taken.

Note that DNB arrogates itself the competence to evaluate the situation. As in the past, the text leaves no room for different interpretations or doubt. In particular about the future.

The liquidity measures were obviously inadequate. It seems that the central banks (or at least their top) didn’t understand their system. Especially the repo markets. The text not only shows “action at last”, but also that the action is governed by same lack of integrity (self-evaluation) and competence the supervisors had shown for over a decade. This of course can only be concluded after September 2008.

6. Quotes with “intransparant products” from DNB annual reports.

AR 2006.

“Intransparent products”(in Dutch: “intransparante producten”) is not found. “Intransparancy” is:

«4.3.8 Cross-sectoral supervision
[...]
Hedge funds and private equity funds

²³² In practical terms roll over means extension of a loan. See the chronicle of the financial crisis, search for “roll”.

Hedge funds and private equity-funds are not supervised. But ever more supervised financial institutions actively work with these alternative investments. In the current supervision and in the periodical investigations DNB therefore pays attention to the risk management concerning these funds (see sections 7.3 and 7.4).

Due to the intransparency of these alternative forms of investment and the limited experience many institutions have with them, it is relatively difficult to get a clear picture of their risks. Since not all institutions have the same expertise, there is a danger that risks accumulate in institutions which are prepared insufficiently. DNB is of the opinion that financial institutions should strengthen their risk management in this respect. DNB has developed guiding principles for this. They were submitted and published on 1 March in order to contribute to better awareness in this field within the financial sector.»²³³

How can banks adequately manage the risks of hedge funds and private equity funds if the hedge funds are opaque and outside the scope of supervision? Why doesn't DNB ever write: "In the opinion of DNB, hedge funds and private equity funds should be regulated and supervised, but regrettably aren't"? Why isn't even the question about regulation or supervision raised, and discussed reasonably, instead of killing the discussion with the dogma "supervision via the regulated institutions"? Why does DNB show a situation creating and magnifying risks, without doing more than improvising obviously deficient solutions? Doesn't DNB have problems with pension funds "investing" in opaque hedge funds and private equity funds?

Why only "guiding principles", and no proposals to reduce the intransparency to such an extent that the cause of the problem is eliminated, and risks can be estimated and managed responsibly? Why doesn't DNB summarize the principles in this annual report?

The course and evaluation of the crisis have shown that the guiding principles were insufficient.

Section 7.4 writes optimistically about Basel II. See the quote in the preceding section.

«7.6.2 Risk management

The rise of new market parties and financial instruments requires adequate risk management from the financial institutions. Supervision is more and more directed at stimulating them to do this.

Important part of it [the risk management?] is the adequate estimation and valuation of risks. The risk awareness and the maintenance of financial buffers are promoted by risk-oriented regulation.²³⁴ More and more, supervisors and regulators are looking for a balance between regulation on the one hand, and stimulating 'best practices' or solutions from within the sector itself and market discipline on the other ('proportionality'²³⁵). In the year under review this was discussed in a dialogue between supervisors and regulators assembled in the Financial Stability Forum (FSF) and the Joint Forum on the one hand, and the financial sector (represented by the Institute of International Finance, IIF) on the other.²³⁶ In the discussion, principles of effective regulation played central role. DNB too applies the proportionality principle.²³⁷ In this connection principles were developed in 2006 to improve

²³³ DNB AR 2006 p. 85/83. This is the complete section.

²³⁴ Promoted only? Is that sufficient to guarantee safety and soundness? If anything has to be changed, why doesn't DNB say so? On the other hand: does the absence of this remark mean that DNB thinks that the risk-oriented regulation is sufficient? Explanation would be welcome!

²³⁵ As long as 'safe and sound'?! In other words: what is the boundary condition: smiles from the sector, or the safety and soundness for the rest of the world?

²³⁶ This is a fatal setting: compromises between these parties by definition detract from safety and soundness. (Given the absence of meaningful liability and punishability). The attitude of the participating supervisors and regulators shows their incompetence if not lack of integrity, and goes a long way to explain the crisis. Don't forget that this annual report was published in April 2007 (The text should not, but may, have been changed between April and the creation in November of the pdf-file which was used for this study).

²³⁷ The quote contains all occurrences of the word "proportionaliteit" in DNB AR 2006. In other words: the sentence about a balance between on the one hand... and... the other has to be understood as the definition.

supervision of the risk management of complex and intransparant investments, such as hedge funds and private equity (see chapter 4, section 4.3.8).»²³⁸

What reason has DNB to believe that stimulation is sufficient? And why doesn't this annual report explain the admissibility or adequacy of this timid approach? Or protest its need? Why is this sufficient to ensure realization of the goals DNB has been instituted for? We read a lot about promotion and stimulation, and understand that DNB calls compromises "proportionality", but that this is sufficient seems to be less than wishful thinking (doesn't the supervisor implicitly accept the incomprehensibility- euphemistically and wrongly called "complexity"- and intransparency?), and bad risk management. There is at any rate no explanation of the adequacy of the "measures".

Like everywhere else, there is no specification of "good risk management", and of the risks institutions are allowed to take and why. References are not given either.

AR 2007.

«4.6. Supervision above the level of sectors

[...]

The financial institutions which are under supervision, such as banks, insurers and pension funds, invest an increasing part of their assets in alternative investment products, such as private equity and hedge funds. The increasing activity in these asset categories and the corresponding risks require specific attention. In the second half of 2007 DNB has published principles for the evaluation of management of risks of alternative investments. The principles address the areas risk and yield characteristics, portfolio policy, 'due diligence', contract conditions and monitoring, and communication. These principles fit in a principle-based supervision approach. It is the responsibility of the financial institution to adequately implement risk management for alternative investments. The principles do not prescribe a specific implementation of risk management. They offer room for financial institutions to take account of the differences in the wide spectrum of alternative investment possibilities in a fitting way, and to apply a made-to-measure solution for their risk management too.»²³⁹

DNB is responsible for system stability, but nevertheless doesn't want to meddle with the risk management of the institutions. But meddling is one thing, making sure that the risk management ensures safety and soundness, and no serious risk for the rest of society (including pension funds!) another. Instead of, or beside principles, DNB should have imposed conditions. It has not been instituted as an intermediary between society and the financial sector, but as a watchman, to ensure the safety and soundness of the financial system. It doesn't even mind warning the society it represents for the risks of its compromising.

Note that DNB still writes in this detached, "enlightened" and, most important, indulgent way in April 2008. It clearly has no idea of the risks, or their consequences.

Note also that if the principles for risk management of "alternative" investment products had been adequate, the Dutch banks would have had only a small part of the difficulties they actually had, and that Wellink could have referred to the principles in the hearings of the CDW.

²³⁸ DNB AR 2006 p. 124/122. Again, no indication as to the contents of these principles is given. Neither does DNB say anything about the significance of these principles. After all they cannot make something intransparant transparent. In other words: something really has to be explained.

²³⁹ DNB AR 2007 p. 84/78, first paragraph of the (sub)section.

7. Evaluation of some ECB reports 2006-2010.

List of evaluated reports.

This appendix evaluates the following ECB reports:

- Banking sector stability (BSS) report November 2006 (dated 20061106).
- Financial stability report (FSR) December 2006 (dated 20061211).
- Annual report 2006 (dated 20070410).
- FSR December 2008 (dated 20090107).
- Annual report 2008 (dated 20090415).
- BSS report August 2009 (dated 20090828).
- FSR June 2010 (dated 20100531).

From the evaluation of these reports it was concluded that studying more reports has little or no added value.

The reports are listed and discussed in chronological order, according to publication date.

Summary and conclusions.

1. The reports give no indication of the size and consequences of the different risks. Nothing is said about scenario's following the realization of a risk. The reports assume that it is sufficient to note that there is a risk, and/or that it has de- or increased. As a consequence, all risks are considered equal. The reader can only guess at their importance.²⁴⁰
2. Nothing betrays knowledge or understanding of the GAO 1994-1999 reports, and nothing in the ECB reports shows analytic capabilities comparable to those of the GAO. Or of the OFHEO and CGFS 2003 reports.
3. AR 2006 pays attention to government deficits and debts. It stresses the need of fiscal balance²⁴¹, and of continuation of efforts to reduce deficits and debts. But it does not note that large government debts may be a risk for the financial system, the economy, and the freedom of operation in general. Even though the average gross government debt of the OECD countries in 2006 was 77%, and the debts of Greece and Italy were above 120%, twice the agreed EU-criterion.²⁴²
4. In the end, the impression that remains after reading in the selected reports is dominated by ill founded optimistic interpretations ([«...are likely to have enhanced EU banks' resilience to shocks»](#)) or plain wishful thinking. And of lack of clarity about the role and involvement of the ECB.
5. The reports lack recommendations or proposals for action, and do not draw conclusions as regards ECB or other policy. There are many analyses, but they rarely lead somewhere. There are weak exceptions. For example on p. 5 of the BSS report 2006:
[«Nevertheless, the strength of competition in mortgage markets and the potential for the adoption of the rules of the new Basel II Capital Accord in the short-run to release additional regulatory capital, thereby possibly supporting further mortgage lending activity, suggests that banks need to carefully monitor the risks they are taking in mortgage markets.»](#)
This is said in the running text. Not in a list of recommendations or conclusions.
Recommendations are important in themselves, but also because studying phenomena with an eye to recommendations imposes conditions on the analysis. Conditions which preclude superficiality and a noncommittal character, and greatly stimulate thinking.
6. According to its own norms, the ECB did not ensure and/or safeguard the stability of the EU financial system adequately. It did and does not even identify the main sources of risk and vulnerability.

²⁴⁰ This applies to most supervisor publications, and those of for example IMF and OECD.

²⁴¹ Fiscal balance= equality of income and expenditure.

²⁴² The gross debt. According to Table 32 of OECD Economic Outlook nr. 80 of December 2006 (2006-2). For the EU criteria see the Chronicle.

7. Like all reports of all supervisors and related organisations, and although they write about the same subjects, the reports of the ECB show little cooperation or division of labour with other supervisors and related organisations.²⁴³ On the contrary: ECB evaluates the stability of the banking sector on the basis of market indicators and assessments by rating agencies, not on the basis of evaluations by its partners in the Eurosystem.
8. The reports following the crisis of September 2008 give no evaluation of the ECB's inaction and reports published before the crisis. It acknowledges no errors or deficiencies, and does not show any fundamental correction or improvement.
9. A major weakness of all ECB's analyses seems to be, that they refuse to say anything that could connect (man made) disastrous events to specific people or organisations.

The ECB definition of financial stability.

The following was copied on 22/8/14 from <https://www.ecb.europa.eu/pub/fsr/html/index.en.html>.²⁴⁴

«WHAT IS FINANCIAL STABILITY?

Financial stability can be defined as a condition in which the financial system – intermediaries, markets and market infrastructures – can withstand shocks without major disruption in financial intermediation and in the effective allocation of savings to productive investment.

The three parts of the financial system [are]:

- o financial intermediaries, such as banks, insurance companies and other institutional investors that direct funds from those willing to invest/lend to those who want to borrow.
- o financial markets, where lenders and borrowers meet. Examples are money markets and stock exchanges.
- o financial market infrastructures through which money and financial assets flow between buyers and sellers. Examples are payment systems and security settlement systems.

The financial system can be said to be stable if it displays the following three key characteristics:

- o The financial system should be able to efficiently and smoothly transfer resources from savers to investors.
- o Financial risks should be assessed and priced reasonably accurately and should also be relatively well managed.
- o The financial system should be in such a condition that it can comfortably absorb financial and real economic surprises and shocks.

If any one or a combination of these characteristics is not being maintained, then it is likely that the financial system is moving in a direction of becoming less stable, and at some point might exhibit instability.

Understood this way, the safeguarding of financial stability requires identifying the main sources of risk and vulnerability such as inefficiencies in the allocation of financial resources from savers to investors and the mis-pricing or mismanagement of financial risks. This identification of risks and vulnerabilities is necessary because the monitoring of financial stability must be forward looking: inefficiencies in the allocation of capital or shortcomings in the pricing and management of risk can, if they lay the foundations for vulnerabilities, compromise future financial system stability and therefore economic stability.»

The following is the first part of the Foreword of the first Financial Stability Report, of December 2004, signed by Jean-Claude Trichet:

²⁴³ Both national and international organisations. Relevant if not simply better are the Economic Outlook of the OECD and the Global financial stability reports (GFSR) of the IMF. All of them can be found on the internet or in the dossier.

²⁴⁴ The layout has been changed a little: points have been added.

«Central banks have a strong and natural interest in the safeguarding of financial stability. This is in particular because financial institutions, notably banks, are issuers of by far the largest component of the money stock. It is equally because a stable financial system is needed for an effective transmission of monetary policy and for the smooth operation of payment systems. A robust financial system is therefore needed to ensure that the single monetary policy can deliver on the primary objective of maintaining price stability in the euro area. Finally, but not least, the health of the financial system is inextricably intertwined with the performance of the economy and its resilience to shocks. These are the reasons why the European Central Bank (ECB) and the Eurosystem have an important stake in financial stability in the euro area.

Complex to define, financial stability should not be seen only from the perspective of avoiding financial crises. Financial stability also has a positive dimension. It is a condition where the financial system is capable of performing well at all of its normal tasks and where it is expected to do so for the foreseeable future. From this viewpoint, financial system stability requires that the principal components of the system – i.e. financial institutions, markets and infrastructures – are jointly capable of absorbing adverse disturbances. It requires that the financial system is facilitating a smooth and efficient reallocation of financial resources from savers to investors, that financial risk is being assessed and priced accurately and that risks are being efficiently managed. Financial stability also has an important forward-looking dimension: inefficiencies in the allocation of capital or shortcomings in the pricing of risk can, by laying the foundations for vulnerabilities, compromise future financial system stability and therefore economic stability.»

In other words: financial stability is a boundary condition for the proper functioning of the financial and economic systems.

Banking sector stability (BSS) report November 2006 (dated 20061106).

The following quotes are from the executive summary of ECB BSS November 2006 report.

«The financial condition of EU banks continued to improve in 2005 and for the first half of 2006, adding to the trend in place since 2003.»²⁴⁵

«The solvency position of EU banks experienced a slight drop in 2005, largely due to the expansion of lending activities, which lead to an increase in the risk-weighted asset base. A slight drop in solvency levels of large EU banks was also observed in the first half of 2006, mostly on account of major acquisitions made in the previous year. However, solvency levels of EU banks remained strong and comfortably exceeded regulatory requirements.»²⁴⁶

«New lending to households has continued at a brisk pace, both for house purchases and for consumer credit, with banks indicating that competitive pressures were the main factor behind the easing of their credit standards on both new mortgages and consumer credit.»²⁴⁷

«It cannot be excluded that the appetite for risk-taking by banks was encouraged by persistently low volatility across various financial asset classes. This may have allowed banks to increase their trading exposures without necessarily breaching their risk limits. Moreover, the increasing blurring of the borderlines between banks' banking books and their trading books, facilitated by financial innovation and developments in risk management techniques, may have made it difficult for regulators and market participants to gauge the overall risks in banks' balance sheets. These problems may have been further aggravated by the aforementioned difficulties in comparing various banks' financial statements that are prepared on the basis of different accounting standards.»²⁴⁸

The executive summary is concluded with an

²⁴⁵ ECB BSS report 2006 p. 4 left.

²⁴⁶ ECB BSS report 2006 p. 4 left.

²⁴⁷ ECB BSS report 2006 p. 5 left.

²⁴⁸ ECB BSS report 2006 p. 6 left.

«OVERALL ASSESSMENT

The accounting and prudential information available, complemented by information derived from financial market indicators suggests that the near-term outlook for EU banks is one of continuing solid performance. This overall positive assessment should, however, be seen as a baseline scenario that could be affected by positive and negative factors. In particular, the outlook for risks that confront EU banks could be changing on account of the changes in the global and the EU macro-financial environment, namely the more evenly spread growth patterns and the upward movement of interest rates across all maturities of the yield curve. On the positive side the strong profits recorded by EU banks in 2005 and in the first half of 2006, as well as the improvement of their risk management techniques in recent years, are likely to have enhanced EU banks' resilience to shocks. On the negative side, the gradually maturing profit and interest rate cycles could contribute to a turn in the credit cycle, with the possibility of deteriorating credit conditions denting banks' performance in the foreseeable future. In particular for the set of large EU banks, increasing activity in leveraged buy-out transactions and in prime brokerage services provided for hedge funds could pose future risks if stiff competition on market shares force them to compromise in due diligence processes.»²⁴⁹

The assertion about “the improvement of their risk management techniques” is unsubstantiated. It can only be based on hearsay. The facts have shown that whatever improvements were made, they were insufficient. Note that the phrasing of “are likely to have enhanced EU banks' resilience to shocks” betrays that this is no more than one more example of wishful thinking. The profits can have encouraged risk taking. They may have been reinvested, increasing risks. Furthermore, the “overall assessment” is hard to reconcile with the last two sentences of the previous quote: “Moreover... standards”. The lack of information should have been reason for expressing uncertainty and making reservations (risk management!).

Chapter 4 is entitled EU BANKS' ABILITY TO WITHSTAND SHOCKS. It has two sections:

- MARKET INDICATORS CONTINUE TO SUGGEST A POSITIVE OUTLOOK
- RATING AGENCIES CONTINUE TO ASSESS BANKS POSITIVELY

So the ECB uses two types of information to evaluate EU banks' ability to withstand shocks: market indicators and the ratings of rating agencies. Given that the ECB is part of Eurosystem, one might suppose it to be well-informed by its partners, the national supervisors. Shouldn't the national supervisors be much better informed than the rating agencies? So what this chapter shows is an important lack of information exchange within the Eurosystem, lack of confidence in Eurosystem central banks and supervisors, and unfounded reliance on rating agencies. Note that the ECB itself makes no comment on this situation. Pp. 37-38 discuss the rating of EU banks by the three US rating agencies as if they were reliable. How could the rating agencies know?²⁵⁰

Chapter 6 of the report is titled OVERALL ASSESSMENT (as well). Its last paragraph is the following:

«Looking forward, market indicators continue to suggest a robust outlook for the EU banking sector in terms of profitability and credit quality, possibly reflecting a favourable assessment of the capacity of the banking system to absorb shocks.»²⁵¹

The report often mentions or discusses European affairs. In this connection it never or almost never mentions the rest of the world, and its influence on European (banking) affairs. When one reads p. 5 one might think that the EU is an isolated island. But EU banks often are worldwide banks, and hold large amounts of US securities, to mention just two simple points. The stability of EU banks strongly depends on adequate regulation and the proper functioning of supervisors elsewhere. This gets no attention whatsoever.²⁵² It seems to be assumed that all is as good as it should be. That is: the report relies on wishful thinking.

²⁴⁹ ECB BSS report 2006 p. 6 right.

²⁵⁰ Compare the IMF evaluation of the Dutch financial system and supervision, mentioned in the DNB appendix. It was found to be arrogant nonsense. Part of a system of mutual delusion.

²⁵¹ ECB BSS report 2006 p. 46. Do you understand why the first part of the sentence “possibly reflects” anything about the ability to absorb shocks? (I don't).

²⁵² There is an exception of a kind: chapter 5 is devoted to the risks of foreign currency lending.

Financial stability report (FSR) December 2006 (dated 20061211).

«PREFACE

Financial stability can be defined as a condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities. Understood this way, the safeguarding of financial stability requires identifying the main sources of risk and vulnerability such as inefficiencies in the allocation of financial resources from savers to investors and the mis-pricing or mismanagement of financial risks. This identification of risks and vulnerabilities is necessary because the monitoring of financial stability must be forward looking: inefficiencies in the allocation of capital or shortcomings in the pricing and management of risk can, if they lay the foundations for vulnerabilities, compromise future financial system stability and therefore economic stability. This Review assesses the stability of the euro area financial system both with regard to the role it plays in facilitating economic processes, and to its ability to prevent adverse shocks from having inordinately disruptive impacts.

The purpose of publishing this Review is to promote awareness in the financial industry and among the public at large of issues that are relevant for safeguarding the stability of the euro area financial system. By providing an overview of the possible sources of risk and vulnerability to financial stability, the Review also seeks to play a role in preventing financial crises.»²⁵³

The report has no (executive) summary. An OVERVIEW OF RISKS TO FINANCIAL STABILITY seems to take its place. It concludes with the following:

«OVERALL ASSESSMENT

The strength and resilience of the euro area financial system has been confirmed in the six months following the finalisation of the June 2006 FSR, although several potential sources of risk and vulnerability have grown in the past six months. Some of these vulnerabilities could be transformed into plausible, albeit unlikely, risk scenarios by unexpected changes in global liquidity conditions or unexpected credit events.

A medium-term risk for global financial stability continues to be the possibility of an abrupt unwinding of global imbalances. This is not only because these imbalances are expected to widen further, but also because the financing of the US current account deficit could prove unsustainable in the medium term, and may moreover have become vulnerable to geopolitical risk. While the likelihood of an abrupt adjustment still appears rather low the materialisation of such an event would represent a challenging test for the risk management systems and loss-absorption capacities of key financial institutions. Within the euro area, the relentless rise of household sector indebtedness will require close monitoring, as will the recent surge of leverage in some parts of the corporate sector.

Within the financial system, to the extent that long-term rates and risk premia have been driven too low in some financial markets, valuations could prove vulnerable to several potential adverse disturbances, which could leave banks exposed to greater than normal risks, especially if market events were to challenge the loss-absorption capacities of their counterparties. There has also been growing unease about the extent of CRT²⁵⁴ outside the banking system, especially concerning the extent to which hedge funds may have taken on greater credit risk exposure. Again, this is not so much because of doubts about the risk management capacities of hedge funds, which are often quite advanced, but because very little is known about how CRT markets would function under stressed conditions.»²⁵⁵

²⁵³ ECB FSR 20061211 p. 7. Only the last paragraph of the Preface, acknowledging the cooperation of the Banking Supervision Committee (BSC) of the EU, has been dropped.

²⁵⁴ CRT= credit risk transfer.

²⁵⁵ ECB FSR 20061211 pp. 15-6. What facts were known about the risk management of hedge funds to warrant a comforting remark? The remark can also be interpreted as the result of lobbying by hedgefunds. Risk management may appear advanced, but need not for that reason be any the better, or even adequate.

Some remarks about the “overall assessment”:

1. Like all supervisors and related organizations (IMF, OECD and the like), the ECB has made its own analysis. Without due regard for the work of predecessors and similar organizations. It is just as deficient as the others. It is not even useful, because one only knows for certain that it cannot be reliable. The most important deficiency being a lack of knowledge and understanding of both the relevant literature and the financial system. Ignorance of the oft mentioned GAO, OFHEO and CGFS reports is inexcusable. Every analysis that wants to be reliable should take account of the relevant literature, and discuss it appropriately.
2. What is meant by: “The strength and resilience of the euro area financial system”? It would seem anyway that the strength of resilience can only be shown by reactions to disturbances. Without disturbances, the resilience can at best be shown theoretically, by argumentation. Already the education section of chapter 7B has shown that it is madness to rely upon that.
3. No attention is given to the (potential) consequences of risks. Thinking stops at the observation (assumption) “albeit unlikely”. ECB should construct scenarios, and take measures adapted to them.
4. The words “unlikely” and “unexpected” in the sentence “Some of these vulnerabilities... credit events” are unprofessional and misleading. The “unlikely... by unexpected...” is an unnecessary doubling, and misleadingly downplays dangers. The question is: does the risk exist? If so, can it be reduced? What are the possible consequences? What are possible scenarios? What can be done to affect the scenarios and mitigate the consequences?
5. In fact, the sentence “Some of these vulnerabilities... credit events” seems to be incompatible with the oft mentioned GAO, OFHEO and CGFS reports, and with knowledge of repo lending.
6. The second paragraph pays no attention to government deficits and debts in the EU area or elsewhere. Even though these would cause the second crisis, and not the deficit, debt or trade imbalances of the USA.
7. The second paragraph makes no mention of scenarios and measures to reduce undesired consequences to a minimum.
8. Is only household sector indebtedness *in the EU* relevant for the EU financial stability? (No).
9. There is no attention to the risks posed by possibly inadequate financial supervision outside the EU.
10. Does nobody at ECB or any supervisor think it worth while to study the potential consequences of a turnaround in the development (rise) of home prices in a EU country, EU countries or the USA?

“Government debt” is not found in this report. “Government gross debt” is only found in Chart S6 on p. S5 with US general government and federal debt-to-GDP ratio.²⁵⁶

Annual report 2006 (dated 20070410).

Concise conclusions (by the present author).

- Reasonable though not sufficient as an annual report.
- As a rule, the analyses in the report lack depth, width and quality.
- The attention given to stability is unpractical and theoretically insufficient.
- Due to inadequate analysis, the attention given to supervision and regulation is inadequate.

The report has no (executive) summary. It seems that the Foreword, signed by Jean-Claude Trichet, is intended to take its place. The following is the last paragraph of the material part of the Foreword (of 4 pages):

«The Eurosystem²⁵⁷ continued to contribute to the stability of the financial system in the euro area and in the EU by monitoring and assessing major sources of risk and vulnerability, contributing to policy discussions at the European and international levels on the main regulatory and supervisory issues, and enhancing its framework and operations for the management of possible financial crises.»

²⁵⁶ This is p. 180 of the pdf-file.

²⁵⁷ Eurosystem= the ECB and the national central banks of the euro area countries. See the Chronicle.

The first and largest part of the Foreword is devoted to economic developments, GDP and employment, etcetera. No substantial attention is given to risks, even to risks that may cause recession and loss of employment for many years.

The Foreword continues with matters related to internal ECB human resources management. The following are the first two sentences:

«The total number of budgeted staff positions for 2006 was 1,343 full-time equivalent (FTE) positions. This compares with 1,369 FTE positions for 2005.»

Chapter 2 of the annual report has the title: “CENTRAL BANK OPERATIONS AND ACTIVITIES”. There is an annex titled “CHRONOLOGY OF MONETARY POLICY MEASURES OF THE EUROSYSTEM”. These and other text items go a long way to make the report a real annual report. But the practically relevant work of the ECB on stability remains largely hidden behind rather obscure statements of fact in section 2.6.2 “Advisory functions”. A relatively informative sample:

«The ECB also issued an opinion on a Polish draft law establishing a new institutional framework for the supervision of banking, capital markets, insurance and pension funds in Poland. In line with past ECB opinions on banking and financial supervisory reforms, the opinion favoured the involvement of central banks in prudential supervision, positively assessed the existing supervisory model and stressed the need to maintain banking and financial expertise under the new supervisory framework. In a later opinion, the ECB recommended that Narodowy Bank Polski be expressly allocated the task of overseeing securities settlement and clearing systems, on the grounds that such oversight function is inherent in central banks’ task of promoting sound market infrastructure, in order to safeguard the effectiveness of monetary policy and the overall stability of the financial system.»²⁵⁸

Section 1, “FINANCIAL STABILITY”, of chapter 4, “FINANCIAL STABILITY AND INTEGRATION”, consists mainly of detached analysis:

«The ECB, in collaboration with the ESCB’s Banking Supervision Committee (BSC), analyses risks to financial stability in order to assess the financial system’s shock-absorbing capacity.»

The ECB analyses give rise to remarks like the following:

«The resulting diversification of income sources may contribute to lowering banks’ risks and to stabilising their profits. However, channelling risks away from banks to other, often less regulated, financial intermediaries may also increase the overall level of risk uncertainty.»

Which are not followed by actions or recommendations. There is no attention for the sequence of events that will or may follow the realization of a given risk (initial event). On the other hand, section 4.1.2 is devoted to “COOPERATION IN FINANCIAL CRISIS SITUATIONS”. So there is an amazing descriptive and analytic gap between simple initial risks and the situation where things have run out of hand.

Section 2.5, Fiscal developments, considers government deficits and debts. It is descriptive and somewhat normative. It says nothing about the risks caused by for example the very large debts of Greece and Italy. (According to the ECB the debts are resp. 104 and 107% of gross of GDP, over 120% according to the OECD). It stresses the need to “strengthen consolidation efforts”, meaning reduction of deficits and debts to below the agreed levels.

The annexes of the report contain lists of:

1. legal instruments adopted by the ECB;
2. opinions adopted by the ECB;
3. monetary policy measures of the eurosystem;
4. documents published by the European central bank since 2006.

FSR December 2008 (dated 20090107).

By December 2008 events have shown that the earlier FSR were unreliable, and useless as a basis

²⁵⁸ ECB AR 2006 pp. 119-20.

for financial economic decision making. This FSR December 2008 is the first FSR after September 2008. The FSR does not acknowledge the failure or deficiency of its earlier analyses. It does not explain its errors, and does not show why future FSRs will be fundamentally better. It is written in the same style as earlier FSR; as if nothing has happened. It is therefore entirely unclear why a reader should take this report seriously, and should consider ECB honourable and competent.

The report has no (executive) summary. An OVERVIEW seems to take its place. It concludes with the following:

«OVERALL ASSESSMENT OF THE EURO AREA FINANCIAL STABILITY OUTLOOK

The euro area financial system has undergone a further significant test of its shock-absorption capacity since the finalisation of the June 2008 FSR. Moreover, there are a number of risks and vulnerabilities ahead that the financial system may have to cope with. These include the possibility of a further deterioration of the US and euro area housing markets, the risk of a deeper and more prolonged slowdown in economic activity, which could exacerbate the credit cycle, and financial market risks related to hedge funds. Hence, the financial stability outlook remains uncertain, not least because of concerns that the longer bank funding costs remain high and the more banks respond to this by deleveraging or passing on the costs to borrowers, the greater will become the risk of an adverse feed-back loop that could spark a more traditional credit-cycle downturn.

The extraordinary remedial actions taken by central banks and governments with a view to addressing liquidity stresses and strengthening capital positions, thereby contributing to restoring confidence in and improving the resilience of financial systems, were successful in stabilising the euro area banking system. The measures also helped to stabilise LCBG²⁵⁹ stock prices and should mitigate counterparty credit risks from trading in unsecured interbank money markets. Over time, these measures should improve the functioning of the term money markets and the access of banks to wholesale funding markets, thus lowering the cost of bank credit and facilitating its provision to the economy. That said, in order to revive the process of efficient financial intermediation, financial institutions will need to play their part in the adjustment process by taking advantage of these measures to effectively recapitalise and repair their balance sheets. Hence, there is no room for complacency: banks will need to be especially vigilant in ensuring that they have adequate capital and liquidity buffers to cushion the risks that lie ahead.»

Because of the failure to address, analyze, and correct evident gross errors, the text is little more than a certificate of incompetence. The ECB simply continues its shallow discussions. The lack of understanding, and the inability to argue reliably, is demonstrated by the inconsistent use of the words “stability”, “resilience”, and “risk”. The word “stability” is used both as the systemic ability to defy change- a property which can only change slowly- and to denote the purpose of this ability: a more or less stationary state. It is unclear what is meant by the financial stability outlook, but one thing is sure, and that is that the shock-absorption capacity of the banks was and is very uncertain (that is: the size of the shocks they can survive is very uncertain). The stock price of LCBG or whatever is not made resistant to shocks, but supported in such a way as to keep it from crashing.

As in FSR 2006, “government gross debt” is only found in one place, namely Chart S8 on p. S6 with the US general government and federal debt-to-GDP ratio.²⁶⁰ “Fiscal balance” is not found at all.

There are no recommendations or proposals for action. There is no announcement of measures to be taken by the ECB itself.

Annual report 2008 (dated 20090415).

The report has no (executive) summary. It seems that the Foreword, signed by the Jean-Claude Trichet, is intended to take its place. The following is its first paragraph:

«In 2008 the European Central Bank celebrated its tenth anniversary. With annual inflation

²⁵⁹ LCBG= large and complex banking groups.

²⁶⁰ This is p. 171 of the pdf-file.

averaging only slightly above 2% in the euro area, we have witnessed a decade of relatively stable prices, in line with the ECB's mandate to deliver price stability. Likewise, longer-term inflation expectations have remained broadly anchored at levels in line with price stability during this time, reflecting the high degree of credibility enjoyed by the ECB's monetary policy. This success is also tangible proof of the institutional robustness, coherence and unity of the Eurosystem – of its capacity to act in a truly European spirit on the basis of shared values, high standards and common principles. From the outset, the euro has been a stable currency. It is now used by 329 million fellow citizens in 16 euro area countries and is also widely accepted in international financial markets. I would like to take this opportunity to welcome the citizens of Slovakia to the euro area. Following the adoption of the euro by Cyprus and Malta in 2008, Slovakia joined the euro area as the 16th member on 1 January 2009.»

The Foreword describes the main events constituting the subprime crisis from the point of view of an observer in a distant galaxy. Nothing betrays that the writer had the duty to prevent such a disaster. The events had shown that the EU financial system is not stable, and many large European banks not safe and sound. Even if the ECB had vaguely noted risks, it never warned that the EU financial system is not stable, and could collapse as a consequence of probable, relatively small, events. Since safeguarding the stability is one of its main duties, the ECB should have explained (among other things) why disruptions of the European financial system by financial events in the USA could not have been prevented. And/or why dependency on, and weaknesses of, US supervision were a risk for the European financial system. And why it failed to show the relevant more fundamental (“GAO”) risks and their consequences. In 1994-2007 that is.

The annexes of the report contain lists of:

1. legal instruments adopted by the ECB;
2. opinions adopted by the ECB;
3. monetary policy measures of the eurosystem;
4. communications related to the provision of euro liquidity;
5. open market operations by currency;
6. documents published by the European central bank since 2008.

BSS report August 2009 (dated 20090828).

Note. In August 2014 no BSS report 2008 could be found on the ECB website. In the 2009 report I could not find an explanation.

Like the other reports, this one is very cool, and betrays very little involvement or responsibility for the events and situation. A reader who has no previous information about the situation might easily misinterpret the report and underestimate the seriousness of the situation. The report uses the word “crisis” only once (on p. 21). There is plenty that will evoke questions from the reader, but nothing that makes him understand that without government (taxpayers) help half of the Dutch financial system would have been wiped out, and that apart from the world wars, this was the most serious crisis since that of 1929 (-1932).

After an introductory paragraph about the preparation of the report, the material part of the executive summary opens as follows:

«THE FINANCIAL CONDITION OF EU BANKS IN 2008 AND IN THE FIRST QUARTER OF 2009

After a significant decrease in the profitability of the EU banking sector in the second half of 2007, the financial performance of EU banks deteriorated further in 2008, and the aggregate return on equity (ROE) of EU banks moved into negative territory. Nevertheless, significant differences could be observed across banks and countries. The overall fall in profitability was heavily influenced by the very large losses experienced by some banks, which influenced the overall EU aggregate.»²⁶¹

This is not followed by the remark that quite a few (how many?) banks could not have survived

²⁶¹ ECB BSS report p. 5.

independently, and could only remain in business (somehow!) with government help or take over.

The following is the closing paragraph of chapter 5, OVERALL ASSESSMENT:

«In summary, while the unprecedented policy measures taken by central banks and governments were successful in stabilising the EU banking sector, the outlook for banks remains uncertain. Despite recent signs that the pace of macroeconomic deterioration may be moderating in many parts of the EU, risks to stability remain elevated as the credit cycle has not yet reached its trough, meaning that loan losses may not peak before the end of 2009. Hence, there is no room for complacency and banks will need to ensure that they maintain adequate capital and liquidity buffers to mitigate against possible future shocks, possibly by taking advantage of existing public sector schemes for financial support.»²⁶²

Of course, the events have shown that many important banks were not resilient or stable enough, “can withstand shocks without major disruption in financial intermediation” (from the definition, see above). But none of the ECB reports says (admits) so.

Spending more time and energy on this report seems to have no added value, and is therefore forgone.

FSR June 2010 (dated 20100531).

This report has been checked for mention of the discovery of the deceit by the Greek government of Kostas Karamanlis about the size of the government debt. It seems not to be mentioned. The report seems to look only at the present and the future. It doesn’t analyse past “mistakes”.

Still, a minor correction is made. For the first time this FSR contains a Box 8 about FISCAL POLICIES AND FINANCIAL STABILITY: ANALYTICAL FRAMEWORK.²⁶³

It is interesting to note that the section SOURCES OF RISK AND VULNERABILITIES OUTSIDE THE EURO AREA FINANCIAL SYSTEM²⁶⁴ actually reports and discusses sources not outside but inside the euro area. It gives a useful interpretation and analysis of recent events:

« SOURCES OF RISK AND VULNERABILITIES OUTSIDE THE EURO AREA FINANCIAL SYSTEM

Concerns about mature-economy sovereign credit risks progressively intensified over the last six months, also within the euro area, and became acute in early May. In financial markets, worries surfaced first in a progressive widening of intra-euro area government bond and sovereign credit default swap (CDS) spreads of several euro area issuers with large fiscal imbalances. As unease over the broader macrofinancial implications of large and persistent fiscal imbalances grew, investors retrenched from risk-taking across a variety of asset classes and contagion channels opened up, impinging on bond, stock, commodity and money markets. The main trigger for the market’s reappraisal of sovereign risk appeared to be the fiscal woes of Greece and uncertainty surrounding the prospect of agreeing a credible fiscal consolidation plan. This focused investor attention on the abrupt, marked and widespread deterioration of public sector balance sheets that took place within the euro area and elsewhere after the eruption of the financial crisis.

An important lesson from economic history is that governments and, therefore, ultimately taxpayers have largely borne the direct costs of banking system crises. Avoidance of these fiscal costs, which have often amounted to sizeable fractions of GDP, is one of the reasons why financial crisis prevention moved high on the public policy agenda over the past decade or more. The principal ways in which euro area governments addressed recent stresses in their banking sectors was to offer guarantees on bank liabilities in exchange for fees and to protect assets against tail risk. While such

²⁶² ECB BSS report p. 30. Note the incorrect use of the words “risk” and “stability”. Risks do not change rapidly, and the stability that was at stake was not the stability of the definition, but stability in the sense of approximate constancy, or smooth instead of abrupt change.

²⁶³ Of course this should have been discussed years ago, and have been followed by conclusions, warnings, and recommendations.

²⁶⁴ ECB FSR p. 10 and following.

measures often avoided immediate financial outlays and direct fiscal costs, they created contingent liabilities for the public sector. Investors quickly priced the value of this downside protection into sovereign funding costs, which raised government debt servicing costs. In many cases, governments also bore direct costs and expanded their balance sheets through injections of capital into banks, the extension of loans and the setting up of bad bank schemes. These far-reaching measures, which led to a substantial transfer of risk from financial sectors to the fiscal authorities, also had adverse impacts on the public debt positions of a number of euro area countries. That said, for the euro area as a whole, the government support of financial sectors was not the most important source of enlarged fiscal imbalances.

The main reason for the severe deterioration of public finances was the activation of automatic stabilisers – that is the loss of tax revenue and higher government expenditure outlays that ordinarily results from weaker economic activity – as a consequence of the marked contraction of economic activity that followed the collapse of Lehman Brothers. Because the structural fiscal imbalances of a number of euro area countries were sizeable before the financial crisis erupted, fiscal deficits in those countries expanded to very high levels. Added to this were the discretionary fiscal measures taken by many countries to stimulate their economies following the agreement in December 2008 of the European Economic Recovery Plan. This fiscal stimulus came close to matching the impact on deficits of automatic stabilisers. Eventually, by end-2009 the aggregate euro area public sector debt-to-GDP ratio had scaled heights not seen in half a century or more, with little near-term prospect of correction.»²⁶⁵

All this was foreseeable. So the reader wonders: why do we hear this only after the fact?

And why is the analysis not supplemented by the remark that recent events have made the EU even more vulnerable than it was before the subprime crisis for events that require large outlays? Such as (international) military operations or environmental disasters. The risk of such requirements should be part of all risk management at government level. Because of their impact on the financial economic system they should be integral part of the Financial Stability Reports of the ESB (and IMF, OECD, Fed and others). They need not be discussed extensively. But mentioning them may serve as a warning, and as part of an explanation of the need to reduce government debt as much as possible, so as to be prepared for more adverse times.

²⁶⁵ ECB FSR pp. 10-1. The section is continued.

8. The Fed & its annual and GPRA reports 2006-2011.

This appendix not only considers reports from the prehistory of the crisis, but also reports from a few of the years following the crash. It evaluates the Fed and US government reaction to the crash and crisis.

Table of contents of this appendix.

- Conclusions
- About the Fed.
- Fed AR 2006, and the GPRA report it refers to.
- The succession of Greenspan by Bernanke.
- Note about the annual reports 2008 and 2009, and the GPRA reports 2008-2009 and 2010.
- Fed AR 2010 and 2011 and the Dodd-Frank Act.

Conclusions about the performance of the Fed in the decade before the crisis, with some additional information.²⁶⁶

Factual observations.

1. The GPRA- and annual reports are incomplete in essential respects.²⁶⁷ The most important being that they do not report about the execution of a main duty of the Fed, maintaining the stability of the financial system and containing systemic risk;
2. Government and/or Congress could and should have seen this and other objective defects of the reports, and very easily. Because of their constitutional duties (such as promotion of the general welfare) they should have taken corrective action. They didn't;
3. The misconduct and consequential failure of the principal persons in the Fed and government, and at least a majority of Congress, had no negative consequences for themselves. Rather the contrary. For example, president Obama appointed Geithner, former head of the NY Fed, as secretary of the treasury;
4. The Fed promoted affordable housing- and CRA-aims by refusing to take action, and obstructing those, such as the CFTC, who proposed action. It gave realization of extraneous policy aims higher priority than containment of systemic risk;
5. The Fed has demonstrated structural incompetence and lack of devotion to its duties. Perhaps the Fed has the low and authoritarian level of its disciplines: economics and finance. It is clear anyway that the quality of the economics textbooks is insufficient as a basis for the proper fulfillment of financial supervisory duties;
6. The GPRA- and/or annual reports of the years immediately following the crisis (2009 and 2010) do not explain or evaluate the failure of the Fed in the decade before the crisis;
7. Neither do these reports explain or evaluate the ad hoc conduct during the crisis;
8. No errors or misguided policies are mentioned, explained or admitted;
9. The boundary condition requiring the Fed to work within the framework of the overall objectives of economic and financial policy established by the government has been left unchanged.

Evaluative conclusions:

1. There was nothing wrong with the (primary) duties of the Fed. There is no indication that its powers were a problem;
2. When given sufficiently high priority, the boundary condition of adaptation to federal government policies may have made adequate execution of the primary duties difficult or impossible. The

²⁶⁶ The supervision of individual financial institutions is left out of consideration. Section F, Prudential supervision in the 2000s, on pp. 13-4 of the FCIC-staff study *The role of the Federal Reserve in banking supervision and regulation* shows that in the years 2000-2007 this kind of supervision became more superficial and less reliable. It was reduced from a broad investigation through investigation of supposedly weak points to a kind of benchmarking of similar institutions.

²⁶⁷ GPRA= the Government Performance and Results Act.

- necessity of compromises and the way in which choices were made should be discussed in the annual reports. This was not done however;
3. There is an abundance of evidence showing misconduct of the Fed management. The Fed neglected its primary duties. This could have been seen from the annual reports too, but also from its reaction to GAO and OFHEO reports, and the elimination of Brooksley Born. But neither Administration nor Congress took corrective action;
 4. It follows that the problem of Feds failure cannot be solved by a reorganization of supervision, more powers or other formal changes;
 5. Appointment methods and/or policy failed disastrously;
 6. The system of rules meant to ensure that Administration and Congress serve the general welfare as good (and responsible) as possible has failed structurally (and not just accidentally or marginally);
 7. The same can be seen to apply to the media (press), education and science;
 8. It isn't credible that none of the approximately 1500 employees of the Fed saw systemic risk and the need of Fed action or intervention.²⁶⁸ Because of the duties of the Fed, its management must have been repressive.²⁶⁹ It lacked competence, sound judgment and the ability to find solutions. If there was a whistleblower code, it clearly allowed insufficient room for common sense and openness;
 9. For a major part, the pretensions of the Fed were false;
 10. It would already be quite something if it were generally acknowledged that organizations do not have only a single truth, that of the boss (CEO), but truly respect all main opinions (including judgments), and present and discuss their arguments for and against in the relevant reports.

About the Fed.

Information about the role of the Fed can be found in the book *The Federal Reserve System: Purposes & Functions*, and in the FCIC-staff study *The role of the federal reserve in banking supervision and regulation*. In *The Federal Reserve System- Purposes & functions* the duties of the Fed are defined as follows:

«Today, the Federal Reserve's duties fall into four general areas:

- conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system»²⁷⁰

«The Federal Reserve System is considered to be an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive branch of government. The System is, however, subject to oversight by the U.S. Congress. **The Federal Reserve must work**

²⁶⁸ P. 94/122 of the FCIC-report supports this hypothesis. The page gives examples of situations where not "staff" but "officials" default. As a consequence the number of subprime loans grew much stronger than it would have done if the Fed had done its legal duty. Both to protect consumers and the stability of the financial system. The page also supports the hypothesis that the Fed gave a higher priority to AH- and CRA-policy than to its own duties..

²⁶⁹ In the annual report, the management wrote that it had the duty to contain systemic risk. But it neglected this duty fully 100%. Notwithstanding GAO and OFHEO reports. Obviously more than enough reason to feel uneasy and protest, if need be even to the external world. Whistleblowing might have prevented a worldwide crisis.

²⁷⁰ P. 1 of *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005.

within the framework of the overall objectives of economic and financial policy established by the government; therefore, the description of the System as “independent within the government” is more accurate.»²⁷¹

It is strange that neither the Fed nor the FCIC discuss this boundary condition in connection with the four primary duties, and that (almost) nothing is said about this in the hearings of the FCIC. Namely because the boundary condition explicitly requires the Fed to weigh the requirements of supervision and government policy where these might interfere. Supervision is incompatible with deregulation (as meant at the time), and hampering risk taking reduces the possibility of home ownership. That is: affordable housing.

The silence about the boundary condition is the more peculiar because there is positive evidence that it really played an influential role. The hearing of Susan S. Bies, from 1998 (!?)-2012 member of the Board of Governors of the Fed, shows that AH policy did indeed play an influential role in supervision policy:

«Bies said [in the FCIC hearing of 11/10/10] that deliberations over the potential guidance also stirred debate within the Fed, because some critics feared it both would stifle the financial innovation that was bringing record profits to Wall Street and the banks and would make homes less affordable.»²⁷²

The following quote describes (political) procedure for the appointment of Fed members:

«The Board of Governors of the Federal Reserve System is a federal government agency. The Board is composed of seven members, who are appointed by the President of the United States and confirmed by the U.S. Senate. The full term of a Board member is fourteen years, and the appointments are staggered so that one term expires on January 31 of each even-numbered year. After serving a full term, a Board member may not be reappointed. If a member leaves the Board before his or her term expires, however, the person appointed and confirmed to serve the remainder of the term may later be reappointed to a full term. The Chairman and the Vice Chairman of the Board are also appointed by the President and confirmed by the Senate. The nominees to these posts must already be members of the Board or must be simultaneously appointed to the Board. The terms for these positions are four years.»²⁷³

On p. 5, the annual report 2006 presents an *Overview of the Federal Reserve*. It begins as follows:

«As the nation’s central bank, the Federal Reserve System has numerous, varied responsibilities:

- a. conducting the nation’s monetary policy by influencing monetary and credit conditions in the economy;
- b. supervising and regulating banking institutions, to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers;
- c. maintaining the stability of the financial system and containing systemic risk that may arise in financial markets;
- d. providing financial services to depository institutions, the U.S. government, and foreign official institutions.

The Federal Reserve is a federal system composed of a central, governmental agency- the Board of Governors- and twelve regional Federal Reserve Banks. The Board of Governors, located in Washington, D.C., is made up of seven members appointed by the President of the United States and

²⁷¹ Pp. 2-3 of *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005. Boldface from the present author (= JFCvV).

²⁷² FCIC report p. 21/49.

²⁷³ *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005, p. 4.

supported by a staff of about 1,850.²⁷⁴ In addition to conducting research, analysis, and policymaking related to domestic and international financial and economic matters, the Board plays a major role in the supervision and regulation of the U.S. banking system and administers most of the nation's laws regarding consumer credit protection.»²⁷⁵

In other words: the annual report confirms the text of the book about the Fed mentioned earlier.

Lack of liability and punishability.

It is to be noted that the Fed may have duties, but that there is no liability and there are no sanctions for failure to adequately fulfill these duties. Moreover, neglect of duties is not justiciable: nobody can go to a court to start a trial against the chairman, management or other employees of the Fed for neglect of duty or the consequences thereof.

Fed AR 2006, and the GPRA reports 2004-2005 and 2006-2007.

The Fed Annual report 2006 has the following parts:²⁷⁶

1. Monetary Policy and Economic Developments.
2. Federal Reserve Operations (with the chapters: Banking supervision and regulation, Consumer and community affairs, Federal reserve banks, The board of governors and the government performance and results act, and Federal legislative developments).
3. Records (mainly regulations and minutes of the federal open market committee (FOMC) meetings).
4. Federal Reserve System Organization.
5. Statistical Tables.
6. Federal Reserve System Audits.

The table of contents suggests a problem. No direct or indirect mention is made of the financial system as a system: a collection of coherent and interacting organizations, instruments, products, and processes. Upon closer inspection the fields of interest and operation of the Fed turn out to be quite selective. Much more limited than its duties seem to require. Many of the problematic products and processes which the reader met in the Chronicle or the reports of the BIS and GAO mentioned there seem to be unknown to the Fed. In the Fed annual reports of 2006 and 2007, the acronyms "CDO" "OTC" and "repo" are only found in words like "anecdotal", "notched" and "report".²⁷⁷ While CDO, OTC and repo played major roles in increasing the instability of the financial system and the causation of the crash and crisis.

In other respects too the reporting by the Fed leaves much to be desired. In general, necessary explanation and discussion, or references to them, are missing. The structure of the annual reports differs from the structure implied by the duties listed in the Overview. Neither does it use the goals and objectives of the Board in connection with the GPRA as a framework. The work done for these goals and objectives is reported in a separate publication. Without explaining why the GPRA report, or a summary thereof, is absent from the annual report. Which after all, and in the first place, is a report of activities. In the GPRA report too, necessary explanation and discussion, or references to them, are missing. The performance measures often look quite debatable.²⁷⁸

The annual reports present a relatively extensive description of the (supposedly) most important financial and economic developments in the year under consideration. It may be useful, but is not necessary. It is no more than a subjective description. As can be found in the annual reports of all

²⁷⁴ In 2004 1400. Source: *The Federal Reserve System: Purposes and Functions*, 9th edition, June 2005, p. 4. (Note of the present author).

²⁷⁵ For reference purposes the dots of the original have been replaced by a-d.

²⁷⁶ The numbering is by the present author.

²⁷⁷ Pp. 14-5/25-6 of AR 2007 presents a box headed *The Federal Reserve's Responses to the Subprime Mortgage Crisis*. It only pays attention to the difficulties in the mortgage market in the limited sense. There is no trace of awareness of systemic risk.

²⁷⁸ As noted earlier, in general explanation and discussion are missing.

financial supervisors everywhere. There is no explanation or discussion. In particular there is no explanation or discussion of differences with similar descriptions in the annual reports of other supervisors, and those of IMF, OECD and still others.

The annual report 2006 includes a section *Economic Projections for 2007 and 2008*. It includes the following paragraph. Please take note: this annual report is dated June 2007.

«In conjunction with the FOMC²⁷⁹ meeting in January, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2007 and 2008. The projections indicate that the participants expect sustainable expansion of real economic activity during the next two years, assuming an appropriate course for monetary policy. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 2,5 percent to 3 percent over the four quarters of 2007 and 2,75 percent to 3 percent over the four quarters of 2008. The central tendency of their forecasts for the civilian unemployment rate is 4,5 percent to 4,75 percent in the fourth quarter both of this year and of 2008. [...] The economy is projected to expand at a moderate rate. Although the cooling of the housing market continues to damp economic activity, the drag on economic growth from declining construction activity is expected to diminish later this year.»²⁸⁰

The style of this forecast closely resembles the style of corresponding texts of the “central economic plan” (CEP) of the Dutch Centraal Planbureau (CPB).²⁸¹ The remarkable thing is that in the year 2007 an organization of 1850 well-educated and highly paid people, having access to all the knowledge in the world, is unable to produce a financial economic forecast better than this: nonsense. The forecast actually proves that the Fed does not know and understand the given financial system, at least not in a meaningful sense, and that it does not know or remember the discussions and analyses of authoritative related organizations.²⁸² It cannot handle uncertainty.

In the hearings of inquiry commissions after the crash, many of the witnesses claimed that there will always be crises. Which obviously means that there is always a nonzero probability that a crisis will start in the following year. If you believe that there will always be crises, and want to make a forecast, you clearly should take account of the probability of a crisis. The forecast shows that those responsible didn't. They don't act in accordance with what they say to believe.

The annual report does not explain why the Fed thinks it should present economic projections. It does not seem to be a logical consequence of its “responsibilities”. The forecast may be useful for the determination of monetary policy. But the various sections concerning monetary policy seem to belie this explanation. The Fed's monetary policy seems to be mainly reactive, in response to actual developments, and at most marginally influenced by projections such as those of part 4.

Note that the outlook further relativizes the “analysis” of the developments in the year under consideration. I.e.: it cannot be taken seriously.

The responsibilities of the Fed require attention to systemic risks. But hardly anything, or nothing, is found about actions taken in connection with the responsibility for systemic risk. In the annual report 2006, the word “systemic” occurs twice. To wit: in the overview, and on p. 136/139, in the chapter *The Board of Governors and the Government Performance and Results Act (GPRA)*. The chapter begins with an explanation:

«The Government Performance and Results Act (GPRA) of 1993 requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. Although the Federal Reserve

²⁷⁹ FOMC= Federal Open Market Committee.

²⁸⁰ Fed AR 2006 pp. 6-7/14-5. Note that only “an appropriate course for monetary policy” is mentioned as a condition for a rose-colored economic future.

²⁸¹ Though called “plan”, it certainly is not a plan. It is a kind of tentative forecast, preview, of the coming years. In the present appendix, the CEP only serves as an example of many similar texts. Most countries have agencies which produce reports containing similar texts, and some international organizations produce them too. Independent of one another.

²⁸² In particular those of GAO 1994-1999, and OFHEO and CGFS from 2003.

is not covered by the GPRA, the Board of Governors voluntarily complies with the spirit of the act.»

The subdivision and formulations of this chapter differ from those of the overview. Reasons for the differences are not given.

On p. 136 systemic risk is mentioned as part of one of the four objectives specifying the goal “To promote a safe, sound, competitive, and accessible banking system and stable financial markets”. But systemic risk is only mentioned. The annual report nowhere describes systemic risks, and nowhere reports about activities meant to contain (or eliminate!) the risks. There is no explanation of the fact that the annual report does report about Banking supervision and regulation and about Consumer and community affairs supervision, but not about systemic risk.

The GPRA chapter refers to the bi-annual²⁸³ GPRA reports to Congress:

«The performance report discusses the Board’s performance in relation to its goals. The most recent performance report indicates that the Board generally met its goals for 2004–05.»²⁸⁴

The GPRA report 2004-2005 mentions the “objective”:

«Promote overall financial stability, manage and contain systemic risk, and ensure that emerging financial problems are identified early and resolved successfully before they become crises.»²⁸⁵

The “performance measure” for this objective is described as follows:

«Identify and resolve supervisory and financial problems in a timely manner, working alone or in cooperation with other authorities, to minimize disruptions to the financial and payment systems and the economy more generally.

2004–05 target: No specific target.

Results: In 2004 and 2005, there were no major disruptions from inadequate supervision.»²⁸⁶

The corresponding paragraphs about 2006-2007 are the following:

«Identify and resolve supervisory and financial problems in a timely manner, working alone or in cooperation with other authorities, to minimize disruptions to the financial and payment systems and the economy more generally.

2006–07 target: No specific target.

Results: The Federal Reserve, along with other federal and state banking supervisors, continues to closely monitor events in the subprime markets. Supervisors are in the process of assessing lessons learned from recent events. Enhancement to supervisory programs will be made as appropriate.»²⁸⁷

If the report about 2004-2005 had been adequate, and the Fed honorable, then the report about 2006-2007 should have included sentences like these: “In 2007, as a consequence of inadequate systemic risk management, there were major disruptions of financial markets. In 2008 they developed

²⁸³ And with substantial delays. The pdf file of the report about 2004-2005 is dated 28/9/06, that about 2006-2007 is dated 7/1/09.

²⁸⁴ Fed AR 2006 p. 135/138. The last sentence (mutatis mutandis) is missing (and rightly so!) in Fed AR 2008 (p. 181/191).

²⁸⁵ GPRA report 2004-2005 p. 9/13. The performance indicators are very debatable by the way. But as this observation is compatible with the other findings of this study and does not contribute anything new, it is left alone.

²⁸⁶ GPRA report 2004-2005 p. 10/14.

²⁸⁷ GPRA report 2006-2007 p. 9/11. The pdf file is dated 7/1/09.

into a crisis".²⁸⁸ As an explanation, it could have added: "In the past decade, the Fed has given insufficient attention to signals about systemic risks. It failed to act in a timely manner. Until the end of September 2008, the Fed tried to solve problems as they arose, without however recognizing them as harbingers of a crisis."

The analysis by the GAO of 1994, and the prehistory²⁸⁹ of the financial crisis, show that there was already a significant systemic risk for over a decade. Its annual reports show that the Fed didn't want to see and acknowledge this risk, and did nothing to reduce or eliminate it. On the contrary: Greenspan lobbied for further deregulation. While according to the same Fed, "containing systemic risk" and "ensuring the safety and soundness of the nation's banking and financial system" were two of its four main duties. It has to be concluded that the Fed acted utterly irresponsibly and completely failed its duties.

The above analysis of Fed annual reports shows that the failure of the Fed to contain systemic risk is not the exception confirming the rule. With respect to consumer protection too, the Fed had far too many pretensions. Almost every consumer suffered from the crisis; many mortgage borrowers very badly.²⁹⁰ Theoretically the failure of the Fed could have been caused by incompatible goals or boundary conditions. Especially if the incompatibility would not be noticed. For example if the protection of credit rights of consumers of duty b is taken to mean that affordable housing and CRA policy are inviolable and have to be supported at all costs.

In any case it is clear that the Fed didn't oppose or object to government policies. The GPRA report 2004-2005 explicitly presents the following "goal":

«Enforce the consumer financial services laws fully and fairly, protect and promote the rights of consumers under these laws, and encourage banks to meet the credit needs of consumers, including those in low- and moderate-income neighborhoods.»²⁹¹

This is followed by the following "objective":

«Take a leadership role in shaping the national dialogue on consumer protection in financial services, addressing the rapidly emerging issues that affect today's consumers, strengthening consumer compliance supervision programs when required, and remaining sensitive to the burden on supervised institutions.»²⁹²

(Note the selectivity of: "sensitive to the burden on supervised institutions").

On the one hand banks should be encouraged to lend money to people with lower incomes, while on the other hand consumers should be protected. So if the Fed really wanted to initiate and manage a discussion about consumer protection in banking matters, it should have asked questions about the ever increasing quantitative goals of the affordable housing policy.²⁹³ Instead, the Fed seems to have looked away. It did not assume an independent position, but subordinated itself to HUD.

The Fed knew about the weakening of mortgage conditions, and therefore of the increasing risks

²⁸⁸ The addition about 2008 is meant as explanation, and fitting because the report was published only in January 2009.

²⁸⁹ Prehistory in the following sense: the history of the period in which the building blocks for a crisis were made and assembled, in which new instabilities were created (as by repo lending), and the consequences of instabilities were magnified (as by increasing dependencies on the smoothly running of processes, on nothing going wrong).

²⁹⁰ See the chapters 21 and 22 of the FCIC report.

²⁹¹ GPRA report 2004-2005 p. 9/13. Regrettably, given the conduct of Greenspan, Summers and others in the top of finance, one can only guess how the text has to be interpreted, assuming it to be true at least in some sense. The interpretation depends on the contents of the consumer laws, and on the meaning of "under these laws". The possibility seems real that the consumers are meant to be duped. Anyway, the Fed does not explain the goal in either the annual report or the GPRA report.

²⁹² Fed AR 2006 p. 136/139 (middle of the right column) and GPRA report 2006-2007 p. 8/10.

²⁹³ The more so since this policy affected the value of securities which were essential for the healthy operation of the financial system. Poisoning of these securities creates systemic risk.

for the mortgage borrower/ consumer.²⁹⁴ On pp. 94-5/98-9 of the annual report about 2006 it discusses the “Nontraditional Mortgages- Balancing Innovation, Regulation, and Education”²⁹⁵ It saw the “balancing” as a problem. Although it euphemistically called it a “challenge”, and covered the irresponsible goal setting with the word “innovation”:

«While increased competition and product choice provide consumers with new opportunities, they also present many challenges for both borrowers, who must be prepared to evaluate their options, and for regulators, who seek to ensure consumer protections without hindering market innovation through overly restrictive regulation.»

It is left unsaid that insufficient consumer protection implies (greater) financial risk not only for the consumer, but also for the value of mortgage backed and related securities. And therefore for the financial system as a whole.

The Fed does not explain why innovation should be a goal in itself, independent of the costs or benefits for users and other people. Therefore it very much looks as if an abstract fictional value-innovation- is given a real and large weight in a comparison with the truly real interests of people.

In the text column on the right hand side of p. 94 the Fed mentions several signs of increased consumer risks. It comments:

«However, the need to ensure that consumer protections are in place for non-traditional mortgages must be balanced with the desire to encourage innovation and flexibility in the mortgage industry.»

So again: why do “innovation and flexibility in the mortgage industry” have a value independent of their value for users and other people? And what price is to be paid for what innovation- assuming innovation to be the right word!- and why? For someone who does not acknowledge the independent value there is nothing to be compared or weighed.

To get more insight the Fed organized a number of hearings. It improved information. The section concludes:

«The Board also published a consumer information brochure, “*Interest-Only Mortgage Payments and Payment-Option ARMs- Are They for You?*,” which includes a glossary of lending terms, a mortgage shopping worksheet, and a list of additional information sources to help consumers evaluate whether these types of loans are right for them. This publication stresses the importance of understanding key mortgage loan terms, warns of the risks consumers may face, and urges borrowers to be realistic about whether they can handle future payment increases. In addition, interagency guidance on non-traditional mortgages, issued in September, highlights the increased risk for lenders and borrowers that nontraditional mortgages can present. The guidance discusses the importance of

- (1) carefully managing the potential heightened risk levels, for the benefit of both lenders and borrowers;
- (2) using prudent loan-structuring and -underwriting standards;
- (3) considering a borrower’s repayment capacity; and
- (4) ensuring that consumers have sufficient information to understand the terms and risks before making a loan or payment choice.

The mortgage industry has proven to be innovative in developing a wide range of mortgage credit products. Through its supervisory responsibilities, research, consumer education, and outreach to communities and lenders, the Federal Reserve will continue to strive to balance such innovation in the financial services industry with responsive oversight and consumer protection.»²⁹⁶

The Fed does not consider the possibility that there is a correlation between the borrowing of a more risky mortgage and not bothering to find and read appropriate information. It would anyway be

²⁹⁴ Fed AR 2006 p. 94/98.

²⁹⁵ A tell-tale title: It does not read: “Nontraditional Mortgages- Managing the Risks”.

²⁹⁶ Fed AR 2006 p. 95/99 right hand column.

quite remarkable if the Fed believed in the efficacy of only (passive) information.²⁹⁷ Especially given the efforts by mortgage originators to sell mortgages to people with lower incomes. Efforts they must necessary make to realize the HUD-goals.

The efficacy of the Fed information is not discussed. It clearly was not sufficient. The Fed shows no sign of more than superficial thinking, if that. It says nothing about the relationship between risks of mortgage borrowers and systemic risk. It failed to nip the growth of such risks in the bud.

In its own field, the Fed did not comply with the rules it recommended to others. The text on pp. 94-95 of the annual report 2006 unambiguously shows that the Fed was aware of substantial risks. It suggests that something has to be done about it,²⁹⁸ but does not mention a connection with risks for the markets of mortgage backed securities and related paper.

Neither in connection with systemic risks nor in other connections did the Fed ask for changes in the organization of financial supervision or of its powers. Indeed, suggesting that the organization of financial supervision and/or the powers of the Fed were defective can be misleading. The problem was that the Fed, and the Fed only, was responsible for containing systemic risk, but simply gave systemic risk no attention at all. If it had taken this duty seriously, it may have run into formal problems. But since the Fed ignored this duty this did not happen. Moreover, it is clear that the Fed could already have done very much in the given regulatory framework. The world would have been very different if the Fed had taken the warnings of the GAO and Brooksley Born seriously, and allowed open discussions.

The above evaluation of the activities and omissions of the Fed in the field of systemic risk is supported by the contents of chapter III, Approach to systemic risk, of the FCIC staff study *The role of the Federal Reserve in banking supervision and regulation*.²⁹⁹ This study only reports about the words of some Fed bosses, possibly quoted from speeches. It does not mention any serious action. Considering the Fed's inaction and other words (and actions) of the same people, the quotes must be non-representative. Utterances seriously underestimating or even promoting systemic risk are ignored. Important examples are the rejection of the GAO recommendations on systemic risk, and the resistance by Greenspan (and others) against the proposal of the CFTC to discuss the regulation of OTC:

«Aside from safety and soundness regulation of derivatives dealers under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary.»³⁰⁰

Its exclusive reliance on words suggests that the staff study could not find any deeds by which the Fed tried to contain systemic risk.

The succession of Greenspan by Bernanke.

In the period under consideration, roughly 1994-2010, the chair of the Fed was occupied by:

A. (Alan) Greenspan	11/8/87- 31/1/06
B. S. (Ben) Bernanke	1/2/06- 3/2/14.

²⁹⁷ Making available can be called passive. TV advertising and home to home delivery of brochures are a bit more active.

²⁹⁸ The consumer information may have been meant as a soother. If the Fed didn't want to do anything substantial, but nevertheless be able to say that it had done what was needed.

²⁹⁹ Chapter III, on pp. 14-6, has a length of two out of 24 pages. Of course, it is quite remarkable, and very bad methodologically, that the staff study does not tell anything about what the Fed has actually done to contain systemic risk, but only (selectively) quotes from speeches. Compare Wellink, who never quotes from annual or other reports of DNB, but only from speeches. See *Wellink's meineid* and the CDW hearing reports it is based on.

³⁰⁰ FCIC report p. 47/75. See also the sequel on p. 48/76.

The annual reports of Bernanke's first 4 years (minus one month) have the "traditional" format of the annual reports of his predecessor. The overview of the annual report 2008 still mentions the responsibilities a-d listed above. Starting with the annual report 2009 the list of duties in the overview is replaced by:

«The Board of Governors, located in Washington, D.C., consists of seven members appointed by the President of the United States and supported by a 2,100-person staff. Besides conducting research, analysis, and policymaking related to domestic and international financial and economic matters, the Board plays a major role in the supervision and regulation of the U.S. banking system and administers most of the nation's laws regarding consumer credit protection. It also has broad oversight responsibility for the nation's payments system and the operations and activities of the Federal Reserve Banks.»³⁰¹

It is most remarkable that former duty c, "maintaining the stability of the financial system and containing systemic risks" has disappeared. Exactly the duty which was fully ignored in the years 2000-2007, with catastrophic consequences. It is the same in the annual reports of 2010 and 2011. Explanation and justification of the change are missing, at least in this part of the annual report. The duty is back however in the GPRA report of 2010. See the next section.

In the years 2005-2009 the format and table of contents of the annual reports did not change. As from the annual report 2010 both were revised. The table of contents mainly or only superficially: some sections are converted into chapters. The visual appearance of the annual report changed greatly.

For the appointment of Greenspan by president Reagan, and other information about Greenspan and Bernanke don't forget to see the film *Inside Job*.

The annual reports 2008 and 2009, and the GPRA reports 2008-2009 and 2010.

The main purpose of this and the following section is to try and find out whether the Fed has evaluated its actions and omissions in 1994-2007. The conclusion is that it did not. This refutes the implicit assertion by Walton & Rockoff in their History of the American Economy that those responsible learn from experience.

AR 2008 was created 16/6/09 and modified 9/3/10. AR 2009 was created 17/5/10 and modified 19/5/10. Neither gives an evaluation of the Fed in 1994-2007, or parts of this period. The subchapter "The Board of Governors and the Government Performance and Results Act" in the chapter "Federal Reserve Operations" refers to GPRA reports, but gives no summary.

The GPRA report 2008-2009 was created 21/9/10, and modified 27/9/10. It measures performance with the help of "performance measures" which are methodologically incomplete if not simply erroneous, and do not provide a useful picture. (What's the use of saying that 90% of a job was done well, without indicating the reasons and consequences of what did not go well?). The supposedly implied Fed (self) evaluation is essentially empty, and can only be called ridiculous. There is however an indication of a review being under way. For the "Measure"

«Identify and resolve supervisory and financial problems in a timely manner, working alone or in cooperation with other authorities, to minimize disruptions to the financial and payment systems and the economy more generally»,³⁰²

there is

«No specific target»,

but the "Results" are:

«The Federal Reserve is actively reviewing current prudential standards and supervisory approaches to incorporate the lessons learned from the recent financial crisis. On the supervisory front, the Federal Reserve is taking steps to strengthen oversight and enforcement, including augmenting traditional microprudential methods of oversight with a more macroprudential approach that should

³⁰¹ Fed AR 2008 p. 5 of the pdf file. The page is not numbered.

³⁰² Fed GPRA report 2008-2009 p. 7/13. The following two quotes are from the same page.

better anticipate and mitigate broader threats to financial stability.»

If we knew nothing of 1994-2008 this might seem comforting. Knowing the history and causes of the crisis, and knowing that the Fed knows it even better, this seems extremely inadequate. No self criticism, and no awareness of errors are found in any of its reports. Nothing is said either in the annual reports or GPRA reports about what could have been done better.

As from 2010, the GPRA reports are published annually. The report about 2010 was created 2/8/11 and modified 8/8/11.

In GPRA 2010 the systemic risk duty has reappeared. The “Overview of the Federal Reserve System” lists 5 duties (which it calls “duties”), of which number 2 reads as follows:

«supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking system, maintaining the stability of the financial system, and containing systemic risk that may arise in financial markets»³⁰³

But the possibility of conflicting interests (duties) has not been eliminated:

«System Role in the Government

The System is considered to be an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive branch of government. The System is, however, subject to oversight by the U.S. Congress. **The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government;** therefore, the description of the System as “independent within the government” is more accurate.»³⁰⁴

This can be seen as a very important, potentially fatal, consequence of inadequate analyses, which failed to see or refused to acknowledge the affordable housing policy as main cause of the crash and crisis.

The first of the annual performance objectives is:

«Financial stability and risk containment: Promoting overall financial stability by identifying emerging financial problems early so that crises can be averted»³⁰⁵

The first item in Table 1 is:

«Identify and resolve supervisory and financial problems in a timely manner, working alone or in cooperation with other authorities.»

There is “No specific target”. The corresponding “Results” are:

«During the recent crisis, central banks were creative and innovative in developing programs that played a significant role in easing financial stress and supporting economic activity. As the global financial system and national economies became increasingly complex and interdependent, innovative policy responses were needed. In addition, the Federal Reserve has restructured its financial supervisory functions so that staff members with expertise in a range of areas work closely together in evaluating potential risks.»

About lessons (explicitly) learnt nothing could be found. In particular there are no results of the review mentioned in GPRA report 2008-2009. Nothing contradicts the hypothesis that the Fed has not tried to figure out what it could have done better in 1994-2007, or what errors it has made.

Fed AR 2010 en 2011 and the Dodd-Frank Act.

The annual report about 2010 reports that on 21/7/10 the Dodd-Frank Wall Street Reform and

³⁰³ Fed GPRA report 2010 p. 1/7.

³⁰⁴ Fed GPRA report 2010 p. 2/8. Bold face by the present author.

³⁰⁵ Fed GPRA report 2010 p. 7/13. The following 2 quotes are from the same page.

Consumer Protection Act has been signed into law.³⁰⁶ The name of the law is abbreviated Dodd-Frank Act. Regarding its contents the annual report says the following:

«The act includes many of the reforms championed by the Federal Reserve to help strengthen the financial system and reduce the likelihood of future financial crises.³⁰⁷ [...]»

The act establishes a new Financial Stability Oversight Council (FSOC) charged with a number of important duties, including monitoring and identifying emerging risks to financial stability across the entire financial system, identifying potential regulatory gaps, and coordinating the agencies' responses to potential systemic risks.

The FSOC is composed of

- the Treasury Secretary (who is also chairperson of the FSOC);
- the Chairman of the Federal Reserve Board;
- the heads of the
 - Consumer Financial Protection Bureau,
 - Office of the Comptroller of the Currency (OCC),
 - Securities and Exchange Commission (SEC),
 - Federal Deposit Insurance Corporation (FDIC),
 - Commodity Futures Trading Commission (CFTC),
 - Federal Housing Finance Agency (FHFA), and
 - National Credit Union Administration (NCUA); and
- an independent member with insurance expertise appointed by the President and confirmed by the Senate. [...]»

With the submission of the annual report to Congress, each voting member of the FSOC must either state that he or she believes the FSOC, the government, and the private sector are taking all reasonable steps to ensure financial stability and mitigate systemic risk, or identify what actions he or she believes need to be taken.

The act also establishes a new Office of Financial Research (OFR) within the Treasury Department to collect, standardize, and analyze data for the FSOC and member agencies in connection with the FSOC's duties. The OFR will be headed by a director appointed by the President with the advice and consent of the Senate.»³⁰⁸

This suggests that the problem was a matter of organization. As if changes in organization and the distribution of duties are necessary and sufficient to prevent repetition. If from now on everybody will do what he is supposed to do it will work. But that was already true before the new law, without any reorganization or redistribution of duties. Worse: the new law guarantees nothing. It does complicate the organization, and blur responsibilities. But the most important point is that it does not address the real problem. Being that for over a decade the government and the heads of supervision didn't want to adjust supervision to the changes in the financial system and didn't listen to well-founded advice. And abused their power to silence everyone who dared voice different opinions. The sentence "With the submission..." will not change anything. As the annual reports if not the hearings witness ("nobody had foreseen"), Greenspan, Cox and all other heads of supervision would gladly have made the required statement. They will only think twice about accepting their job and the required statement if the stipulation is complemented by provisions regarding liability and punishment.

Note that the president appoints the head of the office that serves the FSOC, and that this office is part of the Treasury department.

The Fed annual report about 2011 claims the following:

«... the Dodd-Frank Act seeks to address critical gaps and weaknesses in the U.S. regulatory

³⁰⁶ In other words: half a year before the publication of the FCIC report on 25/1/11. And more than a month before the hearings by the FCIC ended. And remember: Congress itself had instituted the FCIC.

³⁰⁷ This is an effort to falsify history. As if the Fed has always been a champion of stability, and only failed due to defective law and regulation. Probably the Fed chairman was the main problem, and this problem, the appointment of honorable and competent chairpeople, has not been mentioned let alone addressed.

³⁰⁸ Fed AR 2010 p. 144/152. Layout by the present author.

framework that were revealed by the financial crisis.»³⁰⁹

This is clearly untrue.

The sentence is part of the section *Regulatory Developments: Dodd-Frank Act Implementation* of the chapter *Other Federal Reserve Operations*. The table of contents of the annual report 2011 shows that the Fed does not see the subject systemic risk (management) as deserving a separate section or chapter.

The Dodd-Frank-Act seems to consist of a large number of very specific measures. It seems beyond doubt that many measures reduce known risks (if implemented and executed properly). At the same time it seems impossible to exclude the possibility that remaining risks can prove fatal, and to exclude the existence or invention of instruments or procedures which can be used to avoid or circumvent letter or spirit, and/or create new risks. No system analysis could be found from which the law was derived, or which shows that the law covers what it has to cover. What could be found suggests a haphazard collection of measures. Neither the above nor the Wikipedia page about the Act mentions personal liability, penalties, or a safety net. It would seem that nobody has to fear consequences of non-compliance.

Pp. 24-5/32-4 of annual report 2011 present a “box” titled “Financial Stability at the Federal Reserve”. It begins with a paragraph demonstrating a complete lack of honest self-evaluation, and efforts at falsification of history:

«The Federal Reserve’s responsibility for promoting financial stability stems from its role in supervising and regulating banks, operating the nation’s payments system, and serving as the lender of last resort. In the decades prior to the financial crisis, financial stability policy tended to be overshadowed by monetary policy, which had come to be viewed as the principal function of central banks. However, in the aftermath of the financial crisis, financial stability policy has taken on greater prominence and is now generally considered an equally critical responsibility of central banks. As such, the Federal Reserve has made significant organizational changes and taken other actions to improve its ability to understand and address systemic risk. In addition, its statutory role in maintaining financial stability has been expanded by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).»

Note that complete neglect of systemic risk, and active repression of efforts by others to reduce that risk, is quasi justified by first suggesting that it is only derived from other duties instead of being an explicitly mentioned primary duty, and then by presenting it as being overshadowed by monetary policy. In the absence of evidence, the “which had come to be viewed” must be assumed to be a self-serving fantasy. The “view” cannot be found in the annual reports or GPRA reports of the prehistory of the crisis.

The box concludes with the promising paragraph:

«In summary, the Federal Reserve has taken a series of actions to implement the relevant provisions of the Dodd-Frank Act and to meet its broader financial stability responsibilities in a timely way. The Federal Reserve has made important changes to its organizational structure to support a macroprudential approach to supervision and regulation, and it has instituted processes for identifying and responding to sources of systemic risk.»

As if we need not worry any more.

Inside job alleges that the new law is more semblance than reality.

³⁰⁹ Fed AR 2011 p. 155/163.

9. The GAO 1994, 1996 and 1999 reports on financial derivatives and systemic risk.

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- About the GAO.
- The GAO report of May 1994.
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- The FCIC-report about the 1994 GAO-report.
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About the GAO.

«Government Accountability Office.

The Government Accountability Office (GAO) is the audit, evaluation, and investigative arm of the United States Congress. It is part of the legislative branch of the United States government.

The GAO was established as the General Accounting Office by the Budget and Accounting Act of 1921. This Act required the head of GAO to "investigate, at the seat of government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds, and shall make to the President ... and to Congress ... reports [and] recommendations looking to greater economy or efficiency in public expenditures". According to GAO's current mission statement, the agency exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.

The name was changed in 2004 by the GAO Human Capital Reform Act to better reflect the mission of the office. While most other countries have government entities similar to the GAO, their focus is primarily on conducting financial audits. The GAO's auditors conduct not only financial audits, but also engage in a wide assortment of performance audits. [...]

The GAO is headed by the Comptroller General of the United States, a professional and non-partisan position in the U.S. government. The Comptroller General is appointed by the President, by and with the advice and consent of the Senate, for a 15-year, non-renewable term. The President selects a nominee from a list of at least three individuals recommended by an eight member bipartisan, bicameral commission of congressional leaders. The Comptroller General may not be removed by the President, but only by Congress through impeachment or joint resolution for specific reasons. Since 1921, there have been only seven Comptrollers General, and no formal attempt has ever been made to remove a Comptroller General. According to the GAO website, "the long tenure of the Comptroller General gives GAO a continuity of leadership that is rare within government." [...]

The Government Accountability Office also establishes standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other nongovernmental organizations. These standards, often referred to as Generally Accepted Government Auditing Standards (GAGAS), are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. These standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.»³¹⁰

³¹⁰ Wikipedia 7/8/12.

The GAO report of May 1994.

FINANCIAL DERIVATIVES

Actions Needed to Protect the Financial System

Report to Congressional Requesters

This report was written as a consequence of “a wave of significant losses and scandals” concerning derivatives.³¹¹ The background is described in various places in the GAO report, while specific examples of losses and scandals are given by the FCIC report, in the third paragraph of the section quoted below.

In the opinion of the present author, this GAO report even in 2016 remains one of the most useful as an introduction to derivatives and the crisis.

The table of contents of this report is found on pp. 18/20 and following. Because it gives a good idea of the contents it is quoted in full. With a somewhat changed layout.

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³¹¹ The quote is from the FCIC report. See below, in the section on the FCIC-report..

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The GAO sees a real systemic risk:

«Derivatives activities are rapidly expanding and increasingly affected by the globalization of commerce and financial markets. Much OTC derivatives activity in the United States is concentrated among 15 major U.S. dealers that are extensively linked to one another, end-users, and the exchange-traded markets. This combination of global involvement, concentration, and linkages means that the sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole. Although the federal government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, the federal government would be likely to intervene to keep the financial system functioning in cases of severe financial stress. While federal regulators have often been able to keep financial disruptions from becoming crises, in some cases intervention has and could result in industry loans or a financial bailout paid for by taxpayers.»³¹²

There is no guarantee for good risk management.

³¹² P. 7/9 of the report. The report can be found in the dossier under 19940531.

«GAO found that no comprehensive industry or federal regulatory requirements existed to ensure that U.S. OTC derivatives dealers followed good risk-management practices. [...] Regulators have recently issued guidelines for certain bank dealers, and both regulators and market participants said improvements in risk-management systems have already been made as a result of these recommendations and guidelines. However, GAO noted that no regulatory mechanism existed to bring all major OTC dealers into compliance with them.

GAO also noted that in such a rapidly growing and dynamic industry, new participants are likely to enter the market. Some of these new entrants may not be as knowledgeable as present dealers or may take on unwarranted risk in an attempt to gain market share or increase profits. In either case, systemic risk could increase.»³¹³

The GAO points out that a growing part of the sector is unsupervised. Which means increasing risks. But even if there is supervision, this is not to say that the supervisor can see everything, and that there are norms or rules for all relevant activities. See for example pp. 11/13 and following.

There are information problems too:

«Further compounding the regulators' problems and contributing to the lack of knowledge by investors, creditors, and other market participants are inadequate rules for financial reporting of derivatives activity. GAO found that accounting standards for derivatives, particularly those used for hedging purposes by end-users, were incomplete and inconsistent and have not kept pace with business practices. Insufficient accounting rules for derivatives increase the likelihood that financial reports will not fairly represent the substance and risk of these complex activities. In addition, the lack of rules for certain products makes it likely that accounting for these products will be inconsistent, thereby greatly reducing the comparability of financial reports.»³¹⁴

The GAO weighed the regulation, and found it too light:

«GAO believes that innovation and creativity are strengths of the U.S. financial services industry and that these strengths should not be eroded by excessive regulation. However, GAO also believes the regulatory gaps and weaknesses that presently exist must be addressed, especially considering the rapid growth in derivatives activity. The issue is one of striking a proper balance between (1) allowing the U.S. financial services industry to grow and innovate and (2) protecting the safety and soundness of the nation's financial system. Achieving this balance will require unprecedented cooperation among U.S. and foreign regulators, market participants, and members of the accounting profession. GAO makes recommendations designed to help Congress, the regulators, and the industry address this issue.»³¹⁵

It is not explained why (1) and (2) are to be balanced, instead of allowing (1) under the (inviolable) side condition (2). Maybe growth and innovation are assumed to be imperative but impossible under condition (2). But this assumption is not stated explicitly, and not proven either.

The recommendations to Congress begin as follows:

«Given the weaknesses and gaps that impede regulatory preparedness for dealing with a crisis associated with derivatives, GAO recommends that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. Regulators should attempt to prevent financial disruptions from turning into crises and resolve crises to minimize risks to the financial system. Thus, firms that become insolvent should be allowed to fail but to do so in an orderly fashion.»³¹⁶

This is elaborated in practical terms.

According to the GAO the present problem shows that the given supervisory system is outdated. It recommends a systematic and complete overhaul:

³¹³ P. 7/9 of the report.

³¹⁴ P. 8/10 of the report.

³¹⁵ Pp. 8-9/10-11 of the report.

³¹⁶ P. 14/16 of the report.

«GAO also recommends that Congress systematically address the need to revamp and modernize the entire U.S. financial regulatory system. Gaps and weaknesses in OTC derivatives regulation clearly demonstrate that the existing regulatory structure has not kept pace with the dramatic and rapid changes in the domestic and global financial markets that have occurred over the past several years. Banking, securities, futures, and insurance are no longer separate and distinct industries that can be well regulated by the existing patchwork quilt of federal and state agencies.»³¹⁷

This is followed by recommendations addressed to the supervisors (regulators), the Financial Accounting Standards Board (FASB), and the SEC.³¹⁸ The following quote is unabridged.

«Recommendations to Congress.

Given the weaknesses and gaps that impede regulatory preparedness for dealing with a crisis associated with derivatives, we recommend that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. Regulators should attempt to prevent financial disruptions from turning into crises and resolve crises to minimize risks to the financial system. Thus, firms that become insolvent should be allowed to fail but to do so in an orderly fashion.

The immediate need is for Congress to bring the currently unregulated OTC derivatives activities of securities firm and insurance company affiliates under the purview of one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies. This could be done in several ways. For example, one legislative proposal would accomplish this goal by assigning the responsibility for the unregulated entities to SEC and creating an interagency commission to establish principles and standards for each federal financial regulator to use in supervising derivatives activities. Another approach could be based on the concept that underlies the arrangement established for government securities dealers. Under this concept, lead responsibility for setting principles and standards applicable to all major U.S. derivatives dealers would be divided among existing agencies on the basis of their expertise and mission. Extensive consultation with all of the agencies supervising derivatives activities would be required before any principles or standards were adopted.

We also recommend that Congress begin systematically addressing the need to revamp and modernize the entire US. financial regulatory system. Gaps and weaknesses in OTC derivatives regulation clearly demonstrate that the existing regulatory structure has not kept pace with the dramatic and rapid changes in the domestic and global financial markets. Banking, securities, futures, and insurance are no longer separate and distinct industries that can be well regulated by the existing patchwork quilt of federal and state agencies. Many issues need to be debated and decided, including the appropriate uses of federally insured deposits and the extent to which they should be used to finance activities, such as large-scale proprietary trading in derivatives or other financial instruments. One of the first issues that needs to be addressed is how the U.S. regulatory system should be restructured to better reflect the realities of today's rapidly evolving global financial markets. We recommend that the committees of jurisdiction work together on this issue. In addition, these committees should hold hearings, at least annually, on developments that affect the safety, soundness, and stability of the U.S. financial system.»

«Recommendations to Financial Regulators.

We recommend that the appropriate regulatory authorities take the following actions to improve their capability to oversee OTC derivatives activities and to anticipate and respond to any financial crisis involving derivatives. Developing specific solutions should involve working closely with industry representatives to:

- Develop and maintain accurate, current, and centralized information, that is accessible to all regulators, including information on the extent of major OTC dealers' counterparty concentrations and the sources and amounts of their derivatives earnings;

³¹⁷ P. 15/17 of the report.

³¹⁸ Pp. 14-16/16-18 of the report.

- Develop and adopt a consistent set of capital standards for OTC derivatives dealers sufficient to ensure that all of the major risks associated with derivatives as well as legally enforceable netting agreements are reflected in capital.
- Establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers. Internal control reporting by boards of directors, managers, and external auditors should include assessments of derivatives risk-management systems.
- Perform comprehensive, annual examinations of the adequacy of major OTC derivatives dealers' risk-management systems, using a consistent set of standards established for this purpose and including consideration of the internal control assessments performed by boards of directors, management, and auditors.
- Provide leadership in working with industry representatives and regulators from other major countries to harmonize disclosure; capital, legal requirements including netting enforceability; and examination and accounting standards for derivatives.»

«Recommendations to FASB.

We recommend that FASB:

- Proceed expeditiously to issue the existing exposure draft on disclosures of derivatives and fair value of financial instruments.
- Proceed expeditiously to develop and issue an exposure draft that provides comprehensive, consistent accounting rules for derivative products, including expanded disclosure requirements that provide additional needed information about derivatives activities.
- Consider adopting a market value accounting model for all financial instruments, including derivative products.»

«Recommendations to SEC.

We recommend that SEC:

- Ensure that SEC registrants that are major end-users of complex derivative products establish and implement corporate requirements for independent, knowledgeable audit committees and public reporting on internal controls. Internal control reporting by boards of directors, managers, and external auditors should include assessments of derivatives risk-management systems.
- Ensure that FASB proceeds expeditiously to develop and adopt comprehensive, consistent accounting rules and disclosure requirements for derivative products.»

The progress report of November 1996.

In November 1996 the GAO reported about the implementation of its recommendations. The report can be found in the dossier under the date 19961130. Part of the recommendations was implemented, but not all, and those that were, were implemented incompletely. Reasons for worry remain.³¹⁹

The progress report doesn't deserve a prize for clarity. The above shows well-structured recommendations. It would have been simple to structure the implementation accordingly. But only elements of the original structure are kept. In the recommendations Congress is addressed first, but on p. 3/5 of the progress report Congress is listed after the regulators.

First we present the table of contents.³²⁰

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³¹⁹ The reader may study CGFS 20 of 2003 in the light of the two GAO reports. Perhaps they can be combined in a synoptic table.

³²⁰ Pp. 16-20/18-22 of the report.

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As regards implementation, the Executive Summary concludes the following:

«Recommendations.

A number of actions have been taken or proposed since 1994 that are consistent with the recommendations that GAO made in its 1994 report. However, GAO notes that its key recommendations to improve corporate governance and internal controls for major derivatives dealers and end-users, close regulatory gaps, establish comprehensive and consistent accounting standards, and harmonize regulatory and accounting standards internationally have yet to be fully implemented. While GAO is making no new recommendations in this report, it believes that regulators, accounting standards-setters, and others need to continue to take actions necessary to completely respond to the intent of its prior recommendations.»³²¹

The Introduction (!) reports about the implementation of the recommendations to Congress:

«Six derivatives-related bills were introduced in Congress in 1994. These bills included proposals to

- regulate derivatives activity and promote uniformity of such regulation;
- require increased disclosure about derivatives activity;
- require that GAO study the speculative uses of derivatives and the feasibility of imposing taxes and margin requirements on speculative derivatives activity;
- establish principles and standards related to accounting, customer suitability, and risk management;
- require derivatives dealers to register with SEC; and
- prohibit depository institutions from using derivatives for speculation.

None of these bills were passed.

As of June 30, 1996, four new derivatives-related bills were introduced. These bills included proposals to

- establish a federal derivatives commission to set principles and standards for the supervision of derivatives activities;
- authorize the Federal Reserve to create a self-regulatory organization whose members would include derivatives dealers not under the direct regulation of SEC or CFTC;
- require regulatory agencies to jointly establish principles and standards relating to capital, accounting, disclosure, customer suitability, and risk management;
- require financial institutions to have a management plan that ensures appropriate management oversight;
- establish prudent standards for managing risk and provide a framework for internal controls;
- require that all derivatives dealers register and be subject to SEC regulation; and
- prohibit depository institutions and credit unions from engaging in certain derivatives activities.

As of July 1996, all four of the bills had been referred to committee with no further action taken.»³²²

This explains the only recommendation(s) of this progress report:

«Recommendations.

We recommended that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. We said the immediate need was for Congress to bring the unregulated OTC derivatives activities of securities firm and insurance company affiliates under the purview of

³²¹ 1996 GAO report p. 15/17.

³²² 1996 GAO report pp. 31-2/33-4.

one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies.”³²³

The FCIC-report about the 1994 GAO-report.

“Pages in the history of derivative trading”.

The following quote is copied from the section THE GROWTH OF DERIVATIVES: “BY FAR THE MOST SIGNIFICANT EVENT IN FINANCE DURING THE PAST DECADE” of the FCIC report. It shows how the GAO came to write its 1994 and 1999 reports.

«The principal legislation governing these markets is the Commodity Exchange Act of 1936, which originally applied only to derivatives on domestic agricultural products. In 1974, Congress amended the act to require that futures and options contracts on virtually all commodities, including financial instruments, be traded on a regulated exchange, and created a new federal independent agency, the Commodity Futures Trading Commission (CFTC), to regulate and supervise the market.

Outside of this regulated market, an over-the-counter market began to develop and grow rapidly in the 1980s. The large financial institutions acting as OTC derivatives dealers worried that the Commodity Exchange Act’s requirement that trading occur on a regulated exchange might be applied to the products they were buying and selling. In 1993, the CFTC sought to address these concerns by exempting certain nonstandardized OTC derivatives from that requirement and from certain other provisions of the Commodity Exchange Act, except for prohibitions against fraud and manipulation.

As the OTC market grew following the CFTC’s exemption, a wave of significant losses and scandals hit the market. Among many examples, in 1994 Procter & Gamble, a leading consumer products company, reported a pretax loss of \$157 million, the largest derivatives loss by a nonfinancial firm, stemming from OTC interest and foreign exchange rate derivatives sold to it by Bankers Trust. Procter & Gamble sued Bankers Trust for fraud—a suit settled when Bankers Trust forgave most of the money that Procter & Gamble owed it. That year, the CFTC and the Securities and Exchange Commission (SEC) fined Bankers Trust \$10 million for misleading Gibson Greeting Cards on interest rate swaps resulting in a mark-to-market loss of \$23 million, larger than Gibson’s prior-year profits. In late 1994, Orange County, California, announced it had lost \$1.5 billion speculating in OTC derivatives. The county filed for bankruptcy—the largest by a municipality in U.S. history. Its derivatives dealer, Merrill Lynch, paid \$400 million to settle claims.

In response, the U.S. General Accounting Office issued a report on financial derivatives that found dangers in the concentration of OTC derivatives activity among 15 major dealers, concluding that “the sudden failure or abrupt withdrawal from trading of any one of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole.” While Congress then held hearings on the OTC derivatives market, the adoption of regulatory legislation failed amid intense lobbying by the OTC derivatives dealers and opposition by Fed Chairman Greenspan.

In 1996, Japan’s Sumitomo Corporation lost \$2.6 billion on copper derivatives traded on a London exchange. The CFTC charged the company with using derivatives to manipulate copper prices, including using OTC derivatives contracts to disguise the speculation and to finance the scheme. Sumitomo settled for \$150 million in penalties and restitution. The CFTC also charged Merrill Lynch with knowingly and intentionally aiding, abetting, and assisting the manipulation of copper prices; it settled for a fine of \$15 million.

Debate intensified in 1998. In May, the CFTC under Chairperson Brooksley Born said the agency would re-examine the way it regulated the OTC derivatives market, given the market’s rapid evolution and the string of major losses since 1993. The CFTC requested comments. It got them.

Some came from other regulators, who took the unusual step of publicly criticizing the CFTC. On the day that the CFTC issued a concept release, Treasury Secretary Robert Rubin, Greenspan, and SEC Chairman Arthur Levitt issued a joint statement denouncing the CFTC’s move: “We have grave concerns about this action and its possible consequences. . . . We are very concerned about reports that

³²³ P. 69/71 of the report.

the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives.” They proposed a moratorium on the CFTC’s ability to regulate OTC derivatives.

For months, Rubin, Greenspan, Levitt, and Deputy Treasury Secretary Lawrence Summers opposed the CFTC’s efforts in testimony to Congress and in other public pronouncements. As Alan Greenspan said: “Aside from safety and soundness regulation of derivatives dealers under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary.”³²⁴

The 1999 GAO report “LONG-TERM CAPITAL MANAGEMENT- Regulators Need to Focus Greater Attention on Systemic Risk” to Congressional Requesters.

This is the publication mentioned in note 37 of chapter 3 on p. 560/588 of the FCIC report.

The Letter in the GAO LTCM report is dated 29/10/99. The pdf-file of the report is dated 29/10/12. This is the date under both “Created” and “Modified”.

For the principal elements of the history of the LTCM crisis see pp. 1-3/3-5 of the report. For more details see the chapter “The LTCM episode” in the PWG report on LTCM.

The pdf-file has linked tables of contents. Even though there is no table of contents of the most important part of the report, the Letter. That is, for the pages 1-35. So the following table of contents is not a simple copy. For the first 35 pages it has been constructed by listing the “headings” in the margins. The page number in the pdf-file is obtained by adding 2 to the page numbers in the following table. In other words, page numbers for this report are written $n/(n+2)$.

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³²⁴ FCIC pp. 46-7/74-5.

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FCM = futures commission merchant (A list of abbreviations is given on p. 37/39 of the LTCM report).

As respects clarity, the title and subtitle of the report leave nothing to be desired. One can only miss the message if one misses the report. The title is quoted twice by the FCIC report. But only in the notes.³²⁵

The LTCM report gives indisputable analyses of the relevant phenomena and events. A more convincing report is hardly imaginable. The report identifies all phenomena which caused the crisis, except the passivity of supervisors and government. (The follow-up report does). Its recommendations are logical and feasible.

The report is not only of prime importance because of its contents however, but also because it shows that a study of the facts could have shown everyone both the dangers, and the means to avoid their realization. It shows that open analysis and drawing obvious conclusions, and even simple listening, would have been sufficient to avoid the subprime crisis.

But the recommendations clearly have not been implemented, or not sufficiently. The following section will show that the US supervisors and Treasury said they were largely unnecessary. (Standard reactions from such irresponsible political organizations). During and after the crisis, the LTCM report and the GAO reports mentioned earlier were mostly “forgotten”. They have not been discussed seriously anywhere, especially not by the inquiry commissions.

The following part of the table of contents of the Letter can serve as its summary:³²⁶

1. Lapses in Market Discipline Enabled LTCM to Have Large, Leveraged Trading Positions, Creating Potential Systemic Risk;
2. Market Discipline Did Not Constrain LTCM’s Leverage and Risk-taking;
3. The LTCM Crisis Illustrated that Potential Systemic Risk Can Exist in Large Trading Positions;
4. After the Crisis, Major Financial Firms Proposed Improved Risk Standards;
5. Regulatory Oversight Did Not Identify Lapses in Risk Management Practices and the Threat Posed by LTCM;
6. Federal Regulators Had Expressed General Concerns About Hedge Funds for Years;
7. Regulators Did Not Identify Weaknesses in Firms’ Risk Management Practices Until After the Crisis;
8. Offsite Monitoring Did Not Reveal the Potential Systemic Threat Posed by LTCM;
9. Regulators and Industry Adopted and Recommended Improved Oversight and Practices;
10. Existing Coordination Could be Improved to Enhance Regulators’ Ability to Identify Risks Across Industries and Markets;
11. Gap in SEC’s and CFTC’s Regulatory Authority Limits Their Ability to Identify and Mitigate Systemic Risk;

³²⁵ This can be concluded from a search for “focus greater attention”.

³²⁶ For easy referencing the items are numbered.

12. SEC and CFTC Lack Authority to Regulate Affiliates of Broker-Dealers and FCMs;
13. Regulators Recommended Limited Expansion of SEC and CFTC Authority Over Activities of Affiliates of Broker-Dealers and FCMs, but Regulatory Gap Would Remain;
14. Expanding SEC and CFTC Authority Over Affiliates Would Raise Controversial Issues.

The formulations seem to be somewhat softened in comparison with the full text, and do not excel in unambiguity. The “could be improved” in 10 does not suggest necessity. Are the improvements indicated in 9 sufficient?

P. 2/4 gives a definition of “Systemic risk”:

«Systemic risk is generally defined as the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) could cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole.»

(In the present report the term systemic risk is only used for risks threatening the financial system as a whole. The difference between the definitions is not so large as it may seem, because it is extremely improbable that a systemic risk of the GAO does not threaten the rest of the system).

The following is a very important section of the LTCM report. It is therefore quoted in full:

«Financial Regulatory Structure.

Hedge funds are generally not subject to direct federal regulation, instead they are indirectly “regulated” by the banks and securities and futures firms that are their creditors and counterparties. The regulators’ role is to ensure that those banks and securities and futures firms are practicing prudent risk management, including the risks they take in dealing with hedge funds. A primary mission of bank regulators is to promote the safety and soundness of the banking system, and this is achieved primarily through ensuring the safety and soundness of individual institutions. Three federal bank regulators oversee banks, some of which are also subject to state regulatory oversight. Bank regulators have the authority to establish capital requirements, establish information-reporting requirements, conduct periodic examinations, and take enforcement actions. The Federal Reserve, the lender of last resort for banks and other financial institutions, also has an additional objective of ensuring the overall stability of the U.S. financial system.

SEC’s and CFTC’s primary purposes are to protect investors or customers in the public securities and futures markets and to maintain fair and orderly markets. Unlike the bank regulators, which can regulate all bank activities, SEC and CFTC are authorized to regulate only activities involving securities and futures and only those entities that trade these products. SEC regulates activities involving securities and the firms that trade these products. Such firms include broker-dealers, which must register with SEC and comply with its requirements, including capital requirements. Broker-dealers must also comply with the requirements of various self-regulatory organizations (SROs) of which they are members, such as the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD). CFTC regulates activities involving FCMs, which must also comply with rules imposed by futures SROs—the various futures exchanges, such as the Chicago Board of Trade and Chicago Mercantile Exchange, and an industry association, the National Futures Association (NFA). SEC and CFTC have the authority to establish capital standards and information reporting requirements, conduct examinations, and take enforcement actions against registered broker-dealers and FCMs, but generally not their unregulated affiliates.

The U.S. financial regulatory system has evolved over time, in part, in response to financial crises. For example, SEC and the Federal Deposit Insurance Corporation (FDIC) were created during the depression to fill perceived gaps in the regulatory structure. In the 1980s and 1990s, crises and disruptions to markets have revealed additional regulatory gaps. Many of these gaps have been filled by extensions of authority rather than by the creation of new agencies. For example in 1990 and 1992, in response to the Drexel bankruptcy, Congress provided SEC and CFTC, respectively, with authority to obtain information from certain broker-dealer and FCM affiliates. However, SEC and CFTC still lack consolidated regulatory authority over securities and futures firms.»³²⁷

³²⁷ 1999 GAO report GGD-00-3 pp. 7-8/9-10.

The following paragraph points out that there is insufficient attention to interrelationships:

«Because of the blurring in recent years of traditional lines that separate the businesses of banks and securities and futures firms, it is more important than ever for regulators to assess information that cuts across these lines. **Regulators for each industry have generally continued to focus on individual firms and markets, the risks they face, and the soundness of their practices, but they have failed to address interrelationships across each industry.** The risks posed by LTCM crossed traditional regulatory and industry boundaries, and the regulators would have needed to coordinate their activities to have had a chance of identifying these risks. Although regulators have recommended improvements to information reporting requirements, they have not recommended ways to better identify risks across markets and industries. We are recommending that federal financial regulators develop ways to better coordinate oversight activities that cross traditional regulatory and industry boundaries.»³²⁸

In fact, it is logically impossible to evaluate the safety and soundness of individual institutions without sufficient knowledge of all elements of the system they are formally or informally connected with.

A similar remark is made in the conclusions on p. 30:

«LTCM's crisis showed that the traditional focus of federal financial regulators on individual institutions and markets is not adequate to identify potential systemic threats that cross these institutions and markets. Developing ways to enhance coordination of activities related to identifying risks that cross traditional boundaries could better position these regulators to address potential systemic risk before it reaches crisis proportions.»³²⁹

The statement in boldface agrees with what one sees in all annual reports of all supervisors, of all years up to and including 2006-2008.³³⁰ They all “failed to address interrelationships”. The “continued to focus on” is moreover misleading if interpreted literally instead of diplomatically. For the supervisors were not interested in interrelationships at all. The “continued to focus on” could better have been replaced by “failed to look beyond”.

Another unambiguous warning:

«Gaps in SEC's and CFTC's regulatory authority impede their ability to observe and assess activities in securities and futures firms' affiliates that might give rise to systemic risk. Although the Federal Reserve's consolidated oversight of bank holding companies did not reveal banks' risk management weaknesses related to LTCM, recommended or already implemented improvements in examination focus and in information gathered may give bank regulators a better opportunity to identify future problems that might pose systemic risk. **Without similar authority over the consolidated activities of securities and futures firms, SEC and CFTC cannot contribute effectively to regulatory oversight of potential systemic risk, because a large and growing proportion of those firms' risk taking is in their unregulated affiliates.** The affiliates may have large positions in markets such as OTC derivatives and can be major providers of leverage in the markets, as they were in the LTCM case. How they manage their own risks, as well as their provision of leverage to counterparties, can affect the financial system.»³³¹

Supervisors could and should have been aware of what they didn't see and know, and of the fact that this lack of knowledge made it difficult or impossible to guarantee the safety and soundness of their part of the system. This is only a matter of logic.

The GAO presents the following as a *Matter for Congressional Consideration*:

³²⁸ 1999 GAO report p. 3/5. Boldface is by the present author.

³²⁹ 1999 GAO report p. 30/32.

³³⁰ The present author has not checked later reports.

³³¹ 1999 GAO report p. 30-1/32-3.

«In an effort to identify and prevent potential future crises, Congress should consider providing SEC and CFTC with the authority to regulate the activities of securities and futures firms' affiliates similar to that provided the Federal Reserve with respect to bank holding companies. If this authority is provided, it should generally include the authority to examine, set capital standards, and take enforcement actions. However, SEC and CFTC should have the flexibility to vary the extent of their regulation depending on the size and potential threat posed by the securities and futures firm.»³³²

The reactions of supervisors and Treasury on the draft LTCM report of the GAO.

A draft of the LTCM report was submitted to the supervisors and Treasury for their comment. Facsimiles of the answering letters are printed on the pp. 48-53 of the report. In this section, the text of the letters is quoted in full.

The supervisors mention a report of the PWG which is dated 28/4/99. In addition it should be kept in mind that «In May [1998], the CFTC under Chairperson Brooksley Born said the agency would reexamine the way it regulated the OTC derivatives market, given the market's rapid evolution and the string of major losses since 1993», and that this was followed by the successful repressive actions of Greenspan (Fed), Levitt (SEC) and Rubin and Summers of the Treasury.³³³

CFTC

(The reaction is dated 14/10/99).

«Thank you for the opportunity to comment on the General Accounting Office (GAO) draft report entitled "LONG-TERM CAPITAL MANAGEMENT: Regulators Need to Focus Greater Attention on Systemic Risk." The Commission commends GAO's in-depth analysis of these important and timely issues of regulatory reform.

As the draft report indicates, the President's Working Group on Financial Markets (PWG) recently issued a report that made several recommendations in light of this episode. These recommendations include action to promote greater disclosure of information- both disclosure by hedge funds about their own risk exposures and disclosure by financial institutions and other publicly-held companies about their dealings with hedge funds. This disclosure will increase market transparency and thus will enhance the ability of creditors, counterparties, investors, and other market participants to monitor, and to discipline, leverage and risk taking by hedge funds.

CFTC is working to implement those recommendations which are within its authority and has already begun working with other members of the PWG to address issues raised by the LTCM situation. Specifically, CFTC staff have developed possible models for disclosure of risk information by institutions whose size and leverage render them capable of posing potential systemic risk threats. These models would call for disclosure in a format that would be shared with other federal financial regulators and the public. CFTC is consulting with other members of the PWG concerning these models of disclosure. The goal is to reduce the likelihood of systemic risk by increasing transparency, thereby strengthening market discipline.»

The following are the last sentences of the evaluation of this reaction by the GAO:

«As pointed out in our report, although market discipline is the primary mechanism for controlling risk-taking, LTCM's creditors and counterparties failed to apply it in LTCM's case. Thus, we continue to believe that market discipline should be supplemented by regulatory offsite monitoring and on-site examinations to help ensure the prompt identification and correction of weaknesses in risk management practices.»³³⁴

In addition the following observations can be made:

1. The LTCM near-collapse is a failure of the PWG too. CFTC should have explained why PWG can be trusted as from now.

³³² 1999 GAO report p. 31/33.

³³³ The LTCM crisis was in September 1998. Born left the CFTC on 6/1/99.

³³⁴ 1999 GAO report p. 31-2/33-4.

2. Many of the points made by the CFTC are too vague to know whether they mean anything useful. It is unclear why they are more than wishful thinking. They seem to assume voluntary cooperation of all relevant market participants, but don't explain why this assumption is credible.
3. The gist of the reaction of the CFTC is that already much is being done. Implicitly it suggests that what is being done is enough. But this is not substantiated in any way.
4. The CFTC says nothing about deficiencies in its authority or the relevant regulation.
5. Nothing is said about the failure of the supervisors "to address interrelationships across each industry". The problem that for the time being even together they don't see what is needed to ensure safety and soundness is not addressed.
6. Without an appendix in which the various assertions are specified and substantiated this is actually a rather indecent letter. CFTC seems to think that it cannot avoid sending a reaction, but also that it need not react responsibly.
7. CFTC does not cooperate constructively with the GAO.
8. PWG and CFTC did not realize their goals, not even in 10 years.

Fed

(The reaction is dated 20/10/99).

«The Board of Governors of the Federal Reserve System submits this response on the draft report entitled: Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk.

The report recommends that the Federal Reserve and other federal financial regulators develop ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries. As you know, the President's Working Group was reinvigorated in 1994, in part to address coordination concerns, and the Board is committed to making the Working Group function effectively. The Board believes that the structure for coordinating currently is adequate. Although in certain cases there may be statutory limitations on the agencies' ability to share some information, legislative proposals under consideration would address any such limitations that may apply to the Board.

Broadly, the report's recommendation suggests that the federal financial regulators focus on developing data that might reveal potential systemic risks and then coordinate on the assessment of that risk. Identifying the particular types of data that might reveal potential systemic risk is a particularly challenging task, in no small measure because systemic crises tend to embody unique features that are hard to anticipate in advance. Various working groups under the auspices of the Committee on the Global Financial System of the Group of Ten Central Banks and the Financial Stability Forum are struggling with trying to identify the types of data that might improve our understanding of the risks being taken in financial markets. We do not want to prejudge the results of such efforts, but the task is an extremely difficult one. In the final analysis, our ability to perceive systemic crises in data is likely to be limited. We, thus, fall back to our longstanding position, that the soundest course for financial regulators is to ensure that the institutions they supervise can withstand the shocks that inevitably occur in markets. To this end, federal financial regulators are working to strengthen further the risk management practices at the institutions they supervise.»³³⁵

The following is the last sentence of the evaluation of this reaction by the GAO:

«However, such oversight is not currently applied to all financial institutions that can originate or transmit risk and does not include effective ways to monitor and assess risks that cut across markets.»³³⁶

Observations by the present author:

1. After the LTCM crisis the remark that- since 1994!- "the Board is committed to making the Working Group function effectively" is not particularly reassuring. The failure to prevent the LTCM crisis requires an explanation. Why is one to believe that no more accidents will occur?

³³⁵ Signed by Alan Greenspan.

³³⁶ 1999 GAO report p. 33/35.

2. As the GAO analyses show, phrases like “developing data that might reveal potential systemic risks” are misleading because no (additional) data are needed to reveal systemic risk. More transparency (data) is necessary to enable all participants to reduce and manage risks.
3. The Fed does not substantiate its assertion that developing, identifying, etcetera, data which improve understanding of risks is extremely difficult.³³⁷
4. The assertion is incompatible with the analyses of the GAO. The GAO analyses show that the identification of systemic risk is not in the first place a matter of data but of understanding interrelationships (mechanisms).
5. The conclusion of the Fed, that its duties do not require it to look across industries and markets, is incompatible with the fact that the safety and soundness of an institution can only be adequately evaluated with sufficient knowledge of its environment.³³⁸
6. The sentence “Broadly...” is a highly debatable if not plainly incorrect interpretation of the GAO conclusions.
7. Because of its dubious interpretation of some of the GAO conclusions, the neglect of other conclusions, and the lack of substantiation, the Fed’s reaction is proof of irresponsible arrogance.
8. The reaction of the Fed is incompatible with at least two of its primary duties:³³⁹
 - «supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers
 - maintaining the stability of the financial system and containing systemic risk that may arise in financial markets ».³⁴⁰

SEC

(The reaction is dated 18/10/99).³⁴¹

«I appreciate the opportunity to comment on the General Accounting Office's (“GAO”) draft report entitled Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk (“Draft Report”). I commend the GAO on its thorough review of the events and practices that contributed to the difficulties associated with Long-Term Capital Management (“LTCM”).

As the scope of trading and credit activities conducted outside the regulated broker-dealer has expanded, the Securities and Exchange Commission (“SEC”) has found it increasingly difficult to closely monitor the systemic risks posed by unregulated broker-dealer affiliates. Therefore, I believe the Draft Report accurately concludes that the SEC requires additional risk assessment authority over these unregulated affiliates. The finding also is consistent with the recommendations recently made in the report prepared by the President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*.

³³⁷ The Fed may be unable to, because it never showed any understanding of systemic risks other than via institutional risks, and even that understanding was fatally deficient.

³³⁸ Its opinion shows fatal incompetence.

³³⁹ The Fed obviously failed utterly in the realization of the objectives in terms of which these duties had been translated.. The text describing the objectives clearly does not agree with reality, and not by far. Important examples are:

- «Maintain an understanding of the effect of financial innovation and technology (for example, new powers and products, new risk management and measurement methodologies, and electronic banking) on the operations and risk profile of banking organizations and the payment system; ensure that supervisory programs accommodate prudent advances that benefit consumers and businesses or improve risk management
- Remove unnecessary banking restrictions, consistent with safety and soundness. Refine or eliminate unnecessary or ineffective policies, procedures, regulations, or restrictions to ensure that reforms are effectively implemented, consistent with safety and soundness of banking organizations»

Quoted from Fed AR 1998, p. 96/100.

³⁴⁰ P. 1 of the brochure *Purposes and functions* of the Fed, dated June 2005. The text can also be found in various annual reports.

³⁴¹ The red is by the present author, for additional clarity.

In addition to our general comments on the conclusions reached in the Draft Report, we have the following three specific concerns:

First, the Draft Report compares, but does not distinguish, the leverage ratios of LTCM and several large securities firms. Though some securities firms had simple balance sheet leverage ratios (assets/equity capital) in the same range as LTCM, the assets carried by the securities firms were less volatile than the assets earned by LTCM. Moreover, securities firms are subject to regulatory capital requirements. Therefore, a general comparison of simple leverage ratios without further explanation may cause the misimpression that securities firms posed as much risk as LTCM.

Second, the Draft Report claims there is an inability of existing coordination methods to monitor risks across industry and market lines. I believe that productive avenues for sharing important information exist today. For example, the President's Working Group on Financial Markets provides an ongoing forum for the primary financial regulators to discuss issues cutting across jurisdictional boundaries. While the exchange of information between regulators can be improved to facilitate better cooperation and coordination, in my view the focus should be on public dissemination of information regarding hedge funds. The President's Working Group report therefore recommended that hedge funds should be required to publicly disclose information in the form of quarterly financial reports that include comprehensive measures of market risk. The SEC's staff also is working on a rule proposal to require public companies to disclose their direct material exposures to significantly leveraged financial institutions.

Third, the Draft Report claims that because of current limitations on the SEC's regulatory authority over broker-dealer affiliates, the SEC cannot fully assess the risk exposures of broker-dealers. The SEC, however, has sufficient information to assess and evaluate the risks incurred at the broker-dealer level. It is at the broader, broker-dealer holding structure level, which encompasses unregulated broker-dealer affiliates, that the SEC encounters difficulty in assessing risk.

In closing, while rigorous market discipline is an effective deterrent against market excesses and disruptions, the LTCM episode demonstrated that financial regulators need better tools to identify intermarket risks, especially those stemming from lapses in private market discipline. Thank you again for this opportunity to provide comments to the GAO as it prepares its final draft of the report.»

In its evaluation of the SEC's reaction the GAO notes the following:

«Although we agree that hedge fund disclosures could be of some use, we believe that efforts should be made to improve regulatory coordination because future systemic problems may not involve hedge funds. Thus, we continue to support our recommendation that financial regulators find ways to better coordinate the assessment of risks that cross traditional regulatory and industry boundaries.

Finally, as to SEC's third issue, we continue to be concerned that SEC may be unable to fully assess risks to the broker-dealers because of its inability to oversee holding companies (and unregulated affiliates) of broker-dealers. For example, when broker-dealers are part of holding company structures, whose risk management function is located at the holding company level, SEC is unable to review that broker-dealers risk management system unless the holding company provides the information voluntarily.»³⁴²

Observations by the present author:

1. The SEC agrees somewhat with the GAO about expansion of the regulatory authority of the SEC. But the SEC does not seem to understand the GAO and/or the financial system sufficiently. It does not show that the (other) changes asked by the GAO are unnecessary.³⁴³
2. Like the CFTC and Fed, the SEC hides behind the PWG without providing arguments that show why henceforth the PWG will do its job effectively. As noted by the GAO, the suggestion that only hedge funds (like LTCM) can cause problems for the financial system is incorrect and dangerous.

³⁴² 1999 GAO report p. 33-4/35-6.

³⁴³ Wishful thinking is not accepted as an argument.

3. Although the reaction of the SEC shows a more positive attitude than those of CFTC, Fed and Treasury, its analytic weakness, and the absence of signs of understanding, give rise to doubts about the adequacy of its supervision.³⁴⁴

Treasury

(The reaction is dated 25/10/99).

«Thank you for your letter to Secretary Summers and for this opportunity to review and comment upon the draft report entitled, Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk. The draft report recommends that the Treasury, the Federal Reserve Board, the SEC, and the CFTC "develop ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries." We believe that such coordination is already occurring in the President's Working Group. The members of the Working Group meet on a regular basis- at both the principal and staff levels- and have developed a productive and candid multilateral environment for exchanging information on significant market developments. The process works well and our working relationships continue to grow and develop over time. While the Working Group is not itself a regulatory body, it serves as an important forum for federal financial regulators that better enables them to respond to market events in effective and appropriate ways.

Thank you again for this opportunity to review and comment on the draft report. We find that its factual presentation is in general agreement with our understanding of the events related to the LTCM episode.»³⁴⁵

The following is the second half of the GAO's evaluation of this reaction:

«As we stated previously, we agree that the President's Working Group serves as an important forum that better enables regulators to respond to market events, although primarily after the fact, but existing coordination efforts failed to allow regulators to identify the cross-industry risks that LTCM posed. Therefore, we continue to support our recommendation that the financial regulators develop better ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries.»³⁴⁶

Observations by the present author:

1. The claim that the PWG works well is incompatible with the facts of the LTCM crisis.
2. The PWG is again used as a panacea.
3. The reaction of the Treasury completely (and shamefully) ignores the conclusions and recommendations of the GAO.
4. The reaction of the Treasury actually ignores the LTCM crisis. It does as if nothing of importance has happened, and nothing can and has to be learned.
5. The Treasury reaction is an example of abuse of power. It is not really a reaction, and assumes that it need not react. It does not say so however, and gives no explanation. It reacts as if it is not accountable.

Closing remarks about the reactions.

- CFTC, Fed, SEC, and Treasury are supposed to cooperate in the PWG. The way in which they cooperate with the GAO does not inspire confidence.
- The reactions show that the public financial authorities do not work properly, and do not properly account for their policies. For elucidation they could have referred to other documents. But they didn't, or hardly.

“Hardly” because of the references to the PWG-report. The PWG report however covers only part of the problems, and inadequately. See below and the full report (in the dossier). The CFTC, Fed, SEC,

³⁴⁴ Which is in agreement with its performance in the recent past (i.e. the years before 1999).

³⁴⁵ Signed by Gary Gensler, Under Secretary (Domestic Finance).

³⁴⁶ 1999 GAO report p. 34/36.

and Treasury could have systematically compared the GAO report with that of the PWG, but didn't. It is easy to see that its superficiality and noncommittal character ensured that no substantial improvement took place.

Appendix. The LTCM report of the PWG.

The report is dated 28 April 1999.

The summary (and report) can be compared with the GAO analyses.

«EXECUTIVE SUMMARY

The President's Working Group on Financial Markets recommends a number of measures designed to constrain excessive leverage in the financial system. The events in global financial markets in the summer and fall of 1998 demonstrated that excessive leverage can greatly magnify the negative effects of any event or series of events on the financial system as a whole. The near collapse of Long-Term Capital Management ("LTCM"), a private sector investment firm, highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system.

Although LTCM is a hedge fund, this issue is not limited to hedge funds. Other financial institutions, including some banks and securities firms, are larger, and generally more highly leveraged, than hedge funds.

While leverage can play a positive role in our financial system, problems can arise when financial institutions go too far in extending credit to their customers and counterparties. The near collapse of LTCM illustrates the need for all participants in our financial system, not only hedge funds, to face constraints on the amount of leverage they assume.

Our market-based economy relies primarily on market discipline to constrain leverage. But market discipline can break down. In the case of LTCM, its investors, creditors, and counterparties did not provide an effective check on its overall activities. Moreover, some of the same market and credit risk management weaknesses that permitted LTCM to achieve its extraordinary leverage were evident in other market participants. In the immediate aftermath of LTCM's near collapse, credit risk management practices vis-a-vis highly leveraged institutions were tightened. But market history indicates that even painful lessons recede from memory with time.

Therefore, the Working Group recommends the following measures:

- More frequent and meaningful information on hedge funds should be made public.
- Public companies, including financial institutions, should publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds.
- Financial institutions should enhance their practices for counterparty risk management.
- Regulators should encourage improvements in the risk-management systems of regulated entities.
- Regulators should promote the development of more risk-sensitive but prudent approaches to capital adequacy.
- Regulators need expanded risk assessment authority for the unregulated affiliates of broker-dealers and futures commission merchants.
- The Congress should enact the provisions proposed by the President's Working Group to support financial contract netting.
- Regulators should consider stronger incentives to encourage offshore financial centers to comply with international standards.

The Working Group will be monitoring and assessing the effectiveness of the measures outlined above. If further evidence emerges that indirect regulation of currently unregulated market participants is not effective in constraining excessive leverage, there are several matters that could be given further consideration; however, the Working Group is not recommending any of them at this time.

Concerns have been expressed about the activities of highly leveraged institutions with respect to their impact on market dynamics generally and vulnerable economies in particular. Such activity can affect markets in some circumstances and for limited periods although, as a number of independent

studies that have been undertaken so far have suggested, the activities of highly leveraged institutions do not appear to have played a significant role in precipitating the financial market crises of the past few years. Further study of this issue will be undertaken by the Financial Stability Forum, recently established by the G-7.

This report includes a Background section that provides a description of hedge funds, their activities and their counterparties, and also describes the events surrounding the near collapse of LTCM. The second section, on Public Policy Issues, discusses a number of questions raised by LTCM. In the Conclusions and Recommendations section we fully discuss the recommendations summarized above. This report also includes a number of appendices that address some key topics in more detail.»³⁴⁷

The PWG report was signed by Robert Rubin of the Treasury, Alan Greenspan of the Fed, Arthur Levitt of the SEC, and Brooksley Born of the CFTC.

Some observations:

1. Remarkable is the almost exclusive attention to leverage. Without this being translated in credible specific proposals à la Basel (or proposals to strengthen Basel). PWG does make a recommendation in the direction of Basel, but its relation with the problems at hand is not clear:
«The Basle Committee on Banking Supervision should proceed to revise the Capital Accord in order to align capital requirements more closely with the actual risks taken by financial institutions. These efforts include greater differentiation among claims (or instruments or counterparties) based on credit quality.»³⁴⁸
2. The vagueness of the recommendations is somewhat reduced by the full text. Still, they seem to address at most part of the problems/ risks. The full text moreover systematically relies on wishful thinking: it frequently assumes that certain supposedly small risks with major consequences can safely be ignored.
3. Almost all measures are both elastic (= may mean nothing) and require subjective interpretation and voluntary compliance.
4. The “measures” ignore the fact that reliable risk management requires full and reliable information (and common boundary conditions). Because of the noncommittal character of the relevant “measures” the system may remain just as opaque (and unsafe) as it is.
5. The last paragraph but one is obviously wrong. It is disproved by both the LTCM crisis and the subprime crisis. It is also illogical. It is saying that one domino does not affect the other ones (or only for a limited period...). Nothing has been heard about the “further study” by the Financial Stability Forum.³⁴⁹
6. The proposals of the PWG could nevertheless mean appreciable improvements if implemented appropriately. The vagueness and elasticity of the text required close monitoring however. Nobody seems to have done that. For outsiders (market participants/ discipline!) it was and is a problem that neither PWG nor individual supervisors report clearly about developments and implementation. Of course, parliaments are responsible and should require adequate reporting, but until at least 2020 they don’t. As a consequence the supervisors don’t feel any pressure.
7. The unambiguous all-out repressive action against Brooksley Born beginning in May 1998 shows that any benefits of doubt as to the PWG-majority’s intentions that survived analysis of its report are misplaced.
8. The annual reports of the supervisors are silent about the promised monitoring. In this connection the reader is reminded of the fact that those of the Fed are 100% silent about systemic risk. (Those of the others too, but this is less amazing since they had no explicit duty in that respect).

³⁴⁷ Unambiguous page numbers cannot be given because the text could only be obtained as a webpage. However, the quotes are sufficiently long to find them easily in the original context.

³⁴⁸ Quoted from the FCIC report, p. 47/75.

³⁴⁹ Headed from 1999-2003 by Andrew Crockett of BIS, from 2003-2006 by Roger Ferguson of the Fed, and from 2006-2011 by Mario Draghi of the Italian central bank).

10. Timothy Franz Geithner.

Table of contents of this appendix.

- Summary and conclusions.
- Miscellaneous notes.
- Curriculum vitae.
- 28/2/06: speech at the 7th Annual Risk Management Convention & Exhibition of the GARP.
- 6/5/10: Geithner is heard by the FCIC.

Summary and conclusions.

1. Geithner studied economics;
2. In a vital period for the financial system he occupied vital positions. From 1998-2001 he was undersecretary of the Treasury for international affairs under secretaries Rubin and Summers. As from 2003 he was head of the NY Fed;³⁵⁰
3. His speeches have the semblance of being those of an expert;
4. His speech of 28/2/06 shows a fatal lack of understanding of risk management, and an attitude of passivity which is incompatible with his duty;
5. For example as regards supervision there is a fundamental difference between his stories of before and after the crash;
6. His answers to questions of the FCIC include lies and nonsense;
7. Flatters his questioners (“An excellent question”);
8. Before the crash he was a member of the self regulation choir of Greenspan, Summers a.o.;
9. He did nothing that might have conflicted with his master’s wishes, especially not when these wishes hurt the general welfare;
10. He does not admit errors;
11. One cannot know the value of his utterances, whether or not he is cheating you. (See in this connection especially the question of Thomas quoted at the end of this appendix).
12. Therefore and because his misconduct has caused great harm, he should be prohibited to work in public administration, and to publish³⁵¹. He should be paid no more than the legal minimum income. His fortune should be transferred to the Treasury, as partial compensation for harm caused.

The suspicion that he was a protégée of Rubin of Summers³⁵² should have been reason to disqualify him for any function in public administration, in particular for a function is supervision.

Miscellaneous notes.

The annual report of the New York Fed is a financial annual report. It does not report about activities, policies, realization of goals, and plans.

CV.

- 18/8/61 Born in Brooklyn (NY).
1985 M A international economics and East Asian studies from Johns Hopkins University's School of Advanced International Studies,
1985-1988 Kissinger Associates.
1988-1995 Job in the federal government.

³⁵⁰ Of course, regulation had important international aspects. It affected for example stability and the boundary conditions for international competition.

³⁵¹ Including publishing through others, such as journalists. He should therefore not be interviewed.

³⁵² Wiki-page Geithner, 10/12/12.

1995-6 Deputy assistant secretary for international monetary and financial policy.
1996-7 Senior deputy assistant secretary for international affairs.
1997-8 Assistant secretary for international affairs.
1998-2001 Under Secretary of the Treasury for International Affairs under Treasury Secretaries Robert Rubin and Lawrence Summers.
2002 Senior Fellow in the International Economics department of the Council on Foreign Relations.
2001-3 Director of the Policy Development and Review Department of the IMF.
17/11/03-26/1/09 President of the New York Fed.³⁵³
26/1/09- Secretary of the Treasury. Appointed by president Obama.

Geithner has evaded taxes in various ways.³⁵⁴

According to the Wikipedia, Paulson has described Geithner as a "very unusually talented young man [... who] understands government and understands markets". The facts show that Geithner doesn't. It follows that Paulson does neither. This is confirmed by the facts. The remark of Paulson may mean no more than that Paulson and Geithner belong to the same clan, and push one another whenever helpful to further personal interests.

28/2/06.

Geithner's speech at the 7th Annual Risk Management Convention & Exhibition of the GARP.

The following is the heading of the document with the text of the speech:

«**Risk management challenges in the US financial system.** Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Global Association of Risk Professionals (GARP) 7th Annual Risk Management Convention & Exhibition, New York City, 28 February 2006.»³⁵⁵

Given the practices of large hierarchical organizations it must be assumed that Geithner did not write the speech himself. He is responsible anyway.

The speech paints the growth of the financial sector, of the unregulated part of the sector, of the volume of new products, and of (systemic) risks. The qualitative analysis is quite adequate. However, Geithner does not try to estimate the size of the risks (like all supervisors), and does not seem to be aware of the risk of a crash and of crash scenarios. He notes that as a rule the adjustment of risk management is behind the developments which make adjustment necessary. He seems to think that this is only a problem for the sector, in agreement with the dogma of self regulation. Supervisors only have to cooperate better, with one another, and with the sector.

The second paragraph of the speech, and the first sentence of the second, are:

«These developments provide substantial benefits to the financial system. Financial institutions are able to measure and manage risk much more effectively. Risks are spread more widely, across a more diverse group of financial intermediaries, within and across countries.

These changes have contributed to a substantial improvement in the financial strength of the core financial intermediaries and in the overall flexibility and resilience of the financial system in the United States.»

But: «there are aspects of the latest changes in financial innovation that could increase systemic risk in some circumstances, by amplifying rather than dampening the movement in asset prices, the reduction in market liquidity and the associated damage to financial institutions.» (2nd sentence of the

³⁵³ The president of the New York Fed is nominated by its Board of Directors, and appointed (approved) by the Board of Governors of the Federal Reserve System.

³⁵⁴ Wiki-page Geithner.

³⁵⁵ In BIS review 14/2006. The pdf-file in the dossier is dated 20060228.

5th paragraph).

He notes that innovations generally precede adjustments of regulation. There is a “gap”:

«Market discipline exercised by counterparties should create incentives to close these gaps relatively quickly, but competition among financial intermediaries can, at least for some period of time, create offsetting incentives and may make individual institutions less willing to move ahead of the pace of improvement of average practice among market participants. This can take the form of what economists call a collective action problem, leaving individual institutions and the systems as a whole with more risk than would be desirable.»

The collective action problem can be solved by supervision and government. But Geithner doesn’t say so. Worse, he seems not to have said it in Fed conferences either.

In a number of points, Geithner next presents some highlights meant to give an impression of the enormous volume of new financial products, the large uncertainties and the (very) large risks:

«What can be done to mitigate these risks? The two general areas that offer the highest potential return in reducing systemic risk are improvements

- (1) in the sophistication of the risk management process used to generate adequate capital and liquidity cushions against a severe economic or market disruption and
- (2) in the post trade processing and settlement infrastructure [for OTC].»

No mention is made of further analysis by the (NY) Fed. Changes, or proposals for changes, in laws or regulation are not mentioned. Neither at a later time, when Geithner discusses the role of supervision. While it is clear that realization of risks will also hurt outsiders.

Will the (NY) Fed make sure that “adequate cushions” are created? Why doesn’t Geithner say so?

By (1) Geithner means:

«The frontier of challenges in the risk management process lies principally in the discipline of stress testing and scenario analysis to capture potential losses in adverse conditions in the "tail" of the distribution. This has been and will continue to be a principal focus of our supervisory efforts.»

Given the scenario’s sketched years ago by the GAO and more recently by OFHEO and CGFS, this is quite remarkable. It is furthermore important to note that reliable stress-testing requires thorough understanding of the system, and that stress-testing institutions does not necessarily include stress-testing the system (the assembly of cooperating financial institutions).

Then Geithner enumerates some conditions for “best practices”. At first sight, these seem to be all right. But what is wrong is that they should not be best practice, but requirements. And the NY Fed and others should verify compliance.

Subsequently Geithner sketches some developments regarding his point (2).

Geithner wants to conclude with «a few observations about the role of supervision in encouraging progress in both these areas of risk management and the infrastructure for these markets.»

He observes that we live in a financial system in which «the differences between the activities of bank-centered financial institutions and nonbanks has substantially diminished,³⁵⁶ and in which the largest banks and investment banks in the world compete together in the U.S. market and in other major markets.

These changes have many positive implications but they also mean that differences in the incentives faced by institutions with different supervisory and regulatory regimes can have larger competitive effects, and the effects of regulatory arbitrage can reduce the impact of changes applied

³⁵⁶ This assertion is hard to reconcile with Geithner’s answer to a question by Wallison in the FCIC hearing: «In the hearings that we have held so far, it seems fairly clear that it did not really matter whether you were a regulated bank, or you were a less regulated investment bank, in terms of what happened to that institution in the financial crisis. Would you agree with that?

WITNESS GEITHNER: No, I wouldn’t agree with that. I would say that in a- let’s think of it this way. [blabla]»

only to regulated or supervised institutions.³⁵⁷ They suggest that adverse developments outside the banking system, such as the failure of a major nonbank financial intermediary, can potentially cause greater damage to the core of the financial system than might have been the case in the past. They mean that in thinking about ways to mitigate systemic risk it is not tenable to focus simply on bank-centered financial institutions, and it is not feasible to achieve change through national approaches applied only to the institutions of the home country.»

Geithner next pleads for more cooperation between the sector and supervision. He mentions the CRMPG recommendations, and implicitly accepts them. (But he says nothing about implementation, or the supervision thereof).

He also pleads for more cooperation between supervisors. In particular with respect to stress testing and scenario analysis in the largest institutions.

The concluding paragraph of the speech reads as follows:

«The evidence to date suggests that dramatic growth in new instruments for risk transfer and the greater role of nonbank financial institutions have contributed to a more stable and more efficient financial system. But these changes present continuing challenges for the discipline of risk management. And these challenges are likely to continue to require a substantial level of investment by financial institutions to improve the sophistication of the risk management process and the operational infrastructure that supports these markets.»

“The evidence to date” simply does not justify a conclusion like “have contributed to a more stable and more efficient financial system”. When formal proof cannot be given, only time can tell whether a system is stable. By now of course time has told us that the system was not stable at all. It was very unstable. In agreement with what one could have inferred theoretically, and had indeed been inferred years ago by the GAO and OFHEO. Geithner nowhere explains how the stability of the system can be established or measured.³⁵⁸ In the eyes of the present author he seems to be talking illogical nonsense. Because the sentences about risk management suggest that the system has not become more stable, but rather more unstable (as indeed was the case).

It is all extremely vague, unspecified. The (new) risks are not specified, and neither is the risk management. It sounds nice, but what does it mean? What is good risk management? Earlier in the speech he said the following about risk management:

«However, we still face considerable uncertainty about how market liquidity will behave in the context of a major deterioration in credit conditions or a sharp increase in volatility in equity and credit spreads, and this uncertainty is hard to quantify and therefore hard to integrate into the risk management process.»

Is this true? (No, at least not if risk management requires exclusion of the possibility of bankruptcy). Geithner gives no solid arguments, let alone proof. If true, doesn't it mean that the concluding sentence (“And these challenges... markets”) is meaningless, because the risk management is bound to be leaky?

Don't forget the player of Russian roulette. As long as he lives he can say “The evidence to date suggests bla bla”.

Inside job presents evidence suggesting that the assertion that new products caused “a more stable and more efficient financial system” is no more than an invention of the Wall Street lobby, and therefore need not be based on any empirical observations or formal proof. The present author has never seen a specification of the assertion (what does it mean: more stable?) or source.

The end of *Inside job* suggests a financial-political complex. Like the military-industrial complex known from the cold war. Like Bush and others before him, Obama is seen to have surrounded himself with a group of deregulation champions. It also follows that the “CHANGE” on a rostrum of Obama is a lie, and can only have been meant to mislead voters.

³⁵⁷ Regulatory arbitrage is the (re)organization of activities so as to minimize undesired effects of regulation.

³⁵⁸ The stress tests prove nothing. (Unless one somehow manages to prove that their assumptions represent all (!) the worst possible cases). In the light of the GAO, OFHEO and CGFS reports the stress tests are quite superfluous and ridiculous.

Why by the way can't a published speech give references to proofs?

6/5/10.

Geithner heard as a witness by the FCIC.

In his introduction Geithner asserts:

«And over time, a large parallel banking system took root outside of the regulatory framework established for banks. In this parallel system, a diverse group of financial institutions were allowed to engage in the business of banking, providing financial services to individuals and companies without being regulated as banks. [...] And much of that system used substantial leverage with relatively thin cushions against the possibility of loss. This parallel financial system, operating with much weaker protections, proved exceptionally vulnerable to a loss of confidence.»³⁵⁹

Which is the opposite of what he said on 28/2/06:

«The evidence to date suggests that dramatic growth in new instruments for risk transfer and the greater role of nonbank financial institutions have contributed to a more stable and more efficient financial system.»

Geithner tells two lies about partial causes of the crisis: the splintered organization of supervision, and the lack of responsibility for systemic risk:

«But part of the cause lies in our balkanized, fragmented regulatory system designed in a different era that lagged far behind changes in the financial markets. [...] And more broadly, and this is critical, no regulator or supervisor had the core mission of looking across the financial system and taking action to prevent the diversion of activity away from the protections regulations were designed to provide.»

He neglects to mention that in the section “Financial Regulatory Structure” of its LTCM report of 1999, the GAO had explicitly and clearly explained the need to overhaul of the US supervisory system, and that this was fully 100% ignored by the financial supervisors.

He does not note that nobody in supervision and government (outside GAO and OFHEO) drew attention to any serious problem or risk. That instead they tranquilized the world with unjustified reassuring chatter. Giving especially the financial world the wrong signal.

Geithner fails to answer the following question of the chairman:

«CHAIRMAN ANGELIDES: [...] I do want to talk to you in your role as President of the Federal Reserve Board of New York, recognizing that you had direct supervisorial responsibilities over bank holding companies, but beyond that in many respects you were the eyes and ears of the Federal Reserve on Wall Street. You were in constant contact with primary dealers. You had a board that did have linkages to the financial community. And that you had played a special role in monitoring systemic risk, and in fact had undertaken some efforts with respect to cleaning up the backlog in trade confirmations in the OTC derivatives market. So one of the things I noted in preparing over the last month for our look at the shadow banking system is that in the period of 2004, 2005, 2006 you actually made a number of speeches about risks that were extant on derivatives, and contagion, shadow banking- I will note you made two different speeches on the same day, May 19th, it must have been a busy day, talking about risk, about concentration of risk posed by CDOs and credit derivatives; and about leverage in the system. And it seems to me you were in a place where you had an extraordinary access to information, not just market data, but what primary dealers were telling you, info on the repo markets. So this is a pretty fundamental question that I have, particularly as we look forward trying to assess the impact. What didn't you know? And this doesn't need to be just ad hominem, but what did you and other key policy makers not know and not have before you to understand the magnitude of what might hit us?»

³⁵⁹ Both system and parts are fatally sensitive to reduction of trust. This could have been known and understood already more than a century ago. Certainly by governments and supervisors. It was demonstrated for the n-th time by the LTCM-crisis. The GARP-speech refused to acknowledge it.

WITNESS GEITHNER: [...] So I think the simplest way to answer your question about what did we not know, what we did not know was the degree to which the system was reliant on ratings, ratings that did not capture what falling house prices would do to losses across the system. We did not know the extent to which this parallel financial system had built up leverage and exposure to liquidity risk in a level that would, when it came crashing down, would threaten the stability of the rest of the system. We did not know how vulnerable money markets were to runs, how unstable that basic funding structure was.»

Even if this lack of information existed, then it should already have been understood as a big risk many years ago (at least since LTCM). In the past decade, Geithner and the other supervisors only gave assurances, suggesting that they knew what had to be known.

Most probably Geithner knows that he is telling lies. He gives a political answer: only refutable by someone well-informed, and willing to call Geithner a liar.

Geithner's answers suggest that he thinks to understand everything. He never says that he doesn't know or understand. But much of what he says is incorrect or incompatible with his conduct (his passivity) and his speeches before the crisis. One thing is absolutely 100% certain, and that is that he failed completely.

Holtz-Eakin asks why the PWG did not consider systemic risk:

«**COMMISSIONER HOLTZ-EAKIN:** [...] But to what extent did we not already have a President's Working Group on Financial Markets that had the capacity to do exactly what you're suggesting: sit down, look at risks, and we got a financial crisis anyway?

WITNESS GEITHNER: An excellent question, I agree, and I think that that body did not provide this important function. And you're also right to say that it's just establishing in statute that it's now a Council with a more formal mandate won't necessarily make sure that people use that with that effect. But I think it is an important difference in the sense that the way the reforms are designed now, there really is an explicit mandate with the ability to in effect deter weakening of, let's say, prudential safety and soundness requirements, and to recommend they be higher. And the existing, much more informal structure that is the President's Working Group doesn't come with that mandate or that responsibility.»

Much more informal structure? That seems to be untrue. The PWG was established in 1988 by Executive Order 12631, with the goal “to enhance the integrity, efficiency, orderliness and competitiveness of the financial markets while maintaining investor confidence”, as quoted in section 7B5.5 of the chapter Analysis. Remember also the reactions of the supervisors about the draft LTCM report of the GAO. And even if true, it would not seem to be a valid excuse. What after all is the purpose of supervision?

The Fed moreover did have an explicit and unambiguous duty with respect to systemic risk. But did nothing about it.³⁶⁰

Geithner's argumentation is an excellent example wishful thinking which ignores, and is contradicted by, experience. The heads in the PWG would seem to have denied the risks on the basis of their self regulation dogma. This dogma made supervision and thinking about systemic risk unnecessary. The brilliant Geithner doesn't say anything of this kind, however.

As long as it has not become clear why the PWG did nothing while it could and should, as it implicitly acknowledges in the reactions to the GAO draft report just mentioned, there is no assurance of a better performance of any new or recommissioned body.

Geithner tries to deny that he joined the chorus, and tries to wriggle out of co-responsibility:

«**COMMISSIONER HOLTZ-EAKIN:** I want to go back now to your time as president of the New York Fed. During that period, the Board of Governors came to the conclusion that the risks in subprime housing could be contained, and indeed made a statement to that effect. Did you agree with that?

WITNESS GEITHNER: I never made that statement, was not part of making it-

COMMISSIONER HOLTZ-EAKIN: Did you agree with it?

WITNESS GEITHNER: - and I would not have said it that way. What I said, and I believe I tried to

³⁶⁰ See the FC Analysis.

say this, was that I think we faced growing risks across this financial system of exposure to a very dramatic crisis. And part of it of course was what was happening in real estate markets. It was not principally because of what was happening in subprime. It was a much broader phenomenon [...]»

This is obviously falsified by the 28/2/06 speech. Is there any proof of the claim that in 2006 or earlier he has said unambiguously and loudly that “we face growing risks across this financial system of exposure to a very dramatic crisis”? One would suppose that if this were the case, a man as brilliant as Geithner would have been able to hand the FCIC at least one Fed or NY Fed annual report confirming this.

In the sequel Geithner suggests that he could not see all of the risks because certain matters were not regulated. If true, he should have realized that this might substantially increase the risks for the regulated institutions and the system. He could and should have argued for regulation. Of course, the risks were already invisible during the GARP speech, which for that reason should not have claimed more stability. If your knowledge has important gaps, you cannot make claims about risks or stability.

«WITNESS GEITHNER: [...] I'm not an economist [...]»³⁶¹

He did study economics though.

During the questioning by Wallison, Geithner shows that he has insufficient understanding of the concepts of risk and instability. Several important questions are not answered adequately.

«COMMISSIONER WALLISON: [...] And I think the reason is that we're talking about an asset size larger than anything we've ever experienced before- about \$2 trillion in mortgage-backed securities, and related securities scattered throughout the financial world, and suddenly becoming almost, not worthless, but very difficult to sell except into the most distressful circumstances. So isn't that a problem? Rather than whether we had sufficient regulation?

WITNESS GEITHNER: No, I don't think so, because [...] almost every financial crisis sort of has real estate at the scene of the crime. It doesn't really matter how fancy the products are.»

Geithner doesn't answer the question.

Geithner knows very well what his audience expects from a responsible official:

«But the job of government is to make sure that you make those failures less damaging; that they don't cause so much collateral damage to the innocent, they don't have such catastrophic consequences for the economy»

Perhaps the ability to say what is socially desirable explains at least part of his fall upwards. But when part of public administration he did not do what he requires public administrators to do. Not by far.

Geithner did everything necessary, especially at the NY Fed:

«WITNESS GEITHNER: Sure. Let me just start by saying I had spent the previous 15 years in public service dealing with a series of incredibly damaging emerging market financial crises, and the financial crisis in Japan. So when I went to the New York Fed, I had been blessed or scarred by the experience of watching countries manage and mismanage the development of risk in systems, and how to clean up and contain the damage in the aftermath. And when I went to the New York Fed, early in that process beginning in 2004 we began a series of very important initiatives to try to contain, dial back, reduce the growing risk we saw in the system and improve the odds that if conditions changed, if we faced a shock, a recession, that the system was going to be stronger, in a stronger position to withstand that shock. [...]»

WITNESS GEITHNER: Well as I tried to explain, we did a lot of things, starting in 2004, which were designed to make the system more resilient and reduce the risk that, whatever happened, it would be less damaging. And as I said, I think those steps- I think they were- had the right objectives. They were very effective in many areas. Think, for example, of what happened to how little effect hedge

³⁶¹ The wikipage calls him “American economist and central banker”. See also his CV, given at the beginning of this appendix.

fund failures had on the system as a whole. A lot of examples of things that those results that were helpful for the system. But [it] absolutely did not do enough soon enough to make the system strong enough to withstand that.»

It is a pity that he does not explain why he did nothing with the OFHEO/GAO report about the GSEs and with the CGFS reports. And of course the earlier GAO reports. It is an even greater pity that his activities seem to have had no effect whatsoever on the course of events, or even on the functioning of the Fed.

A pity too that these claims are incompatible with the GARP speech.

Geithner wants to make the system “less fragile” and “less damaging”, but doesn’t mention liability.

Thomas makes a very cynical and very apt remark about new laws proposed by Geithner before the FCIC has completed its inquiry into the causes of the crisis:

«**VICE CHAIRMAN THOMAS: Mr. Secretary, we are going to be sending you a list of causes, those that had been mentioned and those that weren't, and we really appreciate you helping us. But probably more fundamental than that, as one of the major architects of the financial regulatory reform that's currently being examined by Congress, would you provide a 30-second, or a one-minute pep talk to the Commission as we're going forward attempting to find the causes of the financial crisis, while you and others have already decided what it was?»**

Of course, this confirms the unlimited arrogance of Geithner, and the hypothesis that the FCIC is mainly meant for window dressing, and prevention of better inquiries.

11. (Additional) Graphs.

The front cover of Annual Report 2001 of Fannie Mae.

THE AMERICAN DREAM DECADE

MEETING THE GROWING DEMAND FOR HOME OWNERSHIP

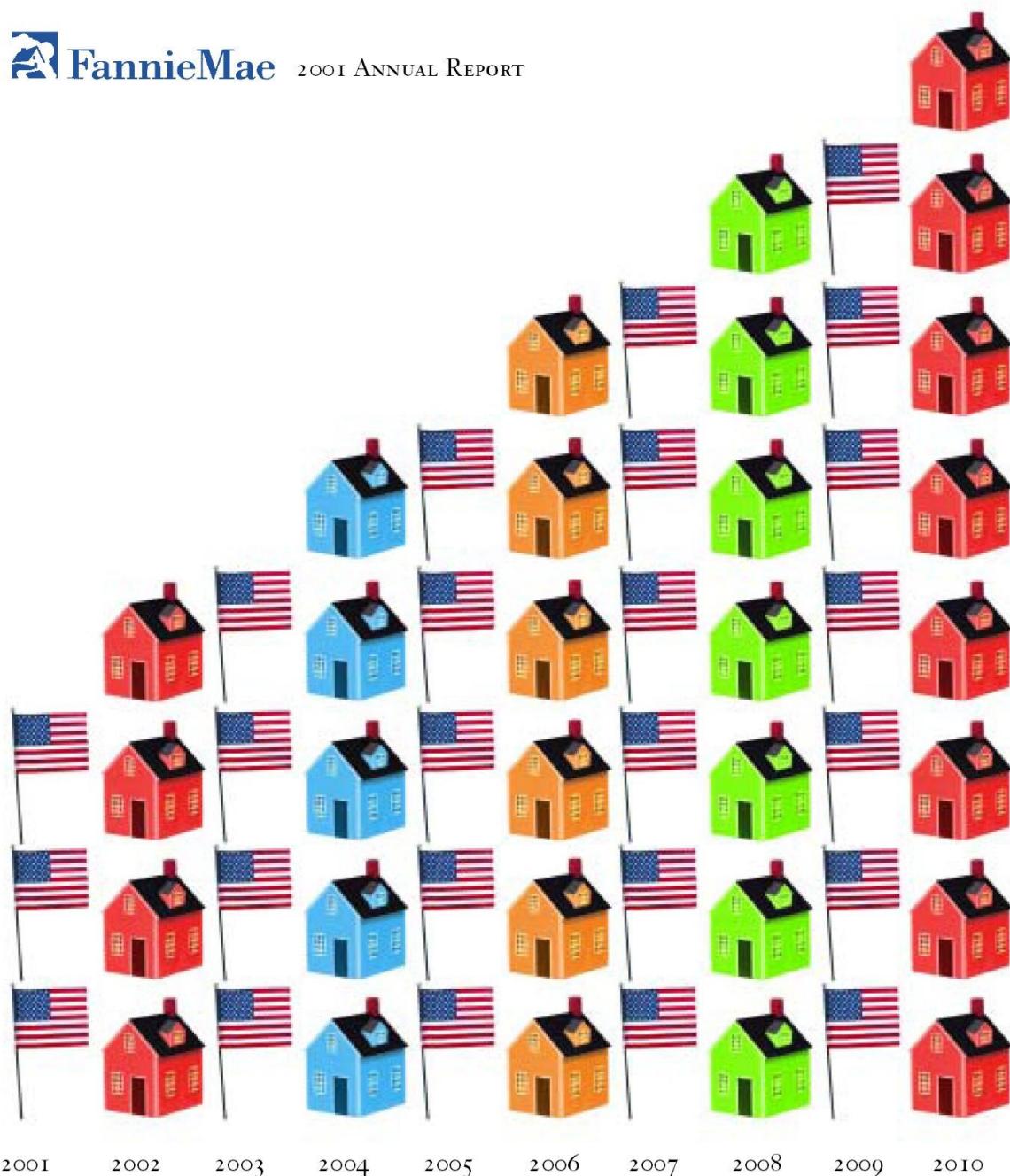
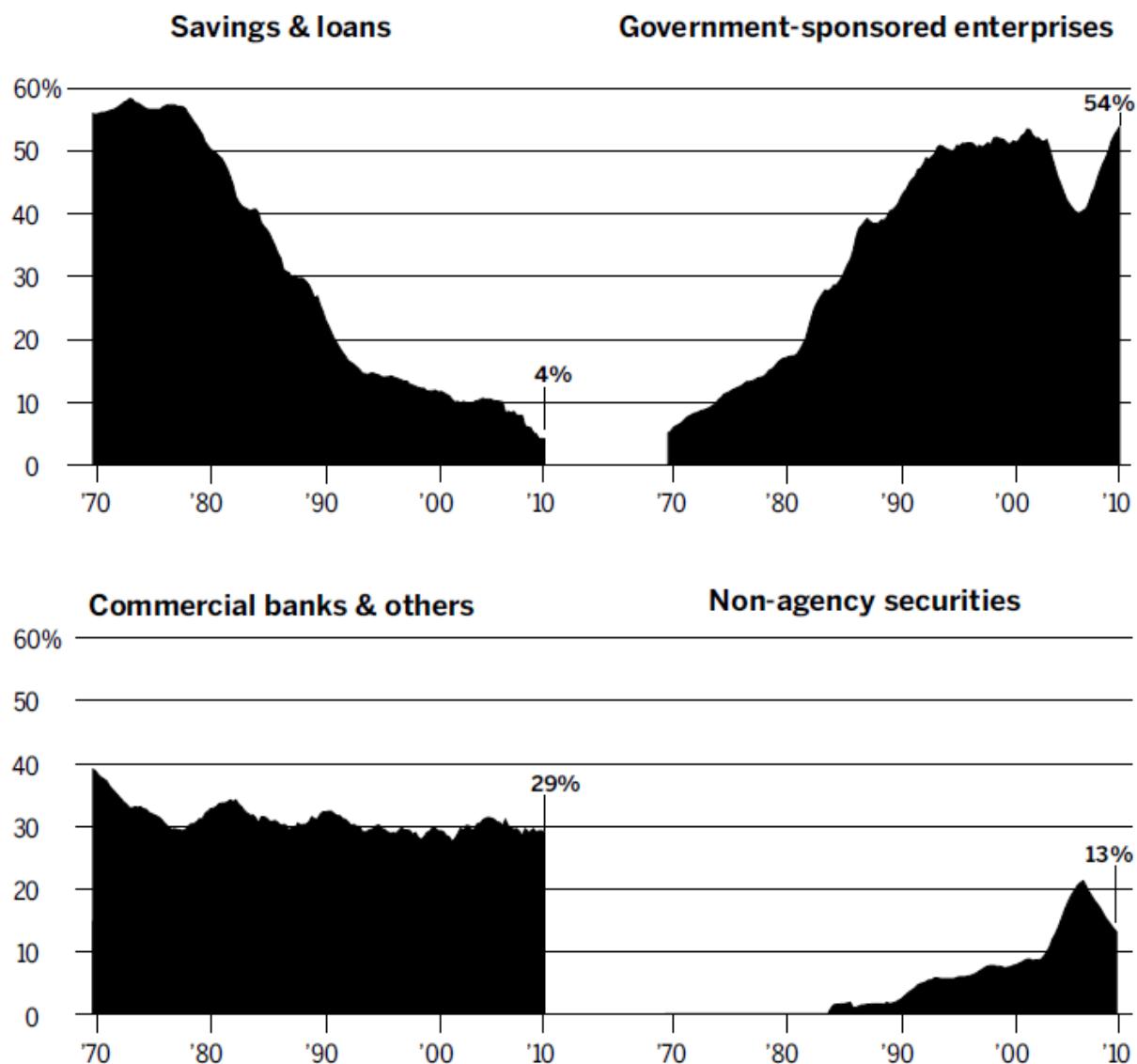


Fig 5.1 of the FCIC report, on p. 69/97.

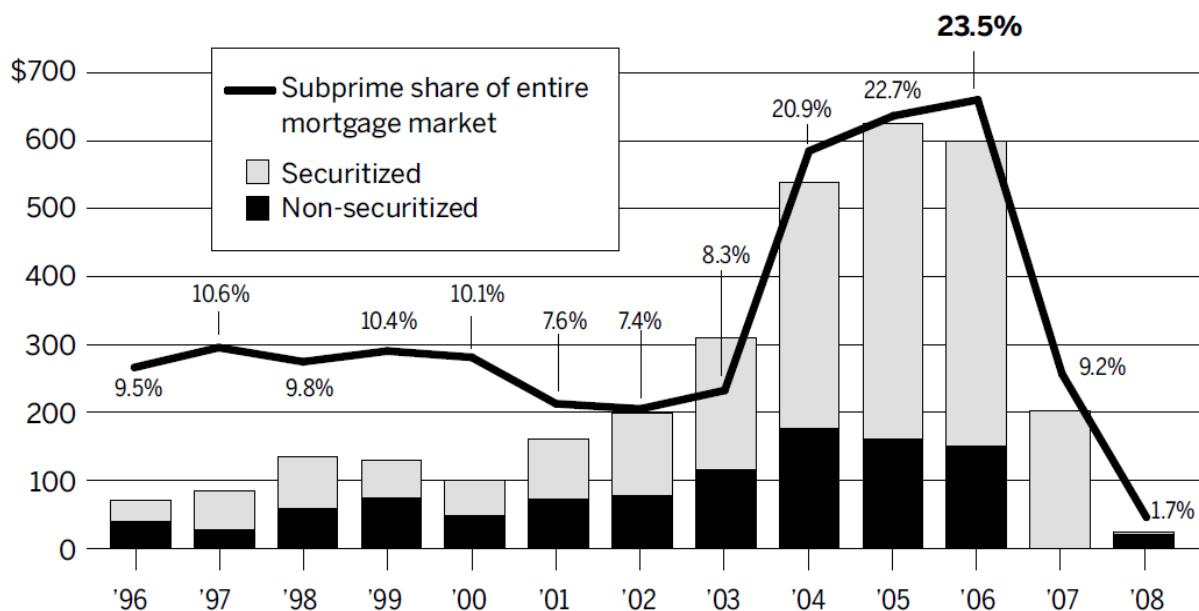
Funding for Mortgages, in percent by source.



SOURCE: Federal Reserve Flow of Funds Report.

Fig 5.2 of the FCIC report, on p. 70/98.

Subprime mortgage originations, in billions of dollars.

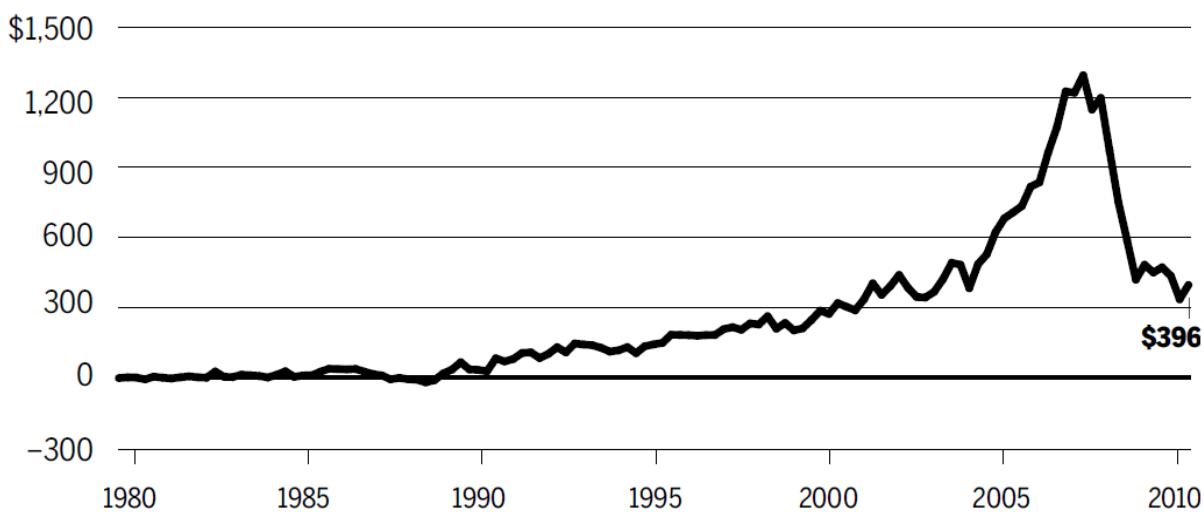


Note: Percent securitized is defined as subprime securities issued divided by originations in a given year. In 2007, securities issued exceeded originations.

SOURCE: Inside Mortgage Finance

Fig 7.1 of the FCIC report, on p. 115/143.

Repo Borrowing, in billions of dollars.

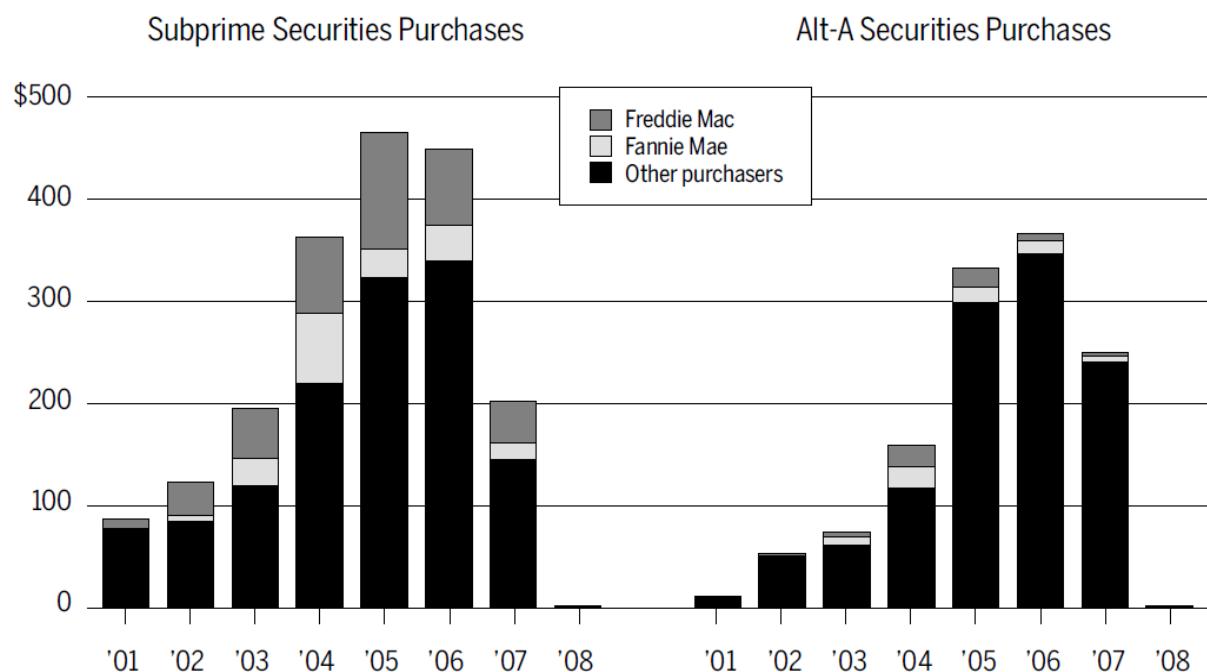


NOTE: Net borrowing by broker-dealers.

SOURCE: Federal Reserve Flow of Funds Report

Fig. 7.3 of the FCIC report, on p. 124/152.

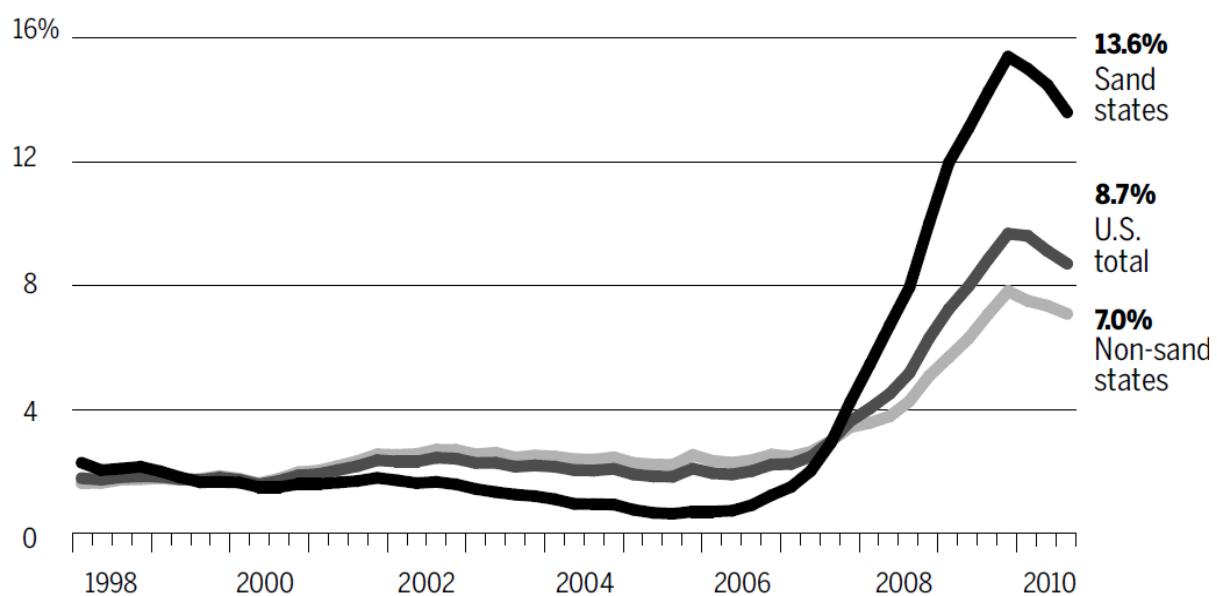
Buyers of Non-GSE Mortgage-Backed Securities. In billions of dollars.



SOURCES: Inside Mortgage Finance, Fannie Mae, Freddie Mac.

Fig. 11.1 of the FCIC report, on p. 216/244.

Mortgage Delinquencies by Region. In percent, by region.

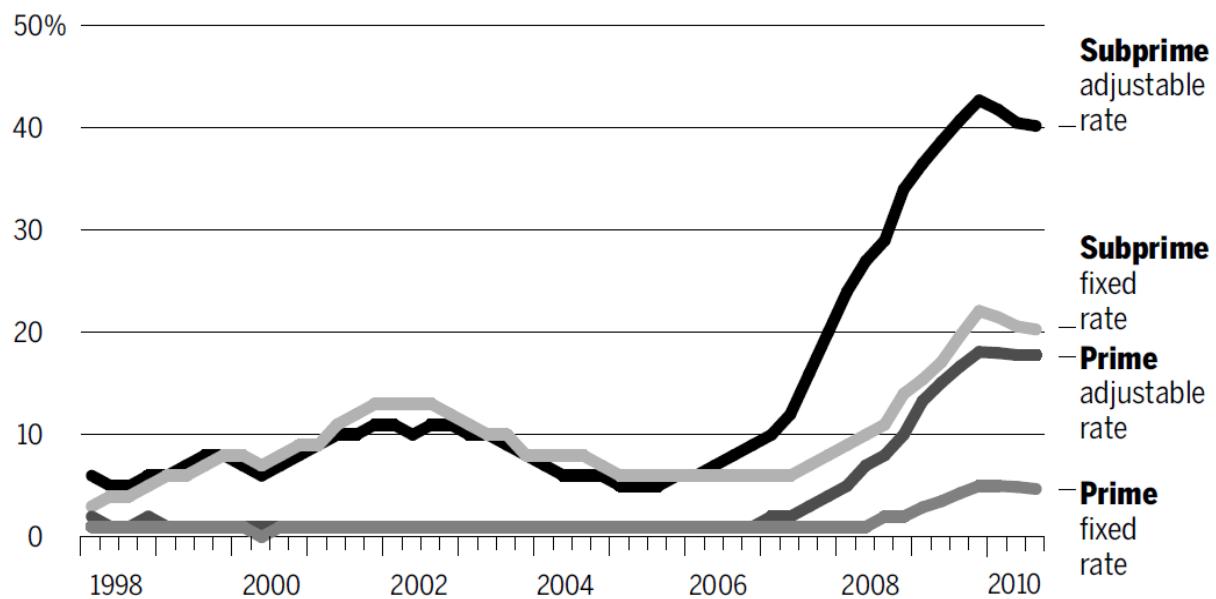


SOURCE: Mortgage Bankers Association National Delinquency Survey

NOTE: Serious delinquencies include mortgages 90 days or more past due and those in foreclosure.

Fig. 11.2 of the FCIC report, on p. 217/245.

Mortgage Delinquencies by loan type. In percent, by type.



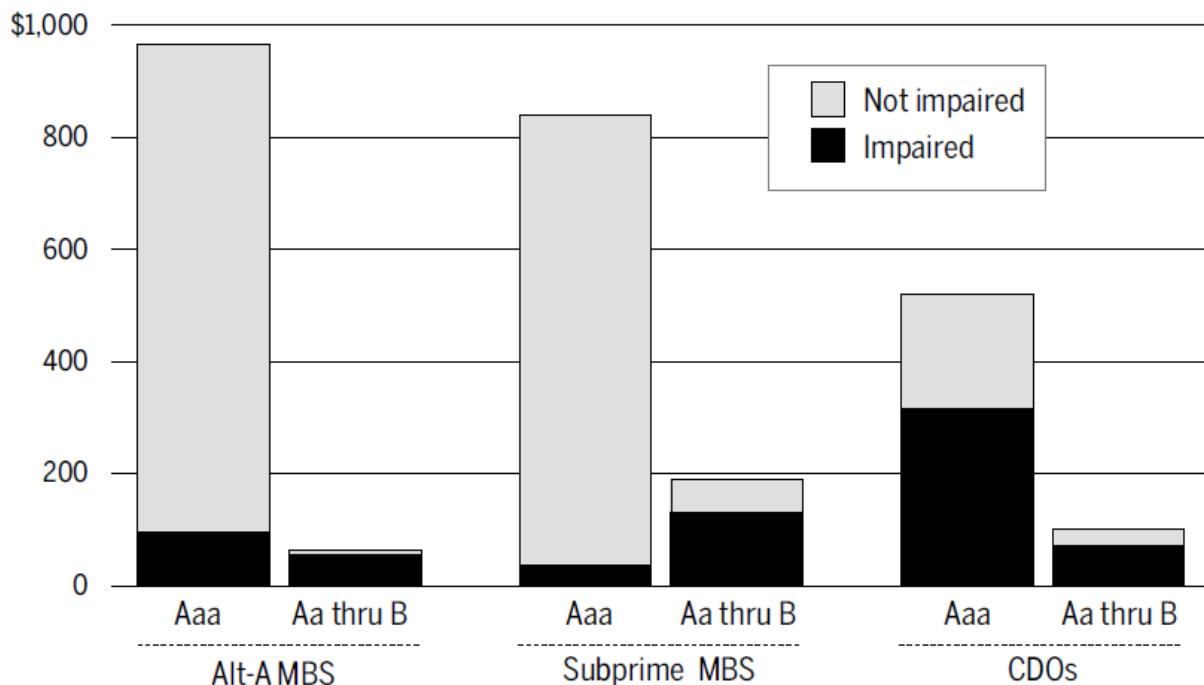
NOTE: Serious delinquencies include mortgages 90 days or more past due and those in foreclosure.

SOURCE: Mortgage Bankers Association National Delinquency Survey.

Fig. 11.4 of the FCIC report, on p. 229/257.

Impaired Securities. In billions of dollars.

Impairment of 2005-2007 vintage mortgage-backed securities (MBS) and CDOs as of year-end 2009, by initial rating. A security is impaired when it is downgraded to C or Ca, or when it suffers a principal loss.

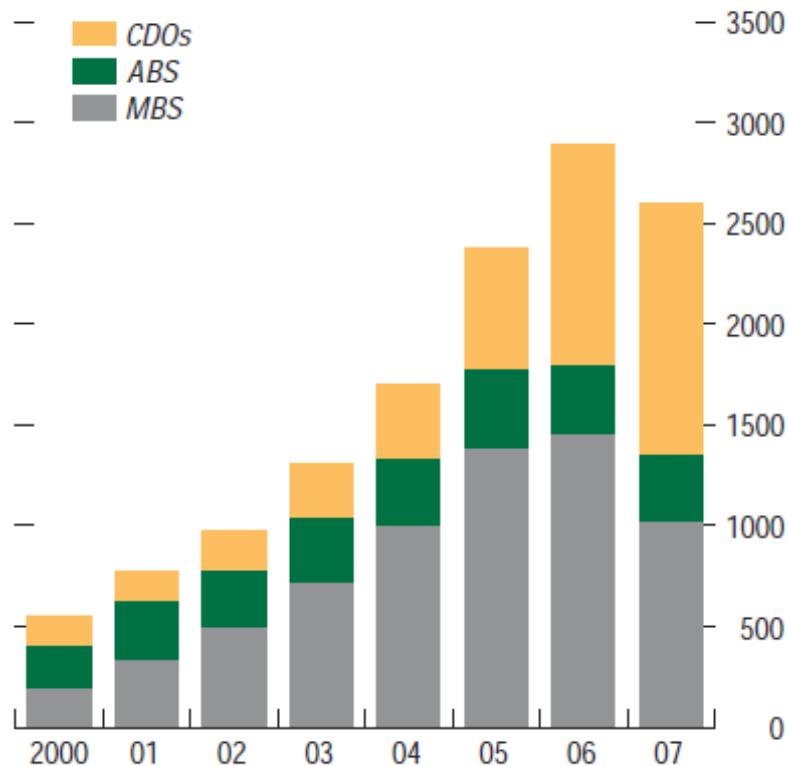


SOURCE: Moody's Investors Service, "Special Comment: Default & Loss Rates of Structured Finance Securities: 1993-2009"; Moody's SFDRS.

This figure shows the poisoning of securities, in particular of CDOs.

IMF GFSR April 2008, p. 56.

European and U.S. Structured Credit Issuance (in billions of U.S. dollars)

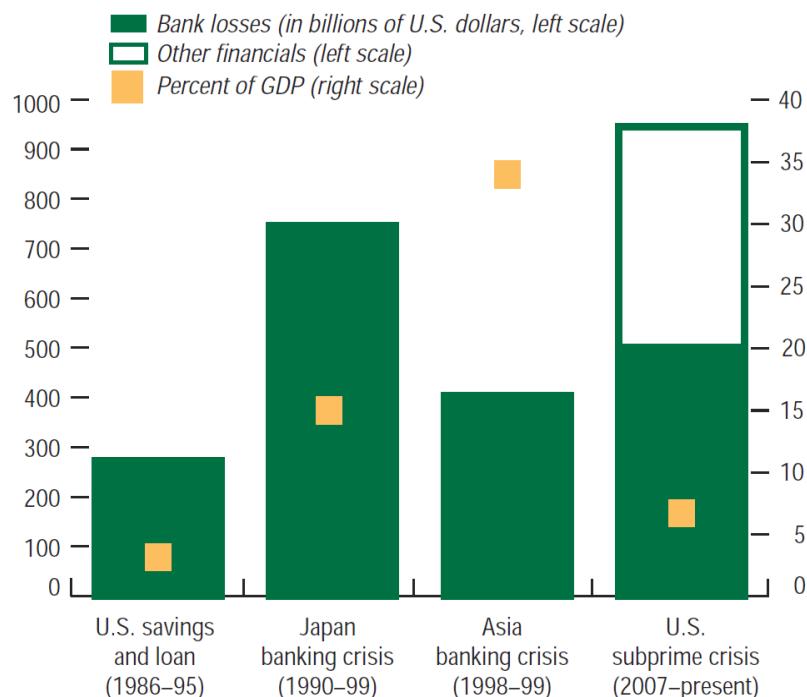


Sources: Inside MBS & ABS; JPMorgan Chase & Co.; and European Securitization Forum.

Note: CDOs = collateralized debt obligations; ABS = asset-backed securities, including auto, credit card, etc., and excluding MBS; and MBS = mortgage-backed securities, excluding U.S. agency MBS. (Underlining by JFCvV).

IMF GFSR April 2008, Figure 1.12, p. 13.

Comparison of Financial Crises

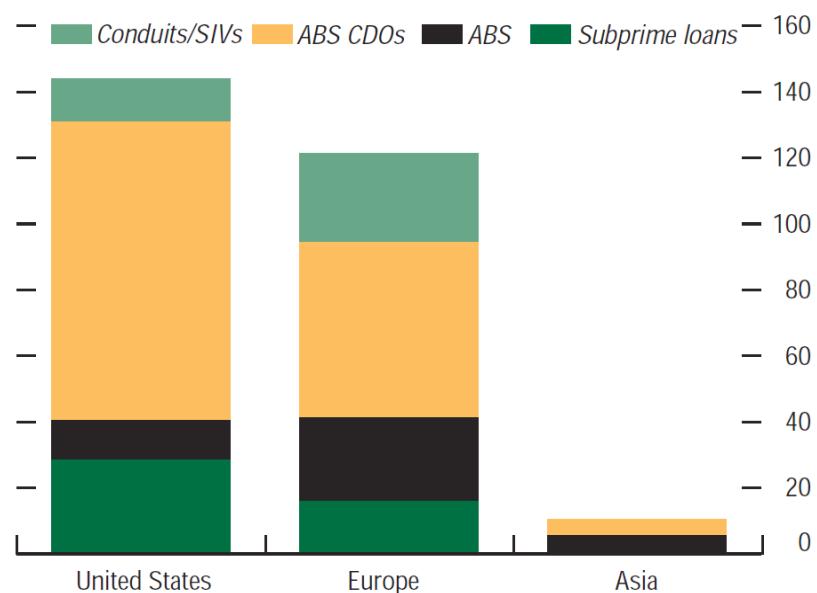


Sources: World Bank; and IMF staff estimates.

Note: U.S. subprime costs represent staff estimates of losses on banks and other financial institutions from Table 1.1. All costs are in real 2007 dollars. Asia includes Indonesia, Korea, the Philippines, and Thailand.

IMF GFSR April 2008, Figure 1.13, p. 13.

Expected Bank Losses as of March 2008 (In billions of U.S. dollars)

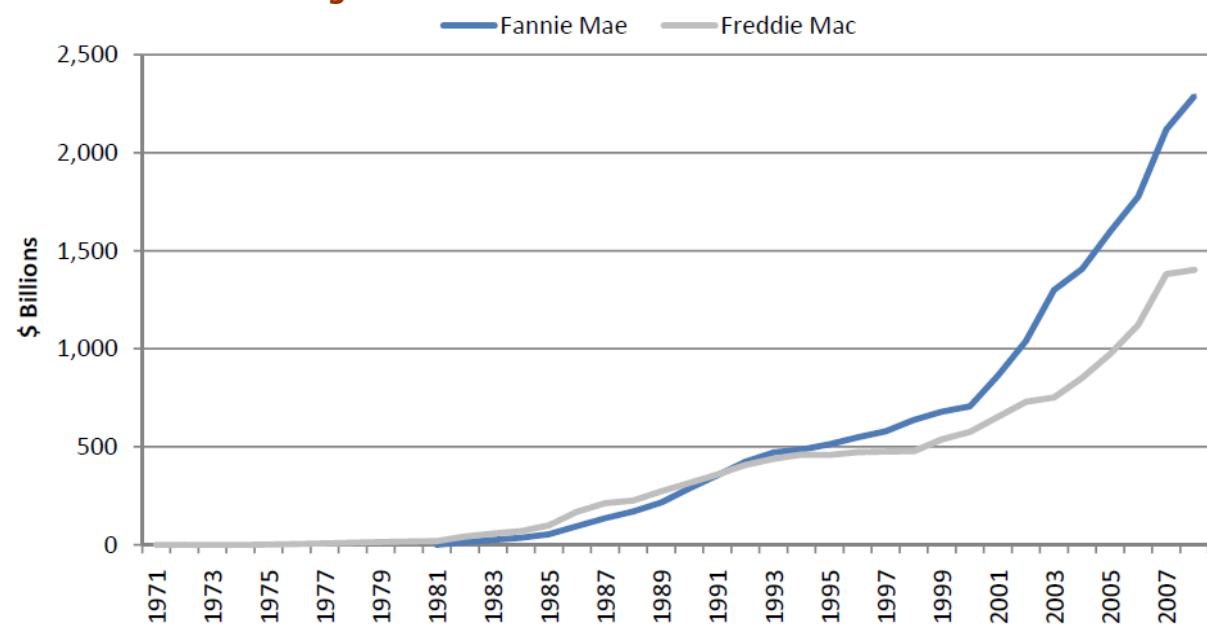


Sources: Goldman Sachs; UBS; and IMF staff estimates.

Note: ABS = asset-backed security; CDO = collateralized debt obligation; SIV = structured investment vehicle.

Preliminary FCIC staff report *GSEs and the financial crisis*, Figure 10, p. 14.

Total MBS outstanding.

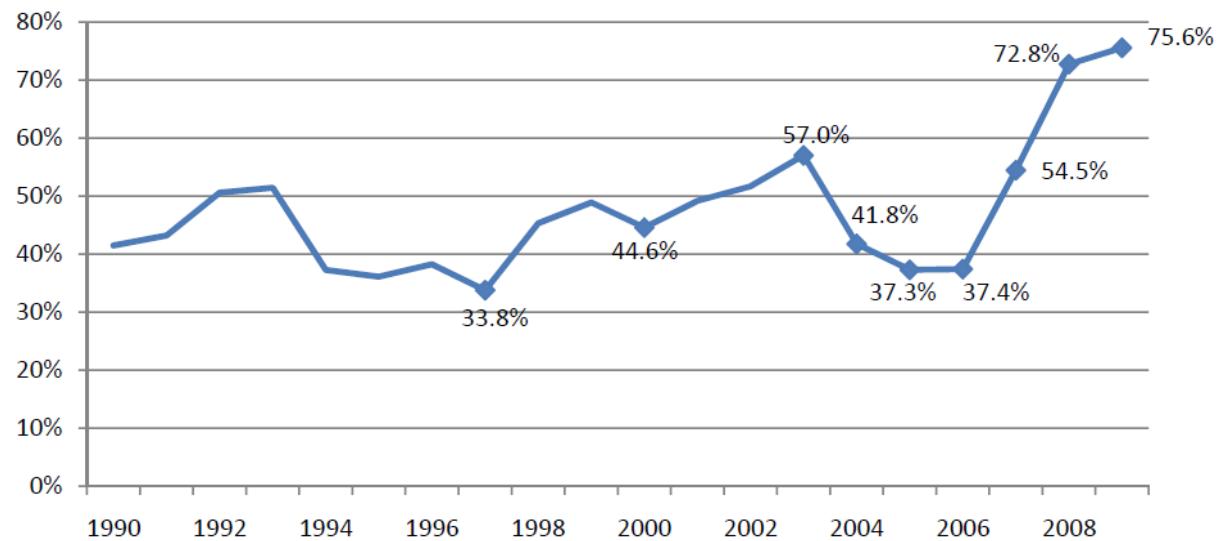


The figure «shows the growth of the two companies in terms of the total volume of guaranteed MBS that were held outside of the GSEs' own portfolio. These MBS are referred to as "MBS outstanding". The consent agreements with OFHEO did not cap the companies' MBS business.»

Source: Federal Housing Finance Agency.

Preliminary FCIC staff report *GSEs and the financial crisis*, Figure 11, p. 15.

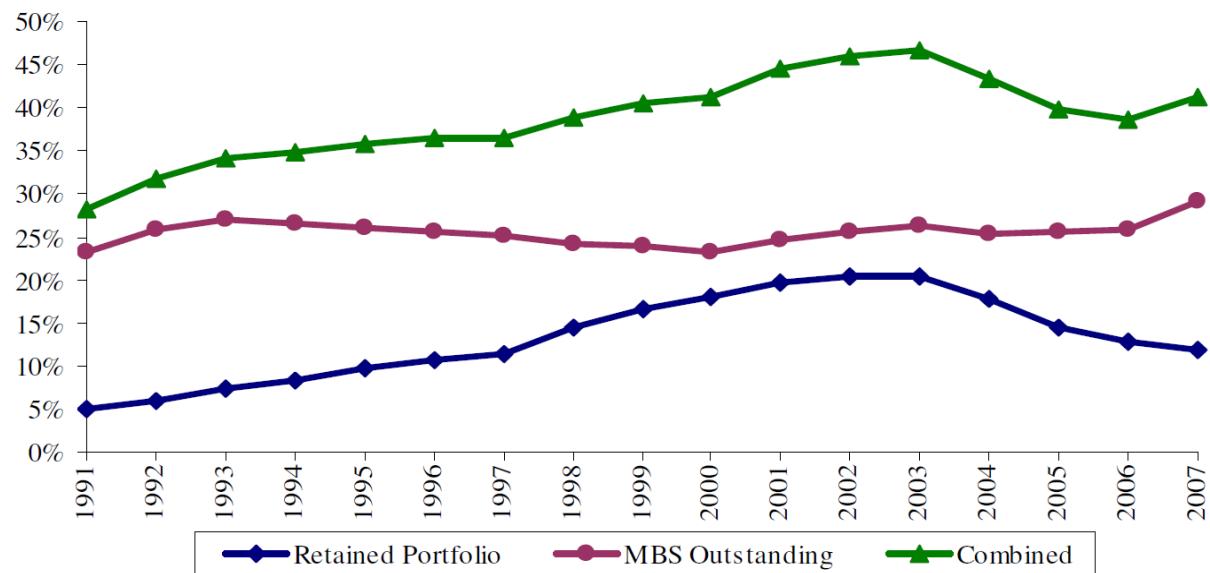
Fannie and Freddie Market Share of New Business Originations.



Source: Federal Housing Finance Agency.

FHFA: Mortgage Markets and the Enterprises in 2007,³⁶² Figure 33.³⁶³

Enterprise Share of Residential Mortgage Debt Outstanding.

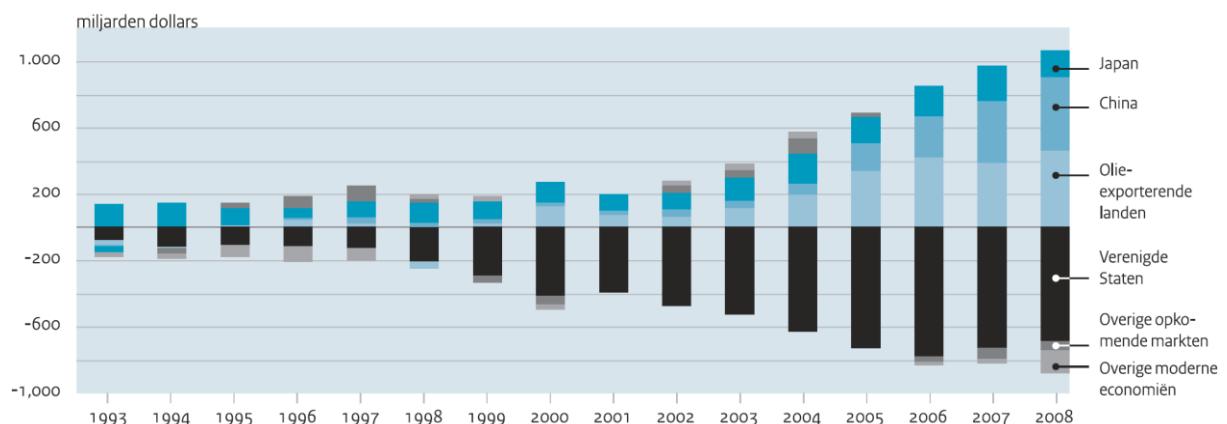


Source: Fannie Mae, Freddie Mac, Board of Governors of the Federal Reserve System.

First report of the parliamentary inquiry commissie De Wit (CDW), p. 37/33.

«Global, macro-economic lack of balance.

Growing surpluses and deficits in the current accounts of countries.»



Source: ITurner review, April 2009, p. 12. The left hand scale is billions of dollars.

N.B. At p. 42/38 the first report of the CDW has a graph of the debts of households as compared with GDP, but it pays no attention to government deficits and debts.

³⁶² Original publication July 2008, Revised February 2009.

³⁶³ The graph is consistent with Pinto's assertion at p. 49: «Whereas the GSEs started 1991 with 28.2% share of all outstanding mortgages, they ended 2003 with a 46.8%.» His source is a spreadsheet in the FHFA website.

12. Alan Greenspan.

This appendix concerns Greenspan. There is a separate appendix about the Fed.

Table of contents of this appendix.

- From the Wiki-page Greenspan.
- Congressional testimony on October 23, 2008.
- From the hearing of Greenspan by the FCIC on April 7, 2010
- From the FCIC-rapport (2011).
- By way of conclusion.

From the Wiki-page Greenspan.

(Repetitions and other redundant words have been dropped)

Alan Greenspan was born on 6/3/26 in New York City.

Education.

1943-1944 Studies clarinet at Juilliard School.

1945-1950 Economics at NY University (B.S. 1948 and M.A. 1950)

Goes to Columbia University to study advanced economics, but drops out.

1966. «U.S. economist Michael Hudson once fired Alan Greenspan, in 1966, 21 years before he became chairman of the U.S. Federal Reserve; "he was known as a hack that always gave ... his clients what they wanted instead of something actual".»

1977. Ph.D. in economics from NY University. «His dissertation is not available from the university since it was removed at Greenspan's request in 1987, when he became Chairman of the Federal Reserve Board. However, a single copy has been found, and the 'introduction includes a discussion of soaring housing prices and their effect on consumer spending; it even anticipates a bursting housing bubble'».

Career.

«During his economic studies at New York University, Greenspan worked under Eugene Banks, a managing director at the Wall Street investment bank Brown Brothers Harriman, working in the firm's equity research department.»

«1948 - 1953. Economic analyst at The National Industrial Conference Board, a business and industry oriented think-tank in New York City.»

«1955 - 1987. Chairman and president of Townsend-Greenspan & Co., Inc., an economic consulting firm in New York City, a 33-year stint interrupted only from 1974 to 1977 by his service as Chairman of the Council of Economic Advisers under President Gerald Ford.»

In this same period:

Mid 1968. Greenspan agreed to serve Richard Nixon as coordinator on domestic policy in the nomination campaign.

Greenspan served as a corporate director for Aluminum Company of America (Alcoa); Automatic Data Processing; Capital Cities/ABC, Inc.; General Foods; J.P. Morgan & Co.; Morgan Guaranty Trust Company; Mobil Corporation; and the Pittston Company.

He was a director of the Council on Foreign Relations foreign policy organization between 1982 and 1988.

He also served as a member of the influential Washington-based financial advisory body, the Group of Thirty, in 1984.

For some relevant information about Greenspan in the period before the Fed see Part 1 of the film *Inside Job*.

August 11, 1987 - January 31, 2006. Fed chairman. ((Re)appointed by the presidents Reagan, George H. W. Bush, Clinton en George W. Bush).

Greenspan meddled with political questions. Examples are social security and tax policy.³⁶⁴ Other examples are found in his speeches. He is seen to give opinions about virtually everything.

«Democratic leaders of Congress criticized him for politicizing his office because of his support for Social Security privatization and tax cuts that they felt would increase the deficit.»

The Wiki-page gives quotes from Greenspan-speeches which show his belief in the resilience of the financial system and uneasiness about the risks of derivatives.

Since 2006 Greenspan is involved in various forms of consultancy, especially through his “economic consulting firm, Greenspan Associates LLC”.

Congressional testimony on October 23, 2008.

«In Congressional testimony on October 23, 2008, Greenspan finally conceded error on regulation. *The New York Times* wrote, “a humbled Mr. Greenspan admitted that he had put too much faith in the self-correcting power of free markets and had failed to anticipate the self-destructive power of wanton mortgage lending. ... Mr. Greenspan refused to accept blame for the crisis but acknowledged that his belief in deregulation had been shaken.” Although many Republican lawmakers tried to blame the housing bubble on Fannie Mae and Freddie Mac, Greenspan placed far more blame on Wall Street for bundling subprime mortgages into securities. [...]»

Greenspan acknowledged that he was “partially” wrong in opposing regulation and stated “Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity—myself especially— are in a state of shocked disbelief.” Referring to his free-market ideology, Greenspan said: “I have found a flaw. I don't know how significant or permanent it is. But I have been very distressed by that fact.” Rep. Henry Waxman (D-CA) then pressed him to clarify his words. “In other words, you found that your view of the world, your ideology, was not right, it was not working,” Waxman said. “Absolutely, precisely,” Greenspan replied. “You know, that's precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well.”³⁶⁵ Greenspan admitted fault in opposing regulation of derivatives and acknowledged that financial institutions didn't protect shareholders and investments as well as he expected.»³⁶⁶

From the hearing of Greenspan by the FCIC on April 7, 2010.³⁶⁷

Remark. The Fed is not paid by taxes, and its budget does not need approval of Congress.

Greenspan explicitly blames AH policy, and the government:

«The search and demand for mortgage-backed securities was heavily driven by Fannie Mae and Freddie Mac, which were pressed by the Department of Housing and Urban Development and the Congress to expand affordable housing commitments»

³⁶⁴ For this subject too, the Wiki-page gives more opinions than facts.

³⁶⁵ The LTCM crisis shows that this is untrue. This crisis showed the absence and failure of self- and deregulation.

³⁶⁶ Wiki-page Alan Greenspan 23/11/12.

³⁶⁷ Transcript of session 1 of day 1 of the hearings about subprime lending, securitization & GSE's, held on Wednesday, April 7, 2010 9:00 A.M. Rayburn House Office Building, Washington, D.C.

«Alan Greenspan, the Fed chairman during the two decades leading up to the crash, told the Commission that it was beyond the ability of regulators to ever foresee such a sharp decline. “History tells us [regulators] cannot identify the timing of a crisis, or anticipate exactly where it will be located or how large the losses and spillovers will be.”»³⁶⁸

The quote of Greenspan does not justify the remark of the FCIC. The regulators could be aware of the risk of a crisis, and of the possibility that it would be catastrophic. They could see the risk of a decline in housing prices. This does not mean however that they could forecast the precise month or extent (which cannot even be described after the fact).

MR. GREENSPAN: «The search and demand for mortgage-backed securities was heavily driven by Fannie Mae and Freddie Mac, which were pressed by the Department of Housing and Urban Development and the Congress to expand affordable housing commitments.»

In the hearing, Greenspan claims to have warned, in 2002 and 2004 for example, of “GSE risks”. No warnings can be found in the Fed’s annual reports of these years.

An example of Greenspan’s bullshit:

«VICE CHAIRMAN THOMAS: Is it fair for me to indicate that the thrust of your testimony was that the crisis to a very great extent was caused by the demand for subprime securities; is that a fair - MR. GREENSPAN: Well, the fundamental cause of the crisis goes back to the end of the Cold War, which is pretty obscure, but it's a global crisis. You cannot think of the United States crisis in any form without looking at the global context.»

Greenspan supported AH-policy:

«MR. GREENSPAN: Well, Mr. Wallison, as I mentioned in my prepared remarks, government policy, as such, was very strongly related to the issue of enhancing home ownership for lower and middle income groups. The way I put it, when Honda was a major issue, early on, to the Federal Reserve, and we were beginning to observe the extent of discrimination that was involved in a lot of mortgage-making, the thrust of policies were all acutely aware was very strongly to move towards increasing home ownership, a policy which I supported, because I think in a market-oriented capitalist economy, the greater the degree of ownership of property, the greater the participation of all people in that- that type of economy.»

Much of Greenspan’s speculations in the following quote sound probable. But they can only be used as an excuse if a supervisor is allowed to neglect the consequences of a decline of house prices. To neglect risks. Given its actual duties, what Congress (= part of Congress) thinks is no excuse for the Fed to sit back and take a nap. The quote shows that Congress, if it wanted good supervision, appointed (approved) the wrong person. And if not, the good one. In the quote, Greenspan chooses to ignore the risk of a crisis as a consequence of falling house prices. If events would not have consequences and crises would not exist, he and Congress would have a case. But everyone knows that one thing causes another, and that some events cause crises or increase its risk. Greenspan should have explained Congress, and reported and warned in his (Annual) reports. Or not have accepted the job of Fed chairperson.

«COMMISSIONER WALLISON: In 2003, 2004, maybe even 2005, if the Federal Reserve had tried to clamp down on subprime lending when home ownership was increasing in the United States, what would you imagine would have happened?

MR. GREENSPAN: Well, observe that at that time foreclosures were low, home ownership was expanding; the delinquencies in subprime markets were remarkably small. If the Fed, as a regulator, tried to thwart what everyone perceived in, I would say, a fairly broad consensus, that the trend was in the right direction, home ownership was rising, that was an unmitigated good, the Congress would have clamped down on us. There's a presumption there that the Federal Reserve is an independent agency, and it is up to a point, but we are a creature of the Congress. And if in that midst of period of expanding home ownership no problems perceived in the subprime markets had we said we were

³⁶⁸ FCIC p. 3/31. In the hearing transcript [regulators] has no brackets.

running into a bubble and we would have to start to retrench, the Congress would say we haven't a clue what you are talking about. And I can virtually guarantee, indeed, if you want to go back and look at what various members of the House and the Senate said during these periods, on the subject, I would suggest the staff do a little run and you will be fascinated by how different it sounded back then than the way the retrospective view of history has evolved. I mean, I sat through meeting after meeting in which the pressures on the Federal Reserve and on, I might add, all the other regulatory agencies to enhance lending were remarkable- the less- right now we have, as you point out, a nonexistent subprime market. There's also a nonexistent Alt-A market, as well. And we have a lot of regulations for subprime, especially HOEPA, which are non-operative, at this stage [2010]. There is no market. I certainly trust it comes back, but the private subprime market shows no signs of moving, and it's not self-evident to me that it's coming back, so we could argue what the rules should be. The rules over what? There's nothing left. And I- I am merely saying that having gone 18 and a half years before the Congress, there's a lot of amnesia that is emerging currently.»

“a creature of Congress”?

So Greenspan tries to explain why he did nothing. But this does not explain the complete silence of this Annual reports. All this could and should have been discussed there (and more).

At the same time, Greenspan does indeed prove that he has all reasons for cynicism in the world. Being questioned by the FCIC, a creature of House and Senate. Congress was at least as important as the Fed.

Commissioner Born takes Greenspan in headlock:

«COMMISSIONER BORN: You've long championed the growth of the over-the-counter derivative market because of the risk-shifting opportunities that it provides. You've also taken the position that the over-the-counter derivatives market should not be regulated. As chair of the Federal Reserve board, you endorsed a President's Working Group report in November 1999 calling on Congress to eliminate regulation of the OTC derivatives market. You then welcomed the adoption of the Commodity Futures Modernization Act of 2000, which eliminated virtually all federal government regulation of the OTC derivatives market and also pre-empted certain state laws relating to it. So as a result OTC derivatives have been trading with virtually no regulation for a decade. And the market grew to exceed 800- 680 trillion dollars in notional amount by the summer of 2008.»

Born confronts Greenspan with a summary of what she thinks are his worst policies and actions:

«COMMISSIONER BORN: Mr. Chairman, the market for credit default swaps had risen to 60 trillion dollars in notional amount equal to the gross national- the gross domestic product of all the countries in the world by 2008. Also, let me point out, that had these been being sold as insurance products, they would have been regulated by insurance regulators and supervisors. There would have been a requirement of capital reserves. There would have been a requirement that these contracts could only have been sold to entities that had an insurable interest, that is, held the bonds or securities that were being insured against. There was no such regulation in the OTC derivatives market thanks to the action of the president's working group and Congress in 2000.

Let me go on to another subject. In your recent book, you described yourself as an outlier in your libertarian opposition to most regulation. Your ideology has essentially been that financial markets, like the OTC derivatives market, are self-regulatory and the government- and the government regulation is either unnecessary or harmful. You've also stated that as a result of the financial crisis, you have now found a flaw in that ideology.

You served as chairman of the Federal Reserve Board for more than 18 years, retiring in 2006, and became, during that period, the most respected sage on the financial markets in the world. I wonder if your belief in deregulation had any impact on the level of regulation over the financial markets in the United States and in the world.

You said that the mandates of the Federal Reserve were monetary policy, supervision and regulation of banks and bank holding companies, and systemic risk. You appropriately argue that the role of regulation is preventative but the Fed utterly failed to prevent the financial crisis. The Fed and the banking regulators failed to prevent the housing bubble; they failed to prevent the predatory lending scandal; they failed to prevent our biggest banks and bank holding companies from engaging in activities that would bring them to the verge of collapse without massive taxpayer bailouts; they

failed to recognize the systemic risk posed by an unregulated over-the-counter derivatives market; and they permitted the financial system and the economy to reach the brink of disaster. You also failed to prevent many of our banks from consolidating and growing into gigantic institutions that are now too big and/or too interconnected to fail. Didn't the Federal Reserve system fail to meet its responsibilities, fail to carry its mandates?

CHAIRMAN ANGELIDES: And by the way, on this, I'm going to yield two minutes for the response. We're over time.

MR. GREENSPAN: First of all, the flaw in system that I acknowledged was an inability to fully understand the state and extent of potential risks that were as yet untested. We didn't see what those risks were until they unwound at the end of the Lehman Brothers' bankruptcy. And I had always presumed, as did virtually everyone in academia, regulatory areas, banks, presumed that risk potential was, having failed there, means that we were undercapitalizing the banking system probably for 40 or 50 years. And that has to be adjusted. But the notion that somehow my views on regulation were predominant and effective as influencing the Congress is something you may have perceived. It didn't look that way from my point of view. First of all, I took an oath of office to support the laws of the land. I don't have the discretion to use my own etiology to effect my judgments as to what Congress is requiring the Federal Reserve and others to do. As far as I'm concerned, if somebody asked me my view on a particular subject, I would give it to them, and I express them in the book you're referring to, but that is not the way I ran my office. I ran my office as required by law. And there's an awful lot of laws that I would not have constructed in the way that they were constructed. But I enforced them, nevertheless, because that was my job: That was built into my oath of office when I took over the Fed's chairmanship in 1987.

CHAIRMAN ANGELIDES: Thank you.

MR. GREENSPAN: So, I know my time has run out, but I really fundamentally disagree with your point of view.»

As various quotes in the present report too clearly show, the sentence «**But the notion...**», halfway Greenspan's answer, is misleading. It ignores the fact that Greenspan put a lot of energy into getting Congress adopt his views. Together with Rubin, Summer, Levitt and others he actively conspired to eliminate Born from supervision. The law of the land had nothing to do with that.

Greenspan knows about risk management, but fails to manage risks as head of the Fed. He did not order the Fed to make plans for various contingencies (scenario's). He considered himself infallible, also in his forecasting powers. He made everyone depend on his infallibility.

Greenspan lies. The term "untested risks" is an example of a half truth, and misleading. The risks were foreseeable and to a large extent known from the events surrounding the fall of LTCM, and the report of the GAO about these events. A supervisor and anyone in a responsible position, may presume what he wants, but should take nothing for certain. He should think in terms of probabilities and uncertainties. There always being uncertainties. Risk management is always necessary.

Greenspan definitely didn't run his office as required by the law. For one thing, as amply proven, he fully ignored the systemic risk duty. (And/Though Congress did not complain). For substantiation see especially the Analysis and the appendix on the Fed.

Note that the tenor of Greenspan's answer strongly resembles that of Wellink's utterances before the Dutch inquiry commission. See the Wellink appendix, of the separate report *Wellink's perjury (Wellinks meeneed*, only available in Dutch).

The FCIC report on Greenspan.

On the effects of a decline of house prices ("bursting of the housing bubble").

Greenspan and Bernanke terribly underestimated the effects of a decline in the house prices. They did not take account of the possibility that they might be mistaken. They never betrayed any acquaintance of the relevant GAO, OFHEO and CGFS reports (which they should have known, given their jobs). They seem to have assumed their infallibility, and did not take account of, and manage, risks:

«As home prices shot up in much of the country, many observers began to wonder if the country

was witnessing a housing bubble. On June 18,³⁶⁹ 2005, *The Economist* magazine's cover story posited that the day of reckoning was at hand, with the headline "House Prices: After the Fall." The illustration depicted a brick plummeting out of the sky. "It is not going to be pretty," the article declared. "How the current housing boom ends could decide the course of the entire world economy over the next few years."

That same month, Fed Chairman Greenspan acknowledged the issue, telling the Joint Economic Committee of the U.S. Congress that "the apparent froth in housing markets may have spilled over into the mortgage markets." For years, he had warned that Fannie Mae and Freddie Mac, bolstered by investors' belief that these institutions had the backing of the U.S. government, were growing so large, with so little oversight, that they were creating systemic risks for the financial system. Still, he reassured legislators that the U.S. economy was on a "reasonably firm footing" and that the financial system would be resilient if the housing market turned sour. "The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable rate mortgages, are developments of particular concern," he testified in June [2005].³⁷⁰

"To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace..."

Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macroeconomic implications. Nationwide banking and widespread securitization of mortgages makes it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections."

Indeed, Greenspan would not be the only one confident that a housing downturn would leave the broader financial system largely unscathed. As late as March 2007, after housing prices had been declining for a year, Bernanke testified to Congress that "the problems in the subprime market were likely to be contained"- that is, he expected little spillover to the broader economy. »³⁷¹

It is unclear what the claim, that Greenspan "had warned that Fannie Mae and Freddie Mac [...] were growing so large, with so little oversight, that they were creating systemic risks for the financial system", is based on. Not on the Fed's annual reports anyway. It seems rather out of Greenspan's tune.

The case for self-regulation.

«More and more, regulators looked to financial institutions to police themselves- "deregulation" was the label. [April 12, 1997] Former Fed chairman Alan Greenspan put it this way: "The market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures."» FCIC p. 28/56.

[November 19, 2002,] «Fed Chairman Greenspan described the argument for deregulation: "Those of us who support market capitalism in its more competitive forms might argue that unfettered markets create a degree of wealth that fosters a more civilized existence. I have always found that insight compelling."» FCIC p 34/62.

«Fed Chairman Greenspan and many other regulators and legislators supported and encouraged this shift toward deregulated financial markets. They argued that financial institutions had strong incentives to protect their shareholders and would therefore regulate themselves through improved risk management. Likewise, financial markets would exert strong and effective discipline through analysts, credit rating agencies, and investors. Greenspan argued that the urgent question about government regulation was whether it strengthened or weakened private regulation.

Testifying before Congress [... May 22,] 1997, he framed the issue this way: "financial modernization" was needed to "remove outdated restrictions that serve no useful purpose, that

³⁶⁹ Note 80 on p. 556/584 mentions 16/6/05, so sixteen instead of eighteen.

³⁷⁰ On 9/6/05, according to note 81 on p. 556/584.

³⁷¹ FCIC-rapport pp. 16-7/44-5.

decrease economic efficiency, and that . . . limit choices and options for the consumer of financial services.” Removing the barriers “would permit banking organizations to compete more effectively in their natural markets. The result would be a more efficient financial system providing better services to the public.”» FCIC p 35/63.

Isn’t this trying to influence or pressure Congress? For more examples see the next section.

Greenspan seems to ignore that liability and punishability are largely absent. Obviously this reduces the need of self-regulation.

Obstructs OTC regulation:

[In 1994] «the U.S. General Accounting Office issued a report on financial derivatives that found dangers in the concentration of OTC derivatives activity among 15 major dealers, concluding that “the sudden failure or abrupt withdrawal from trading of any one of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole.” While Congress then held hearings on the OTC derivatives market, the adoption of regulatory legislation failed amid intense lobbying by the OTC derivatives dealers and opposition by Fed Chairman Greenspan.» FCIC p. 47/75.

He conspires against the CFTC proposal for re-examination of regulation of OTC-derivatives:

«Debate intensified in 1998. In May, the CFTC under Chairperson Brooksley Born said the agency would reexamine the way it regulated the OTC derivatives market, given the market’s rapid evolution and the string of major losses since 1993. The CFTC requested comments. It got them.

Some came from other regulators, who took the unusual step of publicly criticizing the CFTC. On the day that the CFTC issued a concept release, Treasury Secretary Robert Rubin, Greenspan, and SEC Chairman Arthur Levitt issued a joint statement denouncing the CFTC’s move: “We have grave concerns about this action and its possible consequences... We are very concerned about reports that the CFTC’s action may increase the legal uncertainty concerning certain types of OTC derivatives.”

They proposed a moratorium on the CFTC’s ability to regulate OTC derivatives. For months, Rubin, Greenspan, Levitt, and Deputy Treasury Secretary Lawrence Summers opposed the CFTC’s efforts in testimony to Congress and in other public pronouncements. As Alan Greenspan said: “Aside from safety and soundness regulation of derivatives dealers under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary.”» FCIC p. 47/75.

Advocates institutional freedom to chose its supervisor:

«To create checks and balances and keep any agency from becoming arbitrary or inflexible, senior policy makers pushed to keep multiple regulators. In 1994, Greenspan testified against proposals to consolidate bank regulation: “The current structure provides banks with a method... of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. The pressure of a potential loss of institutions has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate.”³⁷² Further, some regulators, including the OTS and Office of the Comptroller of the Currency (OCC), were funded largely by assessments from the institutions they regulated. As a result, the larger the number of institutions that chose these regulators, the greater their budget.» FCIC p. 54/82.

Reduces interest rate to stimulate the house market:

«At a congressional hearing in November 2002, Greenspan acknowledged- at least implicitly- that after the dot-com bubble burst, the Fed cut interest rates in part to promote housing. Greenspan argued that the Fed’s low-interest-rate policy had stimulated the economy by encouraging home sales and housing starts with “mortgage interest rates that are at lows not seen in decades.” As Greenspan explained, “Mortgage markets have also been a powerful stabilizing force over the past two years of

³⁷² Fed Chairman Alan Greenspan, statement before the Senate Committee on Banking, Housing, and Urban Affairs, 103rd Cong., 2nd sess., March 2, 1994, reprinted in the Federal Reserve Bulletin, May 1, 1994, p. 382.

economic distress by facilitating the extraction of some of the equity that home-owners had built up.”³⁷³ In February 2004, he reiterated his point, referring to “a large extraction of cash from home equity.”»³⁷⁴ FCIC p. 88/116.

Speculates irresponsibly:

«Nationwide, house prices had never risen so far, so fast. And national indices masked important variations. House prices in the four sand states, especially California, had dramatically larger spikes-and subsequent declines- than did the nation. If there was a bubble, perhaps, as Fed Chairman Alan Greenspan said, it was only in certain regions. He told a congressional committee in June 2005 that growth in nonprime mortgages was helping to push home prices in some markets to unsustainable levels, “although a ‘bubble’ in home prices for the nation as a whole does not appear likely.”» FCIC p. 158/186. What is the basis of this judgment? Doesn’t he realize that even a small probability may have very large consequences?

The FCIC report gives many examples of warnings given to Greenspan (beside those of the GAO). Greenspan always knew better.

By way of conclusion.

Journalist «Matt Taibbi described the Greenspan put and its bad consequences saying: “every time the banks blew up a speculative bubble, they could go back to the Fed and borrow money at zero or one or two percent, and then start the game all over”, thereby making it “almost impossible” for the banks to lose money. He also called Greenspan a “classic con man” who, through political savvy, “flattered and bullshitted his way up the Matterhorn of American power and ... jacked himself off to the attention of Wall Street for 20 consecutive years.”»³⁷⁵

³⁷³ Fed Chairman Alan Greenspan, “The Economic Outlook,” prepared testimony before the Joint Economic Committee, 107th Cong., 2nd sess., November 13, 2002.

³⁷⁴ Fed Chairman Alan Greenspan, “Federal Reserve Board’s Semiannual Monetary Policy Report to the Congress,” prepared testimony before the House Committee on Financial Services, 108th Cong., 2nd sess., February 12, 2004.

³⁷⁵ From the Wiki-page Greenspan., in the dossier under 20120704.

13. Evaluation of some crisis-relevant IMF reports.

This appendix evaluates the following IMF reports:

- Global financial stability report (GFSR) 2005-2 (September 2005)
- GFSR 2006-1 (April 2006)
- Annual report (AR) 2006 (September 2006)
- GFSR 2007-1 (April 2007).
- AR 2009 (July 2009).

The reports are discussed in chronological order, according to publication date.

The discussion of the reports is preceded by a section *Summary and conclusions* and a section with information about the IMF.

Summary and conclusions.

The following conclusions are based on a study of the facts and the above mentioned reports.

1. The role of the IMF with respect to supervisors and governments is unclear, and not discussed. As a consequence the meaning and status of the advice of the IMF is unclear. The unsystematic character and the lack of specification of the advice, and the absence of any kind of monitoring of its implementation suggest that it isn't clear to the IMF itself either.
2. Until the GFSR of April 2007 reckless optimism is the rule. Opportunities are exaggerated in the optimistic sense, while risks are underestimated. In the GFSR of April 2007 the rose colored glasses have been largely taken off.
3. "To secure financial stability" is one of the four main duties of the IMF. AR 2006 claims that the IMF has "tools for identifying vulnerabilities and weaknesses in its member countries and in the international financial system so that they can be addressed before a crisis erupts". The reports don't identify or describe these tools. Neither do they show which "vulnerabilities and weaknesses" they have helped identify. In fact the IMF shows no knowledge or insight better than that of other financial supervisors. IMF studied dangers only superficially, and overestimated positive developments and the supposed stability. IMF not only failed to secure stability, but even failed to warn of real dangers.
4. The reports say nothing about the size and consequences of the risks. No effort is made to trace the consequences of a realized risk, and to describe them in a scenario. No (comparative) analysis of size and consequences was found in the reports. Risks are not distinguished; they could as well be equally (un)important. Nothing is said about a method for finding sources of risk; there is no guarantee for completeness.
5. Unbalanced balances of payments are mentioned as a destabilizing factor, government debts are not. The IMF should have done so, and taken action not only to secure stability, but also to prevent being asked to provide (additional!) loans to countries that got themselves into this kind of trouble. Its mission required it to warn timely, clearly and unambiguously, and to make unambiguous recommendations. It could simply have supported those of the GAO.
6. Global imbalances are called imbalances, and seen as a problem. However: why they are a problem and/or risk, and how they can be solved/ reduced is not explained.
7. The IMF has 2600 employees. It is impossible to believe that none of them can produce anything better than what is found in the reports. The reports therefore show that the management is insufficient. And if the IMF really has no people who can produce anything better, it is just as insufficient.
8. The reports give useful information.³⁷⁶ The information makes an ad hoc impression however. No effort seems to have been made to collect the information necessary for accomplishing the mission, and to present the information in a helpful way. In general, the analyses are superficial.
9. IMF gave potentially effective opinions and advice, but ad hoc instead of systematically. And it did next to nothing to explain the necessity of action. It did not show the consequences of inaction.

³⁷⁶ Although less than those of the OECD.

10. None of the reports betrays knowledge or understanding of the GAO 1994-1999 reports, and nothing in the IMF reports shows analytic capabilities comparable to those of the GAO. The OFHEO and CGFS reports are ignored as well. In other words: IMF is not acquainted with the literature it should be acquainted with because of its duties and mission.
11. Still, the GFSR of April 2007 sees more risks than all other supervisors. But the IMF overestimates the supposed stability of the financial system just as much as it underestimates the risks. What advice it gives is extremely undercooled.³⁷⁷
12. The weakness of the analyses and recommendations in the reports agrees with the failure of IMF to prevent the crises and deal with them. It failed to secure financial stability, a vital part of its mission. Its pretensions were false.
13. There is no sense of urgency and responsibility in any of the studied reports.
14. The IMF has not learnt the most important lessons of the crisis. It has not acknowledged its failure. It has not changed in any fundamental way.
15. There is a general lack of reflection, especially as regards definitions. Hypotheses (illusions) are mistaken for facts. No effort is made to discover and analyze the sequence of consequences which follows the realization of a risk.
16. The IMF is not honorable and not competent. It is utterly unreliable.

About the IMF.

«The International Monetary Fund (IMF) works to

- foster international monetary cooperation,
- secure financial stability,
- facilitate international trade,
- promote high employment and sustainable economic growth, and reduce poverty around the world.

Created in 1945, the IMF is governed by and accountable to the 188 countries that make up its near-global membership.»³⁷⁸

«The Board of Governors, the highest decision-making body of the IMF, consists of one governor and one alternate governor for each member country. The governor is appointed by the member country and is usually the minister of finance or the governor of the central bank. All powers of the IMF are vested in the Board of Governors. The Board of Governors may delegate to the Executive Board all except certain reserved powers. The Board of Governors normally meets once a year.»

«The Executive Board (the Board) is responsible for conducting the day-to-day business of the IMF. It is composed of 24 Directors, who are appointed or elected by member countries or by groups of countries, and the Managing Director, who serves as its Chairman. The Board usually meets several times each week. It carries out its work largely on the basis of papers prepared by IMF management and staff.»

The managing directors of the period 2000-2012 were:

- C Lagarde 5/7/11-
- D Strauss-Kahn 1/11/07-18/5/11
- R de Rato 7/6/04-31/10/07
- H Köhler 1/5/00-4/3/04
- M Camdessus 16/1/87-14/2/00

(There are some gaps indeed).

The Wikipedia-biography of Rodrigo de Rato is in the dossier. There are good reasons for denying his suitability for the IMF-position. Both as regards competence and integrity. He was succeeded by

³⁷⁷ For example: «... ensuring that underwriting standards are maintained is critical to supporting market discipline and, in this regard, recently issued guidelines are welcome.». P. 32 of IMF GFSR April 2007.

³⁷⁸ Factsheet IMF, 8/8/12. The layout with dots is of the present author.

Dominique Strauss Kahn. In his case too, there were good reasons for denying his suitability for the IMF-position. Both as regards competence and integrity. Idem for Christine Lagarde.³⁷⁹

The head office of the IMF is in Washington D.C. The IMF has approximately 2610 employees.³⁸⁰

In the summer of 2012 the web page *Publications* of the IMF called the following of its publications “Essential Reading”:

- World Economic Outlook
- Global Financial Stability Report (GFSR)
- Fiscal Monitor
- Regional Economic Outlook
- IMF Annual Report 2011
- Finance & Development.

Because the IMF is studied in the context of an analysis of the financial crises, the IMF reports selected for evaluation are some GFSRs and the annual reports 2006 and 2009. The GFSR is published twice a year, in April and September. We will discuss the publications of September 2005, April 2006 and April 2007. The first two date from well before the crises. The third dates from a time with a growing number of signs of strain. But nobody knew that a major crisis was around the corner. The events had nevertheless eroded the customary optimism of the IMF.

The GFSRs document a change in thinking. The annual reports are studied as a check. To check for consistency with the GFSR, to see if they tell something new, and to be consequent: the AR 2006 is studied for all supervisors. The AR 2009 is studied to see if and how IMF evaluates its past performance, and to see what lessons it learnt.

IMF GFSR 2005-2 (September 2005).

Conclusions.

1. The GFSR is overly optimistic due to systematic wishful thinking and illogical argumentation;³⁸¹
2. Analytically it is insufficient. It shows no understanding of the operation of the financial system as a system;
3. Still, it does see risks, and mentions risks that would contribute to the depth and extent of the crisis. But it does not consider the sequel of realisation of risks, and does not try to get an idea of the consequences;
4. As regards recommendations it is weak, maybe partly due to its optimistic attitude. It warns against reduction of conditions for loans, but says to welcome the release of CRMPG II (as if no distinction has to be made between words and deeds), and the measured tightening by the Fed.

Quotes.

The following quotes come from Chapter 1, Overview.

«Balance of Risks, Current Assessment.³⁸²

Hence, in the short term, the current configuration of solid growth, low inflation, as well as low bond yields, flat yield curves, and compressed credit risk premiums provides the global financial system with a favorable environment. At the same time, growth and interest rate differentials in favor

³⁷⁹ For verification one can start with the biographies in the Wikipedia and Google. More than enough evidence can be found in the dossier. And the present document shows ample proof of their false pretensions anyway.

³⁸⁰ Factsheet IMF, 8/8/12.

³⁸¹ Illogical argumentation: for example by saying that something follows if it does not.

³⁸² The IMF uses the word “risk” inconsistently. Section 1 of chapter 1 of the GFSR of April 2005 ends as follows: «**Looking ahead, while there is no particular reason to believe that this benign scenario might come to an end any time soon, we see a number of risks that could test the resiliency of the financial system. At a time when the financial sector is in solid shape, the risks are—by definition—more on the downside.»**

of the United States, and consequently private investors' current appetite for U.S. dollar assets, allow for a smooth financing of global imbalances. The same benign forces underpinning continued growth and buoyant financial markets, however, have also created larger global imbalances and built up higher levels of debt, particularly by the household sector. Consequently, the potential for a substantial adjustment of investor preferences for asset classes and currencies in the medium term has grown. In short, recent economic and market developments have reduced risks in the near term, but they are storing up potential vulnerabilities for the future. When assessing the balance of risks, however, experience shows that even at times of sharp asset price movements, countervailing forces tend to mitigate such developments before long. This report sheds light on a few trends that could act as "buffers" in times of stress.»

Note that the first sentence is only true if there are no risks. Otherwise it should have been formulated conditionally.

“In short...”: has it been shown that all relevant (short term, =?) risks have decreased? No. A favourable situation need not mean the absence of risks. By the way: both the US and European countries have by now seen many years of uninterrupted home price rises exceeding income rises.

“When assessing...” Experience has also shown that home prices do not increase indefinitely. The assessment should have taken the mechanisms into account which were indicated by the GAO in its 1994-1999 reports, and by the CGFS in 2003.

The information IMF mentions is qualitative. How then does IMF weigh the risks? It does not give an indication of the uncertainty of its result. Neither does it outline what will happen if one or more risks are realised.

The section *Potential Triggers for Market Corrections* bears witness to (paradigmatic/ dogmatic) thinking in terms of a supposed business cycle. In other words: mistaking theory for reality, and ignoring facts, insights and warnings/recommendations of GAO, OFHEO, and CGFS. The first paragraph describes the program of this and the following section:

«After examining some of the risk factors that might trigger market corrections going forward, we will analyze some of the trends that, in our view, create self-stabilizing forces in the financial markets.»

Among the risks, mention is made of the mortgage market in the US:

«In the United States, marginal homebuyers have been attracted by mortgages designed to minimize interest payments in the first few years by pushing off the debt service burden into the future, and also by a relaxation of credit standards. The U.S. regulatory authorities have rightly expressed concerns about these trends, and it is important to monitor them in the foreseeable future.»

«Trends That Could Enhance Financial Stability

In addition to the more cyclical factors discussed above, two observable trends could help enhance financial stability over time, especially to protect against the risk of abrupt and indiscriminate reversals of capital flows.

- Demographic changes and ensuing pension reforms increase the size and importance of institutional investors such as pension funds and life insurance companies relative to more short-term-oriented investors. To the extent that these long-term institutional investors need to match their assets to longterm liabilities, their corresponding asset liability management has shown a strong commitment to strategic asset allocation; such allocation is largely guided by longterm fundamentals as opposed to day-today noise in the markets. This type of investor is usually very large and can, by definition, move markets, especially if the markets are small and narrow. In addition, institutional investors' reallocations are typically infrequent and implemented at a rather deliberate speed. In short, the fast growth of assets under management of this type of investor will probably have a stabilizing effect on financial markets.
- A much enhanced transparency and disclosure in financial markets, including on the part of emerging market borrowers, together with a much more sophisticated investor base can reduce the likelihood of contagion risk, at least the “knee-jerk” contagion seen some years ago. Specific credit events or country problems may occur, but judging from market reactions to such events in the recent past, there is reason to expect that, in the foreseeable future, these

events would be regarded as specific rather than generalized, further containing future market volatility.»

(This is the complete, unabridged section).

Several of the assertions in this section are debatable if not untrue (see below), and in general no or insufficient substantiation is given. The coming years would show that substantiation simply did not exist, and that the assertions can only have been inferred from wishful thinking.

“In short...” (last sentence of first point): the conclusion asserts very much more than the premise warrants. The GFSR exaggerates the role of pension fund managers. Market changes and volatility are not created by those who do little or nothing, but by those who trade actively. (Remember: markets are a marginal phenomenon in the sense of section 7B1.1). House prices are made by buyers and sellers, not by people who did not buy or sell, and will not buy or sell, for a (very) long time.

“Transparency and disclosure” were not “much enhanced” at all. Please note that IMF’s head office is in Washington DC. Did it really miss and forget the upheaval around OTC regulation? Obviously, if transparency and disclosure had improved at all, it clearly had not improved sufficiently.

IMF seems to see developments through rose-coloured glasses. The section is one-sided. A section “Trends That Could Reduce Financial Stability”, or “Phenomena that could initiate a downward spiral” is missing. The way of working is incompatible with what is required to “secure financial stability”.

The section “Trends That Could Enhance Financial Stability” is followed by a section with recommendations. It opens as follows:

«Policy Measures to Mitigate Risks.

As explained above, the short-term outlook for global financial stability is rather benign because of solid growth and favorable financial conditions. Traditional countervailing forces in financial markets, but also some of the more recent trends explained in the previous section, add to this benign assessment. As always, the ongoing risk management by and prudential supervision of individual market participants are the most important line of defense.»

The first sentence reflects procyclical thinking: it overlooks the historical and theoretical fact that a good looking situation offers no guarantee for the (near) future. A good looking situation does not mean the absence or irrelevance of risks, but only that no substantial risks are being realized.

The section mentions some of the risks, and gives sound (though late and insufficient) advice. Such as:

«Financial supervisors also need to ensure—as they have begun to do in the context of household indebtedness—that lending institutions do not relax credit standards, which would in turn lead to tomorrow’s nonperforming loans.»

It is clear that this and other advice has not been (sufficiently) implemented.

IMF GFSR 2006-1 (April 2006).

Conclusions.

1. Chapter 1 gives an incorrect optimistic forecast for the development of the financial system. It is based on unfounded and incorrect belief in the stability of the system, and uncritical wishful thinking. According to the IMF the system has become safer, and is therefore safe. Risks that are seen, are insufficiently analysed and not found to need action.
2. Chapter 2 describes credit derivatives and their markets, and their development in time. It sees the world through rose coloured glasses. Credit derivatives are an improvement. Like chapter 1, chapter 2 cannot resist the temptation of wishful thinking. It tends to assume that reality agrees with theoretical possibilities and good intentions, and develops in the desired direction of its own accord. It is quick to assume that risks are adequately tackled by supervisors. It sees illiquidity of CRT markets as the largest and real risk. But it does not study the consequences of market failures or illiquidity of participants, nor does it take account of the possible (psychological) effects of

- depreciation and downgrading as a consequence of market disruptions. Even though these phenomena are logical and seen in all historical crises.
3. Chapter 2 does not consider derivatives in the context of the financial system as a whole. The question whether they cause risks for the operation of the system as a system is not asked. It does not try to find the conditions under which derivatives can operate safely, without creating potentially disastrous risks for the system.
 4. These gaps can be explained by noting that IMF stops thinking as soon as it finds a “risk”. Indeed, nothing is said about the relative sizes of risks (and consequences). No effort is made to discover and analyse the consequences of risks. To outline the sequence of events following the realisation of a given risk. There is an extensive summary, but there are no clear conclusions and recommendations.
 5. A reason for writing and publishing chapter 2, given similar CGFS reports, is not given. It does not appear from the text. The added value of the chapter, given the BIS-publications, seems to be zero or negative. Namely because it creates confusion, enables playing off IMF against BIS, and is anyway inefficient.
 6. The chapter gives rise to the question of the reason for existence of the department³⁸³ that wrote it. It shows that the quality control by the IMF-management was insufficient.
 7. The same applies to the summary of the chairman in the Annex.
 8. IMF does not betray acquaintance with the often mentioned GAO, OFHEO and CGFS reports.
 9. Summarized in three short sentences: the IMF GFSR of April 2006 was inadequate and misleading. It suggests that the financial system can be relied upon. It had a negative influence: it helped preventing actions that could have prevented the crises.

Introduction.

The report consists of a Preface and three chapters. The report itself does not contain a summary or conclusions. The paragraphs headed “conclusions” do not give conclusions. There is an “Annex” titled *Summing up by the chairman*. Chapter 1 is titled *Overview*, and its introductory section might well be a summary.

The following tries to give an impression of the chapters 1 and 2 and the *Summing up by the chairman*. Chapter 3, *Structural Changes in Emerging Sovereign Debt and Implications for Financial Stability* is left outside consideration because it has almost nothing to do with the crises. The “*emerging sovereign debt*” denotes the government debt of “emerging” countries.

Quotes and evaluation.

Chapter 1 is titled *Global financial system resilience in the face of cyclical challenges*. The first page is representative for the style of the report: overoptimistic and uncritical thinking about the stability (resilience) of the financial system, and about risks that more often than not are dismissed with magical formulas.

«Previous issues of the Global Financial Stability Report (GFSR) have analysed and assessed how the global financial system recovered from various shocks, including the bursting of the equity bubble in 2000–01 and the debt crises in a few emerging market (EM) countries. They spelled out in detail how cyclically favorable conditions³⁸⁴ and structural changes have made financial intermediaries much stronger.³⁸⁵ The positive assessment contained in the September 2005 GFSR that “the global financial system has yet again gathered strength and resilience” has been validated by recent developments.³⁸⁶ However, a number of cyclical challenges appear to be gathering on the horizon, which necessitate a

³⁸³ Mentioned in the Preface.

³⁸⁴ The hypothetical notion of cyclicity comes from economic theory. The reader can observe that the quoted text tacitly assumes cyclicity to be a fact. The assumption is not justified. The assumption of a cycle or periodicity with an approximately constant length is falsified by the empirical evidence. Cycles should be distinguished from sequences of up- and downward trends (which are almost self evident). The reader is advised never to believe assertions of economists at face value.

³⁸⁵ Hypothetically: nothing has been proven. Events will show this assertion to be meaningless.

³⁸⁶ The report offers no proof for this illogical inference.

more nuanced view of the financial outlook for the remainder of 2006 and beyond.

As this report has argued earlier, globalization and financial innovations have advanced the scope for capital markets to channel credit to various users in the economy. In particular, the emergence of numerous, and often very large, institutional investors and the rapid growth of credit risk transfer instruments have enabled banks to manage their credit risk more actively and to outsource the warehousing of credit risk to a diverse range of investors. A wider dispersion of credit risk has “derisked” the banking sector, which still occupies a strategically important role in the economy, in part because of its role in the payments system. It is widely acknowledged, meanwhile, that holding of credit risk by a diverse multitude of investors increases the ability of the financial system as a whole to absorb potential shocks. This contrasts with a situation where a small number of systemically important banks bear the brunt of making provisions for nonperforming loans.

It is true, as mentioned below, that the details of who holds which risk and in what amount are less transparent outside the banking system because of less stringent reporting requirements. On balance, however, it is the wider dispersion of risks, as such, that increases the shock-absorbing capacity of the financial system. As with a reinsurance system, the risk diversification and dispersion aspects matter more than the precise details of who is the ultimate risk bearer. [...]

All these structural changes, taken together, have made financial markets more flexible and resilient. As former U.S. Federal Reserve Chairman Alan Greenspan said: “These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago.”»

The sentence beginning with “On balance” in the 3rd paragraph is rather mystifying. It suggests that it is the result of a weighing process. But it is unclear what has been weighed against what. And how. Given the facts, it cannot have been the increase of the size of the risks against the extent of the spreading. Spreading risks was not the only development in the financial system. Risks became disproportionately larger as well, in part due to changing processes (like increasing dependence on repo lending). The evidence moreover does not support the conclusion: an analysis of consequences of realization of risks which could prove it is missing.³⁸⁷

Something similar applies to the last paragraph. There is not even the semblance of a proof of the first- very assertive- sentence. The unsubstantiated and authoritarian “have made” could better have been replaced by: “have the potential to make”. With an indication of conditions and/or assumptions. Instead of an unprofessional quote from a supposed authority the text should have given an indication of the proof, or references to proofs. As it is, the text suggest that utterances of Greenspan can pass for proof. Which is dangerous nonsense.

It is not even noted that spreading risks implies spreading damage, and that the illusion of more flexibility and resilience may invite more risk taking.

The “nonperforming loans” at the end of the second paragraph has a footnote inviting incorrect conclusions and unjustified optimism:

«By way of example, the annual number of U.S. bank failures has fallen to a very low level in the past 10 years—a period that witnessed a number of major shocks that in the past could have caused great anxiety among banks and their supervisors.»

This may be true and even relevant, but does not mean that there are no risks, and not even that risks or their potential consequences have diminished.

The “proof by Greenspan” is followed by a paragraph which illustrates how the IMF deals with risks:

«At the same time, this “brave new world” of modern capital markets creates its own set of risks and challenges. As mentioned above, these include a lower level of information about the distribution of risk to and among the nonbank financial institutions, which increases the potential for unpleasant surprises from the less regulated market segments. More important, this new market-based environment for credit risk is predicated much more on the availability of liquidity in all crucial areas of this market. Any potential liquidity disturbance could amplify market corrections (see Chapter II). In

³⁸⁷ This would require more or less complete understanding of the operation of the financial system as a system. Some such understanding has only been found in the GAO reports.

addition, operational risks, such as delays in credit derivative trade confirmations, assignments of contracts to third parties, and contract settlements, have been identified as weaknesses, and remedial actions are being undertaken by market participants to address them.»

So without any analysis of what needs to be done, or to analyse the remedial actions and their (potential) effects, the IMF assumes that it is sufficient to note that “remedial action are being taken”. Suggesting that the risk is under control. For the remedial action no reference is given. Knowing good part of the history of financial supervision, one wonders what may be meant. I for one would not exclude the possibility that remedial actions are not being taken, but only recommended, as by CGFS or CRMPG.

The same optimism is seen in the last, concluding section of the chapter, *Assessment of Financial Stability and Policy Implications*:

«To sum up, in the base case scenario of continued growth and contained inflation, financial systems—from a position of financial strength—should be able to cope with the envisaged cyclical risks rather well. For example, credit spreads would widen and volatility would increase only moderately, and market adjustments would generally remain orderly. Obviously, if the unwinding of the various imbalances were to signal lower-than-expected growth, markets would react more sharply; but there is little evidence from the above analysis to suggest that the expected or likely market corrections in the period ahead would lead to crises of systemic proportions. [...]»

If cyclical changes were indeed to expose some weaker, but non-systemic, spots, such as idiosyncratic credit risks or poor risk management in a number of individual cases, from a macroprudential point of view the present time is an ideal occasion to let the self-correcting forces of the market work out price dislocations by adhering to a strict no-bailout policy. Regulators and supervisors would have an almost unique opportunity to contain complacency and ultimately moral hazard. If certain investors, such as hedge funds, were to experience difficulties, it would be important to “let nature take its course” and let individual investors suffer losses.»³⁸⁸

This can be seen as the result of simplistic qualitative thinking, which is unable to reason beyond one or two subsequent steps from cause to consequence. The thinking is guided by the dogma of cyclical instead of understanding of the financial system, especially of the processes and the relations between its various parts. It is tacitly but wrongly assumed that important financial institutions can get into trouble without bringing other institutions in difficulties. Let alone if the cause of the weakening is of a general nature, and the consequences of bankruptcies have to be added to those of the general difficulties. The analyses of the IMF are simply too superficial.³⁸⁹ Nowhere in the report does one find a sketch of what happens if a certain risk is realized.

Note that the present time may seem to be ideal, but that the time at which a choice must be made between bankruptcy and bailout can definitely not be called ideal. The real question is: is a no-bailout policy good policy in bad times?

Chapter 2 is titled *The influence of credit derivative and structured credit markets on financial stability*. The BIS publications *Credit risk transfer* of 2003 and *The Joint Forum on Credit Risk Transfer* of 2005 are mentioned, but most of their contents is ignored. The IMF seems to be starting not where these reports end, but from zero. Like chapter 1, chapter 2 is optimistic. According to the IMF, credit derivatives have all kinds of advantages, and no important disadvantages. It supposes that the ideal theoretical use agrees with reality. Contrary to its title, the chapter hardly analyses the influence of credit derivative and structured credit markets on financial stability. There are only few assertions about stability, and systemic stability is not considered at all.

Did the IMF find the BIS reports too critical? Whatever it thought, an assessment is lacking. Like all financial supervisors, the IMF essentially ignores all other supervisors. Although it seems to be sensitive to the opinions of the greatest gods, like Greenspan and Geithner. Examples are given below.

The first sentence of the chapter is the following:

³⁸⁸ IMF-GFSR April 2006, chapter pp. 37-8.

³⁸⁹ Not enough information is integrated, and not enough thinking/analysis is devoted to coherent information.

«There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient».³⁹⁰

The sentence refers to the following footnote:

«See Geithner (2006a) for a recent speech regarding credit derivatives, risk management, and related financial stability issues.»

This is the speech which is quoted in the Geithner appendix.

The chapter is concluded with a long section *Conclusions and Policy Implications*. It begins as follows:

«Credit derivative and structured credit markets help to improve financial stability by facilitating the dispersion of credit risks. These markets allow banks, especially systemically important institutions, to shift credit risk to a broader set of investors. As a result, the vulnerability of these institutions, and of the broader banking system, to credit shocks should³⁹¹ be reduced. Some observers, while acknowledging a banking sector gain, are concerned that such markets may have simply shifted credit concentrations elsewhere in the financial system. However, based on the data available, there is no evidence of increased credit concentrations among regulated entities, such as smaller or regional banks, insurance companies, pension funds, or mutual funds, as a result of these risk transfer markets. As such, future credit losses are likely to be more broadly distributed, and individual losses less likely to cause a policy concern for a particular sector.»³⁹²

The “likely” and “less likely” have not been justified or made plausible. The knife of the “no evidence” in the sentence before the last cuts both ways: there is no evidence for broad and even spread either. The text seems more inspired by wishful thinking than based on a thorough and independent analysis. Note that the “based on the information available” means that the argument may very well be incorrect. For the available information is scant.³⁹³

Did the IMF ever notice that securitization increases the distance between borrower and lender, and may easily encourage bad loans? Did it ever notice that the spreading of risk may be more than offset by taking more and greater risks? Why do so many people in government and supervision ape one another without asking for evidence? Why don’t they show more professionalism? Why don’t they try to estimate the size of the risks they are talking about, especially because many security valuations are subjective, and therefore can go anywhere? They talk about the spread of risk as if it were a health insurance. But it isn’t. The financial system creates risks, and very much of them.

The subsections nevertheless make many useful remarks. Much can better, and supervision should play an active role in the process of improvement. But the IMF does not make clear whether, and how much, improvement is necessary to keep or make risks bearable.³⁹⁴ And apart from this the text betrays much uncertainty. Which however is not explicitly seen as a risk. We give two examples. The first in connection with the risk of liquidity difficulties:

«Dialogue and cooperation among public officials are key to successful coordination during a liquidity crisis, for which contingency plans should already be in place.»³⁹⁵

This looks like wise advice. But what if these plans don’t exist and are not made? The facts show that they did not exist or were very inadequate. As a consequence, the unwinding of the crisis showed sluggish ad hoc and inconsistent behaviour which deepened and widened the crisis.

The second example concerns the regulation and supervision of non-bank institutions:

«Likewise, policymakers and supervisory authorities (and rating agencies) should clarify the treatment of risk transfer techniques for non-bank institutions. The largest insurance companies have started to use these techniques to manage their risk exposures, which should be encouraged. However,

³⁹⁰ According to the Merriam-Webster resilient means: capable of withstanding shock without permanent deformation or disruption.

³⁹¹ This is unproven and incorrect. Only the use of words like “could” or “can” would have been warranted.

³⁹² IMF-GFSR April 2006 p. 76/26. The last sentence, i.e. the conclusion, does not follow from what precedes. Not only regulated entities and concentration of credit risk are important.

³⁹³ This should be noted in a risk analysis of the text.

³⁹⁴ Risk understood as the product of total probability and cost of consequences. The “total” refers to the addition over years.

³⁹⁵ IMF-GFSR April 2006 chapter 2 p. 77/27 left column.

such developments are being restrained by a lack of clarity regarding the regulatory and rating agency treatment of such transactions.»³⁹⁶

As to clarity this leaves something to be desired. If only because it is not clear what reliable and useful information about risks looks like. The paragraph mainly shows that there are important unknowns, and therefore risks.

The chapter does not give clear information about the risks caused by credit derivative and structured credit markets. Especially not about the risks they cause for the financial system as a coherent system. The chapter deals with separate products and simple processes. What is missing is a picture of the way in which products and processes are related, combined, and interact. Or at least signs of knowledge and understanding of these. Just like the Fed, the IMF seems to think mainly or only in terms of separate institutions. Even though the text frequently shows that the institutions depend on each other. The chapter had good reasons to say that because of the many different products, processes and rules, the dynamics of the financial system³⁹⁷ is extremely obscure and unpredictable. That the risks are hard to specify, if seen and understood. But this is only shown implicitly. For example in the conclusion of the chapter:

«Credit derivative markets facilitate the continued evolution from a primarily bank-based financial system to a more market-based system. These instruments make more transparent the volatility inherent in credit, which was previously masked by bank balance sheets. By transferring and managing more credit risk in the capital markets, the banking system and the overall financial system may not only become more efficient, but also more stable. Of course, history has shown that this may not be a linear process. New challenges to financial stability and market vulnerabilities may arise. In the structured credit markets, we believe the risk of liquidity disturbances is material. Whether and how these new risks materialize, and the severity of their impact, will critically depend on the degree to which the diversity of market participants increases, the various structural frictions are reduced, and market surveillance is improved. Liquidity may be the best financial stability cushion. [...] Policymakers should continue to support the development of markets, including risk transfer markets, which will not only benefit economic and financial efficiency, but also contribute to further improve financial stability.»³⁹⁸

The IMF does not note that the development from a bank-based to a market-based system has the disadvantage (danger) of making the system more dependent on subjective value judgments. It does not note that the advantage of risk spread may be (more than) offset by increased sensitivity for market sentiments and therefore reduced stability/ increased instability. As often, the IMF tends to see mainly or only the positive side. The question therefore remains unanswered whether the development from a bank-based to a market-based system makes the financial system more stable if all relevant aspects are weighed objectively. Its frequent use of “may” suggests that the IMF feels uneasy about the answer. The euphemisms about a non-linear process and “new challenges” suggest that it is afraid not to have seen all risks. It seems to disbelieve its own positive assessment. But it doesn’t say so explicitly.

In addition the IMF has not seriously thought about the way the financial system will develop if certain (known) risks are realized. What happens if an institution cannot obtain the necessary liquidity? The GFSR makes no effort to think this through, and to outline potential scenario’s. It suggests that officials have contingency plans for a liquidity crisis. It therefore seems to assume that at least the initial course of a (liquidity) crisis is predictable. But why does it only believe this, without trying to check it, or to discover possible scenario’s? Efforts like that could have shown that problems easily spread over the whole financial system, and that there are factors, like mark-to-market accounting, which amplify them.

The remainder of this section about the GFSR of April 2006 is devoted to the *Summing up by the chairman* in the Annex of the GFSR. Comparison shows that the *Summing up* is an adequate summary. The separate chapters are consistent with the *Summing up*. The following is meant to support this assessment. As regards content it is redundant.

³⁹⁶ IMF GFSR April 2006 chapter 2 p. 79/29 right column.

³⁹⁷ I.e. the way in which it develops as a function of “forces” and time.

³⁹⁸ IMF GFSR April 2006 chapter 2 p. 81/31, left column.

The *Summing up* begins with a section *Assessment of Financial Stability and Policy Implication*. The following gives an impression:

«Directors welcomed the continued resilience of the global financial system, which has been supported by solid global growth, low inflation, abundant liquidity, and flat yield curves. They considered that financial conditions will likely remain benign in the most likely scenario of continued growth, contained inflation, and stable inflationary expectations.³⁹⁹

At the same time, Directors noted that the global financial system faces a number of challenges, in particular rising interest rates and a turn in the credit cycle for both the corporate and household sectors. Given the strengthened resilience of the financial system,⁴⁰⁰ most Directors considered that financial markets should be able to deal quite well with the envisaged cyclical risks. A number of Directors, however, cautioned that medium-term risks to financial stability may have increased somewhat in the past six months, given the growing global imbalances, the higher debt levels in the household sector, and possible underpricing of risk by investors in certain asset classes. Directors urged national authorities to underpin the strength and resilience of the financial system by pursuing macroeconomic policies that aim for solid and well-balanced growth, while strengthening the effectiveness of supervisory and regulatory oversight. [...]

Directors commented that housing and mortgage markets also point to a turn in the credit cycle, particularly in the United States where housing activity has moderated in recent months. In particular, higher interest rates could raise the debt servicing burden of households, already at high levels, worsening the credit quality of mortgage markets and causing losses to lending institutions. This risk, however, is mitigated by the fact that the majority of U.S. mortgages are at long-term fixed rates. Directors considered that, while the large prime mortgage market still enjoys good credit quality, the main area of concern may lie in the sub-prime segment of the housing and mortgage market, where marginal borrowers are exposed to the risks of rising interest rates and a stagnation or decline in house prices. [...]

Directors considered that, while cyclical changes could well expose weaker segments and pockets of financial markets, these are unlikely to pose systemic risks. Against this backdrop, many Directors urged regulators to pursue a firm “no-bailout” policy, which would work to contain risks of investor complacency.⁴⁰¹ Broadly, regulators should place greater reliance on the self-correcting forces of financial markets, while focusing attention on ensuring robust market infrastructures, particularly for credit derivative markets. In particular, Directors emphasized that financial regulators should require that rigorous risk management practices are in place. Directors also urged regulators to provide guidance on the content of business continuity plans to address possible vulnerabilities related to event risks, such as an avian flu pandemic.»⁴⁰²

Resilience can only be shown by the absence of appreciable changes due to disturbances (shocks). No disturbances, no proof of resilience. Resilience need not change when a disturbance causes significant effects. The significant effects only show that the belief in resilience was mistaken. In other words: the first paragraph is a demonstration of misunderstanding. Of course, the subprime crisis has shown that the financial system was not resilient at all. (It did not change the resilience).

The resilience of the financial system was and is an illusion. It is something the principal persons made one another believe in. Helped by authorities like Greenspan, who since the nineteen nineties had used his power to eliminate all contrarian voices. The belief in resilience had no empirical or theoretical basis. It rested on one sided wishful thinking and/or a theoretical or dogmatic basis. As shown in the first part of the Analysis, the financial system is not stable at all. It is unstable. Causes of the instability were indicated. The argumentation of the first part of the Analysis is supported by the empirical evidence of history. History is incompatible with stability of the financial system. If the system was stable, there would not have been a financial crisis.

³⁹⁹ The formulations are incompatible with resilience and stable being system properties. “contained inflation, and stable inflationary expectations” probably means “and slowly changing inflation”.

⁴⁰⁰ This is no more than a hypothesis. There is no proof whatsoever, at most consensus in a politically selected top.

⁴⁰¹ Note that this assumes the effectiveness of financial incentives.

⁴⁰² IMF GFSR April 2006 pp. 132-3/1-2. The division in paragraphs has been changed marginally. In the original, all paragraphs start with: “Directors...” .

Note that the growth of household debt is mentioned among the causes of risk increase, but not that of government debts. Which would remain a risk even if reduced by the virtually impossible amount of 10%.

The third paragraph shows that the IMF is aware of developments in the American home and mortgage markets, but lacks the analytical abilities to infer the possible consequences. In spite of chapter 2 with its explanation of CDO's and their tranches,⁴⁰³ and its fear of liquidity problems. The paragraph shows no trace of awareness of possible depreciation of all kinds of derivatives, of the poisoning of derivatives, and the effects of depreciation on ratings and processes. Not even of well-known market mechanisms: disproportional drops in prices as perceived risks increase. As a consequence, the developments are not understood to being far more threatening than those of other paragraphs, such as the bird flu.

The last paragraph is an exemplary collection of essentially incomplete analyses, incorrect conclusions, and ill thought through advice. As the sequel showed, there were major systemic risks.⁴⁰⁴ The tough talk about “no-bailout” policy is in the first place irresponsible. At least at this time in the development.⁴⁰⁵ Did the IMF analyze the potential consequences?⁴⁰⁶ The “self-correcting forces” are figments of the imagination. At the time there was no proof of their existence or effectiveness. They were 100% hypothetical. The crisis showed that they were insufficient, to put it mildly. “Ensuring robust market infrastructures” sounds nice, but has the IMF any idea what these would look like? And so on.

The main weakness of this and other supervisor thinking seems to be: a general lack of better than superficial reflection, mistaking hypothesis (illusions) for facts, and the absence of efforts to discover and analyse the sequence of consequences of risks.⁴⁰⁷ The sequence of events following the realisation of a given risk. Of course, taking into account what the realisation of a risk presumes. The text speaks of a «most likely scenario», but no “less likely” scenarios are mentioned or discussed in the report. Like all other supervisors, the IMF lacks professionalism, and is unable to look beyond its nose.

IMF AR 2006 (September 2006; file created & modified 6/9/06).

Conclusions.

1. The following quote speaks volumes:

«Surveillance is one of the IMF’s main tools in the prevention of financial crises. Although the crises of the 1990s have been followed by several years of relative calm, the IMF continues to refine its tools for identifying vulnerabilities and weaknesses in its member countries and in the international financial system so that they can be addressed before a crisis erupts.»⁴⁰⁸

2. The annual report thinks that the positive economic development will continue. It sees the possibility of disturbances. But it sees no risks that could precipitate a crisis.
3. In the chapters 1 and 4, that is: the chapters with sections about risks, the word “subprime” does not appear. On the other hand, the annual report extensively discusses the risks caused by the bird flu.
4. Notwithstanding its lack of understanding of the financial system, the IMF does give good advice, in particular with respect to government debts.⁴⁰⁹
5. With respect to stability, the annual report differs from GFSR 2006-1. The internal coordination in the IMF seems to be inadequate.

Quotes and evaluation.

⁴⁰³ IMF GFSR April 2006 chapter 2 p. 55/5.

⁴⁰⁴ Including small risks with major consequences.

⁴⁰⁵ It might have been different in 1995.

⁴⁰⁶ It should be obvious that this question should not be asked the IMF, because it cannot answer it reliably.

⁴⁰⁷ And the weighing of risks by the totality of their consequences.

⁴⁰⁸ IMF AR 2006 chapter 4 section 4 p. 54/13.

⁴⁰⁹ There is no contradiction here.

The annual reports of the IMF cover the period 1/5 until (& including) 30/4. Annual report 2006 covers 1/5/05-30/4/06. The files with the annual report 2006 are dated 6/9/06. The website does not offer the annual report as a single file. There is a separate file for each chapter, appendix, list of abbreviations, etcetera.⁴¹⁰

Chapter 1 is called *Overview*. It has the following sections:

- (Introduction)
- The world economy
- Global economic risks
- The work of the fund

The summarizing first paragraph of the section *Global economic risks* mentions the bird flu. Not mortgage derivatives or repo markets. The words “mortgage” and “subprime” do not appear in the *Overview*. The second paragraph discusses global imbalances. (The IMF advocates a multilateral approach). The third and fourth deal with respectively the Doha Round about international trade and the bird flu. The section concludes as follows:

«A period of rapid global growth is perhaps naturally accompanied by concern about the factors that might undermine it. But a prolonged, rapid, and widespread global expansion, such as the one that continued in FY2006, also offers policymakers a rare opportunity to make current growth rates sustainable and to put in place the measures necessary to raise potential growth rates in the future. Fiscal policies that cut budget deficits and make possible countercyclical, supportive policy during downturns; measures to reduce public debt burdens; structural reforms that free up labor and product markets; and trade liberalization: all these are policies that will strengthen growth prospects and benefit industrial and developing countries alike.

Such policy actions can be implemented more readily during a period of expansion, when support is easier to marshal and policy measures can be planned more carefully and coherently. Deferring such actions until the economy is slowing and pressure for adjustment is more urgent can result in hastily implemented reforms that might not command widespread support or achieve their full potential. Moreover, taking pre-emptive policy action can make economies more resilient and so less vulnerable to global downturns in the first place. The greater the number of national economies that have implemented reforms raising their growth potential and reducing their vulnerabilities, the more moderate and short-lived any downturn at the global level, as well as at the country level, is likely to be.»⁴¹¹

So although the IMF fails to understand the operation of the financial system as a coherent system, and in establishing and assessing relevant risks, it does give very wise advice that could have prevented the second crisis.

But in September 2006 the IMF obviously has no inkling of the approaching disaster. Even though the turnaround of the home prices in the US took place in April 2006.

The work on the GFSR-reports seems to be independent of the work on the annual report. The section *Global economic risks* of the AR has a very different style, and discusses several subjects not discussed in the GFSR reports of 2005-2007. The Doha Round for example is not mentioned in the GFSR 2007 at all. Coordination inside the IMF clearly leaves something to be desired.⁴¹²

Chapter 4 is titled *Strengthening surveillance and crisis prevention*. The section *Crisis prevention* has the following table of contents:

- (Introduction)
- IEO report on IMF's approach to capital account liberalization⁴¹³

⁴¹⁰ Among the organisations considered in this study this may not be the only exception, but it certainly is rare and user unfriendly.

⁴¹¹ IMF AR 2006 chapter 1 pp. 14-5/5-6.

⁴¹² Of course, there is no reason to have only a single opinion on everything. But different points of view should be discussed. Motivations and substantiation should be made explicit.

⁴¹³ "IEO" is missing in the IMF GFSR 2007.

- Balance sheet analysis
- Global economic and financial impact of an avian flu pandemic

The introduction begins as follows:

«Surveillance is one of the IMF's main tools in the prevention of financial crises. Although the crises of the 1990s have been followed by several years of relative calm, the IMF continues to refine its tools for identifying vulnerabilities and weaknesses in its member countries and in the international financial system so that they can be addressed before a crisis erupts.»⁴¹⁴

This paragraph is a rather tragic example of false pretensions. In the first place it is regrettable that the IMF does not explain why it thinks that surveillance can be “one of the IMF's main tools in the prevention of financial crises”. And what that surveillance should and/or do consist of. In the second place “continues to refine” wrongly suggests that the tools are already good and adequate, but can (of course) be improved. In the third place the facts of the crisis show that the paragraph is no more than bragging: misleading false pretensions. It suggests that at present there are no “vulnerabilities and weaknesses in [IMF] member countries and in the international financial system”, which is nonsense.

In the meantime, costs were not spared:

«In September 2005, the IMF sponsored a high-level conference at its Washington, D.C., headquarters that addressed key financial stability issues. Participants in the conference—central bank and supervisory officials from 40 of the IMF's member countries—examined the risks stemming from rapid credit growth and asset price bubbles in financial and housing markets, possible monetary and prudential policy responses for addressing these risks, the institutional aspects of implementing the financial stability mandate, and issues related to supervisory gaps and preconditions.»⁴¹⁵

Wow! «addressed key financial stability issues»!

Nothing is said about the results. Even though this is an annual report, and the only accounting document. Why mention (and organize!) the conference if its results are not worth reporting?

Nothing in the section *Crisis prevention* suggests that the IMF is aware of risks that can precipitate a crisis on short notice, and/or considers a crisis a realistic possibility.

GFSR 2007-1 (April 2007; file created 5/6/07, modified 23/10/07).

To be kept in mind when reading this report: ABX index timeseries show that by March 2007, BBB and BB⁻ had fallen more than 30%.

Conclusions.

1. The IMF is still thinking in terms of a stable and resilient financial system.
2. According to the IMF, different kinds of disturbance are nevertheless possible. For example as a consequence of subprime mortgage derivatives. «The challenge, therefore, is to further strengthen the financial system to ensure its resilience should current benign financial conditions change.»
3. There are remarkable changes with respect to the GFSR-report of a year before. Wishful thinking is less frequent. The tough talk of no-bailout from the report of April 2006 is gone. The GFSR of April 2007 is more careful. A mild shower is considered possible. But a thunderstorm is outside the range of thinking, and a devastating hurricane beyond imagination.
4. Nothing is said about the (relative) size of risks and their potential consequences. No effort is made to describe the sequence of events comprising the realization of risks in scenario's, as a basis for the planning for eventualities and interventions.
5. Though late and unsystematically, IMF gives sound advice. But it doesn't warn against consequences of non-compliance. The recommendations of the GAO and CGFS seem to be unknown, and the implementation of advice is not monitored.
6. The substantial differences between the sections on risk in the GFSR and AR suggest that they

⁴¹⁴ IMF-AR 2006 chapter 4 section 4 p. 54/13.

⁴¹⁵ IMF-AR 2006 chapter 4 section 4 p. 55/14.

were written independently and have not been discussed or coordinated.

Quotes and evaluation.

The report has an Annex *Summing up by the Chairman* beside an *Executive summary* in the front. The *Executive summary* begins as follows:

«Favorable global economic prospects, particularly strong momentum in the euro area and in emerging markets led by China and India, continue to serve as a strong foundation for global financial stability. However, some market developments warrant attention, as underlying financial risks and conditions have shifted since the September 2006 Global Financial Stability Report (GFSR). [...]»

The changing mix of assets, source countries, and types of cross-border investors identified in Chapter II should, for the most part, help to stabilize global markets. [...] A theme of Chapter III—that the globalization of banks may help reduce individual bank risk but may not necessarily enhance the resilience of financial systems as a whole—is also echoed in Chapter I, which examines possible spillovers from a deterioration in credit quality in the U.S. subprime mortgage market.

Chapter I identifies several short-term risks.

First, the subprime segment of the U.S. housing market is showing signs of credit quality deterioration. While the fallout to date has been limited, there is scope for it to deepen and spread to other markets, possibly to structured mortgage credit products held by a variety of global investors. Fortunately, the economic impact of the housing market slowdown has been limited and some market indicators have begun to stabilize, suggesting that the financial effects may also be contained.

Second, low interest rates and healthy corporate balance sheets have spurred an increase in private equity buyouts. [...]

Third, capital inflows to some emerging markets have risen rapidly, in part reflecting improved economic fundamentals, but also reflecting the search for yield given low interest rates in most mature markets. [...]

Finally, while the downside risk from a possible disorderly unwinding of global imbalances has receded somewhat, it remains a concern. [...]

Against the backdrop of continued global growth, none of the individually identified risks by themselves threaten financial stability. However, with volatility across asset classes close to historic lows and spreads on a variety of credit instruments tight, investors may not have adequately factored in the possibility that a “volatility shock” may be amplified given the increased linkages across products and markets. Institutions may well be acting in accordance with their own incentives, but collectively their behavior may cause a build-up of investment positions in certain markets, possibly resulting in a disorderly correction when conditions change. For instance, the rapid growth of some innovative instruments, the rise in leverage in parts of the financial system, and the growth of carry trades suggest that market participants are expecting a continuation of the low volatility environment and that a sustained rise in volatility could perturb a wide range of markets.»^{416, 417}

On the one hand this may be one of the best analyses found in any of the supervisor reports. It starts to resemble that of the GAO of 1994-1999. And raises the question: why didn’t the IMF realise and say this much earlier? At the same time, the tendency to think wishfully remains.⁴¹⁸ Events tend to be interpreted positively, the importance of anything positive is stressed, and consequences of risk-realisation are underestimated or downplayed. There is no awareness of missing essential information and understanding. The IMF is nevertheless aware of dangers, though vaguely.

The remainder of the second page of the *Executive summary* (of two pages) is more a table of contents than a summary.

The most important paragraphs from the section *Policies to Mitigate Stability Risks* are the

⁴¹⁶ IMF GFSR April 2007 pp. ix en x.

⁴¹⁷ In this quote, the words “stability”, “stabilize” are used inconsistently. In the first sentence, “stability” is used in a way that is incompatible with the dictionary (and for example ECB) definition. This is not a trivial remark, but can be related to the failure of IMF to understand (cooperative and sequential) risks and their consequences.

⁴¹⁸ Or perhaps the human difficulty to accept the idea that a week of nice weather does not mean that it cannot rain any more: the difficulty to realize the inconstancy of a phenomenon in the correct proportions (probabilities).

following:

«Global economic conditions have been supportive of a benign financial environment, but there are now emerging developments that have the potential to weaken financial stability. [...] The challenge, therefore, is to further strengthen the financial system to ensure its resilience should current benign financial conditions change.

While the weakening U.S. housing market has had a limited effect on the overall financial system, the U.S. subprime segment is showing credit quality strains. So far, this has not affected financial stability overall, but because the complex market structures of mortgage-related securities can disguise how risks are allocated, who holds them, and the degree to which they are hedged,⁴¹⁹ financial supervisors need to identify the potential for spillovers. In this regard, ensuring that underwriting standards are maintained is critical to supporting market discipline and, in this regard, recently issued guidelines are welcome.

For policymakers in mature markets, the substantial growth in private equity buyouts will require continued scrutiny. Financial intermediaries active in these transactions need to understand the risks and be prepared for unlikely constellations of risks—supervisors can encourage them to do so. Specifically, banks that underwrite, provide bridge financing, or are involved in the syndication and distribution of leveraged loans must ensure they are managing their risks appropriately. Regulators need to be mindful that the intense competition for deals could lead to a weakening of credit discipline and lending standards by some market participants.»⁴²⁰

Once again IMF gives sound advice. But late; and IMF could understand: possibly too late. Too much bad paper may already be in the market. Furthermore, the advice is noncommittal, for others. Could IMF itself really do nothing more active? And why doesn't IMF report about the implementation of earlier advice/ recommendations? And those of GAO and CGFS? After all, all of them pursue one and the same goal: the stability and smooth development of the financial system. Why isn't IMF more explicit about the consequences of failure to implement its advice? About the risks implied by the failure of supervisors to heed its advice?

In the meantime IMF is still thinking in terms of a stable system, and in terms of increasing resilience. Implicitly IMF seems to think that the risks are small or manageable. In other words: it grossly underestimates the problem(s). But it is more careful than a year ago. Not much is left of the optimism about the thinning of credit risk. At least in the last quote the unknown is not automatically replaced by something positive, but seen as a risk. Compare for example the paragraph with “likely” and “less likely” in the GFSR of April 2006.

The idea and necessity of the recommendations is clear, but they probably need to be specified to be implementable.⁴²¹ Supposing they can be implemented without time consuming changes in law or regulation. In addition it is not clear whether the recommendations are sufficient to secure safety, to prevent autonomous amplification of disturbances, and to avoid a crisis.

As in the GFSR of April 2006, an analysis of consequences of hypothetical disturbances is absent. It would be nice to show at least the theoretical effect of the implementation of the last and earlier IMF recommendations.

The no-bailout recommendation from the GFSR of April 2006 is not repeated in April 2007. But without discussion or explanation.

⁴¹⁹ This smells like a conscious lie: the problem not being the complexity, but lack of transparency and regulation. Admission of this lack would be self accusatory, and would accuse supervisors who rejected the GAO and CFTC-Born proposals, and/or failed to properly evaluate the risks their institutions were running, and/or the risk management of these institutions.

⁴²⁰ IMF GFSR 2007 pp. 32-3.

⁴²¹ Why doesn't IMF make a remark like this?

Conclusion.

The crisis has not changed the IMF. As before, it writes as if knowing and understanding everything. The crisis has proven that its understanding is fully 100% nonsense. IMF AR 2009 is written as if IMF perfectly understands the crisis. Its explanation mentions phenomena not mentioned before the crisis, and is rather vague. IMF does not acknowledge its own failure. It does not show that it understands why it failed, and shows nothing resembling correction or improvement. The IMF is going to be “modernized”, but the modernization has nothing to do with failings in 1994-2007.

Quotes and evaluation.

Reminder: the annual report 2009 of the IMF covers the period 1/5/08 until (& including) 30/4/09. So the AR 2008 does not cover September 2008, and AR 2009 does.

On p. 9 AR 2009 gives an explanation of the crisis:

«Understanding the causes of the financial crisis is critical for restoring stability and, to avoid another crisis of this magnitude, building a sound global financial system. While the postmortem is likely to continue for many years, the IMF’s initial analysis pointed to a failure in the global architecture in providing adequate warnings prior to the crisis, especially in the surveillance of systemically important advanced countries, and regulatory failures at a number of levels:

- excessive leverage and risk taking, driven by a long period of low real interest rates and high growth;
- shortcomings in the approach to domestic and international financial regulation;
- fragmented regulatory structures;
- inadequate disclosure of risks; and
- weaknesses in crisis management and bank resolution frameworks.

In general, financial regulators were not equipped to see the risk concentrations and flawed incentives behind the financial innovation boom. Neither market discipline nor regulation was able to contain the risks resulting from rapid innovation and increased leverage, which had been building up for years.

With respect to macroeconomic policy, policymakers failed to take sufficiently into account growing macroeconomic imbalances that contributed to the buildup of systemic risks in the financial system and in housing markets. Effective policy cooperation at the international level was not achieved, which compounded the risks inherent in the inability to spot growing vulnerabilities and cross-border links. Central banks focused mainly on inflation, not on risks associated with high asset prices and increased leverage. And financial supervisors were preoccupied with the formal banking sector, not with the risks building in the shadow financial system.»

As before the crisis, the IMF speaks as if it knows and understands everything. There is no discernable change of style. None. In addition, it is obvious that IMF points to causes which it hardly if ever mentioned in earlier reports. These can be understood as revelatory, and as a very important warning. Before the crisis, the IMF clearly failed to see crucial developments. It did not understand what was going on. It was evidently very far wrong. There is not the least reason to assume that IMF has improved, learned anything. The unchanged style shows the contrary: it is just as blind and arrogant as before.

As usual though, the IMF makes sensible remarks. Though not necessarily the most relevant. What it calls causes can indeed be seen as causes in a certain sense. But the causes it mentions can be tackled without eliminating or even reducing the possibility of future similar crises (or disasters). If only because the causes it mentions are vague if not ambiguous, and can be interpreted (“fragmented regulatory structures”, “inadequate disclosure of risks”) or reduced (“excessive leverage and risk taking”) without eliminating them. While other (new) risks are allowed to grow. As happened in the

⁴²² Pdf-files of earlier AR had tables of contents with the names of chapters and sections, and links to sections. This one has not, is unnecessarily cumbersome to use. Things can get worse too.

past.

The point is that all causes mentioned have causes that may remain unchanged by dealing only with those mentioned.

The IMF does not acknowledge its own failure, and (therefore...) does not try to find the causes of this failure. Many of the remarks it makes could and should have been made years earlier. They should have been repeated as long as they were relevant. Why didn't it make them? This and similar observations are implicit in the quoted text, but are not made explicit, nor analysed and tackled. IMF does not say that IMF and all other important supervisors and government could and should have prevented the crisis (by being open in thinking and reporting). As a consequence, you and me have no reason to assume that the IMF will operate any better in the future.

Pp. 10-11 show that the IMF profits from the crisis. It is given an important role in the crisis response, and the Funds' resources are to be boosted.

Lessons from the crisis are said to be drawn on pp. 33 and following. They are verbose and lack clarity and specification. They certainly are insufficient: the problems of government deficits and debts are not mentioned in this AR, although they are potential causes for another crisis or deepening of the ongoing crisis.⁴²³

Don't forget that the lessons have to be implemented by people and organisations which have failed, and have unambiguously shown to lack the necessary competence and integrity.⁴²⁴

Final remark.

The title and subtitle of IMF AR 2011 are:

ANNUAL REPORT 2011- Pursuing Equitable and Balanced Growth

Here too growth as a dominant value. Dogmatism as of old.

⁴²³ They should not have been mentioned among the lessons, but noted if the IMF had learnt from its failure.

⁴²⁴ Otherwise, the IMF would have acknowledged its failure, and have made a thorough self-assessment.

14. Two Irish Investigation Reports.

The two reports are:

- The Irish banking crisis regulatory and financial stability policy 2003-2008. A Report to the Minister for Finance by the Governor of the Central Bank. 31 May 2010.
- Misjudging risk: causes of the systemic banking crisis in Ireland. Report of the commission of investigation into the banking sector in Ireland. March 2011.

The Irish banking crisis regulatory and financial stability policy 2003-2008.

A Report to the Minister for Finance by the Governor of the Central Bank.
31 May 2010.

The following quotes are from the *Summary and conclusions*.

«Overall financial stability policy (Chapter 6)

1.15

The major tool of overall financial stability policy was envisaged to be the Financial Stability Report (FSR). The language of successive FSRs was too reassuring throughout, even as late as November 2007, and did little to induce the banks – or the public and policy makers – to adjust their behaviour to avoid the threats that lay ahead. The FSR drafting overemphasised the central forecast whereas it is the downside scenarios and the condition of the weakest institutions that are the most relevant for a financial stability assessment. Admittedly, the views of outside bodies such as the IMF and OECD – especially in later years – were not sharply different and must have provided reassurance to any internal doubters. In particular, the relatively glowing 2006 update of the IMF’s specialised Financial Sector Assessment Program (FSAP) mission – an exercise designed precisely to identify any weaknesses in prudential regulation and financial stability policy – would have been enough to set any doubts that may have existed at rest. The FSAP Report’s misinterpretation – for whatever reasons – of the prevailing Irish situation **must be considered unfortunate.**»⁴²⁵

In connection with the same, the other report, *Misjudging risks*, says the following:

«4.3.12

Finally, the IMF Financial Sector Assessment Programme (FSAP) report on the Irish financial system in 2006 rated the performance of the FR highly. It did not call for any significant changes in its overall approach or methods. It also concluded that the Irish banking system was basically sound.⁴²⁶ The FSAP methodology itself suffered from weaknesses, especially a concentration on process rather than substance. The positive FSAP report also served to reinforce the confidence in the soundness of the banking system being expressed by the CB/FR in their Financial Stability Report.»⁴²⁷

The FSR is criticised severely. Of the 2007 FSR it is said that hope triumphed over reality.⁴²⁸

«The failure to take sufficient macro-prudential corrective action (Chapter 7)

1.20

Effective financial stability policy in a potential bubble also required intrusive macroprudential policy

⁴²⁵ P. 10/16. Boldface of original.

⁴²⁶ «These views were also broadly reflected in various IMF Article IV Consultation reports during this period. It may be noted that the Independent Evaluation Office of the IMF in its report of 10.1.2011 *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07* paints a bleak picture of the ability of the organisation to detect the financial stability problems arising internationally and particularly in a number of developed countries.» [Note of the original report]

⁴²⁷ Misjudging risk p. 66/82.

⁴²⁸ In 1.16 on p. 10/15.

measures such as additional capital buffer requirements for risky property lending. Although some initiatives were taken, deference and diffidence on the part of the CBFSAI led to insufficient decisive action or even clear and pointed warnings. There was an unresolved anxiety that an aggressive stance would lead to

- (i) a loss of market share by Irish-controlled institutions and/or
- (ii) the triggering of a collapse in confidence, at first in the property market, and later for depositors.

Thus, the belated and relatively modest tightening in 2006 of capital requirements for high loan-to-value (LTV) mortgages, designed mainly as a warning signal, was adopted only after prolonged and agonised debate.

1.21

It is not clear how much merit the first concern ever had, inasmuch as almost all of the foreign-controlled banks operated through locally established subsidiaries which would have been equally subject to restrictive regulatory measures. In any event the legislation was straightforward – promotion of the Irish financial services sector was to be encouraged but subject explicitly to the CBFSAI's mandate to promote financial stability. Far too much weight was also given to the second consideration, especially in the earlier period when decisive intervention could have made a major difference to the length and extent of the property boom. Regulatory measures will inevitably have some disturbing effects on markets; indeed this is their main purpose. The luxury of waiting until more clear-cut evidence becomes available must be set against the costs of inaction, especially when market participants are comforted and implicitly encouraged – or not sufficiently discouraged – to continue with risky borrowing and lending behaviour.»⁴²⁹

(This is the full (sub)section).

Now the second report.

Misjudging risk: causes of the systemic banking crisis in Ireland.

Report of the commission of investigation into the banking sector in Ireland.

March 2011.

Conclusions (by JFCvV).

1. The commission was to find causes, not to make recommendations.⁴³⁰
2. The report is organised according to type of actors. Its attention is evenly distributed over banks, external auditors and supervisors. The ministry of Finance (DoF) may have got too little attention.
3. (Especially) Chapter 5 and the executive summary are very worthwhile reading. The reason being that this inquiry is remarkably more open than that of CDW and FCIC, and provides (additional) helpful information and views.
4. Contrary to CDW and FCIC the Irish commission has taken a look inside banks, supervisors and DoF. It also looked at the practical relations between them.
5. The inquiry finds important if not fatal failures in the operation of the hierarchical organisations as organisations.⁴³¹ Opinions deviating from that of the leadership are repressed without proper argumentation.
6. Implicitly but not explicitly the report establishes incompetency and lack of integrity of all managements concerned. Without exception they are too optimistic and take too much risk.⁴³² And they fail in management too.
7. The commissions⁴³³ note systematically too optimistic/ positive assessments and outlooks of national and international supervisors. (Including EU, IMF and OECD). It is not noted however

⁴²⁹ Pp. 12-3/18-9

⁴³⁰ Terms of reference, p. 141/157.

⁴³¹ This is the interpretation of JFCvV of its findings.

⁴³² This includes, but is much worse than the “disaster myopia” listed in the glossary.

⁴³³ The present commission and that of the earlier report, mentioned below.

- that this implies incompetence and lack of integrity. No effort is made to find causes and remedies.
8. The report lends support to the conclusion that hierarchical organisation promotes repression: everyone has to follow the leader and accept his views, even if irrational, dangerous, etcetera.
 9. The report lends support to the conclusion that strong countervailing forces are necessary to suppress unbearable risk taking and following bad but seemingly profitable examples.⁴³⁴
 10. The report notes irrationalism, repression and intolerance, but does not reflect on this.
 11. The report does not give solutions for all observed important failures, and does not check whether the set of solutions given is sufficient to prevent repetition.
 12. Its analyses are insufficient as a basis for finding a credible set of solutions.
 13. Liability and criminal law are not mentioned.
 14. The selection of the heads is not paid attention.
 15. The financial system is not explicitly considered as a system, and the GAO reports are not mentioned. The report thinks in terms of risks of banks; although these risks are supposed to include system-environmental and market effects.

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⁴³⁴ Unbearable risk taking: unbearable by the risk taker.

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Chapter 5 could have been titled “summary and conclusions”. The hurried reader is advised to skip the executive summary and read or scan chapter 5.

The glossary is the best or one of the best I’ve seen. Examples:⁴³⁵

«Disaster Myopia

A tendency over time to underestimate the probability of low frequency shocks (i.e. “low probability / high impact risks”).»

«Groupthink

A psychological process that reduces the likelihood of critical views being expressed or heard within institutions, due to a desire for unanimity which overrides the motivation to realistically evaluate alternative courses of action.»

⁴³⁵ «Big Four International Auditing Firms: Ernst & Young, Deloitte, KPMG, PricewaterhouseCoopers»

«Herding

The willingness of investors and banks to simultaneously invest in, lend to and own the same type of assets, accompanied by insufficient information gathering and processing.»

«Leverage

The degree to which an investor or business is utilising borrowed money/debt to finance assets. An institution with significantly more debt than equity is considered to be highly leveraged.»

Executive summary.

Introduction.

«In explaining the simultaneity of the failures in Irish institutions, the Commission frequently found behaviour exhibiting bandwagon effects both between institutions (“herding”) and within them (“groupthink”), reinforced by a widespread international belief in the efficiency of financial markets.»

«Throughout this report the term ‘authorities’ will be used to refer to the Irish Financial Services Regulatory Authority (the Financial Regulator), the Central Bank of Ireland and the Department of Finance or to any one or combination of these.»

Contagion.

«This seems to have led to a gradual adoption of lower credit standards by a number of Irish banks (and it appears to the Commission that this was also the case for foreign-owned banks, as evidenced by reported losses) as a method to sustain market share and profitability. In some covered banks this strategy was consciously adopted by the board and was properly delimited. In other banks, boards seem to have simply decided on higher target growth rates, with little apparent realisation of the attendant risks; implementation (and risk policy) was implicitly left to staff.»

«Consensus [herding and groupthink]

A majority of the people interviewed by the Commission indicated that they saw no major problems except lack of liquidity until the end of 2007, at the earliest, and autumn 2008, at the latest. The reasons given were usually very similar, the most prevalent being: property prices in Ireland had never decreased markedly; everybody expected a “soft landing” at worst; loan portfolios appeared sound; property credits were diversified by country or county or class; peer banks abroad did the same thing; and “nobody told them” there was a potential problem.

A minority of people indicated that contrarian views were both difficult to maintain during the long boom and unhealthy to present to boards or superiors. A number of people stated that had they implemented or consistently supported contrarian policies they may ultimately have lost their jobs, positions, or reputations. Other signs were also noted pointing to sanctioning of diverging or contrarian opinions as well as self-censorship because of this. The apparent strength of these expected sanctions is difficult to judge, but the absence of opposition, barring only a handful of identified vociferous contrarians, may have made it easier for institutions to accept toning down the application of vital, tried and traditional prudential practices.»⁴³⁶

«A number of banks essentially appear to have followed the example of peer banks in a “herding” fashion; there is little evidence of original critical analysis of the advantages and risks of the policies. Widespread lack of critical discussion within many banks and authorities indicates a tendency to “groupthink”; serious consideration of alternatives appears to be modest or absent. A tendency to favour silo organisation and submissiveness to superiors strengthened this effect, particularly among the public authorities.

⁴³⁶ P. iii.

In designing the constraints and rules for banking in the future, full account will need to be taken of the failure of private and public institutions to appreciate the emerging risks and to take action. If responsible authorities are affected by the prevailing paradigms, they cannot be expected to uncover its risks and weak points. Financial systems should, in that case, be designed to be as stable as possible even in the absence of unfailingly vigilant and prescient regulators and central banks.»⁴³⁷

A problem is that “designed to be as stable as possible” will not result in a substantially more stable system. The advice is based on a lack of understanding of the financial economic system. Making as stable as possible is to be distinguished from making as sure as possible that outsiders don’t have to pay the costs of (any) risk taking by financial institutions.

It is to be regretted that the commission does not explicitly discuss acquaintance and use of the often mentioned GAO, OFHEO and CGFS reports, or even that of the CRMPG. The “contrarians” were backed by intrinsically sound reports of bodies of the first rank.

Flawed lending: Anglo and INBS.

At these banks, very much fell far short of best practice. Even though at the time especially Anglo was seen as an example to be followed.

«The Financial Regulator (FR) was clearly aware of many of these problems in the two banks. Prior to the commencement of the Period, and consistently throughout, it raised significant concerns regarding governance at INBS.⁴³⁸ It also submitted a comprehensive list of procedural and portfolio problems to Anglo. It furthermore raised minimum capital ratios for both banks. However, such remedies did not prove effective to ensure sufficiently greater prudence and accountability in either of the banks. The system-wide increase in capital charges on certain property loans in 2006, while appropriate in principle, proved too modest in a situation where property lending appeared hugely profitable.

As a result, to outsiders, the two banks may have appeared to operate in ways broadly acceptable to the FR. This may have increased their importance as role models for other Irish banks. It must also have given comfort to leadership in the two banks themselves and encouraged them to continue with these practices.»⁴³⁹

«The Herd: Other Banks

Bank management and boards in some of the other covered banks feared that, if they did not yield to the pressure to be as profitable as Anglo, in particular, they would face loss of long-standing customers, declining bank value, potential takeover and a loss of professional respect. The few that admitted to feeling any degree of concern at the change of strategy often added that consistent opposition would probably have meant formal or informal sanctioning.»

How the top functioned:

«Unfortunately, in many cases the documentation of discussions among board members over the Period was, in the view of the Commission, insufficient. A number of members interviewed indicated a strong preference for consensus on boards as well as among managers. It appears to have been difficult for individual members, especially those without banking experience, to express and maintain a view contrary to the majority view on the board. In some cases, members indicated that their approach was to initially register their opposition to a particular decision, but to then adopt the majority view. Contentious issues or strategies were, probably also in the interest of efficiency, seldom revisited unless it was jointly agreed to do so. Over time, managers known for strict credit and risk management were replaced; there is no indication, however, that this was as a result of any policy to actively encourage risk-taking though it may have had that effect.

⁴³⁷ P. iv.

⁴³⁸ The Period= 1 January 2003 to 15 January 2009. .P. 103/119 (in the Glossary) of the report. The reason for the choice of 2003 is the establishment of the FR in that year, according to 1.1 of the May 2010 report.

⁴³⁹ Pp. iv & v.

In addition, there were some indications that prudential concerns voiced within the operational part of certain banks may have been discouraged. Early warning signs generated lower down in the organisation may in some cases not have reached management or the board. If so, the pressure for conformity in the banks has proven to be quite expensive.»⁴⁴⁰

Note that this “consensus” does not mean a compromise, but that the minority had to submit to the majority.

The Silent Observers: External Auditors.

«Auditors have a number of ways to inform bank leadership of any concerns. In addition to the public audit opinion they give the Audit Committee a more detailed report on their findings on the business and provide a letter setting out any weaknesses identified in the bank’s reporting systems. They are also required to provide the FR with copies of these reports. Auditors’ commentary, however, regularly focuses only on issues which they consider relate to the accuracy of the historic accounts. In practice, this means that auditors look primarily backwards and at technical issues that may influence the accuracy of the accounts. Nevertheless, auditors are also required to assess whether a bank will remain a going concern for the next year; this seems to require them to make a judgment on at least the shortterm sustainability of the bank’s business model and strategy.

The auditors clearly fulfilled this narrow function according to existing rules and regulations. They did not, however, generally report excesses over prudential sector lending limits to the FR. Even if they had, it appears unlikely that anything would have been done about it as in general the FR was already aware of such limit excesses.»⁴⁴¹

«The Enablers: Public Authorities

The Central Bank (CB) and the FR noted macroeconomic risks and risky bank behaviour but appear to have judged them insufficiently alarming to take major restraining policy measures. Among all the authorities a very limited number of individuals, either in boards or among staff, saw the risks as significant and actively argued for stronger measures; in all cases they failed to convince their colleagues or superiors. Thus the authorities largely continued to accept the credit concentration in the property market and avoided forcing action on the failings in the banks. The Government actively supported the market over an extended period against the apparently fairly weak but clear opposition of the Department of Finance (DoF).»⁴⁴²

The section successively discusses CB, FR, DoF and international organizations.

«Surprisingly, since the FR saw itself as regularly meeting with the banks, interviewed bank management and board members could not recall any meaningful engagement with the FR on prudential issues (except technically, as part of the Basel II process).⁴⁴³ According to bank management, prudential issues were tick-the-box checks that formal procedures were in place, not checks on how they worked in practice. On the contrary, when prudential sector concentration ratios were exceeded, the FR did nothing to demand any limitation in risk exposure despite being fully informed. The FR’s passiveness with regard to sanctioning, as a matter of urgency, the weaknesses in governance and risk management in Anglo and INBS has been set out above. Consumer issues were exhaustively, publicly and actively dealt with by the FR, however.»⁴⁴⁴

⁴⁴⁰ p. v.

⁴⁴¹ p. vi.

⁴⁴² P. vii.

⁴⁴³ «Given that the FR did send post-inspection letters to banks requiring serious action, this view is difficult to explain. In one late case, it appears that the letter was not distributed to the Board. In other cases, it may be that FR contacts were made by “too low-level” officials or that the issues were seen as technical rather than strategic in importance. Finally, it may be that issues that the senior FR officials considered substantive in a prudential sense were seen by bankers as formal or technical only.» [Note of the original report]

⁴⁴⁴ P. viii.

«The DoF and the Minister for Finance were regularly provided with a Financial Stability Report, officially jointly written by the CB and the FR. In practice, the FR appears to have participated primarily at board level.»⁴⁴⁵⁴⁴⁶

«Generally, international organisations (IMF, EU, and OECD) were, at most, modestly critical and often complimentary regarding Irish developments and institutions. This gave the authorities and the banks additional reason to assume that all really was well. Domestic doubters were few, late and usually lowkey, possibly because it was thought that expressing contrarian views risked sanction; in addition, a long period of good times had reduced the numbers of those willing to continue to go against the prevailing and apparently proven consensus.»⁴⁴⁷

«Policy with Insufficient Information: the Guarantee

The lack of suspicion and the absence of sufficient information on the underlying quality of the banks' balance sheets is likely to have had a significant impact on the alternatives that were considered reasonable on September 29, 2008. Proper information is a precondition for any crisis management based on reality. As it turned out, decisions were made on the erroneous assumption that all banks were and would remain solvent. Only on that assumption could the decision to simply provide a broad guarantee be understood.»

«If accurate information on banks' exposures had been available at the time it seems quite likely to the Commission that a more limited guarantee combined with a state take-over of at least one bank might have been more seriously contemplated. Indeed, on the basis that such information had been available, banks could have been directed to raise substantially more private capital well before end-September 2008. As it turned out, however, the Government was advised that banks' insolvency risks were small relative to liquidity risks and it was eventually decided not to consider nationalisation. This proved to be only a temporary reprieve, however. After a series of insufficient government actions and initiatives, Anglo was nationalised on January 19, 2009 following the disclosure of significant governance failings. Shortly afterwards, the solvency implications of several banks' excessive property exposures started to emerge.»⁴⁴⁸

In the eyes of the present author there is a crucial gap at this point. The commission should have looked for (“deeper”) causes of the failures/problems it noted. The failures ask for a better explanation than the commission has given up to now.

Some lessons.

«A main lesson is the need to make sure, both in private and public institutions, that there exist both for a and incentives for leadership and staff to openly discuss and challenge strategies and their implementation. It must become respectable and welcome to express professionally argued contrarian views; neither this crisis nor many others have been or will be foreseen by the consensus view of professionals or managers. One way might be to regularly assess “worst case” scenarios relating to proposed strategies and forecasts, with a strong emphasis on using historical and international experiences. Additionally, lower-level staff could be more frequently consulted on implementation issues and their implications.»

⁴⁴⁵ «This was explained to the Commission as the combined result of inter alia bad relations at times between leadership and staff in the two institutions, time constraints by regulatory staff, the lack of economics skills in the FR and difficulties in achieving mutual comprehension (the different professional languages of economists and accountants). To the Commission it seems that this lack of cooperation is stemmed largely from lack of leadership at various levels in both institutions. Cooperation problems may have been compounded by a solid lack of understanding of stability issues at most management levels.» [Note of the original report]

⁴⁴⁶ P. viii.

⁴⁴⁷ P. viii.

⁴⁴⁸ P. ix.

The last two proposals are nice, but ignore the reasons of the management for not doing this on a regular basis in the past. Neither here nor in the following lessons does the commission tackle the deeper causes of the problems it has noted.

The commission should at least have added, that the worst case scenario should be published, and that presenting only a single scenario is never acceptable. Scenarios should always be accompanied by argumentation, and with arguments estimating their probability. The commission should have made recommendations to improve the chances of success of “contrarians”, and on the other hand, to reduce the possibilities for the management to make or keep organizations opaque.

Chapter 5 - Findings & final considerations (p. 88/104).

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[For pdf pagenumber: add 16]

5.3 Findings - Authorities

«5.3.4

It seems remarkable that the FR in practice accepted the severe governance problems in INBS. Allowing this bank to continue operations without major reforms or sanctions must, on the part of the FR, have reflected either a reluctance to pursue legal action or a profound trust in bank management and the board. Similarly, the rapid and concentrated lending growth in Anglo, and later in other banks, did not lead to regulatory action, with reliance being placed on management assurances that all was basically well. The FR continued to accept these assurances, even after the Guarantee decision in late 2008.

5.3.5

The Commission is aware of the view that the FR did not have sufficient powers to intervene. This view is not persuasive given that the FR could have acted in concert with the Central Bank (CB) and, ideally though perhaps unrealistically, with Government support. The real problem was not lack of powers but lack of scepticism and the appetite to prosecute challenges.»⁴⁴⁹

«The Central Bank [unabbreviated]

5.3.6

The CB chose to rely on the FR appropriately handling individual bank stability issues, much as the FR in turn chose to trust bank leadership. By implication, unless there were problems in the individual banks, there could not be major stability issues in the system as a whole. The Financial Stability Report (FSR) was constrained to present benign conclusions with a number of almost routine warnings voiced in the text itself. Simultaneously, macro-economic data signalling the emergence of the two key risks – growing dependence on foreign funding and the concentration of bank lending in the property sector – did not appear to have caused acute concern.

5.3.7

At least at policy level, the CB seems not to have sufficiently appreciated the possibility that, while each bank was following a strategy that made sense, in the aggregate, when followed by all banks, this strategy could have serious consequences for overall financial stability. This was a classic macroeconomic fallacy that must have been recognised in the CB and it remains unclear why it was

⁴⁴⁹ P. 91-2/107-8.

not appreciated at senior levels there. However, there are signs that a hierarchical culture, with elements of self-censorship at various levels, developed in the CB. Of course, this eventually made it even harder to address the increasing instabilities in the financial market.⁴⁵⁰

5.3.8

The Commission is aware of but disagrees with the view that the CB would not have been entitled to intervene to address stability issues concerning individual banks. If the CB management had identified or given sufficient weight to macro-economic vulnerabilities, it could and should have initiated discussions with the FR to ensure a deeper analysis of individual banks' regulatory returns. However, as neither institution suspected any significant problems this does not appear to have been done.»⁴⁵¹

«The Department of Finance [unabbreviated]

5.3.9

The Department of Finance (DoF) did not, despite its mandate, see itself as concretely involved in financial stability issues; it also did not have the requisite professional staff for this. There were regular formal contacts with the FR (via the approval process for its budget) and somewhat more frequently with the CB, both in practice responsible for operational stability assessments. The DoF saw itself as preparing legislation to be implemented by the other authorities, but appears to have avoided addressing other financial market issues unless brought to the table by the FR or the CB (for instance, Credit Union issues during the Period). This apparently was due to their legally independent status. The Commission could find no evidence that the DoF formally tried to influence the FR in its work. The DoF also did not make any efforts to strengthen its own financial market expertise despite crisis management exercises in the EU having shown a need for it among finance ministries.

5.3.10

Had the DoF taken a greater interest in financial market issues early on, preparations for dealing with the financial crisis would have been more comprehensive. It is well documented that the DoF consistently, though not forcefully enough, supported a less expansive fiscal policy, particularly regarding property market incentives. It also appears that worries about the developing financial situation were expressed internally from time to time by some DoF staff. However, nothing came of this as the CB and FR were seen as responsible for financial stability.»⁴⁵²

5.4 Why Did It All Come Together?

This section (pp. 94-6/110-2) is very worthwhile reading, but nevertheless has very serious gaps or shortcomings.

«[T]he paradigm of efficient financial markets was widely accepted». The paradigm included belief in stability, and self-regulation. But «stronger, irrational forces were also present». Note that the paradigm is supposed to be rational, which is incorrect or at least debatable. It is incorrect because of the 100% neglect of the prisoner's dilemma problem, solution of which requires effective supervision. Irrational elements were:

- «the existence of a national speculative mania in Ireland during the Period, centred on the sale and acquisition of property»
- «Warning signs were ignored as continuing economic stability was confidently assumed.
- Traditional values and practices were seen as less relevant in the new financial order.»⁴⁵³

⁴⁵⁰ As noted at other places, not the instability of the system changed, but a disturbance- the fall in home prices- approached a threshold, passing which the financial economic system would leave its equilibrium/ a stationary state.

⁴⁵¹ P. 92/108.

⁴⁵² Pp. 92-3/108-9.

⁴⁵³ P. 94/110, 5.4.3, points added.

According to the commission, this background «goes some way towards explaining why the crisis, despite being the culmination of a number of clearly unsustainable developments, was so totally and generally unexpected almost up to the very last minute.»⁴⁵⁴

The reactions to the GAO, OFHEO and CGFS reports, the treatment of Falcon of OFHEO, and the removal of Brooksley Born of the CFTC should have been added as examples of extremely irrational conduct. The absence of professionalism as demonstrated by the completely separate analysis work of the various supervisors, and by the absence of references to relevant reports, are irrational as well, and should have been added because of both their importance and easy verifiability.

«5.4.6

It may seem remarkable that people in Ireland (and elsewhere) with extensive experience in regulating and operating in financial markets may have accepted such fairly extreme assumptions for their daily work. It has been argued that various bandwagon effects (see Section 1.6 above) may have played an important role in this, as may the fact that international supervisory and banking peers abroad also accepted these assumptions at least to some degree.»⁴⁵⁵

Even in spite of available knowledge and substantiated warnings. In other words: the belief is inexcusable. And it was not only a belief. It was considered absolute truth, and admissible to eliminate disbeliever Born, and at least threaten all other “contrarians”.

«5.4.7

Ireland’s systemic banking crisis would have been impossible without a widespread suspension of prudence and care by those responsible for bank management as well as by those charged with ensuring responsible financial conduct.⁴⁵⁶ Investors and other borrowers as well as bank executive management have an interest in doing deals with each other for profit and for glory; what went missing was prudence in ensuring that such deals were soundly based. Bank boards and public authorities, whose role it is to make it difficult for the dealmakers to go overboard, continued with their traditional work. However, their authority and, unfortunately, their vigilance as watchdogs were in decline. The stability of markets was becoming more dependent on bank management and their risk management systems.

5.4.8

The majority of bank executive management, despite their apparent superior technical knowledge of the business, chose to follow the new but unsustainable banking model. Lending was seen (and rewarded) as selling a loan or service rather than as acquiring a risky asset.⁴⁵⁷ Banks’ management and boards embraced a lending sales culture at the expense of prudence and risk management. This view then spread down through the ranks, partly through the effects of volume targets and bonus systems and partly through indoctrination, causing the massive run-up in risky assets.

The footnote shows that the commission uses the term “stability” not in the sense of the ECB or the present report, but presumably in the sense of “varying only little or slowly”. As a consequence, it lacks a concept like our “stable”.

5.4.9

The external watchdogs generally remained inactive as management’s new banking model was introduced and implemented. There was no strong external reaction when management prudence

⁴⁵⁴ P. 95/111, 5.4.4.

⁴⁵⁵ p. 95/111.

⁴⁵⁶ «It is particularly difficult to understand why the FR apparently drew no conclusions from the quarterly reports it got from each Irish bank on its largest borrowers. These reports were provided to the Board of the FR and the CB and, when consolidated, clearly revealed the extent to which credit in Ireland was heavily concentrated on a small number of borrowers active in the property development market.» [Note of the original report]

⁴⁵⁷ «If the extreme assumption was that markets tended towards stability by themselves, riskiness was less of a concern than before. Further, asset growth would ensure, on average, stable profits growth. As a direct consequence, credit and risk management would lose much of their relevance – mistakenly, as it turned out.» [Note of the original report]

eroded within the Irish banking system, as evidenced by the very rapid growth in lending and wholesale funding. The Commission has not found any clear and documented cause for the simultaneous lack of action by various watchdog authorities; it can therefore offer only the partly hypothetical behavioural factors described earlier in this section.»

(End of section 5.4).

5.6 Lessons to be Learned from the Irish Experience

«5.6.2

The Commission has, having extensively examined the most relevant available documentation as well as interviewed very many people involved in the run-up to the crisis, explained the crisis essentially as a consequence of applying a naïve version of the efficient market paradigm, supported by groupthink and herding. This helped create and strengthen a mania in the Irish property market. Professionals and non-professionals alike became convinced, and convinced each other, that financial markets were stable by themselves, despite historical evidence to the contrary. The implications of this conviction seemed to be in the immediate interest of the overwhelming part of Irish society. The resulting activity was something that, later on, seemed quite unsustainable, puzzling and contrary to prudential requirements and common sense.»

This is vitally incomplete. The belief was coupled with a dogmatic, anti-critical (anti-scientific) attitude. Demonstrations of dangers were rejected on the basis of nonsensical quasi-arguments, and contrarians were silenced. In other words: contrarians were (and still are) terrorized. This is not implied by the factors listed by the commission, but necessary to explain the supposed uniformity of thinking.

The commission does not (sufficiently) consider repression and power as means to enforce “paradigms”. As noted elsewhere, it is unthinkable that people who put pressure on Born and Falcon behaved decently in their own organization, and did not instruct representatives to conferences with other supervisors to act in line with their views, and veto every incompatible recommendation etcetera.

«5.6.3

The development of excess indebtedness and property market overheating appears to have been fairly common in many countries in recent years and decades. This Report contains a short indication of how a groupthink and herding mechanism could support a theory of recurring financial cycles. The Commission has detected signs of such a mechanism both within Irish banks and within Irish public authorities during the run-up to the crisis. This mechanism may have been particularly strong because of the widespread existence of a belief in self-regulating, efficient markets.»⁴⁵⁸

«5.6.4

If this hypothesis is accepted, an important implication emerges. Because the real reason for the crisis is the spread of an ultimately irrational point of view, regulations and watchdog institutions cannot be counted on to be efficient preventers of a systemic crisis. As has been seen in Ireland and other countries, central bankers and regulators embraced much the same paradigm as the market participants and adapted their policies to their convictions. The result, as shown by the crisis itself, was that no effective brake on risk-taking existed for years. It does not appear wholly unfair to propose that this is what may happen also in the future if and when another new financial or banking paradigm appears. Many of the very reforms that recently have been undertaken, at short notice, to shore up the functioning of the present financial system could turn out, once again, to be ineffective.»⁴⁵⁹

The remaining lessons only concern the financial institutions in the narrow sense, not the authorities. Which is rather remarkable. The commission may imply that the lessons will turn out to be ineffective.

⁴⁵⁸ P. 99/115.

⁴⁵⁹ P. 100/116.

The commission does not make suggestions regarding irrational thinking, groupthink and herding, let alone repression and intolerance. The report is clearly incomplete.

15. On the FCIC-hearings of Moody's employees.

Moody's Corporation was one of the three main rating agencies. (The other two being Standard & Poors, and Fitch). In 2006 it had an average of approximately 3300 employees worldwide.⁴⁶⁰

Time and location of the hearings.

The hearings took place on June 2, 2010 in The New School, 55 West 13th Street, New York City.

Regarding relevant additional information.

The directories Moody's and SEC contain many relevant documents: annual reports (also on rating agencies) and examination reports.

In session 1 it is said: “[In August of 2007, the SEC did a report on Moody's. It was part of a larger report which they did on all rating agencies.](#)” The report of the Moody's examination is in the directory Moody's. The pdf-file is dated 2010. On p. 5 there is a (weak) recommendation regarding staff. See also the section immediately preceding the recommendation.

Notation.

The beginning of the first sentences of a quote may have been dropped, even after [...] and when the quote starts with a capital.

MD= managing director (I guess).

Conclusions from the hearings.

Lack of necessary understanding.

Those involved⁴⁶¹ did not have the necessary understanding of:

- Probabilistic multi-scenario instead of single scenario thinking. Probabilistic thinking takes account of more possibilities/futures, single scenario thinking of only one;
- Risk, as the combination of probability of an initial event, and a series of events or consequences;
- Risk management: the ability to take account of all relevant possible scenarios in a responsible way (including the need of boundary conditions);
- the consequences of loss of value of shares or other paper or contracts for the value of other paper or contracts and for markets and financial processes. In other words: those involved were insufficiently aware of the situation (the importance of MBS for the financial system) and processes (such as repo lending with collateral);⁴⁶²
- Instability and the instability of the financial-economic system (although one does have the notion of a price-bubble);

The raters did not seriously consider the possible consequences of the risks, even if these consequences could have been known from authoritative reports.

The people from Moody's may have understood some of the above after the crash, but this does not apply to the FCIC.

The hearings show, and suffer from, the incompetence of the FCIC.

The hearings suffer from the lack of understanding just mentioned and the lack of understanding of other matters by the FCIC. The questioning by the FCIC shows insufficient knowledge and mental abilities. It is clear that the commissioners do not know and understand much of the “millions of pages of documents” which they claim to have studied (according to p. xi of the report). They could have written a fundamentally better report on the basis of only documents. After having seriously studied

⁴⁶⁰ Annual Report 2007 p. 40.

⁴⁶¹ This includes the commissioners, Buffett and McDaniel.

⁴⁶² Note that it was known (for example from the OFHEO systemic risk report of 2003) that MBS was an important part of the required capital of financial institutions.

and analyzed the documents, and drawn a number of conclusions, the FCIC could have held very different hearings. For specific suggestions see *Wellinks meineed*.

No knowledge of CGFS or GAO reports, or the OFHEO systemic risk report.

No knowledge or understanding of the GAO-reports of 1994-1999, the OFHEO systemic risk report of 2003, or any CGFS report is shown.^{463, 464}

Buffett acknowledges importance of (OFHEO) annual reports.

In his answers Buffett uses OFHEO annual reports as authoritative source of the proposition that the GSEs had no problems. This casts (even more) doubts on the failure by CDW and FCIC to use such reports at all.

Liability would cause improvement.

The lawyers/managers at the intermediate levels think that liability would generate substantial quality improvement.

The difficulty of the bubble phenomenon.

Nobody shows understanding of the following questions about bubbles:

- How one can establish that a price rise represents a bubble (instead of “normal” inflation), or: how one can compute the probability that an upward trend represents a bubble;
- How one can compute the date when the upward trend will end.

For this reason one should not lightly accuse someone of failing to recognize a price bubble.

But since the phenomenon of price bubbles is well-known, it is definitely inexcusable that no account is taken of the possibility that an upward trend in the price of a commodity will turn out to prove a bubble. When this is understood, one can ask Moody’s and other raters how they estimated the probability, and how they translated the quantified bubble-possibility into their ratings. In the hearings, no such questions were asked.

Buffett and others explain the phenomenon of “price-bubble”, and the failure to take account of the fact that the rise will end, by supposedly widely shared human properties and/or groupthink. The explanation ignores the fact that it is one thing to recognize an ongoing development as a bubble, and quite another to predict the time of its reversal.

For the effects of possibly widely shared human properties and/or groupthink see *Wellinks meineed*, the section *De instabiliteit van het financieel-economische stelsel* in chapter 3.

Disproportionate attention to supposedly complex products shows lack of understanding of the importance of processes.

The attention given to “complex” products here as well as in the FCIC report is disproportional. The excessive attention is misleading, since there is little or nothing wrong with the products themselves. At least: inherent wrongness has not been shown convincingly by anyone. That they caused harm is due in part to the uncertainty about the distribution of their ownership: who had how much, in combination with the subjectivity of valuations, and the roles they played in the financial system. That they caused harm is due to the lack of awareness and understanding of this, and lack of information about the distribution. And of course the laissez-faire attitude of the supervisors. These factors got far too little attention. Nobody shows understanding of the system as a system, as a set of interacting products and processes. (The FCIC-report gives a useful introduction to this subject, but no more).

Testing on the basis of historical performance.

Calculations or tests based on historical performance outside bubbles and crises are inadequate if

⁴⁶³ Buffett has to be suspected of purposely keeping silent about the GAO-reports. He is found to be very well-read, and repeatedly shows a thorough knowledge of the history since the crisis of 1929.

⁴⁶⁴ Born compliments Buffett with the warnings and predictions in his letters to his shareholders. She says nothing about GAO-reports.

one wants to avoid crises and the consequences of bubble implosion.⁴⁶⁵ In other words: in risk management and safety tests one should use historical time series which are sufficiently long to include several bubbles and crises.

Rating undefined.

Insufficient competence is also shown by the absence of any discussion of the question what a good rating would look like. Or the definition or specification of a (good) rating. Nobody questions the possibility or value of a 1-dimensional rating. (I.e. a rating essentially consisting of a single number, such as the letter-combinations AA+ and BB). There is no discussion about the question which classes of phenomena should have been taken into account in a rating, which classes of phenomena are considered unpredictable (or when) and may or should result in updating a rating, and (other) assumptions and boundary conditions.

It is to be regretted that no (schematic) example of a rating (as given to a customer) is given.

Moody's priorities: market share more important than quality.

Almost everyone at Moody's thought that maintaining or increasing market share should be given the highest (if not inviolable) priority. For this reason a customer rarely got a "no" on his request to rate a given product.

In human resources management too, market share had priority. Quality care should not be detrimental to market share.

In session 1 Kolchinsky explains and defends all conduct and failure by market share as top priority, and, coupled with this, the impossible negotiation position of a Moody's employee with respect to a customer (the producer of a security).

In the discussion, the concept "inviolable priority" is missing, but would have been useful. At Moody's, quality obviously was violable. Questions about the exchangeability of quality and market share, and about dimensions of quality which might be inviolable, are not discussed. The middle managers questioned imply that market share was inviolable. See especially the introduction of Froeba.

The facts that the rating agencies were paid by their customers, and had competitors, helps explain that they mainly served the interests of their customers, instead of the public interest.

Evolution and characteristics of the employee population.

The three sessions taken together, and the third session especially, show active and passive selection at work. Active for example by intimidation and other forms of pressure. The result being a relatively docile population of employees, who have little difficulty with the applied methods (or know no better), or simply believe in them, and have no problem with the priorities of the top, or believe that this does not hurt quality. The best analysts (= who think best) are eliminated. The hearings show that in the course of the years, employees have learnt, and become frustrated (for example Witt, session 3). It is evident that thinking people are not welcome, and selected out. If they do not leave spontaneously, they are asked to, or reorganized out. At the cost of quality and quality correction ("improvement").

Brian Clarkson is an example of an intimidating, perhaps even sadistic, manager. Maintained by the top. Clarkson had been asked to appear on the witness stand. But reported inability to attend. Why didn't the FCIC check the truth or validity of the reasons he gives for his absence? He must have been an important selection instrument.

Quantitatively, human resources did not keep up with the growth of the rating volume. Human resources were or became insufficient. For this matter, see the SEC report of 2008 about the August 2007 examinations, and the declarations of the witnesses. (The SEC report may of course have been (partly) based on similar interviews).

(Note that solution of the quantitative problem would not necessarily have solved the quality

⁴⁶⁵ Questioning of Siegel, session 1, search for "historical".

problem. The understanding necessary for making good ratings, for which people can accept liability, is absent).

In 1997-2007 a cultural transformation took place in Moody's. Together with the changing priorities, the possibilities of independent evaluation by analysts were reduced or eliminated. See the introductions by Froeba and Michalek.

Even if it was better at Moody's before the year 2000, this doesn't mean that it was good. If it had been good, the witnesses from Moody's would have shown fundamentally better insight, and have mentioned the definition problem and specific types of improvement.

According to Siegel and Witt, people sufficiently low in Moody's hierarchy believed in the ratings. But from what is told about the shortage of resources, the failure of efforts to adjust the rating methods, the climate (the culture⁴⁶⁶), and the conduct of the top, it follows that every thinking employee must at least have had doubts.

More specifically about the rating process. Part of Moody's saw possibility of crash.

As the main cause of the crisis everyone or almost everyone mentioned the fall in home prices. (session 1, search for "major cause"; session 2, for McDaniel, search for "weakening").

Moody's models took insufficient account of the volume of subprime mortgages, and of the consequences of defaults on home prices. (Session 1, in Wallison's questioning of Siegel. Search for "outstanding").

Asked to explain why the ratings were too optimistic, all witnesses replied that everybody had underestimated the consequences of a reversal in the development of the home prices. However, not everybody in Moody's was surprised by the consequences. There were more warnings than the GAO and OFHEO reports. In October 2006 a department of Moody's itself, "Moody's economy.com", published a report "Housing at the tipping point". It was written by Zandi, Chen en Carey.⁴⁶⁷ As regards clarity and correctness the analysis in the report leaves nothing to be desired. But as in several other reports studied in the present report (GbL), the *Executive summary* is more optimistic than the report itself. A few quotes suffice to prove this. The summary is on pp. 5-7 of the report. The first quote is from the last paragraph on p. 5:

«Whether the housing correction unravels into a crash will largely depend on the secondary or indirect effects of the housing turndown. These include the impact on [...] financial intermediaries and the global financial system as mortgage credit quality weakens.»

This is correct, but gives nothing to go by.

The *Executive summary* concludes with the following paragraph:

«While the broader economy is expected to bend under the weight of the listing housing market, it is not expected to break. Economic growth has weakened and will remain below the economy's potential as long as the housing correction is unfolding; unemployment will edge higher, but even during the worst of the housing downturn, expected early next year, the expansion should remain intact. This optimism is predicated on the view that the secondary effects from housing's downturn will remain largely contained and that policymakers will not misstep. A much darker scenario is not difficult to construct, but the more sanguine scenario remains the most likely one. Moody's Economy.com will continue to update the tools and analysis described in detail in the study that follows to assess the health of the housing market and the broader economy.»⁴⁶⁸⁴⁶⁹

With the terminology "is not expected to break" and "the most likely one" (professional and correct) probabilistic thinking is set aside. There is room for only one scenario, the most likely one. Henceforth the others are ignored.⁴⁷⁰ This is clearly the custom in the prehistory of the subprime crisis,

⁴⁶⁶ The word "culture" seems less suitable because in normal parlance culture indicates something shared, such as shared norms and values, while in this case it only refers to an atmosphere created or dictated by the top. Not so much by its words, as by its deeds. It is known by all employees, but not necessarily adopted by them.

⁴⁶⁷ On the title page the names of Zandi and Chen is followed by "Ph.D.".

⁴⁶⁸ "state" would have been more neutral than "health". As the main text shows, the system could not really be called "healthy" any more.

⁴⁶⁹ *Housing at the tipping point* p. 7/5.

⁴⁷⁰ In agreement with Locke's human understanding.

but utterly unprofessional all the same.⁴⁷¹ Without having considered their possible consequences. The unthinking reader agrees with the author that there is no reason for action.

For comparison, the following gives a few quotes from the section *Financial markets* on pp. 44-46 of the main text of the report. On p. 45/42 one reads.:

«It is unclear, however, how these new securities [mortgage derivatives] will perform as mortgage credit quality erodes, and it is also unclear whether global investors fully appreciate this. It is not difficult to imagine that global investors' heretofore insatiable appetite for U.S. mortgage-backed debt would quickly sour as their performance weakened.»

and on p. 46/43:

«It is also conceivable that an oft-cited benefit of the mortgage backed securities market, namely its ability to diffuse mortgage credit risk more widely, is also a drawback. Given that the risk is so diffuse, it is unclear to investors who is bearing the risk and to what degree. If even a single investor visibly stumbles when credit quality erodes, liquidity in the market could quickly evaporate. Other investors not knowing who is next to suffer may decide not to engage in any further transactions until the proverbial dust clears.

Under some scenarios, the problems in the mortgage-backed [securities] market would spill over into the rest of the U.S. fixed income and stock markets. Skittish global investors would propel bond yields higher and stock prices lower. The turmoil in U.S. financial markets would immediately reverberate around the world, engendering a global financial event.⁴⁷²

There is historical precedent for this. The asset backed securities market froze in the wake of the Asian crisis and the collapse of Long-Term Capital Management in 1998. Liquidity was restored quickly, but only due to aggressive monetary easing and aggressive buying by Fannie Mae and Freddie Mac. The new Federal Reserve chairman is of course uncontested, and the GSEs are no longer in a position to come to the rescue in the next securities market crisis.»

The main text concludes as follows:

«Optimism that the unfolding adjustment in the housing and mortgage markets will simply be a correction and not a collapse is based on the strength of the broader job market and the balance sheets of financial intermediaries. The optimism is also supported by the heretofore orderly adjustments in the U.K. and Aussie housing markets and economies.

While the national housing market is expected to correct and not to crash, a number of significant metro area housing markets will. Moreover, the risks of a darker scenario in many more parts of the country are skewed decidedly to the downside. It is difficult to gauge just how sharply an asset market infected by speculation, like the housing market, will adjust as sentiment shifts. The broader economic fallout of this could be debilitating. What is expected to be a small disruption to the economy could quickly turn into a major problem.»⁴⁷³

Follows a remark on the purpose of the paper and a promise to update when conditions unfold.

These quotes do not really justify optimism. Optimism can only be found in the *Executive summary*. The weak point of the analysis and conclusions is, that even if the optimistic scenario is the most likely one, it remains only one of the possible scenario's. (It is actually the most, if not only, optimistic scenario). The "less likely" scenarios should get very much more attention. Namely because of its major consequences. An analyst does not do his job adequately if he or she only concludes that in the most probable scenario the dikes will hold, and no more. Any real probability of the dikes breaking deserves serious attention, and action. Failing to realize and mention this is a proof of incompetence.

Still, even from the conclusion of the executive summary an experienced reader can surmise that there is a real possibility for a catastrophic scenario. He or she can verify his conjecture by reading the main text.

⁴⁷¹ The OFHEO systemic risk report of 2003 being an important and the most important exception.

⁴⁷² Did a draft have "crisis" instead of "event"? After all, the word "event" obviously is a mystifying euphemism, which makes one wonder what the authors really think.

⁴⁷³ P. 46/43 of *Housing at the tipping point*.

The conclusion should be that there is no excuse for the underestimation by the rating analysts of the consequences of a housing downturn. They should have taken account of the possibility of a crash, and/or major negative effects on the financial system of a fall in home prices. A (general) crisis was not 100% certain, but the probability was definitely significantly larger than zero. It therefore should have been taken account of. A problem may have been that many people are unable to accept or think in terms of an uncertain future, and in terms of more than one scenario (possible future). Although of course it is possible just as well that the management obstructed the assimilation of undesirable scenarios.

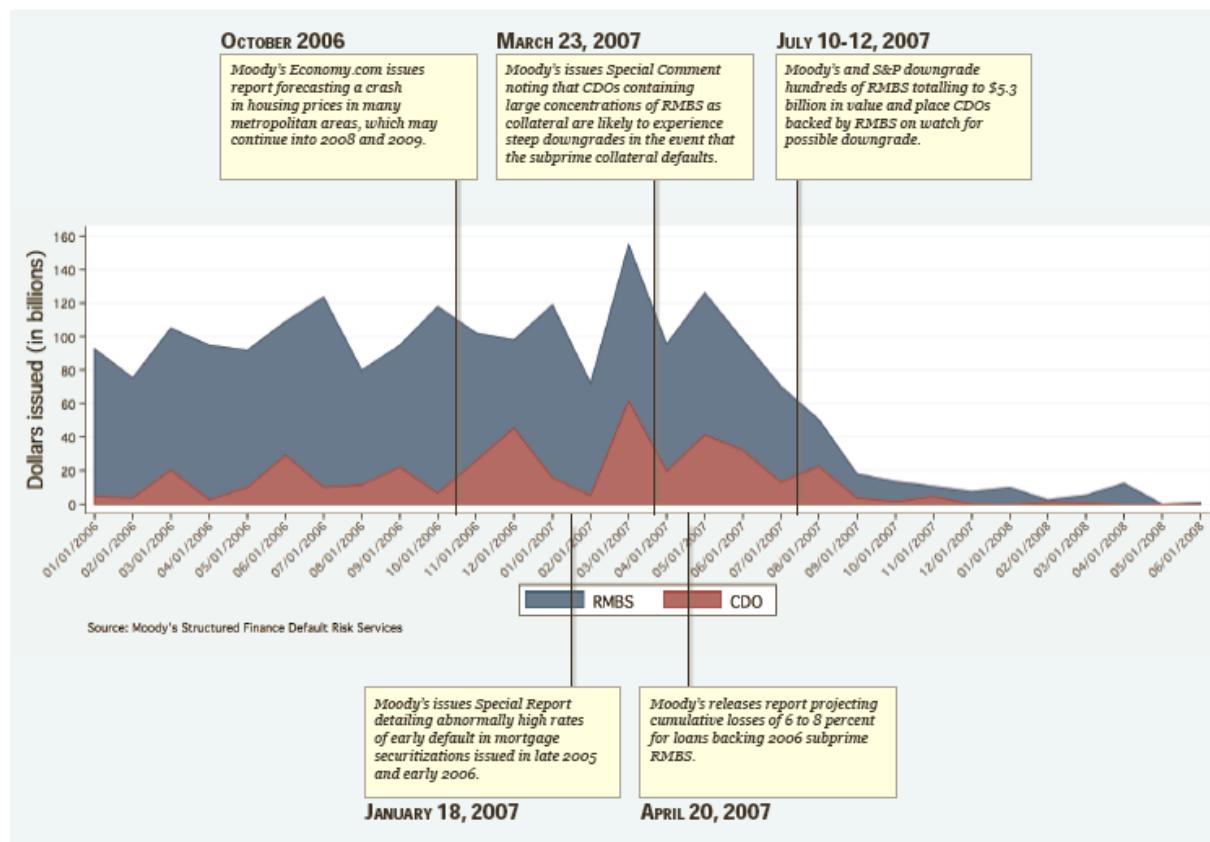
The FCIC too should have noted the incompatibility of summary en main text. The observation should have elicited the following revelatory question to one of the authors: why was the summary given a positive turn? At least one of the authors should have been invited.

The witnesses explain the unusual increase of the number of rated CDO's after the report of Zandi et al. by bankers grasping opportunities, and the wish of bankers and Moody's to have them ready and sold before the next downgrades.⁴⁷⁴ (Be careful. The fluctuations and trend in the graph below suggest that not too much significance can be attached to the "unusual increase").

CEO McDaniel is infallible.

CEO McDaniel (McD) dismisses all criticism as being "without merit". Both because of the actual, defective, ratings (at least as regards definition or specification) and rating methods, and the impossibility of perfection, this lacks credibility. McD implicitly claims to be able to answer all questions. But he is found to be unable for example to explain the AAA ratings after the Zandi report. Of course he utters a sequence of words, but the sequence does not embody an explanation.

Graph of the volume of Moody's RMBS and CDO rating output as a function of time.
The date notation is mm/dd/yyyy.



⁴⁷⁴ Het laatste is wellicht (mede) een hypothese van schrijver dezes.

Graham sees a «recurring pattern in American society where we see bright warning lights going off which are ignored until they mature into a catastrophe.»

The generalization “we” is incorrect and misleading. It hides the fact that those noting warning lights are not the ones who are responsible, and that those responsible fail to heed the warnings and fail to do what they are appointed and paid for.

Buffett's measures needed to prevent repetition.

In the opinion of Warren Buffett the following three things are necessary to prevent repetition:

1. a CEO should consider himself chief risk officer;
2. if the government has to provide aid, then there should be a huge downside for the CEO and a significant downside for the board;
3. less leverage (and thorough reflection on “leverage”, which according to Buffett isn’t simple).

These points repeatedly recur in his answers.

Buffett has a better understanding of rating than all of the others. He tables a problem nobody present is able to tackle. (The chairman even doesn’t seem to understand). Search below for “municipalities”.

The witnesses.

Session 1: (former) Moody's employees.

Eric Kolchinsky. «During the majority of 2007, I was the managing director in charge of the business line which rated subprime-backed collateralized debt obligations at Moody's Investor Services. I spent my entire career in structured finance and began working on CDOs in 1998. In addition to spending eight years at Moody's, I've also worked at Goldman Sachs, Merrill Lynch, Lehman Brothers and MBIA.» He had to leave in October 2007. For the reasons of his departure search for “factory”.

Jay Siegel. «I've worked for Moody's Investors Service for twelve years, from 2001 until 2006, April, when I departed from the company. I was one of two and then three of the managing directors of Moody's responsible for its work rating residential mortgage-backed securities or RMBS.»⁴⁷⁵

The «twelve years, from 2001 until 2006, April» has been checked in the original pdf file. That he left in (April) 2006 is repeated later in the session.

Nicolas Weill. «I'm the Chief Credit Officer for structured finance in Moody's Investors Service. In 2007, I was managing director of U.S. RMBS surveillance.»

Gary Witt. «For the last two years, I have been teaching full time at Temple University in Philadelphia, and no longer have any affiliation with Moody's. [...]. I was an analyst and then managing director in the U.S. derivatives group at Moody's from September 2000 until September 2005, when I was reassigned within Moody's away from CDOs. I was one of three team managing directors in the CDO group from March '04 to September '05. I was responsible for the following areas: Cash flow, ABS CDOs, market value CDOs, collateralized fund obligations, catastrophe bonds, and with another team MD, structured financial operating companies. If this list of my responsibility sounds intimidating, believe me, it was a very big challenge. [...]. After 18 months, in September 2005, I was transferred out of the CDO group.»

Session 2: Moody's shareholder Warren Buffet and Moody's CEO McDaniel.

Warren Buffet, Chairman and CEO of Berkshire Hathaway. Important or most important shareholder of Moody's. He therefore has a substantial interest in what he says and doesn't say.

⁴⁷⁵ Sic. “...twelve years, from 2001 until 2006, April...”.

Raymond McDaniel, Chairman and CEO of Moody's Corporation.

The transcript doesn't say more about these people, and they themselves don't do either.

Session 3. Lawyers/ legal analysts.

Mark Froeba «My name is Mark Froeba. I'm a lawyer. I live and work here in New York City, I am a 1990 graduate of the Harvard Law School cum laude. In 1997, I left Skadden, Arps in New York to join the derivatives group at Moody's. I left Moody's in 2007 as a Senior Vice-President. At that time, I was team leader of the CLO team, co-chair of most CLO rating committees and jointly responsible for evaluating all new CLO rating guidelines. I am happy to say that the majority of CLOs have exhibited a high level of stability throughout this crisis. Today, I'm currently engaged with PF2 Securities Evaluations, a New York-based firm which consults on CDO securities.»⁴⁷⁶

Richard (Rick) Michalek. «I'm a former employee of Moody's. I joined the structured derivatives products group at Moody's in June of 1999. My position was eliminated in December of 2007. At the end of my tenure, I held the title of Vice-President, Senior Credit Officer. My general responsibilities included performing legal analyses on the structure and documentation of complex structured finance transactions in order to assign a rating to that transaction, and to assist in the development and refining of rating practices, policies and methodologies used by the group. My regular responsibilities included participating in rating committees within the group and, on request, for other groups; consulting on legal matters for other groups in New York, London and the Asian offices of Moody's when requested, and speaking at industry conferences on a wide variety of legal and structural issues. I also prepared and published the CDO group's quarterly and annual review and survey of activity, and I assisted with the legal portion of semi-annual training sessions for all new hires in the structured finance department. During my last year at Moody's, my primary responsibilities were split between serving as a senior legal analyst on a team responsible for developing, refining and implementing the methodology for assigning ratings to highly complex credit derivative product companies, and being a project leader responsible for developing a methodology for rating collateral managers.»

Quotes from session 1.

The failure of the rating agencies can be seen as an example of regulatory capture.

Kolchinsky, in his opening statement: «The failure of the rating agencies can be seen as an example of regulatory capture, a term used by economists to describe a scenario where a regulator acts in the benefit of the regulated and not in the public interest.»

In the higher echelons of Moody's hierarchy market share had inviolable priority. Quantity was more important than quality.

Kolchinsky, in his opening statement: «the rating agencies faced the age-old and pedestrian conflict between long-term product quality and short-term profits. [...]】

For senior management, concern about credit quality took a back seat to market share. While there was never any explicit directive to lower credit standards, every missed deal had to be explained and defended. Management also went out of its way to placate bankers and issuers. [...]】

The poor performance of the structured finance ratings is primarily the result of senior management's directive to maintain and increase market share. [...]】

Despite the increasing number of deals and the increasing complexity, our group did not receive adequate resources. By 2007, we were barely keeping up with the deal flow and the developments in the market. Many analysts, under pressure from bankers and their high deal loads, began to do the bare minimum of work required. We did not have the time to do any meaningful research into all the emerging credit issues. My own attempts to stay on top of the increasingly troubled market were chided by my manager. She told me that I spent too much time reading research. [...]】

The only practical solution is to add accountability to the system by mandating minimum credit

⁴⁷⁶ CLO= collateralized loan obligation.

standards.»

According to Siegel everybody believed in his ratings, and nobody foresaw a crash.

«Moody's, like other market participants, certainly did not foresee as imminent the severity or speed of deterioration that occurred in the U.S. housing market after that period or the rapidity of credit tightening that followed and likely exacerbated the situation. During my tenure, however, I believe that Moody's ratings reflected the best opinion on the future creditworthiness of the debt securities based on the information available at that time.»

A little later in the session this is confirmed by Weill.

The belief in one's own ratings is incompatible with the assertion of Witt that liability would make analysts impossible to find.

Weill says that Moody's terribly underestimated the consequences of the downturn:

«As we entered 2007, Moody's believed that residential mortgage-backed securities, RMBS, had sufficient credit protection to withstand a market downturn of similar depth and duration as the previous real estate downturns. Unfortunately, Moody's, like others in the market, did not anticipate the severity or speed of deterioration that occurred in the U.S. housing market, nor the speed of credit tightening that followed and exacerbated the situation. A rating is an opinion of the relative creditworthiness of a security based on certain discussions that can change over time. Once published, we monitor it on an ongoing basis and we change it as appropriate to respond to changes in our original assumptions or updates to our views of the relative creditworthiness of the issuer or obligation.»

Weill claims that the rating quality could only have been better with the use of hindsight and lessons learned.

(Weill uses the same words as Siegel. By accident or prior agreement?)

Capacity lagging growth of workload, underestimation of the consequences of bubble implosion, and failure to grasp the meaning of "rating".

Gary Witt (two years away from Moody's): «Our staffing levels always lagged behind growth. The group struggled to rate new CDO issuance but we had many other responsibilities, including monitoring existing transactions, and keeping rating methods current. The biggest problem in my opinion during that time period was the absence of any reserve staff to develop, maintain and test new rating methods. [...]»

During the financial crisis, many people have been very quick to assign blame to the rating agencies. This is definitely appropriate, but up to a point. We at Moody's, along with almost every major participant in the capital markets, failed to grasp the magnitude of the housing bubble before 2007. [...]

People expect too much from ratings. As my wife once asked me, what good is a rating if it can't predict the future? Well, the answer is that ratings are tools to help investors manage risk. A bond rating is meant to boil down the received wisdom of the market to a single symbol.»

In other words: a rating is not meant to be a difficult story. Conditioning could make it correct, but would also make it useless.

The chairman notes that the «SEC found staffing shortages» in its evaluation of the rating agencies in August 2007.⁴⁷⁷

Witt: «we [...] failed to grasp the magnitude of the housing bubble». This was not the crucial point. The crucial point was that the raters did not realize the consequences of the fall in housing prices, and the uncertainty about the value of MBS. These consequences went much farther than what happened in the housing market itself. Everybody had very much underestimated the risks of MBS and similar paper, and their importance in the financial system.

Witt: «One of the things I did feel strongly about at the time, and I still do now, is that [...] the profit margins were so wide, and especially in the CDO group, and yet management really stunted on

⁴⁷⁷ The SEC-report is in the dossier.

hiring staff, and I just couldn't understand it then and I still don't now.»

As if the higher management simply didn't mind about people and quality.

A snapshot of short-sightedness and underestimation:

«**MR. WEILL:** I was part, as I said in my testimony, on the surveillance team, so we had a lot of dialogue with Moodyseconomy.com among others, and at the time my recollection is, for 2007, the prediction were more for a soft landing at the end of 2007, maybe for a ten percent national price decline, worst case maybe 15. And the level of protection that the securities had would easily take into account a ten- »

Apparently they did not look beyond the home prices and those of MBS. They did not look at the consequences the fall would have on the value of other paper, and the capital and market effects. Since the GAO in 1999 nobody did. There was not the least notion of instability and self-amplification. Therefore the precise percentage could be seen as not very important.

Weill sticks to this view under questioning by Graham, who confronts Weill with a report of Moody's from October 2006, which already uses the word "crash". The underestimation by Weill therefore was not consistent with reasoning elsewhere in Moody's, and quite contestable.

Siegel asserts that «**The analysts were never evaluated based on market coverage. That was a component of the managing directors' evaluation.»**

The chairman tries to find out how the number of ratings could substantially increase even after Moody's had predicted a crash.

Chairman: «**in October of 2006, [...] Mark Zandi and his crew [at Moody's] said there was going to be a crash».**

As shown by the quotes given above, Zandi et al. did not say there was going to be a crash. They said that the optimistic scenario was the most likely, even though they also saw the darker scenario of a crash (at least locally).

Kolchinsky asserts that bankers always try to circumvent rules, and use holes in the net.

«**But the bankers started getting more and more clever with the ways that they would try to counter that rule. And it became almost like a chess game. We would make a move, they would make two moves. And it became very difficult. And this is where my view about saying no, at that point, we should have been able to say, "No. You know what? We see what you're doing." And I saw some portfolios that were clearly meant to game that rule. We should have said, "No, you're not trustworthy. We don't want to do this with you." But we couldn't do that, so we had to play the chess game, which we kept losing.»**

The chairman sees two big issues.

«**It seems to me listening this morning so far, there's kind of two big issues. One is, why the heck were the ratings so wrong? And they were. I just want to put in perspective. They weren't off by small measure. You know, 83 percent of the AAA in 2006 was downgraded. In 2007, 89 percent of the investment-grade products were reduced to junk. I mean, this was way off. And without using the legal term, without casting aspersions, to the extent you're providing a product, this comes as close as you can to the very product being fraudulent or of no use to the marketplace in reality. So one is the quality of ratings. But I'm more struck or equally struck but, I think what you referred to, Dr. Witt, is just the structural problem here. The very system that didn't allow you really to say no to 30 to 40 percent of the deals. You might miss a deal or two, but you really couldn't say no to a whole market slice because you're paid by issuers, and your profit, and that was, it seemed to me always predominant, versus quality of rating. So in 2007, you know, you talked about how things were recalibrated but I want to point out in 2007, when housing prices are heading south fast, Moody's rated more than \$500 billion in residential mortgage-backed securities. After July, when you really start your massive downgrades, \$119 billion get rated as the market's in free fall. And these go very bad very quickly.»**

Summing up:

1. Why were the ratings so wrong?

2. There is a structural problem of being unable to say no even when required by minimal quality standards.
3. How could business continue as usual at a time of general downgrading?

Notwithstanding what the chairman says, the time series graph of the ABX index supports the claim that the ratings are relative, and reliable as such.

In answer to a question of Georgiou, Kolchinsky's says to find the new (legal) controls too weak. (And of course, they do not address the management/ hierarchical organization problem).

Graham outlines the problem of business as usual in spite of downgrades more clearly and more specifically:

«In October of 2006, when the Moody's research unit issued a study called, "Housing at the Tipping Point," the introductory paragraph in the executive summary reading, "The U.S. housing market downturn is in full swing. New and existing home sales and single family housing construction are sliding. Inventories of unsold homes are surging to new record highs and house prices are falling in an increasing number of areas." That was in October of 2006. And you'll note that immediately thereafter, the red line [of the chart] goes into ascent with the number of CDOs jumping in a period of less than 90 days from \$20 billion to over \$40 billion. Then, in January of 2007, Moody's issued a special report detailing abnormally high rates of early default in mortgage securitizations issued in late 2005 and early 2006. Almost immediately after that, another sharp incline in both the RMBSs and the CDOs; in the case of the CDOs, going from less than ten billion to approximately 55 billion in 60 days. Then in March of 2007, Moody's issues a special comment noting that CDOs containing large concentrations of RMBSs as collateral were likely to experience steep downgrades in the event that the subprime collateral defaults. After a short downturn, both the RMBS and the CDO line again goes upward. Then in April of 2007, Moody's releases a report projecting cumulative losses of six to eight percent for loans backed in 2006 [by] subprime RMBSs. And again, both the blue and the red line go up. Finally, in July of 2007, Moody's and S&P downgrade hundreds of RMBSs totaling 5.3 billion in value, and place CDOs backed by RMBSs on watch for possible downgrades.»

Even the word "crash" was already used in Moody's report. Weill and Witt give no plausible answer, or reasoned themselves stuck.

Banks may have seen the events as an opportunity. Banks and Moody's may have hurried to complete the paperwork before things got even worse.

Fact remains: while the home prices went down, the rating business flourished as never before.

But be careful: the graph is not, repeat not, convincing at all. The behavior may be coincidence. It is incorrect to conclude correlation. I think correlation is impossible to prove, given the shortness of the period. Note too that there was a substantial fall between 1/12/06 and 1/2/07. Does the rise have more significance than the fall? So probably you can better forget Graham's allegations.

Wallison notes absence of information which is necessary for rating:

«So you didn't have the data, if I understand correctly, about the total number of subprime and Alt-A mortgages in the market at the time you were doing these ratings. Yet, it is true that there is correlation in the sense that large number of mortgage failures do in fact produce declines in housing prices. And so I'm not sure that I fully understand how you were actually doing these ratings.»

The correlation adds to the risk, and sensitivity to this risk should be expressed in the rating.

Holtz-Eakin asks what a rating actually consists of:

«What would I get, would I get your rating or a full analysis, what would be available to someone using your product?»

MR. SIEGEL: For each RMBS deal we strove to publish what we called a New Issue Report, which would give our ratings, along with a summary of the pool statistics, so investors could see what the collateral was, a summary of the structure and our rating rationale. It would give an explanation, again, not each individual person's, but the committee would come up with a rational, why do we think 20 percent protection is enough for a AA II rating on this tranche.»

“20% protection”=? Similar to the Basel percentages?

Thompson asks for the background of the reassignment and departure of Witt:

«Dr. Witt, in the business I come from, when someone gets reassigned, sometimes that's a euphemism for something else. What does that mean in your language?»

DR. WITT: I believe that I was reassigned out of CDO group because I had- I was looking for another job. I got an offer from a university in Texas and I told my superiors about it. And I ended up not taking the job because the details didn't turn out to be what I was expecting. And, you know, so I stayed on. But about two months later, I was asked to leave the CDO group. I think that was the main reason. But the reason I was looking for another job was the types of things I was talking about in my opening remarks about, I felt like we were being asked, and specifically I was being asked, to be in charge of something that was incredibly complicated, and very difficult to achieve, and I did not have the resources to do it adequately. It wasn't that I thought that we were getting the ratings wrong or that I was being pressured to get the ratings wrong. It was that I thought that I didn't have the resources to make sure that I was getting the ratings right.»

This shows selection in action: someone objecting to false pretensions quits. People who (incorrectly) believe they can responsibly do the job are staying.

Kolchinsky and Moody's did make an essential error of reasoning. They assumed performance in a short past to offer a guarantee.

«But that was one area where it was easy, both to rationalize, because prior to '07, the performance of assets was so- so good. I mean, if you look at the subprime performance up to that point, delinquencies were extremely low, and I'm sure Nicholas [Weill] can tell you about that as well. So it was easy to rationalize concessions. And that's how people effectively gained and maintained market share.»

Utterly unprofessional. Incompetent.

The raters wanted to get the ratings right, even though it played no role in their compensation.

«COMMISSIONER MURREN: And to your knowledge, at Moody's, was there any evaluation of performance by either the analysts, the committee itself or people in managerial positions that were backward-looking, that would say that your performance was being evaluated based on what you just described, which is making sure the ratings were right?

DR. WITT: There's definitely a group that measures the performance ratings, you know, by category, and they would put out a report every year that would tell how ratings did. But did that affect people's pay, people's compensation? I would say in my experience, no.

COMMISSIONER MURREN: Okay. So it was important to you, but not because it was something that was rewarded necessarily at the firm.

DR. WITT: Yes. I mean, people took a lot of pride in trying to get the ratings right. I mean, you know, down at my level, at the analyst level and manager level, it definitely did.»⁴⁷⁸

Quotes from session 2.

The required size of the staff.

McD does not explain the lagging growth of the size of the staff of the department CDO-rating (with respect to the growth of the workload).

He could have said that the ratings were adequate, and that the only problem was that Moody's, like everyone else, underestimated the consequences of the end of the rise in home prices. And that more staff would not have prevented that.

Buffett seems to agree with McD.

Graham confronts McD with seemingly contradictory facts:

1. The observation of a part of Moody's that the rise in home prices had come to an end;
2. The abnormal growth of the volume of CDO's.

McD's answer is not convincing. The suspicion exists or arises that not quality but quantity had the highest priority.

⁴⁷⁸ See the questioning by Murren.

But as noted earlier, the second “fact” may be a figment of the mind of Graham, and in reality due no more than coincidence.

The concept of “rating” is insufficiently analyzed and defined.

As regards the quality of the ratings, the members of the FCIC are unable to be more specific than the very general conclusion that it was insufficient. They have no clear picture of the causes, of the rating (forecasting) procedure, methods or technique, of the definition or specification of a “good rating”, and no well-defined ideas of what is known and what not in this matter.

Moody’s people do no better. At the end of session 2 Buffett notes one of the real problems. As long as you do not solve this problem, you cannot give a 1-dimensional rating.

McD too asserts that a 1-dimensional rating is impossible. Perhaps he had doubts. Because it is not entirely clear what is meant exactly by the following remark of the chairman in the direction of McD:

«**You told our staff that, well, gee, if they had not done the ratings, they would have been howled at by Congress.»**

What do you do if you think you cannot do something that is asked of you? Conversely: people who think it cannot be done were selected out. Witt is an example. See session 1, under Thompson.

The consistency of the 1-dimensional ratings may be doubtful. The chairman sees uncountable AAA in RMBS and only a handful of AAA-corporations. (Search for “42,000” in the hearing’s report).

Missing knowledge of the concept of “instability” and awareness of the instability of the financial economic system.

For example the chairman of the FCIC may have been hindered by a failure to realize that small causes may have large consequences (“massive downgrades”, session 2). The FCIC seems to be looking for “large causes” of the major ratings downgrade operation of 2006. Which according to the present author was required by the foreseeable consequences of the end of the rise of home prices in a system with “complex” (= composite) products, processes, and (or first of all) subjective valuations. However, as from 2000 or earlier nobody cared to consider the system as a coherent whole. GAO had said in 1999: Regulators Need to Focus Greater Attention on Systemic Risk. But the regulators didn’t. There was no widely shared understanding of the workings of the financial system. The FCIC didn’t understand either.

Chairman: «**It seems to me that the resources were not applied to understand these products.»** Understanding the products wasn’t the problem. Problems were: insufficient awareness and understanding of the relations and dependencies in the financial system, lack of understanding of the instability of the system, of the fact that events with small probabilities but very large consequences were ignored, and that the ratings (as written opinions) were too simple. That the wrong people were heading all relevant organizations.

Buffett not only has no understanding of (in)stability, he also thinks too simply about causes and consequences:

«**MR. BUFFETT: Well, in terms of financial institutions that have failed and required assistance by the federal government, I think that when society has to step in to save institutions for societal reasons, that the CEO should basically go away broke, and I think his spouse should go away broke. I think there should be a real downside, and I think incentives are an important aspect in behavior.»**⁴⁷⁹

See also around “bubblette”: an underestimation which is possible only if you think in terms of small causes having small consequences, and not if you understand the system as a coherent whole, and have a notion of instability.

Buffett nowhere notes the essential roles of supervision and government.

Warning for bubble and possibility of bubble.

Individuals like Robert Schiller or Mr. Rubini or Mr. Baker spoke about a bubble. This is noted by the chairman in order to show that warnings had indeed been given. But the point is not only that

⁴⁷⁹ Session 2.

warnings had been given, but that rating agencies, supervisors and governments should always take account of the possibility of a bubble, and the possibility of a reversal of a trend in home prices. Irrespective of warnings. This is noted by neither FCIC nor CDW, who let everything depend on the question: had there been warnings of not. Every really competent expert could and should see the relevant dangers. The only remaining question was: when will the trend reverse? (And, for a competent investigator: why didn't supervisors and governments fail to reproduce the arguments resulting in warnings?)

There may have been few “[red and yellow flashing lights along the way](#)”.⁴⁸⁰ But they had been there. And the report of the GAO of 1999 left nothing to be desired as to argumentation and clarity. Every responsible professional moreover could and should have been aware of the instability of the system, and should have given every possibility a probability larger than zero. This awareness and attitude should have been the norm, and would have made warnings by others redundant.

The meaning of annual reports.

Buffett uses OFHEO AR 2007⁴⁸¹ to show that there was no reason for worry about the GSEs, and to show that the underestimation/ mistake of Moody's was general. The reaction of the chairman is weak:

[«CHAIRMAN ANGELIDES: Well, I actually think, I take a different few \[view?\], if you look at OFHEO's reports, which we've had access to, they raised a number of issues.»](#)

Which? Buffett seems to be right: they were comforting. They certainly gave no clear warning, told of no serious danger. At best, the chairman evaluates with hindsight, at worst he tries to cover up the failure of OFHEO.

Buffett can be seen to know a lot about the financial system and the history of the crisis. It is therefore rather improbable that he doesn't know the GAO reports and the OFHEO systemic risk report. (Of course, the hearings as a whole are very strange, since the FCIC too should have known them. It claims to have conducted an extensive literature study. It should have made an entirely different inquiry. For suggestions for questions see *Wellinks meineid*, chapter 5).

How to prevent repetition? Buffett has 3 conditions.

According to Buffett, there are three conditions:

1. the CEO should consider himself chief risk officer.
2. if the government has to come to the rescue there should be a huge downside for the CEO, and a significant downside for the board.
3. less leverage (and “leverage” should be thoroughly analyzed, which isn't simple).

These conditions crop up repeatedly in his answers.

Favoring corporations.

N.B. Rating agencies had no liability after the judge had decided that ratings were opinions. The chairman says: [«business has had a whole set of legal protections»](#).⁴⁸²

[«CHAIRMAN ANGELIDES: \[...\] So wasn't this system tilted in terms of lots of upside and no downside?»](#)

[MR. BUFFETT: I think much of corporate America is tilted that way.»](#)

So there is a relatively large upside.

Why the warnings were ignored.

Graham asks Buffett [«Why do you think that, as a society, we seem to have missed so many signals across a range of areas?»](#) Buffett answers by explaining the bubble phenomenon. But he does not explain why the GAO reports were ignored, why Brooksley Born was eliminated, why efforts were made by both GSEs and government to repress the OFHEO stability report, or why the Fed completely neglected its duty to manage systemic risk.

⁴⁸⁰ Chairman in session 2.

⁴⁸¹ The letter of submission by Lockhart is dated 30/3/07, in agreement with the remark by Buffett.

⁴⁸² In session 2.

The “as a society” of Graham is of course entirely unfounded, and, given the distribution of functions and responsibilities, a very reprehensible accusation.

Regulation of supervision of rating agencies.

«MR. McDANIEL: Pursuant to the Credit Rating Agency Reform Act of 2006, which became effective in, I believe it was September of 2007, there's been multiple inspections and reviews of our rating processes and practices by the Securities and Exchange Commission. Prior to that period, the oversight was less intensive because there was not a regulatory framework that the SEC was operating under for an inspection and review regime.»

See the footnote for SEC reports about the rating agencies.⁴⁸³ The FCIC is seen to ask many questions which seem to have been answered already by the SEC examinations.

The causes of the crisis according to McD.

In the first part of the questioning by Wallison, McD seems to reject all criticism as being “without merit”.

Wallison's asks what McD sees as the causes of the crisis. McD thinks that the weakening of the housing market, and the consequential tightening of credit for mortgage borrowers was the direct cause of the crisis. Somewhat later on he calls it the catalyst. He doesn't say what he sees as (in)direct causes.

Buffett saw that the GSEs took ever increasing risks.

Zandi, downgrades and AAA.

During the questioning by Georgiou (and/or elsewhere) McD doesn't answer the question(s) how the information in the paper of his own employees, Zandi et al., has been assimilated in de ratings. He doesn't say that he doesn't know either. He thought he should give an opinion. Whereupon the chairman interrupts him with: “Offering opinion is one thing. Offering an opinion that they are AAA is quite another”. In other words: how can one get AAA given Zandi et al? (This question seems to premise absolute instead of relative ratings).

Holtz-Eakin asks more or less the same question. After a clever, trap-like introduction. McD sticks to his line, but after the preceding discussion his answer seems to be unacceptable. In other words: there is no credible, acceptable accounting.

«COMMISSIONER HOLTZ-EAKIN: So the quality of the ratings ends up being the key. And I think you said earlier that you want them to include all the relevant information and make them as good as possible.

MR. McDANIEL: Absolutely.

COMMISSIONER HOLTZ-EAKIN: So I am then very interested in this situation that occurred in

⁴⁸³ SEC AR 2007, p. 31: »«Nationally Recognized Statistical Rating organizations. In FY 2007, the Commission implemented the Credit Rating Agency Reform Act of 2006. The Commission proposed rules detailing the requirements for credit rating agencies that register as nationally recognized statistical rating organizations (NRSROs). After reviewing public comments on the proposed rules, the Commission issued final rules that became effective in June. In September, the SEC issued orders granting the registrations of seven credit rating agencies as NRSROs. The staff also began inspections of a number of NRSROs.»

SEC AR 2008 p. 3: «Other significant actions in connection with the credit crisis included proposed rulemakings using our new authority under the Credit Rating Agency Reform Act to address weaknesses and conflicts of interest in the ratings process and to develop strong additional new requirements for credit rating agencies. In July, we released the findings from extensive examinations of the three largest credit rating agencies: Moody's, Standard & Poor's, and Fitch. Our examinations included hundreds of thousands of pages of the rating agencies' internal records and emails relating to their ratings of subprime residential mortgage-backed securities and collateralized debt obligations. SEC staff also analyzed the ratings history of thousands of structured finance products. The examinations uncovered serious shortcomings at these firms, including a lack of adequate disclosure to investors and the public, a lack of policies and procedures to manage the rating process, and insufficient attention to conflicts of interest. In response to the findings, the Commission proposed sweeping new rules to regulate the internal policies and business practices of credit rating agencies. The reforms addressed conflicts of interest and required new disclosures designed to increase the transparency, accountability, and competition in the credit rating industry.» Note that the pdf file of SEC AR 2008 was created 14/11/08 and modified 30/6/09, and that therefore the FCIC could have known it.

2007 where you had the residential mortgage-backed securities clearly up for downgrade and at the same time are rating CDOs based on the same underlying RMBSs, and went ahead and rated them AAA. It doesn't seem like all the relevant information was brought into the rating process. And how do you feel about that, and the risk it placed to your reputation and the quality of your ratings?

MR. McDANIEL: I believe that all of the information we thought was relevant at the time was brought into the rating process. But obviously, we had the problem of underestimating the extent to which the housing downturn was going to- its magnitude and how widely it was going to affect home prices nationwide. So as a result, the, even though we felt we were including relevant information, we felt we were using the best information we had available in the rating committee process, it proved to be insufficient [...]

We simply, if we thought that the housing problems and collateral consequences from the housing problem, if we had thought they were going to be what they in fact have turned out to be, we would have had very different opinions on those securities. We- we just underestimated and dramatically underestimated the significance of the downturn.»

Thompson traps McD regarding priorities:

«COMMISSIONER THOMPSON: So quality of the product or service that you deliver would be the one outcome that you value most.

MR. McDANIEL: Yes, because I believe that leads to the long-term prosperity of the firm.

COMMISSIONER THOMPSON: So why, then, is quality not a major component in the compensation plans for the managing directors who rate these securities?»

(Only) After the crash this element was introduced in the compensation plans.

Thompson repeats his tric, by letting McD first say that quality is the top priority, unconditionally, and next making him say that quality and market share have to be weighed. Whereupon Thompson addresses Buffett.

Buffett about leverage and derivatives.

In the questioning by Thompson, Buffett remarks:

«Leverage is what gets people in trouble. [...] I think we're always going to be fighting the human tendency to borrow more money than you should. [...] It's just such a human tendency that you need something on the governmental side to counterbalance that.»⁴⁸⁴

Born compliments Buffett with shareholder letters of 2002 and later, which are critical about derivatives. The supposed historical or documentary knowledge premised by this compliment is dubiously selective because the GAO reports, and the OFHEO systemic risk report, remain unmentioned. As ex boss of CFTC at a crucial time Born should know and remember them.

Born makes Buffett say that the derivatives portfolios of various banks were unmanageable. Which implies that these banks had too much pretensions.

According to Buffett “the derivatives market [is] still a time bomb ticking away”.

The following discussion at the end of the session shows that Buffett understands something of the rating problem that escapes the chairman:

«CHAIRMAN ANGELIDES: Last comment as we wrap up here. As I've read the materials provided by the staff, read innumerable interviews, other background materials, I'm struck with the fact that, with respect to the credit rating agencies' practices and models, seems to me that the question isn't so much why did this system fail, but why has it lasted so long. And in that vein, I just want to ask you today what risks do you see from the current credit rating models? In the same way you said there were risks for derivatives, do you see extant risks, current risks from the model essentially being unchanged from where it was when the mistakes, the disaster, however you characterize it, happened?

MR. BUFFETT: Well, the huge question, if you were running a rating agency now, if I were running a rating agency –

CHAIRMAN ANGELIDES: Or if you owned 13 percent in stock-

⁴⁸⁴ Governments consist of human beings too, and indeed create very much debt.

MR. BUFFETT: - how would I rate states and major municipalities? I mean, if the federal government will step in to help them, they are AAA. If the Federal government won't step in to help them, who knows what they are? I mean, if you're looking now at something where you could look back later on and say, "These ratings were crazy," that would be the area. Because it's bimodal. I mean, basically - I don't know how I would rate those myself now. I mean, in other words, because it's a bet on how the federal government will act over time.

CHAIRMAN ANGELIDES: *But the real question - well, but also, in that vein, have you looked at whether the resources, the discipline, the capacity is there internally at Moody's?*

MR. BUFFETT: I don't think - I don't think Moody's or Standard & Poor's or I can come up with anything terribly insightful about the question of state and municipal finance five or ten years from now, except for the fact that there will be a terrible problem and the question become what the federal government –

CHAIRMAN ANGELIDES: But does the model, irrespective of the particular imminent risk, is the model one that still presents risk, given what you've heard and learned today in looking at Moody's?

MR. BUFFETT: I think- you're talking about model-

CHAIRMAN ANGELIDES: Talking about the model, issuer pays, all the associated issues we've raised with respect to the Moody's business model.»

Buffets remark obviously is very much to the point, and indeed strongly relativizes all kinds of quasi sophisticated argumentation and computation. The italicized sentence shows that the chairman understands neither what Buffett says, nor the rating problem. The chairman acts as if Buffett says something irrelevant. Actually Buffett raises a very fundamental and realistic problem. A question which cannot be answered with any amount of resources. Regrettably Buffett only gives an example, and no generally applicable formulation. He could have concluded that a simple 1-dimensional valuation, such as AAA or a number, is inadequate. To the present author it seems that the possibility that a government will or will not intervene timely and effectively, can only be estimated with a very wide margin of uncertainty. Making any 1-dimensional qualification practically meaningless.

Quotes from session 3.

Froeba sketches the change in climate 1997-2007: «When I joined Moody's in late 1997 an analyst's worst fear was that we would contribute to the assignment of a rating that was wrong. When I left Moody's, an analyst's worst fear was that he would do something, or she, that would allow him or her to be singled out for jeopardizing Moody's market share.»

This is incompatible with McD's declaration above. (Perjury).

When was a rating considered to be, or have been, wrong?

Somewhat later, Froeba says:

«Moody's senior managers never set out to make sure that Moody's rating answers were always wrong. Instead, they put in place a new culture that would not tolerate for long any answer that hurt Moody's bottom line. Such an answer became, almost by definition, the wrong answer, whatever its analytical merit. However, arriving at an accurate answer was never objectionable, so long as that answer did not threaten market share and revenue. [...]»

There were [2] ways that Moody's senior management imposed a new culture on Moody's analysts. First, they used intimidation to create a docile population of analysts afraid to upset investment bankers, and ready to cooperate to the maximum extent possible. Second, they emboldened investment bankers, gave them confidence that they could stand up to Moody's analysts and gave them reason to believe that Moody's management would, where necessary, support the bankers against its own analysts».

Froeba describes how the invited but absent Brian Clarkson intimidated analysts. He alleges that «They [= ???] were the ones who put Brian in charge of the RMBS group, and we can be quite confident he was not put there to improve morale.»

He continues by telling about the reduction of the number of PhD's in the MD's of Moody's. Apparently he sees this as a sign of quality reduction. He considers it a problem for the interaction with bankers about technical subjects. But in this regard he is opposed by the chairman. Who has no academic degree, and considers himself none the worse for that. The chairman shows no understanding or value of an academic degree. (No understanding of education!?) Which is consistent

with his chairmanship of the FCIC, because he has no credentials at all for a role as researcher/inquirer. His lack of understanding and his rancor (prejudice) show that he is unfit for an inquiry commission. It certainly troubles his relation with (the clearly open) Froeba.

The argument about the interaction with bankers applies internally as well, with respect to (other) managers. The top moreover must have had reasons for reducing the number of PhD's. The chairman could have asked for the reasons, even if he himself found it irrelevant, instead of entering a discussion about hypothetical non-academic qualities.

Michalek: «In my view, the independence in culture of the derivatives group changed dramatically during my tenure. The willingness to decline to rate or just say no to proposed transactions steadily diminished. That unwillingness to say no grew in parallel with the company's share price and the proportion of total firm revenues represented by structured finance transactions. [...] As our customers, principally, the investment banks, produced more and more product for yield-hungry investors, and as the quality distinction between the different rating agencies lost some of its importance, the threat of losing business to a competitor, even if not realized, absolutely tilted the balance away from an independent arbiter of risk towards a captive facilitator of risk transfer.»

Michalek thinks that more liability would improve the quality:

«Who should bear the risk of getting it wrong, particularly when it's within reach to either not get it wrong or choose not to rate. [...] I also believe that some ratings, in light of the public good they provide, deserve some measure of protection from liability and opportunistic claims of negligence. [...] Where some question can reasonably be raised as to the extent of the public benefit from rating one or more of the highly complex or novel instruments, the liability for getting it wrong might be more fairly assigned to the private parties involved. I'm confident that if questions of negligence were not as easily dismissed by the protestations of free speech and opinion, at least for that subset of ratings on approximate with the benefit of the rating falls primarily to the private parties involved, the agencies would redirect some of their extraordinary profit margins into resources, research, and would once again have an incentive to just say no.»

Human resources management and methods are used to support the competition for market share:

«MR. FROEBA: In the CLO area where I was primarily involved, we had almost no major methodological changes, and we had almost no rating competition. In other areas where there was more pressure, for example, in RMBS, there were major methodological changes about the time that the whole team was fired, and their market share grew substantially. Another area –

CHAIRMAN ANGELIDES: The team being fired in the early 2000s?

MR. FROEBA: Yes. It wasn't just that they fired the team, it was that they also changed their methodology. Another example is in the area of the CDOs of ABS.

CHAIRMAN ANGELIDES: But stop there for a minute. In which ways did they change the methodology?

MR. FROEBA: I'm not an expert in the RMBS methodology.

CHAIRMAN ANGELIDES: Well, you've been told that they changed it?

MR. FROEBA: Yes.

CHAIRMAN ANGELIDES: By?

MR. FROEBA: It was understood at Moody's that the reason Moody's fired all those people, including Mark Adelson, who was the head of the group, was that the market share was 14 or 15 percent, and that his view of the asset was so conservative that it was causing Moody's to not be able to rate the bulk of the deals that were out there. In fact, to my recollection, people described Mark Adelson's departure as being associated primarily with the fact that he allowed the market share to drop to 14 or 15 percent and that he wasn't willing to update his view. When you say, "update his view," what do we mean? Change the methodology. Improve it. To make it more - to keep Moody's in a position to acquire more business.»

Just like Froeba, Michalek gives an example of the management forcing downwards adjustment of a rating method in the interest of market share. Search for “monoline”.

How Brian Clarkson kept the pressure on his employees:

«CHAIRMAN ANGELIDES: [...] You mentioned specific threats against employees if they didn't, what, rate deals?

MR. FROEBA: Well, I think I left out some discussion of ways in which Brian threatened to fire people. That was a key part of his approach –

CHAIRMAN ANGELIDES: It's explicit threats?

MR. FROEBA: Are you saying, "I'm going to fire you unless you rate this transaction?" No, no. It was sort of- it was, he would repeatedly tell you- he would remind you repeatedly that you were vulnerable to being fired, with the example, for example, of all the, the 22 people from the- you probably haven't heard this. Brian was famous for his joke within Moody's that his only regret in firing 22 people from the RMBS group was that one of them got a job before he could fire him. And he repeated that joke regularly. And the point was to remind you that you were vulnerable to being fired. There was a point which Rick [Michalek] has actually talked about- Mr. Michalek has talked about a meeting that many of us who were lawyers in the derivatives group had with him, and that meeting was really designed to remind us that we, too, were vulnerable to being fired when he took over the group. And I could elaborate on that, but you wanted a short answer, so that's my answer.»

Brian Clarkson «took over the group, which was, I think, the derivatives group in 2002.»

Thomas tries to find out whether Kolchinsky and Witt agree with the stories of Froeba and Michalek:

«MR. KOLCHINSKY: Well, I do agree. And in my written and oral testimony, it was the same thing. I think the market share drove the methodologies down, and it created the free fall-

VICE-CHAIRMAN THOMAS: But you've got to admit - you're both attorneys. He really was a lot more graphic than you were.

MR. KOLCHINSKY: I'm- you know, I generally try-

VICE-CHAIRMAN THOMAS: It's okay.

MR. KOLCHINSKY: We have a different style. It's a different style.

VICE-CHAIRMAN THOMAS: I noticed that right off. Dr. Witt?

DR. WITT: You know, I would- Mark's characterization would be a bit, you know, was definitely more forceful than mine. Yes, I agree with some of his points, but you know, and some of them, I just don't know about. I don't know anything about this CLO issue with Europe. I mean, I heard a little bit about it. It wasn't my area. But you know, I agree with a lot of what he says, but definitely not everything. And I think his- if I was going to say it independently of him, it would sound a lot less- I'm not so sure about it, you know, it's like - it's not that I'm saying I disagree with him, it's just that I- maybe he saw things I didn't see.»

The chairman asks: how general was the feeling or belief that market share was the driving force?

«CHAIRMAN ANGELIDES: I'd like to ask, since you're all four back up here, each of you very quickly, so we have four individuals here in a firm with thousands of employees. In the structured products arena in which all of you are operated, how pervasive was the feeling or the belief that market share was the driving force and that you better pay attention to it? How pervasive, do you hold a minority view?

MR. KOLCHINSKY: I would say, obviously, I can't speak for everyone; but for people I know, people who have been there more than a year, so more veterans, I think I would venture close to a hundred percent. I think the people understood that market share drives the train at that point. So...

CHAIRMAN ANGELIDES: Mr. Froeba?

MR. FROEBA: I completely agree. That's why I recommended that you look at the BES survey results. I think that will show a lot.

MR. MICHALEK: I thought that it grew over time. Towards the end it was a hundred percent the point, but initially it wasn't.

DR. WITT: I thought at the time I was there, and this is the CDO group, U.S. CDO group, it was pretty pervasive, that thinking. You know, I think most analysts, that's what they assumed. I definitely felt pressure for market share, you know.»

Graham looks for proofs of the allegation that methods were adjusted downwards to increase

market share. His questioning suggests that there were also changes in methods for other reasons than market share.

During the questioning by Graham it is explained how an AAA security could be created out of BBB securities. Essentially the trick is to assume independence of the probabilities that mortgages get into difficulties, and/or that there is zero (or very little) correlation between the probabilities. In sum:

«DR. WITT: You have to say it was both. It was both the default probability was wrong, and the correlation was wrong or the diversity score».

(Errors in the default probability would also have affected BBB).

Kolchinsky explains that some paper only became saleable by packaging, and the concurrent assumption that this reduced the risk. Under the additional assumption of statistical independence. The chairman doesn't understand the least bit of this.⁴⁸⁵

«CHAIRMAN ANGELIDES: But the original, just to pick up, the original sin was the assumption you'd have the one percent expected loss in a mezzanine tranche of what ended up being a very risky, well a pool of very risky loans that had been made, predicated essentially not on ability to pay but on continuing house price acceleration.»

The point is not that the paper was risky, but that the correlation of the risks was much larger than assumed.

N.B. By hindsight one can “explain” phenomena with incorrect theories as well.

Witt tells about his experience with failed efforts to build a better model. He nevertheless remains very careful in his evaluation:

«DR. WITT: Like I say, it wasn't that we were trying to get it wrong - it wasn't that I thought what we were doing was wrong, it's just that I was so sure that we were not using enough resources to make sure that we were getting it right, and that was at a time when, you know, the profit margin for our group must have been like 80 percent or something.»

Wallison compares the conduct of the rating agencies with that of auditors and law firms. These work under similar pressure as rating agencies. There must be the notion that a little bit less won't harm. Lawyers will resist stronger when the top puts pressure on the norms. Remember OCW.

The lawyers think that liability would help a lot:

«COMMISSIONER GEORGIOU: [...] Do you think that the fact that you were insulated from liability, both statutorily and ostensibly, constitutionally, had any impact on the methodology that you pursued and the failure to comport it to reality?

MR. FROEBA: You know, at one time, I was going to jump in, in response to the question that was being asked of Rick, and say the difference between Moody's and an accounting firm or a law firm is that at least there is some theoretical risk that the accounting firm and the law firm might be found liable. Take the case of Arthur Andersen. Nothing could be better for Moody's then that some other rating agency were to be found liable in a lawsuit and to collapse. Why? Because the fear of future lawsuits would create a discipline in the analytical process that I think would add a tremendous amount of integrity. That is my own opinion about the best way to solve the current problem with rating agencies. Their lack of vulnerability is a serious problem.

And another serious problem relate to it is the fact that they pay no price for degrading their reputation. They learned after Enron, that, you know, no matter how bad the reputation got, their business would grow. What do you think is going to happen now after this crisis if they pay no price? That's a question that the people on this commission should ask because all of your children and family members are facing, you know, a world economy that's vulnerable to that reality.

[...]

⁴⁸⁵ He doesn't seem to understand that not everything can be explained in 5 minutes to everyone, not even to very intelligent (but uneducated, = without prior knowledge) people. Supposing Angelides to be intelligent in the required sense (which has not been tested in education. Or has it?).

MR. KOLCHINSKY: I think in general, legal liability was almost - discussions of legal liability, almost nonexistent. That was part of the problem. People didn't think. [...] I actually want to also add to the other question about the lawyers and accountants, lawyers and accountants have standards. Lawyers have to follow court cases, accountants have GAAP.⁴⁸⁶ Imagine - again to Arthur Andersen, if Arthur Andersen, after Enron, said, "You know what? Yeah, we did this, but that was our methodology. Sorry, we're going to walk away." And that's the difference. [...]

COMMISSIONER GEORGIOS: Mr. Michalek, you're a lawyer as well, are you not?

MR. MICHALEK: I am, and I agree, I think liability would be a necessary deterrent to lack of attention to common issues of negligence that occurred regularly.

COMMISSIONER GEORGIOS: Mr. Witt? Dr. Witt?

DR. WITT: I'm the only non-lawyer here and I don't think the courts are the best way to address this. [...] The Financial Stability Act does give the SEC the power to levy fines, and I thought that a better way to go is to have the SEC basically have a menu of fines that are issued when you get the ratings wrong in a major way. Proportional to how many bonds you misrated, you pay a big fine; and you know when, you're rating it, that's what you're going to have to pay if you misrate. I think to me, that makes more sense.

COMMISSIONER GEORGIOS: You think the analysts who did it ought to have to pay part of the fine, too, or do you think just the company ought to pay the fine?

MR. FROEBA: Certainly make for a more disciplined process if the analysts had to pay.

DR. WITT: If the analyst had to pay, you may not have any analysts at rating agencies.

MR. KOLCHINSKY: [...] But in this case, you don't even have standards to judge by. You can't be found negligent if there's no standards to judge by. [...] So you need standards and you need legal liability.»

Michalek next shows that there were understandable reasons for conservatism at Moody's. Conservatism in the sense of: sticking to proven methods, and resisting change. On the other hand: they were obviously unprepared for what was at least a real possibility, a fall in home prices, and the implosion of the bubble. Since it was well-known that bubbles had imploded in the past, one could and should have taken that possibility into account. Not doing so is a serious, inexcusable error.

Witt claims that with liability "[you may not have any analysts at rating agencies](#)". If that were true, it would show that the analysts do not really believe in their products, and that their guarantees are meaningless. One could ask the analysts to formulate their ratings and guarantees in a way that is acceptable for both themselves and the producer of the security. (They should be able to do this, but the present author nevertheless doubts it). And of course, by way of compromise, a substantial fine could replace full liability.

The claim of Witt contradicts (or voids) the assertion of Siegel and Weill in session 1, that the analysts believe their ratings.

Non-probabilistic thinking.

(See the transcript after [Mr. Michalek: You're asking ...](#))

In de hearings (and other documents) you can see that as regards forecasting, people think in terms of forecasting the one and only future. They want an unambiguous description of a single state. They want to know: is it going to be this or that. Not both or more, but only one. The forecaster should decide, or choose, when need be, one from a multitude of possibilities. The thinking is not in terms of: this may be the most probable, but there also is a possibility that... and another possibility that... And what are the (possible) consequences of the possible alternatives? A responsible professional takes all possibilities into account (he will certainly need to do so if he is liable!). After uncountably many failures the simplistic single future forecasting is foolish and irresponsible. Given that full information, and reliable theories or models do not exist, it is methodologically incorrect and practically impossible. The conclusion must be: one should take all relevant possible futures into account. Where "relevant" is defined by the consequences.

An intriguing paragraph about the downgrades of September 2007 and the departure of Kolchinsky:

⁴⁸⁶ GAAP= Generally Accepted Accounting Principles.

«MR. KOLCHINSKY: One thing, you know, I - once they did make a decision to downgrade in '07, in September, and I found out about it and actually tried to stop the factory, a manager, Ms. Yoshizawa, did not want to do that. And I actually spoke to Dr. Witt. I didn't know what to do. He suggested that we go to somebody more senior- and we did a notching procedure. But that's- it was almost, as I said, the last couple of [my?] bits of paper. And that's one of the reasons, that is the reason, I believe, I was then asked to leave the rating agency in October of that year.»

Yoshizawa was already mentioned earlier today. Not much positive was said about her, except by the chairman...

Under “There's one final point”, Michalek suggests that the peak immediately following the downgrades can be explained by the desire to have them completed and sent before the next downgrade.

The witnesses did not get the impression that quality had top priority for the top, contrary to the declarations of the CEO.

«COMMISSIONER THOMPSON: [...] So you had the opportunity to hear your CEO or former CEO speak of what was the most important metric or outcome, which in his mind [? he said] was rating quality. How do you respond to that, do you believe that's the tone he set at the top or not? I'll start with you, Mr. –

MR. KOLCHINSKY: No, I do not. I don't think he was against ratings quality, but certainly it was not something that I was- there was a culture there, the old culture, but no, I don't believe that that was the tone set at the top.

COMMISSIONER THOMPSON: So would you call him something other than truthful in that representation?

MR. KOLCHINSKY: I can't judge that. Maybe that's what he felt, but what came down to us people working in the trenches was-

COMMISSIONER THOMPSON: So the tone you heard was something other than ratings.

MR. KOLCHINSKY: Yes.

MR. FROEBA: I agree. I don't think- I would have a hard time identifying any particular means by which they communicated their- that that was the value. I mean, I don't recall any.

COMMISSIONER THOMPSON: Mr. Michalek? I got it right, by the way.

MR. MICHALEK: I'm a lawyer, so I'm trained to hold two opposing thoughts in my mind at the same time.

COMMISSIONER THOMPSON: Well, just give me one and I'll come back to the other one later.

MR. MICHALEK: I think he does believe that he was telling people that ratings quality was the most important thing. I think that there were reports internally that he was already receiving suggesting that he was getting information that people were concerned about the quality of the ratings.

DR. WITT: I put this in my written testimony, but there has been other testimony and other investigations saying the same thing. In November or October of 2007, we had a global MD meeting. I'm pretty sure Eric [Kolchinsky] was there. Where- this is after the massive downgrades have already occurred. And the CEO and CFO led off with the exact same tone that they always did, which was to focus on our profit margin relative to Standard & Poor's, and they were talking about, "Oh, it's one percent lower than Standard & Poor's, we've got to work on this." We'd already had these massive downgrades. Morale was really shot. And somebody, one of the MDs in the corporate side raised their hand and said, "You know," this was after about thirty minutes, and said, "What are you doing to restore Moody's reputation?" And all of a sudden, there was this big scramble among management, like, they didn't expect the question. And to me, that was like, the smoking gun in terms of, after that, I didn't give Ray [McD] the benefit of the doubt anymore.»

McD may have been selected, or have been trained, to say one thing and do something else. What matters most is not what managers say, but whom they promote, give gratuities, reassign, etcetera. This is one of the important lessens from Book 1 of the present report.

Moody's could not keep up on financial innovation.

In the questioning by Born, Kolchinsky gives the impression that Moody's was unable to keep the

pace of the developments in the financial products with its updating of rating methods. The updating problem did get attention, and it was even concluded that the ratings should be less optimistic. But a paper with that conclusion was not cleared for publication.

« COMMISSIONER BORN: Did you indicate in your testimony that there was a paper that was prepared on this issue-

MR. KOLCHINSKY: Yes.

COMMISSIONER BORN: - in October of '06?

MR. KOLCHINSKY: Yes, we had a paper ready to go, the author was an analyst, Sushnita Nagarajan- I'll give you the spelling later. But one of the things it says, we want to limit the exposure of the ABX in any deal to a de minimis amount, and I think my manager thought that was not appropriate, given- and she asked not to publish the paper, so we never did.

COMMISSIONER BORN: Because of the potential loss of business?

MR. KOLCHINSKY: Yes. That's what I believe, I don't know but that- I believe that was due to potential loss of business.»

In the past it was not so much better than the old hands suggest.

During the questioning by Murren, Kolchinsky claims that in his first years in Moody's there was "a great culture". To the present author this seems highly doubtful. At least: even then the rating methods cannot have been adequate. For the problem was mainly that system phenomena and processes were insufficiently integrated in the models, and that correlations were badly underestimated. It is very implausible, and has not been said by any of the witnesses, that in the course of time anything has changed in these respects. Neither has anyone noted that the ratings were too simplistic as regards their (1-dimensional) format. Nothing with respect to these fundamental errors was any better in the "good old Moody's".

Another example of out-selection of thinking people:

Michalek gives Murren another example of somebody who wanted more risk in the model, but was discouraged by the management. The position of the analyst concerned was terminated simultaneously with that of Froeba and Michalek:

«DR. WITT: The name of that analyst was Cesar Croussillat, and the reason that I asked was that Cesar, along with Mark [Froeba] and Rick [Michalek], were- their positions were terminated in the fall of 2007. I mean, you've heard their testimony. These were really smart guys, and Moody's needed their services, and I always thought it was the personnel decisions that made me the most uncomfortable, especially at this time, in terms of what was management's real purpose. And of course the other person that they took out of the rating agency at the point in time was Eric. They removed him to a software company. So I mean, these were, like the most independent minded, you know, people they had, and some of the best people they had. As far as the... »

16. On the OCC annual reports 2006-2008.

Short summary.

The character of the annual reports of the OCC is similar to that of the annual reports of the other US supervisors. They give far too little open and serious attention to OCC activities and to the part of the financial system under OCC supervision, and too much attention to employees and the history of the OCC. They are far too complacent. In OCC AR 2008 comptroller Dugan defends the OCC by referring to actions which should have been recorded in OCC AR 2006, but are not mentioned there.

Introduction. The wikipedia on the OCC.

«The Office of the Comptroller of the Currency (OCC) is an independent bureau within the United States Department of the Treasury that was established by the National Currency Act of 1863 and serves to charter, regulate, and supervise all national banks and thrift institutions and the federal branches and agencies of foreign banks in the United States. [...]»

The OCC fulfills a number of main objectives:⁴⁸⁷

1. ensures the safety and soundness of the national banking system;
2. fosters competition by allowing banks to offer new products and services;
3. improves the efficiency and effectiveness of OCC supervision especially to reduce the regulatory burden;
4. ensure fair and equal access to financial services to all Americans;
5. enforces anti-money laundering and anti-terrorism finance laws that apply to national banks and federally-licensed branches and agencies of international banks; and
6. is the agency responsible for investigating and prosecuting acts of misconduct committed by institution-affiliated parties of national banks, including officers, directors, employees, agents and independent contractors (including appraisers, attorneys and accountants).

Headquartered in Washington, D.C., it has four district offices located in New York City, Chicago, Dallas and Denver. It has an additional 48 field offices throughout the United States, and a London office to supervise the international activities of national banks. It is an independent bureau of the United States Department of the Treasury and is headed by the Comptroller of the Currency, appointed to a five-year term by the President with the consent of the Senate. [...]»⁴⁸⁸

The OCC regulates and supervises about 2,000 national banks and 50 federal branches of foreign banks in the U.S., accounting for over three-quarters of the total assets of all U.S. commercial banks (as of 2011). [...]»

As of 2009 [the OCC had] 3104 employees.

The Comptroller also serves as a director of the Neighborhood Reinvestment Corporation, and the Federal Deposit Insurance Corporation.»⁴⁸⁹

OCC «regulated nationally chartered banks—including Bank of America, Citibank, and Wachovia»⁴⁹⁰

The same wiki-page presents the following list of more recent comptrollers:

John G. Heimann	1977–1981
C. T. Conover	1981–1985
Robert L. Clarke	1985–1992

⁴⁸⁷ The source has no numbers but dots. The formulations of the objectives 2 and 3 are not particularly factual and modest. There are potential conflicts between at least the objectives 1, 2 and 3. The bias in favor of new products and services, if followed up, hampers objective evaluation and therefore creates risks.

⁴⁸⁸ The following was dropped: «By monitoring capital, asset quality, management, earnings, liquidity, sensitivity to market risk, information technology, consumer compliance, and community reinvestment, the OCC is able to determine whether or not the bank is operating safely and soundly, and meeting all regulatory requirements.» This is one more example of false pretensions.

⁴⁸⁹ Wikipedia 18/10/12, “Office of the Comptroller of the Currency”.

⁴⁹⁰ FCIC report p. 13/41. There was overlap or interference with the Fed. My notes on the FCIC report may help clarification.

Eugene Ludwig	1993–1998
John D. Hawke, Jr.	1998–2004
John C. Dugan	2005 – 2010
Thomas J. Curry	2012 – present ⁴⁹¹

Conclusions from the evaluation of the annual reports 2006-2008.

1. In terms of the goals which it had formulated itself the OCC has failed;⁴⁹²
2. Important causes of this failure seem to be:
 - a. The text shows that the OCC could not see the wood for the trees. It is only interested in the separate financial institutions. In 2006 there is no awareness of the importance of, and attention for, interactions and processes, and the system as a whole;
 - b. The OCC only had eyes for its own supervision and banks. It had no view on its role in the whole of supervision, or its role with respect to that of other supervisors. (Like the other supervisors);⁴⁹³
 - c. (More or less a consequence of the preceding two conclusions:) It was not aware of gaps in supervision, and the risks these created for its own banks and the system as a whole (and for the Americans);
 - d. OCC ignored the warnings of the GAO, OFHEO and CGFS, and therefore learnt nothing from their reports. (And was unable or unwilling to reproduce their essence).
3. The section “Looking ahead” in AR 2006 notes undesired developments. But the tone is that of “challenges”, not that of “if we don’t take appropriate steps matters may run out of control”;
4. AR 2008 says something about the relation between OCC and the crisis. OCC has not seen certain things. The analysis shows awareness of interacting and cooperating factors;
5. But the AR show no sign of the OCC searching its own heart. The lessons learnt from the crisis regard impersonal aspects of the financial system, not the functioning of the OCC;
6. There is no acknowledgement of deficient functioning in the prehistory of the crash;
7. The AR are strongly Dugan-centered;
8. The AR has no list of (most important) publications;
9. In the opinion of the present author, considered as annual reports, the annual reports of the OCC are notably better than those of CFTC, even though the OCC AR seems not to have won any prizes.⁴⁹⁴

OCC AR 2006.

The pdf file of this report was created 7/12/06 and modified 13/12/06. It is well-made: it has a bookmarked table of contents, and the table of contents in the text is linked too.

In a large font, the inside front cover has the following text:

«The mission of the Office of the Comptroller of the Currency is, and always has been, supervision. We supervise all types of banks in all parts of the country, from the smallest community banks to the trillion dollar “megabanks,” from “ag” banks to credit card banks, and from federal branches of foreign banks to one-branch banks that do their business close to home.

—Comptroller Dugan before the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 19, 2006.»⁴⁹⁵

The OCC describes four “strategic goals”:

«The OCC pursues four strategic goals to achieve its mission:

⁴⁹¹ “present” =18/10/12. (Because the actual date is unimportant in the present context it has not been looked up).

⁴⁹² For the goals see the beginning of the discussion of OCC AR 2006.

⁴⁹³ Coordination by the President’s Working Group on Financial Markets was of course unrealistic and clearly has not had the required effect. US supervision was utterly inadequate and a problem in itself.

⁴⁹⁴ In the OCC AR 2006, 2007 and 2008, the word “prize” is not found.

⁴⁹⁵ The meaning of “ag” banks could not be ascertained. The German “AG” after the name of a firm indicates that it is a shareholder corporation, AG meaning Aktien Gesellschaft.

1. A safe and sound national banking system.
2. Fair access to financial services and fair treatment of bank customers.
3. A flexible legal and regulatory framework that enables the national banking system to provide a full, competitive array of financial services.
4. An expert, highly motivated, and diverse workforce that makes effective use of OCC resources.»⁴⁹⁶

The present author could not find a comparison between the OCC duties and those of other supervisors, or any more or less precise delimitation of OCC duties.

The section on strategic goal 1, A safe and sound national banking system, opens as follows:

«The OCC examines banks to ensure that each national bank operates in a safe and sound manner and complies with applicable laws, rules, and regulations. The agency also analyzes and monitors systemic risk and market trends in the national banking system, the financial services industry, and the economic and regulatory environments».⁴⁹⁷

This is the one and only occurrence of the word “systemic” in this report. In other words: it does not report on its findings about systemic risk.

It is obvious that in terms of the “strategic goals” the OCC has failed very badly.

The table of contents of the annual report 2006 is as follows:

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Comptroller's Viewpoint.

This chapter begins with:

«I am pleased to report that the national banking system not only remained strong throughout fiscal year (FY) 2006, but that both the OCC and the system are well equipped to meet the challenges that lie ahead.»

A worse misjudgment, and better proof of complete lack of understanding, is hardly possible. Still, there maybe cause for concern:

«[...] all evidence suggested that [lending] standards were continuing to loosen because of intensifying competition among lenders for a shrinking pool of buyers»

Where “standards were continuing to loosen” means that less or weaker requirements are imposed on mortgages, and that those buying a mortgage take more risk (on the average).

«As the fiscal year drew to a close, the bank, thrift, and credit union regulatory agencies published guidance addressing nontraditional residential mortgages. At a time of rising house prices in many parts of the country, some lenders introduced options that, for a limited period, allow borrowers to forego regular principal payments (“interest only” loans) or even to waive a portion of the interest due, resulting in negative amortization. Although these products clearly can benefit some consumers, we

⁴⁹⁶ OCC AR 2006 p. 10.

⁴⁹⁷ OCC AR 2006 p. 11.

are concerned that banks may not properly manage the risks they entail, especially in an environment of rising interest rates and softening real estate markets. Our guidance therefore cautions banks to assess a borrower's ability to repay the loan at the fully amortized rate and to ensure that the borrower understands the terms and risks of the product before purchase.»⁴⁹⁸

«We undertook lower-profile, but no less important, initiatives throughout the year that further strengthen risk management in the national banking system.»⁴⁹⁹

Note: “further strengthen” instead of just “strengthen”, followed by an appreciation of the quality (and inadequacy) of the risk management. The quote is followed by a note about a workshop and conference about risk management etcetera organized by the OCC.

As an example of what is possible, of what supervisors could and should have done much more often:

«We also proposed that Congress approve legislation increasing the community development lending authority available to national banks under Part 24 of our regulations, and that measure was adopted and signed into law.»

As regards the duties of the OCC:

«Protecting the rights of bank consumers is one of our agency's fundamental obligations.»

The next section concerns preemption:

«Important legal principles affecting national banks continue to be litigated, including the extent to which state laws are preempted by federal law under the National Bank Act, and the scope of the OCC's exclusive “visitorial” authority over national banks (the authority to examine, supervise, regulate, and sanction national banks). One issue, the question of whether state laws apply to national banks' operating subsidiaries to the same extent as they apply to the parent bank itself, will be considered by the Supreme Court in late 2006, and should be decided in 2007. This case, Watters v. Wachovia Bank, N.A., arose from state efforts to regulate and require state licenses of mortgage banking operating subsidiaries of several large national banks. The OCC believes that if state law is inapplicable to a national bank because of federal preemption, the state law also would be inapplicable to the bank's operating subsidiary because the operating subsidiary is a federally authorized means through which the bank exercises its federally authorized powers.»⁵⁰⁰

Compare FCIC p. 112/140. This action is meant to have an effect contrary to the ostensible intention of the guidance mentioned above.

«Our success depends on the supervisory staff that implements OCC policies: nearly 3,000 examiners, attorneys, economists, information technology experts, and other professionals and support staff. Directly or indirectly, they are responsible for the examination and supervision of the more than 1,800 national banks, federal branches of foreign banks, and uninsured national trust companies.»⁵⁰¹

The most clear example of the OCC's underestimation of the problems is found in the context of human resources management:

«We have also made great strides in assessing the agency's skill requirements and laying plans for the training programs needed to meet them. This is an advantageous moment to be tackling these challenges. The current sound condition of the national banking system allows us to focus on our personnel needs in a measured and orderly way.»⁵⁰²

Fiscal year 2006 Highlights.

⁴⁹⁸ OCC AR 2006 p. 2.

⁴⁹⁹ OCC AR 2006 p. 3.

⁵⁰⁰ OCC AR 2006 p. 4.

⁵⁰¹ OCC AR 2006 p. 5.

⁵⁰² OCC AR 2006 p. 5.

These are found on p. 10. There are ten highlights. In the context of the present study the four most important would seem to be:

«Issued Interagency Guidance on Nontraditional Mortgage Products, which addressed issues raised by interest-only and payment-option mortgage loans.»

«Proposed legislation passed by Congress to raise the limit on banks' investments in urban revitalization and rural redevelopment.»

So the supervisor can make proposals for laws.

«Filed “friend of the court” briefs in cases that affirmed federal preemption of state law restriction of national bank activities.»

So preemption goes on. The OCC gives priority to its own power, and maybe the supposed interests of the firms it supervises, but not to the safety of the Americans. This is why openness and thorough analysis are necessary. Compare FCIC p. 112/140. You may also search for Watters v. Wachovia.

«Fully implemented supervision by risk for both large and community national banks. Effective supervision tailored examinations to risks presented, addressing safety and soundness issues, and applicable specialty areas. There were no national bank failures and many of the problem banks at the beginning of the year returned to sound condition. **Overall, the national banking system remained in safe and sound condition, with adequate capital and earnings to support future operations.**» (Boldface by the present author).

The first sentences seem to assume that the banks know and understand their risks.

For someone more open than the OCC to reports of the development of the financial system in the prehistory of the subprime crisis, it seems highly improbable that all separate banks were safe and sound. Many must be vulnerable, especially for devaluation of MBS. The system certainly wasn't safe and sound. Together with the house prices, in 2006 it was actually approaching the tipping point.

The OCC conclusion goes much farther than warranted by its inquiries. The OCC (any supervisor, because of his duties) should have been aware of the limitations of its knowledge and understanding, its information, and competence, and the limitations of the supervisory system. It should have been (more) explicit about its assumptions, especially as regards “risk based supervision”. It should have taken the reports of GAO, OFHEO and CGFS seriously, and acted upon them. Of course it couldn't: the quotes given above amply prove the incompetence and arrogance of OCC.

IV. Looking Ahead. (This section has a length of one page).

«OCC officials also will be watching for the Supreme Court's decision in Watters v. Wachovia, a case that involves the extent to which states may exercise authority over national bank mortgage lending activities conducted in operating subsidiaries.»

«Uncertainties in the financial and commodities markets and in the global political landscape are likely to continue and may result in a more volatile operating environment for the banking industry. Continued loosening of standards for credit underwriting and pricing, and the increased involvement of hedge funds in syndicated bank loans, heighten concerns about credit quality and may escalate problem credits and losses in the event of unfavorable market developments. Slowdowns in housing, construction, and real estate development may adversely affect banks' balance sheets and earnings streams.»

Many banks and over-leveraged consumers remain vulnerable if interest rates rise. Pressures on net interest margins are likely to continue. Merger and acquisition activity has fostered a growing concentration of banking assets in the largest national banks and reduced the number of major dealers in key money market and derivatives markets.

Risks facing the banking industry and the OCC are increasingly interdependent, cutting across traditional disciplines and business lines. Operational and compliance risks are becoming more prominent, and traditional distinctions between credit and capital markets activities and risk

management tools are eroding. Corporate governance, accounting, compliance, and customer information security continue to be high-visibility issues for the banking industry and for large, publicly traded banks in particular, accentuating the need for strong corporate governance, accounting transparency, internal controls, and audit and compliance programs.

The rapid pace of financial innovation and growing concentrations—both within individual bank's portfolios and across industry segments—pose additional challenges and require improved risk management and information systems. Quantitative risk measurement systems will continue to become more prominent in banks' risk management processes.

The Comptroller, the Executive Committee, and other agency officials will continue to monitor these risks closely in FY 2007 and to develop and refine strategies for the agency's workforce to address them through supervisory and regulatory programs of onsite supervision, timely examination and policy guidance, and balanced regulatory actions. The OCC also will work with other international, federal, and state supervisors to respond to the myriad of cross-cutting issues that face the financial services industry».⁵⁰³

So the OCC seems to be aware of risks. It does not however mention systemic risk. Neither does it say anything about the need for action by anyone. It says nothing about its ability and willingness to reduce risks and/or their potential consequences, either or not in cooperation with other supervisors. It does not express doubts and gives no warnings. It does not conclude that the law is insufficient to ensure a safe and sound financial system. The text seems incompatible with the fact that OCC pleaded preemption in case(s) where this increases risks.

The risk inventory seems hard or impossible to reconcile with the OCC verdict of a safe and sound banking system. An explanation would have been welcome.

In what the bookmarks call "related illustration" under "Looking ahead" one reads:

«Large national banks will remain at the leading edge of developing new banking products and services, requiring that the OCC be at the forefront of the supervisory community in developing and maintaining expertise in assessing such products and determining associated risks.»⁵⁰⁴

This is an excellent example of falsified false pretensions.

The relation with the earlier "supervision tailored examinations to risks presented [by the supervised institutions]" requires explanation. One cannot follow and lead at the same time.

OCC AR 2007.

The pdf file of this report was created 9/1/08 and modified 30/1/08. It is well-made: it has a bookmarked table of contents, but the table of contents in the text is not linked.

This is the thickest of the AR 2006-2008.

The index is found on pp. 101-107.

Summary.

The OCC sees a lot going on, but doesn't know what to make of it. As a consequence, it still underestimates the danger of the situation..

The complete table of contents of OCC AR 2007 can be found at the end of this appendix. That of the most relevant chapter is quoted here:

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⁵⁰³ OCC AR 2006 p. 43.

⁵⁰⁴ OCC AR 2006 p. 42.

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Boldface of section headings is by the present author. The other entries are titles of subsections.

Please take note: "The Watters Decision Clears the Air"!

The "Events" section is terribly OCC and Dugan centered.

Nevertheless, much more is reported and even explained than in most other supervisor annual reports. An important example is the following quote taken from the subsection "Doing Business with Hedge Funds":

«In February 2007, Comptroller Dugan participated in the President's Working Group on Financial Markets (PWG), which called on highly sophisticated lenders, investors, and counterparties to impose “market discipline” on hedge funds. The group offered guidelines for doing so embodied in the “Agreement among PWG and U.S. Agency Principals on Principles and Guidelines regarding Private Pools of Capital,” and OCC examiners expect large national banks to follow those guidelines in 2007 and beyond. Accordingly, banks doing business with hedge funds should carry out appropriate due diligence before entering into a credit relationship with a hedge fund and should establish information flows that enable them to monitor credit exposures effectively.

Comptroller Dugan explained why the PWG chose guidelines over regulation: “When deciding between requirements and guidelines, governments must determine which will have a more positive long-term effect on the markets. The PWG chose guidelines rather than a prescriptive regulatory approach to avoid discouraging financial innovation. But the success of that approach depends on hedge fund investors and creditors exercising appropriate due diligence.”»⁵⁰⁵

Remember that the LTCM crisis took place in 1998, and that the GAO and PWG reports on that event date from 1999. Already in 1999, eight years ago, the PWG participants had made promises at least as nice looking as those indicated here. Everybody could have seen this.⁵⁰⁶

Chapter 5

National: Ensuring the Safety and Soundness of the National Banking System

P. 11-2 says the following:

«FY 2007 was a year of rising, but still moderate, credit risk. The percentage of loans that were noncurrent rose, and provisions for loan and lease losses increased nearly 90 percent over the 12 months ending June 30, 2007. As a result, national bank earnings were not as strong in the first half of this year as they were last year. Annualized year-to-date return on equity at national banks (as of the second quarter of calendar year 2007) was 12.73 percent—nearly 1 percent lower than it was for 2006. (See chart 1.)

⁵⁰⁵ OCC AR p. 16/A16.

⁵⁰⁶ P. 17/A17 of OCC AR 2007 has a block with the heading “Dugan Sees Growing Role for President’s Working Group on Financial Markets”. For someone acquainted with the Chronicle, this must sound shameless.

This rise in credit risk was not unexpected. The U.S. economy has been expanding for six years, and it is typical for loans booked early in an economic cycle to show increasing signs of weakness as the expansion matures. Also, loan underwriting standards customarily slip in the later stages of an expansion as lenders compete for a shrinking pool of the most creditworthy borrowers and begin to dip deeper into the risk pool for customers. In recent years, a highly liquid secondary loan market intensified that competition, as did the growth in the number of nonbank lenders, such as mortgage brokers, who packaged and sold loan products to third-party investors. All these factors helped increase credit risk and put pressure on bank earnings.

The dip in earnings must be viewed against the long-term profitability of national banks. National bank earnings have been strong for the past 15 years, and these strong earnings have contributed to healthy capital ratios. In a statement before the House Committee on Financial Services on September 5, 2007, Comptroller Dugan underscored the system's strength, noting that "national banks remain active in major markets and continue to extend credit to corporate and retail customers, including mortgage credit." He pointed out that "the worst problems we have seen in the markets—insufficient liquidity resulting in substantial declines in capital and sometimes in failure—have occurred outside the commercial banking system."⁵⁰⁷

Note that the style of writing (of the AR) and speaking (of Dugan) breathes expertise and complete understanding. Falsely. The text is even rather stupid politically, because it makes no reservation, and does not allow for an easy escape.

The eye catcher on p. 16/A16 is:

«Dealing in derivatives— instruments whose value is tied to that of underlying securities or other assets—is big business in the banking industry, and the OCC supervises the five largest bank derivatives dealers the United States.»⁵⁰⁷

Of course this is a very important remark, if not confession.

There is no chapter or section "Looking ahead" in this annual report.

OCC AR 2008.

The pdf file of this report was created 9/2/09, and modified 19/3/09. It has a bookmarked table of contents, but the table of contents in the text has no links.

Except for a picture, the inside of the front cover has only the following text:

«OCC VISION

The Office of the Comptroller of the Currency (OCC) seeks to assure a banking system in which national banks soundly manage their risks, comply with applicable laws, compete effectively with other providers of financial services, offer products and services that meet the needs of customers, and provide fair access to financial services and fair treatment of their customers.»

The report has the following table of contents:

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So once more there is no chapter "Looking ahead" (as there was in 2006).

⁵⁰⁷ OCC AR 2007 p. 16.

Comptroller's Viewpoint.

The following quote of the first two paragraphs is meant to show the difference in contents and style of this AR with the preceding AR and AR of other supervisors:

«For the financial system, both here and abroad, the fiscal year that ended September 30 was without question the most extraordinary of my lifetime. In fact, when I look back on all that has happened since we published our last annual report, I am struck by the sheer number of events involving severe credit and market stress, any one of which could have been the most serious financial problem of the year in the much quieter period before 2007.

Just naming the worst of them is both telling and exhausting. The first annual decline in nationwide house prices. Record foreclosure levels. Brutal losses on subprime loans. The near shutdown of interbank lending markets and the liquidity freeze for asset-backed commercial paper and structured investment vehicles, or SIVs. The government takeover of Fannie Mae and Freddie Mac. The failure of Lehman Brothers, IndyMac, and WaMu. The distress sales of Countrywide to Bank of America, Bear Stearns to JPMorgan Chase, and Wachovia to Wells Fargo. The administration plan to use \$700 billion to unfreeze the credit markets.»

So finally there is contact with reality. The last sentence of the next paragraph too deviates positively from the annual reports of most or all other supervisors:

«In reflecting on this “100-year flood,” let me provide a few observations from the perspective of the OCC.»

The remainder of p. 1 outlines relatively positive aspects. Many banks reacted adequately. The OCC had warned for all sorts of things. To a large extent proof can be found in OCC AR 2006, but there also seem to be actions which should have been reported in AR 2006, but could not be found by the present author. (This can easily be checked by searching for keywords or -terms).⁵⁰⁸ But as in the case of the president of Dutch national supervisor Wellink, the defense leans heavily on speeches. Of the following no trace could be found in OCC AR 2007:

«We also recognized early on that community bank failures would accelerate in 2008; we talked about that publicly; and we planned for it.»⁵⁰⁹

“Early on” =?

In AR 2007 the word “bankrupt” is not mentioned, and “failure” never in a context which resembles what comptroller Dugan is saying now.

P. 2 makes observations which are a bit less self-complimentary:

«But there were some problems we clearly did not anticipate, and we need to learn some lessons and make some improvements going forward.»

This is followed by a useful analysis, including relevant information not seen elsewhere:

«Here are a few [problems] that stand out.

- Liquidity. A number of banks were not as prepared to deal with liquidity strains as they should have been, thinking that their access to funding, even in times of stress, would be much better than it proved to be. I think the regulatory community had that same misimpression, and a number of us have concluded that our liquidity metrics were not sufficiently robust. We have been working with banks all over the country to improve their liquidity positions. In addition, the Basel Committee issued a very thoughtful paper on liquidity risk management, and we

⁵⁰⁸ For example, the “risk layering”, “CRE guidance” and “declining underwriting” mentioned by Dugan in his “Comptroller’s Viewpoint” in OCC AR 2008 do not occur in OCC AR 2006.

⁵⁰⁹ We are still on p. 1 of OCC AR 2008.

- have spent a considerable amount of time developing a better template for gathering data to measure liquidity risk. I believe these efforts will produce real improvement over time.
- Risk management for complex financial instruments. Collateralized debt obligations (CDOs) backed by subprime mortgages were the prime example of the need for better efforts here. Despite the inherent risk of the underlying collateral, the industry and regulators were lulled into a false sense of security by the triple-A ratings given to the super-senior tranches of these securities. Some of the exposure was masked in off-balance-sheet vehicles in ways that clouded the full extent of exposure. Indeed, some senior bank management thought they had avoided subprime risk by deliberately choosing to avoid originating such loans in the bank—only to find out after the fact that their investment banks had purchased subprime loans elsewhere to structure them into CDOs. And when the market seized up, some banks that structured the CDOs for sale to third parties wound up holding large positions that no one wanted to buy. That resulted in huge concentrations, which in turn led to huge losses. There was too much reliance on triple-A ratings, not enough transparency and risk aggregation, and too much tolerance for concentrations.
 - Risk concentrations in commercial real estate. The OCC and the banks we supervise did a tremendous amount to anticipate and address potential issues before they turned into problems, and we have been especially proactive in squarely addressing these problems as they have emerged. But I have been troubled in looking at the banks that have failed thus far—both national and state banks—by some toxic combinations of real estate concentrations, rapid growth, extremely high levels of brokered deposits, and out-of-area lending. In the future, I think we will need to do more to check these combinations before they cause unmanageable problems. And let me add this: some concentrations can be so large that even the best risk management will fall short when an economic storm focuses on that same asset class.⁵¹⁰ While the jury is very much still out, and the subject is controversial, regulators and policymakers in the future may very well need to revisit the issue of appropriate levels of concentration.»⁵¹¹

On the right side of p. 3 too there are some useful observations:

«Some banks applied different underwriting standards for loans sold to Wall Street securitizers for further sale to investors, while the standards were more rigorous for loans that banks kept on their books. The same was true for leveraged loans originated by our very largest banks. In both cases, when examiners began to criticize the lower standards for loans that were sold, we often heard the same two arguments in response. First, some argued that weaker underwriting standards should not matter if the risk leaves the bank when the loan is sold to a willing buyer who understands the increased risk. And second, some claimed that if banks were forced to raise their standards above the level required by the market, they would lose business to others who did not have to raise their standards. Events of the last year have revealed the fundamental flaw in those arguments. When funding markets lock up, banks can get stuck holding a large pipeline of the loans they planned to sell, and the weak underwriting can translate into huge writedowns and losses. That is what happened in the leveraged loan market, and it is also what happened to a number of banks with large mortgage warehouses.»

All of this was known to the OCC, or could and should have been known to it. (GAO and the OFHEO systemic risk report had moreover warned years ago for systemic effects). The question what caused the OCC not to see or acknowledge these and other risky phenomena is not asked however. In the left text column on p. 4 it is noted that supervisors cannot always be held responsible for the bankruptcy of a specific bank. This may be true. But it is only part of the truth. What is missing is the remark that it is very different when a substantial number of banks fail due to market and systemic effects, or need taxpayers money to survive. The occurrence of such a phenomenon suggests inadequate system analysis and understanding by supervisors, insufficient risk management and

⁵¹⁰ Again: a meaningful definition of “risk management”, and reflection on the concept and its implementation are direly missed.

⁵¹¹ OCC AR 2008 pp. 2-3.

capital (buffers), and insufficient action by the supervisors, and by their supervisors, and regulators. The more so since only the supervisors were informed about the internal state of financial institutions. The supervised institutions could not but rely on the supervisors as regards assumptions about their competitors. The absence of observations like this is remarkable, and one wonders whether a paragraph or two may have been deleted from a draft of the AR.

The conclusion of Section One, *State of the National Banking System*, tries to sketch events in the proper proportions:

«National banks were generally able to absorb the financial shocks for a number of reasons. The first, and most important, is that banks, having entered this period in overall good health, had the earnings and capital to weather market downturns. Capital levels well in excess of regulatory minimums gave banks the flexibility to absorb sizable quantities of assets on their balance sheets when liquidity in the credit and capital markets became constrained. Throughout the year, banks took steps to further strengthen their balance sheets by increasing loan loss reserves, reducing dividends, and issuing capital in both public and private offerings. Their ability to raise capital reflected investors' belief in the underlying long-term viability of these franchises. Nonetheless, should credit performance worsen, additional loan loss reserves and capital may be required.

National banks, especially larger ones, benefited from diversified lines of business and funding sources. For example, although fees from loan sales, securitizations, and trading were adversely affected by the downturn in housing, other fee income sources remained. Indeed, throughout the year, the national banking system has generally been a source of strength for the financial sector, providing credit and liquidity to both the retail and commercial sectors, and absorbing companies and product lines that faltered or failed under the strains of market dislocation.

While the vast majority of national banks have had the financial capacity and management skills to weather the challenges of the past year, a few have not. In these cases, the OCC's goal has been to effect early and least-cost resolution of the bank so as to minimize losses to depositors and the FDIC insurance fund. During fiscal year 2008, the OCC appointed the FDIC as receiver in five bank failures.»⁵¹²

But even if the failures were limited, the ultimate consequences of the failure of the supervisors in combination with the home market collapse was a worldwide economic downturn which included tens of millions of unemployment-years and lasted for almost ten years.

The FCIC on the OCC.

The following quote may serve to give an overview, and the flavor:

«Cox, the former Minnesota prosecutor, and Madigan, the Illinois attorney general, told the Commission that one of the single biggest obstacles to effective state regulation of unfair lending came from the federal government, particularly the Office of the Comptroller of the Currency (OCC), which regulated nationally chartered banks—including Bank of America, Citibank, and Wachovia—and the OTS, which regulated nationally chartered thrifts. The OCC and OTS issued rules preempting states from enforcing rules against national banks and thrifts. Cox recalled that in 2001, Julie Williams, the chief counsel of the OCC, had delivered what he called a “lecture” to the states’ attorneys general, in a meeting in Washington, warning them that the OCC would “quash” them if they persisted in attempting to control the consumer practices of nationally regulated institutions.

Two former OCC comptrollers, John Hawke and John Dugan, told the Commission that they were defending the agency’s constitutional obligation to block state efforts to impinge on federally created entities. Because state-chartered lenders had more lending problems, they said, the states should have been focusing there rather than looking to involve themselves in federally chartered institutions, an arena where they had no jurisdiction. However, Madigan told the Commission that national banks funded 21 of the 25 largest subprime loan issuers operating with state charters, and that those banks

⁵¹² OCC AR 2008 p. 9.

were the end market for abusive loans originated by the state chartered firms. She noted that the OCC was “particularly zealous in its efforts to thwart state authority over national lenders, and lax in its efforts to protect consumers from the coming crisis.”

Many states nevertheless pushed ahead in enforcing their own lending regulations, as did some cities. In 2003, Charlotte, North Carolina-based Wachovia Bank told state regulators that it would not abide by state laws, because it was a national bank and fell under the supervision of the OCC. Michigan protested Wachovia’s announcement, and Wachovia sued Michigan. The OCC, the American Bankers Association, and the Mortgage Bankers Association entered the fray on Wachovia’s side; the other 49 states, Puerto Rico, and the District of Columbia aligned themselves with Michigan. The legal battle lasted four years. The Supreme Court ruled 5-3 in Wachovia’s favor on April 17, 2007, leaving the OCC its sole regulator for mortgage lending. Cox criticized the federal government: “Not only were they negligent, they were aggressive players attempting to stop any enforcement action[s]. . . . Those guys should have been on our side.”⁵¹³

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(AR 2006 and 2008 only have very short tables of contents).

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⁵¹³ FCIC report p. 13/41. The [s] is in the source.

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17. OECD reports 2006-2009.

Another example of dangerous false pretensions.

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- OECD Annual Report 2007.
- The Economic Outlooks.
- Economic Outlook nr. 80, 2006-2.
- Economic Outlook nr. 82, 2007-2.
- Economic Outlook nr. 83, 2008-1.
- Economic Outlook nr. 84, 2008-2.
- OECD Annual Report 2009.
- The history of the OECD annual reports and the glorification of SG.

Conclusions.

1. The annual reports do give an impression of the activities of the OECD. They are useful guides to more detailed information. Some of the results and benefits of OECD work are mentioned. There are very few tangible results however. Most energy may be spent on support of international discussions and meetings, and on monitoring and supporting relevant international developments.
2. The Economic Outlooks present relevant observations and remarks.
3. The Outlooks saw only superficial phenomena. They show very little knowledge and understanding of financial markets.
4. In general, the analyses of the Outlooks are macro economic and superficial. They assume that macro economics is self sufficient, and does not need other than macro economic information and understanding. Financial crises (and logic) show that this assumption is false. As a consequence, the analyses of the Outlooks are insufficient, and dangerous as a basis for policy recommendations and forecasts.
5. The OECD does not have the knowledge and understanding of, for example, but not only, the financial system, required for its economic evaluations.
6. The Outlooks had only the vaguest notion of risks. They did not try to develop scenario's, and hardly gave recommendations to reduce risks.
7. The argumentation of the recommendations leaves much to be desired. Often they assume (vague) risks. But there are no warnings for serious dangers to be found anywhere in any of the studied reports. There is no analysis showing what will happen next if this or that happens. The reports only pay attention to the "most likely" scenario.
8. The Outlooks, and not in the last place remarks like "steady growth ahead", always suggest business as usual. There is no time without threats, and improvement is always possible. There never are abnormal threats.
9. Sometimes the Outlooks nevertheless give a minimal qualitative indications of the size of risks.⁵¹⁴ They do so more than any of the other studied organizations.
10. Although they present very similar reviews, the Outlooks do not refer to conclusions or recommendations of similar reviews by organizations with similar duties, such as central banks, BIS, CPB, and IMF. Such organizations are not even mentioned (except perhaps in the picture show pages of the SG in the annual reports).
11. There is trace neither of modesty, nor of doubts about OECD's own understanding and abilities. Not before, and not after the crash.
12. The implicit pretension to be able to evaluate, forecast, and make recommendations is false;
13. The OECD did not live up to its "core values", a kind of corporate code of conduct. Who relied on it was deceived.⁵¹⁵

⁵¹⁴ Search this appendix for "distribution of risk", and "fat tail".

14. The falseness of the pretensions and the lack of integrity and analytic abilities are underlined by the complete absence of admission of failings in the years before the crisis, and by the lack of efforts to learn from past errors.
15. The Outlooks show no trace of doubt or amazement about the fact that they implicitly expect readers to have confidence in their competence and authority, even though the OECD obviously presented erroneous economic projections, and failed for many years to clearly and convincingly describe the most relevant risks and recommend remedies. It even did not show acquaintance with the relevant literature.
16. The OECD does useful work.⁵¹⁶ But it lacks necessary self-knowledge, and is insufficiently self-critical. It cannot be considered honorable (unless assumed to be stupid). It is not reliable.
17. It is remarkable that the ministers of the member countries have not done anything effective about the deficiency of the annual reports and its successor, and the replacement of annual reports by “SG reports to ministers”, and have not ended the self-glorification of SG Angel Guría (SG since 2006).
18. The style of the OECD reports is authoritative, like that of government policy documents, and reports of similar organizations and supervisors. In this style there is little room for arguments, refutation of hypothetical counterarguments and proof or references. There is no room for doubt. The style is imposing. The authoritative style is the opposite of an open style where priority is given to showing awareness of the facts and literature, and showing an open eye for possible alternatives and questions. A style that acknowledges the need to be able to answer all relevant questions. An open style manifests a striving for reliability. It tries to convince a critical equal. Without appealing to authority.
19. Especially in the years around the crisis, it is remarkable that the OECD sees no need to study the prehistory. It says that reform of supervision is necessary. (An extremely multivalent and elastic proposition). But it says nothing about supervision or supervisors in 1994-2008.

The OECD according to the OECD.

Many OECD reports are not freely accessible. Some are very hard to find, with or without Google. Reports do not always have a linked table of contents. From the annual reports 2006 and 2007 one cannot copy text. In the study on which this report is based, no other tax-paid organization was less open and user-friendly.

«ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalization. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organization provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.»⁵¹⁷

«Our mission

⁵¹⁵ The OECD does not explain what rights employees derive from the core values. As in other organizations, compliance in the OECD is not supervised by people independent of the line management. Non-compliance is not sanctioned.

⁵¹⁶ This evaluation is based in part on personal OCW experience of the present author. The statistical annex of the Outlooks too seem to be the best in the field, and very useful.

⁵¹⁷ OECD Economic Outlook 2008-2 p. 2.

The mission of the Organization for Economic Co-operation and Development (OECD) is to promote policies that will improve the economic and social well-being of people around the world.

The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. We work with governments to understand what drives economic, social and environmental change. We measure productivity and global flows of trade and investment. We analyze and compare data to predict future trends. We set international standards on a wide range of things, from agriculture and tax to the safety of chemicals.

We look, too, at issues that directly affect the lives of ordinary people, like how much they pay in taxes and social security, and how much leisure time they can take. We compare how different countries' school systems are readying their young people for modern life, and how different countries' pension systems will look after their citizens in old age.

Drawing on facts and real-life experience, we recommend policies designed to make the lives of ordinary people better. We work with business, through the Business and Industry Advisory Committee to the OECD, and with labor, through the Trade Union Advisory Committee. We have active contacts as well with other civil society organizations. The common thread of our work is a shared commitment to market economies backed by democratic institutions and focused on the well-being of all citizens. Along the way, we also set out to make life harder for the terrorists, tax dodgers, crooked businessmen and others whose actions undermine a fair and open society.

OECD at 50 and beyond

As the OECD turns 50, we are focusing on helping governments in our member countries and elsewhere in four main areas:

- First and foremost, governments need to restore confidence in markets and the institutions and companies that make them function. That will require improved regulation and more effective governance at all levels of political and business life. [The present quote dates from 2013].
- Secondly, governments must re-establish healthy public finances as a basis for future sustainable economic growth.
- In parallel, we are looking for ways to foster and support new sources of growth through innovation, environmentally friendly 'green growth' strategies and the development of emerging economies.
- Finally, to underpin innovation and growth, we need to ensure that people of all ages can develop the skills to work productively and satisfactorily in the jobs of tomorrow.

The OECD's core values

- Objective: Our analyses and recommendations are independent and evidence-based.
- Open: We encourage debate and a shared understanding of critical global issues.
- Bold: We dare to challenge conventional wisdom starting with our own.
- Pioneering: We identify and address emerging and long term challenges.
- Ethical: Our credibility is built on trust, integrity and transparency.»⁵¹⁸

According to the annual report 2006:

«The OECD can trace its roots back to the Marshall Plan for rebuilding the European economy after World War II. Its original mission is still valid today:

- to achieve sustainable economic growth and employment, and rising standards of living in member countries while maintaining financial stability, so contributing to the development of the world economy;
- to assist sound economic expansion in member countries and other countries in the process of economic development; and

⁵¹⁸ www.OECD.org 3/1/13. The layout has been adapted to the layout of the present report.

- to contribute to growth in world trade on a multilateral, non-discriminatory basis.»⁵¹⁹

The OECD is organized as follows:

«Council

Decision-making power is vested in the OECD Council. It is made up of one representative per member country, plus a representative of the European Commission.

The Council meets regularly at the level of permanent representatives to OECD and decisions are taken by consensus. These meetings are chaired by the OECD Secretary-General. The Council also meets at ministerial level once a year to discuss key issues and set priorities for OECD work. The work mandated by the Council is carried out by the OECD Secretariat.

Committees

Representatives of the 34 OECD member countries meet in specialized committees to advance ideas and review progress in specific policy areas, such as economics, trade, science, employment, education or financial markets.

There are about 250 committees, working groups and expert groups. Some 40 000 senior officials from national administrations go to OECD committee meetings each year to request, review and contribute to work undertaken by the OECD Secretariat. Once they return home, they have online access to documents and can exchange information through a special network.

Secretariat

Angel Gurría heads the OECD Secretariat and is assisted by one or more Deputy Secretaries-General. Mr Gurría also chairs the Council, providing the link between national delegations and the Secretariat.

The Secretariat in Paris is made up of some 2 500 staff who support the activities of committees, and carry out the work in response to priorities decided by the OECD Council. The staff includes economists, lawyers, scientists and other professionals. Most staff members are based in Paris but some work at OECD centers in other countries.»⁵²⁰

According to p. 9/10 of OECD AR 2007 the OECD budget for 2006 was 336 million euro's.

The significance of the OECD is illustrated by the following table, which appears on p. 6/7, the first page of the chapter “The OECD at a glance”, in the OECD annual report 2007:

- OECD share of world GNI (current USD): 76%⁵²¹
- OECD share of world trade: 84%
- OECD share of world population: 14%
- OECD GDP growth in 2006: 2.6%
- OECD share of world official development assistance: 97%
- OECD contribution to world CO₂ emissions: 49%
- OECD share of world energy production: 34%
- OECD share of world electricity consumption: 60%.

Annual Report 2007.

The pdf file of this report was both created and modified on 11/4/07. The file has no linked table of contents (like the AR 2006, and in contrast with the Economic Outlooks). Copying text from this report, though “Allowed”, turns out to be impossible. (Again in contrast with the Economic Outlooks). Searching in the file is impossible as well.⁵²²

⁵¹⁹ OECD AR 2006 p. 7/8. The quoted text is not given in OECD AR 2007.

⁵²⁰ www.OECD.org 3/1/13. Idem.

⁵²¹ GNI= gross national income, GDP= gross domestic product.

⁵²² The present author considers this extremely user- and research-unfriendly, and inadmissible for an organization paid largely or wholly from taxes.

The report concerns 2006.

At the highest level, the report has the following table of contents:

- | | |
|--------------------------|-------------|
| 1. Overview | pp. 5-16 |
| 2. Key activities | pp. 17-97 |
| 3. About the OECD | pp. 98-120 |
| 4. Practical information | pp. 121-125 |

There is no chapter or information about OECD finances, except in the Overview (marginally).

The chapter Key activities is subdivided in sections headed:

1. Economic growth and stability
2. Employment, social cohesion and environment
3. International trade and taxation
4. Governance
5. Development of non-member economies
6. Statistics
7. Communications

And five shorter sections on specific non-OECD organizations in which the OECD participates.

Activities are described in general terms. In the field of Science, technology and innovation for example, the OECD conducts country reviews, publishes study reports, and manages international programmes aimed at for example cooperation in, and coordination of, thinking about (environmental) safety issues of new technological developments.⁵²³ Reports are the main visible results of these activities. It is impossible however to make a cost benefit analysis. In other words: to weigh the benefits of the OECD against its costs.

The section on Economic growth is far less informative about OECD activities.⁵²⁴ Most of the section seems to be a discussion of the state of economic affairs, as can be found in the Economic Outlooks. It is remarkable that the OECD expects “OECD-wide output [...] to grow at around its potential rate”. As risks it (only) mentions a rise in energy prices, a “sharper-than-expected” rise in long-term interest rates, and the unwinding of current account imbalances.

The section Governance has two subsections: Public and Private governance. It stresses the importance of the subject. It does not remark that there is actually at least one important problem in this field. The OECD is working on indicators of good government, with the help of which the performance of governments of different countries may be compared.⁵²⁵ It has “developed guidelines on how to set up frameworks for ensuring integrity, and particularly for managing conflict of interest to prevent corruption.”⁵²⁶ The subsection mentions one report, titled “Cutting red tape”, on the reduction of administrative burdens.

No effort is made to show that the results of OECD activities justify the costs (over 300 M€).

The Economic Outlooks: generalities.

Economic Outlooks are published twice a year, around 31/5 and around 30/11. They begin with a “summary of projections” in the form of a table with forecasts, for the two coming years, for the following key variables:

- Real GDP growth
- Inflation

⁵²³ “Science, technology and innovation” is a subsection of the section Economic growth and stability.

⁵²⁴ “Economic growth” is a subsection of the section Economic growth and stability.

⁵²⁵ OECD AR 2007 p. 61/62

⁵²⁶ OECD AR 2007 p. 62/63.

- Unemployment rate
- World trade growth
- Current account balance
- Cyclically-adjusted fiscal balance
- Short-term interest rate

As in economics, the summary sees only (quasi) added value. GDP is accepted as the meaningful core measure of economic performance. And the table only mentions current budget deficits, not the total government debt or change therein.

Apart from the table of projections, the Outlooks do not have a summary or conclusions. They do have an Editorial and a *General Assessment of the Macroeconomic Situation*. Which have the character of a summary. Their style is extremely flat. They assert that certain things should be done. But the way in which they say this completely lacks conviction or urgency. Consequences of doing nothing are not mentioned. In most cases, action is waiting already for years, apparently without harmful consequences.

Examples are included in the quotes below.

All studied Outlooks have a linked table of contents. It is not very useful however, because it only mentions larger text units, and, strangely, figures and tables. It is for example impossible to easily find the sections discussing the financial crisis or regulatory reform. It could be worse, but should be much better.

Economic Outlook nr. 80, 2006-2.

The pdf file was created 2 and modified 19/1/07.

Editorial “Smooth rebalancing?”

The editorial was signed on 24/11/06 by Chief Economist Jean-Philippe Cotis.

«This smooth performance has been somewhat disturbed recently, however. In the United States, signs of inflationary pressures and labor market tensions have recently built up while investment in housing has fallen sharply, following a long boom in residential construction. [...]】

Rather than a major slowdown, what the world economy may be facing is a rebalancing of growth across OECD regions. Indeed, recent developments point to an unwinding of cyclical differences, with activity having slowed in the United States and Japan, and gathered speed in Europe. Looking ahead, and given what is seemingly a mild degree of initial excess demand in the United States and Japan, the slowdown in these countries should remain well-contained. [...]】

All in all, Japan and the euro area would grow slightly above trend over the next two years while US growth would return progressively to potential in the course of 2007, following the recent steep deceleration in activity. In its initial phase, however, this growth rebalancing would not be strong enough to prevent a mild and short-lived weakening in 2007 in the OECD area. [...]】

The projected “soft landing” in the United States implies that history would not repeat itself. [...]】

But sustainable growth in the OECD does not only hinge on the balance between aggregate demand and supply. It can also be affected by current account imbalances, or, in other words, by imbalances in the distribution of aggregate demand between its domestic and external components. Clearly, achieving price and output stability requires macroeconomic policies to first balance aggregate supply and demand. But policies to this end find their limits when they generate unsustainable current account imbalances. [...]】

A cooling housing market should therefore not necessarily be a cause for anxiety.

Although in recent years housing markets have played an important role in supporting economic activity, prices may now have reached unsustainable highs in certain countries (notably the United States, Denmark, France and Spain), at least according to OECD Secretariat estimates. When price corrections set in, housing markets may thus reduce the speed of economic expansion, even though the

economy at large is not strongly overheating and macroeconomic policies are only mildly restrictive.

Within bounds, such corrections should not be a cause of concern. However, history suggests that sharp housing corrections can be hard to contain. It is especially so when, as a starting point, the economy is out of kilter, with both over-extended financial markets and clearly overheated product markets. Today, however, this is not the case, implying that a smoother adjustment may be in the offing for the US economy. Recent Australian and UK experience – admittedly helped by favorable circumstances – indeed suggests that for resilient economies landings can be smooth.

In this respect, it is comforting to note that in many countries households seem well prepared to cope with the consequences of a downturn in housing markets, as documented in the special chapter appended to this *Outlook*. Household balance sheets are generally sound and debt-servicing burdens still moderate, although some low-income households may be overstretched. With housing headwinds already affecting the US economy and at risk of materializing elsewhere, it would help the world economy that domestic and household spending fully revive where they have been lagging behind.⁵²⁷ [...]

On the fiscal and structural reform front, not enough is being done in large OECD countries. Although governments today seem much less inclined to spend away tax windfalls than in the past, they generally are not taking advantage of the good overall economic outlook to reduce underlying deficits, with the notable exception of Germany.»⁵²⁸

In short: the Outlook sees a lot, but at the same time fails to see things which should be seen and understood in order to make an optimal forecast. The Outlook's knowledge and understanding of crucial mechanisms in the financial world is insufficient (or absent). Its economic analyses are of the most simplistic kind. There is a strain of wishful thinking. “Landings can be smooth”. Yes indeed. But why not study other possibilities? The Outlook manifests a dangerous absence of doubt. As a consequence, it draws incorrect conclusions.

General assessment of the macroeconomic situation.

The titles in the margin listed below give an idea of the contents.

Overview. Pp. 1-4/10-13.

- Growth has become more uniform throughout the OECD area
- Long-standing tensions endure, but short-term risks are two-sided
- Monetary policy reflects different cyclical positions across regions
- Fiscal consolidation remains a major priority
- Intra-OECD growth gaps have narrowed
- US growth is moderating, not stalling...
- ... while that in the euro area is picking up...
- ... and the expansion in Japan continues apace
- Labour markets are relatively buoyant
- Emerging economies are continuing to expand rapidly

Forces acting and risks. Pp. 4–16/13-25.

- Energy prices have fallen back

⁵²⁷ Even within the context of the Outlook this is a remarkable text. What does the “well-prepared” refer to? From a historical perspective, there were many people in the US who were unprepared. Stabilization of home prices threatened the financial position of quite a few households, given the high percentage of bad (= risky) mortgages. Wishing households to spend more is understandable, but hardly probable. The special chapter lets itself be misled by looking no further than the selected statistics. It does not try to grasp the reality behind the statistics, and the importance of other statistics (developments).

⁵²⁸ OECD EO 2006-2 p. 8/9.

- Tensions and risks look somewhat more benign amid slowing activity
- Refinery bottlenecks have eased
- Substitution effects are at work
- But prices are unlikely to fall significantly further
- Responding of petrodollars has slowed
- Some metal prices have also peaked and may fall further
- Financial markets are buoyant
- Bond yields have fallen
- Not too much should be read into yield curve inversion
- Stock prices are underpinned by strong fundamentals
- Risk premia built into corporate bond yields are low
- Liquidity remains abundant overall [quoted in full below]
- Residential construction remains buoyant outside the United States
- Looking ahead, prices may peak in several markets
- Support to consumption from housing markets is likely to fall
- Global current account imbalances remain large
- The US external deficit is still being financed smoothly
- The US net debtor position remains in check...
- ... while global dollar reserves keep growing rapidly
- But the imbalances seem likely to reverse at some point
- Protectionist sentiments should be resisted

Steady growth ahead. Pp. 16-20/25-30.

- Major OECD economies enter 2007 with good overall momentum
- The US expansion is projected to resume steadily
- Solid growth is sustained in the euro area
- Growth in Japan will gradually slow to its potential rate...
- ... as well as in most other OECD countries
- Emerging markets continue to act as a growth engine

Challenges for macroeconomic policy. Pp. 21-32/31-41.

- Major economies are at various stages of tightening
- A broad range of measures of inflation should be considered
- In the United States monetary tightening has run its course
- In the euro area monetary stimulus will have to be withdrawn
- Japan should guard against premature tightening
- Tax windfalls dominate the picture
- Capital gains are re-bounding
- The commodity bonus is kicking in
- Wealthy taxpayers seem to be getting wealthier
- There is now an opportunity for fiscal consolidation
- The United States needs to tighten further [This concerns government expenditure]
- Euro area countries [governments!] must keep spending in check
- Japan should aim for sustainable [government-] debt levels

Because OECD AR 2009 asserts that “excessive liquidity” was “the fundamental cause” of the financial crisis, we quote the OECD analysis of the liquidity situation in the Outlook 2006-2:

«Liquidity remains abundant overall

High asset prices in recent years are linked to low interest rates and abundant global liquidity associated with the build-up of official dollar reserves across the globe (see below). However, these conditions may also lead investors to become less concerned with risk, a possible example being emerging markets bond spreads, which dropped from an average of around 400 basis points in mid-2005 to 200 basis points at present. Were monetary conditions to tighten significantly and liquidity to contract, risk premia might conceivably widen abruptly. Nonetheless, such concerns have not been validated so far and may not be in the near future. Establishing just how much liquidity is outstanding is tricky, but it appears that global liquidity has not yet started to decelerate, let alone contract, and, as gauged by money and credit based measures, it is still well above historical norms.»⁵²⁹

Note that the OECD makes no effort to find potential sequences of events generated by contraction of liquidity (scenario's). The ability to outline such sequences, and to show that past outlines were correct, can be seen as demonstration of understanding.

In this Outlook the word "mortgage" occurs 56 times. But there is no trace of knowledge of the financial market, derivatives, repo, or other risky products or processes. Abbreviations like "ABS", "CDO", "CDS" and "MBS" are not to be found. The word "swap" is only mentioned in note 3 of the upper table on p. 63/72. The Outlook refers five times to innovations in the mortgage or financial markets.⁵³⁰ The report does not reflect on the possible consequences of the observed phenomena or developments. Not even of those of the (hypothetical!) stabilization of home prices. (It always uses the word stabilization, never "fall"). Neither of the consequences of large current account balances, or large (well-known!) government debts. It simply asks too few questions.

The style of writing suggests that the author believes himself to be able to speak and advise authoritatively about economic developments. But he sees and discusses only macro economic phenomena. He seems to believe in the self-sufficiency of macro economic descriptions and theories, of the macro economic language. The author shows no awareness of, or interest in, the risks produced at lower levels in the various sectors of the economy, especially but not only the financial.

Economic Outlook nr 82, 2007-2.

The pdf file was created 20/12/07 and modified 31/3/08.

Editorial "Dealing with risks".

Signed 27/11/07 by Jørgen Elmeskov, Acting Head, Economics Department.

In spite of shocks, growth is the most probable, though there is a large downside risk:

«Several shocks have hit OECD economies recently: financial turmoil, cooling housing markets, and higher prices of energy and other commodities. Fortunately, they have occurred at a time when growth was being supported by high employment that boosts income and consumption; by high profits and strong balance sheets that underpin investment and resilience in the face of financial losses and tighter credit; and by still buoyant world trade driven by robust growth in emerging economies. Hence, although near-term growth has been revised down virtually everywhere in the OECD area, the baseline scenario depicted in this Economic Outlook is actually not that bad in view of the recent shocks. It represents the outcome that carries the highest probability in the current more uncertain situation [...]»

The trouble is that the probability distribution around this outcome has a fat tail on the downside. The main negative risks include a more pronounced or generalized cooling of housing markets than projected; additional turbulence in financial markets; and further upward pressures on already high commodity prices. Against this backdrop, economic policy should prepare for the contingencies that could arise. [...]»

The OECD analysts clearly think that they know everything that is relevant. They ignore the possibility that they do not know and understand the economic system sufficiently. They probably assume that all supervisors do their duty, and that supervisors warn when there is reason to. Even

⁵²⁹ Economic Outlook 2006-2 p. 8/17.

⁵³⁰ The report does not discuss the nature of the innovations.

though this assumption is not included in Box 1.6. with “policy and other assumptions underlying the projections” on p. 46 of the Outlook. In fact, the box only mentions rather technical assumptions, mainly in the areas of taxes and monetary policy.

If there is a real possibility for a very bad scenario, should that not be mentioned? Should no preventive measures- if possible- be mentioned more explicitly? Is “economic policy” the right remedy, and can it be sufficient? Some more explicit recommendations are given in the section “Challenges for macroeconomic policy” (the title of the section does not cover its content), but (possible) relations with scenario’s remain unmentioned. In other words: the recommendations seem to be just wise or nice things to do.

Continued excessive spending is regretted since it limits possibilities in times of need:

The OECD projections, which are based on currently legislated or clearly announced policies, show no further progress in reducing the underlying OECD-wide fiscal deficit. This is regrettable, not least in view of expected future spending pressures. Going further, there is a risk that decisions could be taken in countries that cannot afford so to permanently raise spending or reduce taxes on the basis of temporarily high receipts. This would imply a weakening of the underlying budget position. Were the downside risks to growth subsequently to materialize, such weaknesses would likely surface and could impede the full working of the fiscal automatic stabilizers at a time when they were needed. Therefore, fiscal policy needs to stay on the straight and narrow despite buoyant revenues.»

The OECD knows of the turmoil in the financial markets, but not of the potentially disastrous processes described by the GAO, OFHEO and CGFS. It implicitly trusts the financial supervisors:

«The financial model based on origination, securitisation and distribution has allowed credit to flow to agents who might not otherwise have found it and risk to be allocated to those willing to hold it. However, the model also has some deficiencies that have come into the open with the collapse of the sub-prime market in the United States. One such deficiency is the lack of information as to where in the system various risks are concentrated. Moreover, the re-pricing of assets and recognition of losses now that the assessment of risk has changed is proving slow. The combination of uncertainty as to who holds risk and slow recognition of losses has caused liquidity to dry up in some markets.

As long as the process of re-pricing and loss discovery continues, financial markets are likely to remain a source of uncertainty and of vulnerability to shocks. Hence, action to speed up the necessary repricing and recognition of losses would be useful. At the same time, regulators and supervisors will need to balance the desire for a rapid restoration of confidence in balance sheets of financial institutions against the risk of triggering a severe retrenchment in credit supply. In due course, the lessons will have to be drawn as to whether and how the regulatory framework around the model needs to change to prevent its malfunctioning in the future.»

Restoration of balance sheets of financial institutions? How?

In the last paragraph the OECD does conclude that the regulatory framework has malfunctioned.

A long closing paragraph discusses lack of equilibrium in exchange rates.

General assessment of the macroeconomic situation.

Overview. Pp. 12-14/14-16.

- Financial turmoil, housing weakness and oil prices are forefront...
- ... but the main scenario remains relatively benign
- Housing slowdowns will impact severely in only a few countries
- But downside risks predominate
- Monetary policy in the three main areas should remain on hold for now
- Fiscal consolidation remains a priority

Recent developments. Pp. 14-24/16-26.

- Financial markets are undergoing a major re-pricing of risks

- Housing markets continue to adjust downward
- The sharp correction in the US housing market continues
- Housing is weakening in other areas but more slowly
- Commodity prices have risen across a broad range
- OECD growth has so far remained strong
- US growth has been resilient despite the drag from housing
- Euro area growth has exceeded potential
- Growth in Japan continues to be led by exports
- Emerging markets have remained major growth poles
- Labour markets have been holding up well...
- ... and wage costs remain contained

Forces shaping the outlook and associated risks. Pp. 24-43/26-45.

- Financial and housing markets will be important
- The direct impact of the financial turmoil is likely to be limited
- The cost of external financing has risen moderately...
- ... and bank lending terms are tightening
- The non-financial corporate sector is healthy
- Credit to households is being restricted
- The financial sector remains vulnerable to shocks
- Risk reassessment could spread to emerging markets
- Some cooling in housing markets is to be expected
- Housing investment in many countries is in line with fundamentals [& at 10-year high]
- Construction downturns were often triggered by monetary tightening
- US problems have been concentrated in variable rate sub-prime mortgages
- A key issue is whether conditions for prime mortgages worsen
- A range of factors need to be examined in assessing housing risks
- A key issue for the US outlook is the impact of housing on consumption
- Cross-country evidence suggests that collateral effects are important
- Oil prices have rebounded sharply...
- ... while imports by oil producers have firmed
- Prices are likely to remain high...
- ... with further price increases posing risks
- Rising non-oil commodity prices are adding to these risks
- Although the US current account deficit has fallen...
- ... global imbalances are still large and persistent
- Financing imbalances remains orderly so far
- Adjustment will have to occur
- The role of official purchases has been growing...
- ... and investment protectionism is on the rise
- Trade protection sentiments are also on the rise

Growth prospects. Pp. 43-49/45-51.

- There are divergences in near-term growth with...
- ... the US economy slowing
- In the short-term construction will slow activity in Japan
- The euro area is set to grow slightly below trend
- UK and Canadian growth could slow in the near term
- US growth is nearing its cyclical low...
- ... while the pace of the expansion in the euro area eases...

- ... as well as in Japan
- Growth in many other OECD countries will temporarily slow
- Emerging markets continue to stimulate the global expansion

Challenges for macroeconomic policy. Pp. 50-60/52-62.

- Central banks had to provide liquidity to contain turmoil
- There are potential upward pressures on inflation...
- ... including from the effects of globalization
- Interest rate cuts can remain on hold for now in the United States...
- ... and also in the euro area
- Further hikes in Japanese rates should wait
- There is room to ease UK but not Canadian interest rates
- China should allow exchange rate appreciation
- Revenues have been buoyant in recent years
- Corporate taxes have surged, largely driven by temporary factors...
- ... and personal income taxes have also played a role
- Short-term fiscal gains have often given rise to long-term pain
- Underlying fiscal positions are hard to assess at the peak
- Several countries are cutting taxes or boosting spending
- Fiscal consolidation is expected to stall over coming years with...
- ... the US deficit widening...
- ... while the structural balance in Japan improves and...
- ... that in the euro area stagnates
- The improvement in the UK structural deficit remains insufficient
- Canada maintains a surplus
- Some smaller economies should see larger improvements

To show the OECD's understanding, the section "The direct impact of the financial turmoil is likely to be limited" is quoted unabridged:

«The effect of financial turmoil on total activity stemming from the sector itself is likely to be small. Only some segments of the sector are expected to be affected, and the sector accounts for less than 10% of the value added and about 5% of employment in most OECD economies. Indirect effects of the turmoil via higher cost of funding and tighter credit standards are uncertain but likely to be more significant. While at this stage their impact on activity seems contained, this could change if turbulence does not gradually fade as expected or even turned into a renewed bout of market tremors.»⁵³¹

There is a useful Box 1.1. *A chronology of the financial market turmoil* on pp. 14-5/16-7. The notes in the box mention possibly useful references. They seem to be arbitrarily selected, and all of them are dated 2007. Which the present author considers absurd. The box is clear however about the cause of the "turmoil":

«The origins of the financial turmoil were lax lending standards for US mortgages, particularly in the subprime market. The consequences were magnified by information failures; in particular the complexity of financial products linked to sub-prime loans made it very difficult to assess asset values and location of risk exposure. These failures exposed inherent weaknesses in the expansion of securitisation and the widespread use of the "originate and distribute model", by which banks and other credit institutions have been able to issue credit without carrying it on their balance sheets. Credit originators had little incentive to properly assess credit risks; investors in secondary markets for loans did not have enough expertise, or experience, to assess risks; and rating agencies' assessments used as a substitute for own risk analysis proved to be far too optimistic.»⁵³²

⁵³¹ Economic Outlook 2007-2 p. 25/27.

⁵³² Economic Outlook 2007-2 p. 15/17. This is the concluding paragraph of the box.

Economic Outlook nr 83, 2008-1.

The pdf file was created 20/6 and modified 18/8/08.

Editorial: "After the storm?"

Signed 28/5/08 by Jørgen Elmeskov Acting Head, Economics Department.

The most important things- for an economist- first: economic growth:

«Several quarters of weak growth lie ahead for most OECD economies. [...] This scenario is the combined outcome of financial market turmoil, cooling housing markets and sharply higher commodity prices. The projections in this OECD Economic Outlook carry both upside and downside risks and embody the following main features:

- US activity is essentially flat through 2008 and then picks up thereafter as housing adjustment ends, credit conditions normalize and the effects of past monetary ease are felt. [...]
- Euro area activity is restrained through the current year by tighter credit, squeezed real incomes, lower export market growth and market share losses. Growth gradually recovers as these factors fade, though falling housing investment remains a drag throughout. [...]

The current economic situation is particularly unsettled and the distribution of risk around the projections is wide.»

Then the financial markets.

« Financial market influences on growth remain hard to gauge. The odds have improved that financial market dislocation has passed its peak, but this is far from a foregone conclusion. And even if true, the effects on growth are likely to linger. Uncertainty is compounded by the likely feed-back from a weaker growth environment on financial markets and by the fact that problems at financial institutions can be resolved in different ways. In this regard, it is desirable for capital deficiency to be addressed through the injection of new capital and asset disposal rather than through credit compression. While a slower than projected normalization of financial markets cannot be excluded, nor can a more rapid restoration, especially if improved confidence were to create a positive feed-back between financial asset prices and institutions' balance sheets. Central banks need to stand ready to deal with both eventualities.

Apart from dealing with the fall-out on demand from current financial market distress, it will be necessary to re-visit the prudential and supervisory framework for financial markets. The Financial Stability Forum has recently provided directions for change in these areas and efforts towards implementation are in some cases already underway. It will be important to carry through with the required reforms, also when the memory of recent turmoil becomes more distant and those subject to tighter regulation more likely to resist. At the same time, regulatory overkill needs to be avoided. Many recent innovations in financial markets have the capacity to improve welfare, when appropriately harnessed.»⁵³³

How does one measure the amount of regulation, of regulatory overhead? What is the justification for speaking of "overkill", especially when liability is rejected, and outsiders are not safeguarded? What is "appropriately harnessed"? Does the OECD claim that "financial markets improved welfare" in 1994-2008, also of those outside the financial sector? Why should one believe the OECD after the obvious failure of its analyses and projections in 1994-2008? In fact, the "recommendations" are 100% authoritative, without any visible basis in analysis of the causes of the present turmoil, and especially the performance of the supervisors. The OECD too should understand that the Financial Stability Forum probably failed badly, and should not be taken seriously without a thorough investigation.

"injection of new capital": where should the new capital come from? From the printing presses?

The report shows that by June 2008 the OECD is aware of its lack of information and understanding. This is translated in uncertainty, and a substantial downside risk. Its argumentation remains vague however. It has not enough knowledge and understanding of the workings of the

⁵³³ Economic Outlook 2008-1 p. 8/10.

financial markets to realize the possibility if not inevitability of worse to come. Because of the great importance of the financial system for the whole economy, it could and should have known that MBS forms a substantial part of the capital of many banks (and other organizations, such as pension funds). It could and should have known that substantial devaluation of the capital of these organizations inevitably brings them into great difficulties, even cause insolvency. It could and should have seen both the relevant factual information and scenarios in the OFHEO systemic risk report. It could and should, but clearly didn't. It shows no knowledge of the supervisory system. It nevertheless considers itself competent to make recommendations about that system.

The editorial concludes:

«Overall, OECD economies have been hit by strong gales over the recent past and it will take time and well-judged policies to get back on course. Nonetheless, it is a tribute to the effects of past structural reform and well-honed macro-policy frameworks that the effects of this near-perfect storm have not been worse. This underlines the need to persevere with such policies.»

This supports the hypothesis of irresponsible arrogance. The OECD praises “reform and a well-honed frameworks”. Is it going to criticize policies after the crisis? Of course not. (Therefore, the OECD is biased). The policies were definitely not really good. What changes are needed? Again you can be sure the OECD will be very soft at best.

It is of course very premature and arrogant to assert “that the effects of this near-perfect storm have not been worse”. As if the author had forgotten the downside risks of the preceding pages, or as if normalcy had already returned.

Estimates of downside risks or their consequences are missing. The OECD thinks that only the most likely scenario is relevant. The scenario is not described by the way.⁵³⁴

In Outlook 2008-1, specifications of downside risks could not be found. The Outlook only makes qualitative assertions about the downside risks. It mentions a “fat [downside] tail” for example. Argumentation is lacking. The Outlook mentions factors which could have a detrimental effect on economic growth. Large or small, the OECD doesn't say. It seems not to be aware of the primitive nature of its analysis and the information it provides. According to this Outlook, in the end it is only the most likely outcome that matters: «Overall, the projection is best characterized as a most likely outcome.» p. 13/15.

Economic Outlook nr. 84, 2008-2.

The pdf file was created 10/12/08, and modified 16/12/08.

Editorial: “Managing the global financial crisis and economic downturn”.

Signed 25/11/08 by Klaus Schmidt-Hebbel, Chief Economist.

The editorial opens with a summary of the state of affairs. The projection of the previous Outlook has to be revised downwards.

«Many OECD economies are in or are on the verge of a protracted recession of a magnitude not experienced since the early 1980s. As a result, the number of unemployed in the OECD area could rise by 8 million over the next two years. At the same time, inflation will abate in all OECD countries and some even face a risk, albeit small, of deflation.

This Economic Outlook represents a substantial downward revision from just a few months ago: many of the downside risks previously identified have materialized.»

The downside risks were not or hardly “identified” in any of the preceding Outlooks. Risks were said to exist, but little more than that. No indication of their nature or size or of the seriousness of their consequences had been given. None is given in the present Outlook.

The OECD expects normalization to begin only in 2010, but the uncertainty is substantial.

«I would like to emphasize upfront that the uncertainties associated with this OECD Economic

⁵³⁴ It is far from trivial. Efforts to develop or trace a scenario might show that there is no or hardly a positive way out of the given situation. Positive in the sense of: autonomous, without taxpayers aid.

Outlook are exceptionally large, especially those related to the assumptions regarding the speed at which the financial market crisis- the prime driver of the downturn- is overcome. Specifically, we assume that the extreme financial stress since mid-September will be short-lived, but will be followed by an extended period of financial headwinds through late 2009, with a gradual normalization thereafter.»

There is no trace of awareness of the possibility of realization of risks in the areas of balance of payment or government debt.

Indirect effects of the crash are indicated:

«The financial crisis is not the only development shaping the projections. Other important drivers include ongoing adjustments in housing markets, which in many European economies, based on past housing cycles, still have a long way to go. Moreover, they come on top of negative wealth effects from the steep fall in equity prices. Partially offsetting these contractionary forces is the sizeable monetary stimulus, including non-traditional means, recently introduced and built into the projections, and the boost to real household incomes due to sharply lower commodity prices.»

Couldn't the effects of the increase in unemployment and the costs of bailouts outweigh the effects of corrective measures? And don't "stimuli" create their own new problems?

What is a government expected to do with the following nebulous suggestions?

«In this unusual situation, fiscal policy stimulus over and above the support provided through automatic stabilisers has an important role to play. Fiscal stimulus packages, however, need to be evaluated on a case-by-case basis in those countries where room for budgetary maneuver exists. It is vital that any discretionary action be timely and temporary and designed to ensure maximum effectiveness. Infrastructure investment is often mentioned as a desirable instrument for stimulus. While it will boost both supply and demand, provided the investments are well chosen, infrastructure investment typically takes a long time to be brought on stream and, once begun, is difficult to wind down in line with a recovery in activity. Alternatives, such as tax cuts or transfer payments aimed at credit-constrained, poorer households, might prove more effective in boosting demand.»

The OECD knows that government debts quite generally exceed 60% of GDP. So when and why is there budgetary room for maneuver? How to forecast effectiveness? How long is one supposed to continue investing (witness the government debts- once undoubtedly defended as "investments")?

Reform of financial market supervision and regulation is necessary:

«Reform of financial market supervision and regulation is clearly necessary to build a more resilient financial system. Here, our efforts need to focus on identifying the market imperfections that gave rise to the incentives for excess risk taking and high leverage, as well as the regulatory failures that together caused this unprecedented global financial crisis. This will involve, *inter alia*, strengthening and streamlining the prudential oversight of financial and capital markets, and plugging the gaps and inconsistencies in regulatory regimes. It also requires enhancing transparency of market instruments, transactions, and the governance rules that determine corporate incentives and decisions. The tendency for pro-cyclicality of financial markets and macroeconomic policies also has to be corrected and ideally reversed.»

"Market imperfections imperfections that gave rise to the incentives for excess risk taking and high leverage"? A typical example of a mechanical, superficial interpretation on the basis of dogmas instead of a thorough study of the financial system, its products and processes.

For elucidation of the OECD ideas see pp. 66/68 and following. Dogmatic follies and the active neglect of warnings are not addressed. The OECD underwrites the generally proposed kind of measures. Essentially assuming that inadequate financial regulation caused the crisis. Overlooking the observational fact that in the past decade, none of the supervisors had complained about inadequate regulation, at least not about inadequacy in the present sense(!). In other words: the OECD neglects to note that serious inadequacy of regulation implies inadequate supervision and/or government. It overlooks the possibility that competent supervision could have prevented the crisis even with the given regulation. It jumps to conclusions.

The Outlook says nothing about the performance of the financial supervisors and governments, especially as regards affordable housing policy and deregulation. And will the OECD/ Economic

Outlook evaluate the measures after the reform is completed? Nothing about monitoring progress could be found.

The crisis has taught the OECD nothing; it has lost none of its false- and dangerous pretensions:
«The recent G20 meeting initiated an action plan and a process for addressing many of these issues.

[...] In this context, the OECD drawing on its structural analysis expertise will identify policy reforms that support the functioning and performance of financial markets and policies that promote higher growth.»

In 1994-2008 the “structural analysis expertise” of the OECD has proven its worth. It counts for nothing, or rather: failure. The OECD too ignored the signals and warnings by GAO, Born (CFTC), OFHEO, and CGFS in the past decade.

Chapter 1 has a very useful

«APPENDIX 1.A1 A chronology of policy responses to the financial market crisis».⁵³⁵

This Outlook gives a lot of seemingly sensible advice and arguments for desirables. But it gives no attention to bad or worst case scenario's. As Outlook 2008-1.

Annual Report 2009.

The Preface by the OECD Secretary-General, Angel Gurria, begins as follows:

«The OECD has faced many challenges in the last 50 years, but perhaps none as great as the current global crisis. Response to the crisis has been swift and massive. But despite some cautious optimism, the immediate future does not offer much relief. The global economic system must undergo many structural changes if we are to avoid a repetition of this scenario.»⁵³⁶

Is it the global economic system, and only that system, that must change? Of course, after having failed even to listen to the analyses and warnings of others, let alone see the dangers on its own, the OECD has shown to lack the competence to identify the causes (see below) and remedies, and to assert what its SG asserts here.

The concluding paragraph of the Preface includes the following sentence:

«The OECD's unique ability to address the complex nature of the global crisis, which affects virtually every aspect of policy making, is presented and developed in the pages that follow.»⁵³⁷

Comparison of the OECD reports of the past decade with the events of 2007-2008 prove that this is untrue, shows a dangerous lack of self-knowledge, and is irresponsible.

Pp. 10-13 are four pages each with four pictures of “events”. Most of them represent the OECD SG with a minister or chairperson of an important international body. It looks like a big ego-trip of the OECD SG. Look how important I am.

The chapter “Spotlight” discusses three topics. The first is the financial crisis.⁵³⁸ It begins as follows:

«The trigger of the financial and economic crisis was the collapse of the subprime mortgage market in the United States; but that was really only “the canary in the coal mine”. The fundamental cause of the global financial crisis was excess global liquidity, which fuelled, among other things, a housing market bubble, driven by a complex combination of regulatory, market and policy failures. What makes this financial crisis unique is its global reach, having spread at an extraordinary pace from the United States to other countries and leading to a widespread loss of confidence.»⁵³⁹

⁵³⁵ Economic Outlook nr 84 (2008-2) pp. 70-76/72-78.

⁵³⁶ OECD AR 2009 p. 5/6.

⁵³⁷ OECD AR 2009 p. 5/6.

⁵³⁸ The other two are climate change and possibly growing income inequality.

⁵³⁹ OECD AR 2009 p. 20/21.

The supposedly excessive global liquidity was nothing new. It had existed for years. If it really was such a great danger, why didn't the OECD say so? In Outlook 2006-2 liquidity was not called excessive but abundant. It was said to have risks, but nothing was said about the nature and seriousness of those risks. In AR 2007 two risks are mentioned, not including excess liquidity.

In fact, the most important facts about the subprime crisis are that it was at least greatly helped by a decade long of reckless affordable housing policy of the US government, and that it could have been prevented by the supervisors. The crisis and its follow up first of all prove the lack of necessary integrity and competence of governments and supervisors. It was not a system that was wrong, but the people responsible for its sound organization and safe operation.

The OECD should have studied the prehistory of the crisis, and prove that it really understands, before telling the world what to do.

As in the annual report 2007, the chapter Governance has two parts, public and private. In order to show the state of understanding or affairs, the text unit "Integrity and corruption resistance" of the part Public governance is quoted in full:

«Integrity and corruption resistance

To help countries promote a culture of integrity, transparency and accountability in government, the OECD has developed the Integrity Framework. This Framework sets out instruments, processes, structures and conditions for implementation in public organizations, as well as benchmarks and data on vulnerable areas, such as public procurement, postpublic employment and lobbying (see box page 72). In October 2008, countries adopted the Principles for Enhancing Integrity in Public Procurement as an OECD "soft law" instrument. A toolkit is also being developed to help countries implement the Principles, and to help detect fraud and corruption in public procurement.

The OECD carries out peer review exercises known as Joint Learning Studies (JLS) which support reforms to enhance integrity and prevent corruption in countries in the Middle East and North Africa (MENA) region. In 2008, a first JLS was carried out with Morocco. These Studies are part of broader efforts to share OECD experience with the region and to promote dialogue on public management reform among the MENA countries themselves.»

An outline of the integrity framework could be found, but not a more comprehensive report.⁵⁴⁰ Annual report nor infosheet defines "corruption". So much for openness. The outline resembles Dutch governmental publications on the topic. Comparison with reality shows that it is no more than false propaganda.

On p. 72/73, in the Public governance subchapter, there is a box on lobbying. It is quite remarkable that it is the subchapter Private sector governance that has the box "Preventing future crisis". There is no such box in the Public governance subchapter.

The OECD annual report 2009 contains no self-evaluation of, or any form of reflection on, its performance in the past decade.

The OECD annual report 2009 is an informative report. It mentions many potentially useful other reports. Where it should not be forgotten that "useful" does not imply "good".

The history of the OECD annual reports and the glorification of SG.

For the time being, the OECD annual report of 2009 is the last report titled "OECD annual report". The series of annual reports is succeeded by a series of "Secretary-General's Reports to Ministers". As regards their contents, these reports resemble the former annual reports. Though for example the report 2012 has no linked table of contents. In the report of 2016 a large number- of the order of 50 (fifty)- of photo's featuring the SG and prominent international politicians suggest that glorification of the SG

⁵⁴⁰ 20091103_Infosheet Integrity framework_OECD.pdf. It can be found in the directory OECD.

has become one of the principal aims of the report. The report of 2019 is well structured, and has a linked table of contents. It is a useful guide to work of the OECD. The self glorification of the SG continues. On p. 14/16 one can even see how many of his 564 meetings were with ministers (153), high-level officials (128),..., parliamentarians (14) and academics (9).

«During the year, the Secretary-General delivered 342 speeches and was quoted 4 823 times in the media and in 869 original articles. He authored 4 op-eds in different media outlets as well as several other articles and pieces translated into 13 languages.»⁵⁴¹

Etcetera, etcetera.

In this report, the word “secretary” is found 212 times, the word fragment “salar” not at all.

⁵⁴¹ SG report to ministers 2019, p. 15/17.

18. OFHEO AR 2002-2008, FHFA AR 2008, and some other reports.

This appendix tries to give an impression of OFHEO and the supervision of the GSEs. It is more detailed than the appendices of most other supervisors for three reasons: 1) because OFHEO supervises only two (large) corporations, 2) because it gives a relatively close view of supervision in action, and 3) because it is ambiguous and inconsistent and seems inexplicable.

The annual reports give a rather detailed picture of OFHEOs supervision and the management of the GSEs. This picture is a substantial contribution to the explanation of in the first place the subprime crisis.

Table of contents of this appendix.

- Abbreviations.
- Summary, conclusions and a few remarks.
- Directors and signatures under annual reports (until 2007) and FHFA (as from 2008).
- Miscellaneous information about OFHEO.
- OFHEO AR 2002.
- The systemic risk report of February 2003.
- OFHEO AR 2003.
- Intermezzo on improvement of GSE/ supervisor regulation.
- OFHEO AR 2004.
- OFHEO AR 2005.
- OFHEO AR 2006.
- OFHEO AR 2007.
- OFHEO AR 2008.
- FHFA AR 2008.
- Testimony of director Falcon before the FCIC on 9/4/10.

Abbreviations.

AR= annual report.

CAMELS is an acronym referring to six components of the condition of the Enterprises that have been evaluated through OFHEO's supervisory programs. The six areas evaluated were: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to market and interest rate risks.⁵⁴²

FHFA= Federal Housing Finance Agency.

OFHEO= Office of Federal Housing Enterprise Oversight.

PAR= Performance and Accountability Report

The choice of the AR years.

Around 2002 OFHEO discovered serious deficiencies and mismanagement in Fannie and Freddie. The consequences of the deficiencies and mismanagement had not been completely remediated when the crisis struck, in September 2008. In order to reduce the probability of missing information which may be relevant for understanding the organizations and developments, this evaluation begins with a relatively early annual report. That of 2002.

Summary and conclusions.

1. This appendix is based on a study of the facts and of OFHEO AR 2002-2008, FHFA AR 2008, the OFHEO PAR 2005 and 2007, and FHFA PAR 2008, and the OFHEO systemic risk report of 2003.

⁵⁴² OFHEO AR 2004 p. 10/16.

2. OFHEO is an example of a supervisor with potentially conflicting duties. It is to ensure safety and soundness of the GSEs, and to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing. The potential conflict is not discussed in any of the reports consulted in this study (in the wide sense).
3. OFHEO AR 2002 reports that everything at the GSEs is well. No reservations are made.
4. In February 2003 OFHEO publishes a report about the systemic risk posed by the GSEs. The conclusion is that a significant systemic risk exists. The annual reports of following years, including AR 2003, show no trace of this study. In other words: OFHEO does not seem to have drawn conclusions regarding its supervisory norms and activities.⁵⁴³
5. OFHEO AR 2003 informs of the discovery of accounting errors at Freddie. Fannie is evaluated positively in all respects. In addition to the usual annual examination, OFHEO announces that it will do a special examination at both GSEs.
6. OFHEO systematically misled the financial world by giving a too positive picture of the situation. This could have been concluded from the OFHEO reports themselves. They never answer serious logical questions, and ignore past errors of judgment. No errors are admitted, and no lessons learnt. The irregularities found in 2002 (AR 2003) had only been solved partially when the crisis struck.
7. The use of OFHEO AR is confirmed by Warren Buffett in the hearings of the FCIC about Moody's on 2/6/2010.
8. Only in the letters of transmittal action is requested from outsiders.
9. The letters of transmittal ask Congress for improvements in legislation. Especially regarding the authority and budget of OFHEO. Though part of the request is evidently justified, the reports don't clearly show why authority is a problem, and what problems would be solved by granting which authority. More authority certainly would not solve the much more serious problems indicated in the foregoing points.
10. Year after year OFHEO AR report that the GSEs have important internal deficiencies, and that the GSEs and OFHEO are working to correct them. The process takes longer than OFHEO expected. It does not draw any conclusions from this. Neither does it analyze or say what negative effects the remaining deficiencies have on the operation of the GSEs.
11. It would seem that in 2003 OFHEO should have concluded that for the time being the GSEs did not and could not operate in a safe and sound manner. That for the time being the GSEs should not enter any new contracts.
12. The annual reports suggest that notwithstanding all kinds of very serious deficiencies, business at the GSEs continues as usual.
13. Apart from the isolated systemic risk report, nothing in OFHEO reports shows awareness of the existence of systemic risk, and the influence on that risk of developments on house and mortgage markets and in the financial world.
14. Even OFHEO AR 2008 (dated 29/5/08, and modified 9/4/09) gives no inkling about what is to come (in 2008). «Last year [= 2007] was a very eventful and challenging year for Fannie Mae and Freddie Mac and the housing markets that they serve. To a large extent, the Enterprises rose to those challenges. [...] The challenges of 2007 are still present this year. The problems in the housing markets are continuing. OFHEO expects that Fannie Mae's and Freddie Mac's Consent Agreements will be lifted in the near-term and all major internal control issues should be remediated this year. It is my hope with the completion of their remediation efforts, significant additional capital and an enhanced regulatory regime we will end 2008 with the stakeholders in the nation's housing finance system much stronger than today.»⁵⁴⁴
15. In none of its AR does OFHEO reflect on possible scenario's. What if the negative developments in the financial sector of 2007 pursue their logical course? Possible scenario's were sketched in the systemic risk report of OFHEO of 2003 and the GAO reports of 1994-1999. OFHEO AR 2008 is silent about them. Its AR never refer to these reports.⁵⁴⁵ It clearly gives no warning. It shows

⁵⁴³ It could have included a chapter “The systemic risk report and its consequences for OFHEO” in AR 2003 or 2004. In fact, AR 2004 (on 2003) only mentions the report in the section *OFHEO Research and publications*.

⁵⁴⁴ Sic. Letter of transmittal, OFHEO AR 2008.

⁵⁴⁵ The systemic risk report is mentioned in the section *Research and publications* of OFHEO AR 2004.

- numerous reasons for worry (without noting that they are reasons for worry), and numerous substantial uncertainties. But it says nothing about the risk of illiquidity and/or insolvency.
16. FHFA AR 2008 cannot ignore the financial crisis. But the style of the text has not changed. There were problems, which were or are being solved. An explanatory analysis of what went wrong at the GSEs and OFHEO is missing. Conclusions are not drawn, and lessons are not learnt. Director Lockhart's claim that for years he had asked for more authority for OFHEO is correct. But the AR never explained why this was necessary, and what it would help. OFHEO never said what conditions GSEs should satisfy and why. FHFA does not try to show that the capital requirements of other types of financial institution could have prevented the given development. Or that acceptance and implementation of its proposals would have prevented the insolvency of the GSEs.
 17. The annual reports of OFHEO and FHFA notice some problems, but ignore others. They underestimated the problems very badly. OFHEO forgot its own systemic risk report. The annual reports do not indicate what risks given situations created for the GSEs, and what the consequences of realization of the risks might be. Risks or scenario's for the coming year were not discussed. The reports were useless as a basis for policy or action. They nevertheless provide useful information, and are a good basis for asking questions. Which among other things should lead to improved annual reports.
 18. The systemic risk report shows that OFHEO did have employees who understood some of the risks, and that the management failed to take appropriate action. It didn't even use the report to press its recommendations for legislative reform.
 19. The problem of OFHEO was not authority or budget process, but lack of a critical attitude, openness (saying what has to be said) and competence.
 20. To aid correct interpretation, supervisor (annual) reports should always contain both their legal duties (which may prohibit certain types of inquiry) and method (which may only use documents submitted by the institution, i.e. the top (!), being supervised). OFHEO AR 2000 gives the relevant legal duties and responsibilities,⁵⁴⁶ OFHEO AR 2006 does not.
 21. Congress and the administration not only failed to properly supervise OFHEO (and other supervisors), but also required it to work within an inadequate regulatory framework.

The inconsistency of OFHEO is confirmed and further illustrated by the history of August-September 2008. In these weeks OFHEO/FHFA made a complete turnaround in its opinion about the GSEs. This episode is described in the Chronicle, in the paragraphs beginning with "In the two weeks between 22/8 and 4/9". This is part of the subsection *Fannie and Freddie up to and including 7/9/08* of the chronicle of March- mid September 2008.

Miscellaneous remarks.

OFHEO notes harmful deficiencies of the law.

Important deficiencies in the law, including legal procedure, and especially liability and criminal law, can be seen at the wiki-page on Franklin Raines. (It is included in the dossier).

In OFHEO AR 2004 one finds the following quote:

«OFHEO conducted a special examination of the events leading to the public announcement on June 9, 2003, of the termination, resignation, and retirement of the three principal executive officers of Freddie Mac.»

In OFHEO AR 2006 one finds the following quote:

«On December 9, 2005, OMB⁵⁴⁷ returned, for further consideration by OFHEO, a draft proposed amendment to OFHEO's corporate governance regulation which would have prohibited the Enterprises from indemnifying directors and executive officers for civil money penalties and

⁵⁴⁶ At the very end of the report.

⁵⁴⁷ OMB= Office for the Management of the Budget.

restitution or recoupment orders assessed against them in actions initiated by OFHEO. OFHEO continues to review approaches to addressing indemnification issues, including examination guidance.»⁵⁴⁸

OFHEO authority and capital requirements.

Specifics about the capital requirements of the GSEs are given in the FCIC staff study *GSEs and the financial crisis*:

«As a result of the GSE guarantee, the institution holding the MBS faced lower capital requirements.»⁵⁴⁹

«For example, under Basel I total capital required for an agency MBS was 1.6%, versus 4% on whole loans.»⁵⁵⁰ (The norm of Basel I was 8%. 1.6= 20% of 8; 4= 50% of 8).

«As one example of weakness, OFHEO was limited in the discretion that it could exercise to increase capital requirements for Fannie Mae and Freddie Mac. The minimum capital standards were set by law at 2.5 percent of on-balance sheet assets and 0.45 percent of off-balance sheet guarantees. The law also prescribed parameters for the GSEs' risk-based capital. These specified the parameters under which credit risk and interest rate risk could be used to calculate the level of risk-based capital required for the two GSEs. The risk-based capital test generated values below the statutory minimums, which became the binding capital requirements on the two enterprises. As a result of the statutory prescriptions, the two GSEs operated with significant leverage: For Fannie Mae, the ratio of core capital to total assets plus MBS outstanding amounted to around 1.5 percent for year-end 2007; for Freddie Mac it was around 1.7 percent. By contrast, a commercial bank or thrift institution would be subject to capital requirements at least twice as high.»⁵⁵¹

«Fannie Mae had \$56 billion of total capital in mid-2008; Freddie Mac had \$43 billion.»⁵⁵²

The occurrence of "housing goals" in OFHEO AR ("Reports to Congress").

In AR 2005 it is only found on p. 22/28, in the following sentences: «Although the quality of single-family purchases remains strong, certain underwriting standards have been relaxed to increase market share and achieve affordable housing goals. Examples include the purchase of non-Loan Prospector and No Income/No Asset documentation loans. OFHEO has encouraged management to identify and implement strategies to quantify the impact of rising caution and defect rates on profitability, ROE, market share and affordable housing goals.»

and a little bit further down:

«Management has reported that credit quality and returns may decline in 2005 due to pressures to meet the Department of Housing and Urban Development's (HUD) affordable housing goals.»

In the AR of 2006 and 2008 they are not mentioned.

In AR 2007 it is only found in the sentence: «The Enterprise purchased higher volumes of non-agency floating-rate securities because of their positive impact on affordable housing goals and the risk/return profile.»⁵⁵³

Miscellaneous information about OFHEO.

Introduction: the Wiki-page OFHEO.

The following is quoted from the Wiki-page.

⁵⁴⁸ OFHEO AR 2006 p. 8/13.

⁵⁴⁹ FCIC staff study *GSEs and the financial crisis* p. 11.

⁵⁵⁰ FCIC staff study *GSEs and the financial crisis* p. 11.

⁵⁵¹ FCIC staff study *GSEs and the financial crisis* p. 20.

⁵⁵² FCIC staff study *GSEs and the financial crisis* p. 24.

⁵⁵³ P. 40, OFHEO AR 2007.

«The Office of Federal Housing Enterprise Oversight (OFHEO) was an agency within the Department of Housing and Urban Development. It was charged with ensuring the capital adequacy and financial safety and soundness of two government sponsored enterprises—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). It was established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

OFHEO was managed by a Director, appointed by the President and ratified by the Senate. The final Director was James B. Lockhart III, assuming the position during a time of crisis as Acting Director April 28, 2006, when nominated, confirmed to the post on June 15, and sworn in June 26, 2006.

The previous Director was Armando Falcon, Jr, confirmed September 29, 1999, and forced to resign February 4, 2003, over the release of critical oversight reports. However, the White House withdrew the nomination of his successor and he served as Director beyond the end of his term as provided by law.

On July 30, 2008, the Housing and Economic Recovery Act of 2008 combined OFHEO and the Federal Housing Finance Board (FHFB) to form the new Federal Housing Finance Agency (FHFA). OFHEO director James B. Lockhart III oversaw the agency at its conception, but departed after less than a year.»^{554, 555}

Approximate size and budget.

In AR 2006 the number of employees of OFHEO could not be found.

According to OFHEO PAR 2005, in 2004 and 2005 the supervisor had resp. 152 en 198 fte employees.⁵⁵⁶

In 2006 Fannie had 6000 employees.⁵⁵⁷

In 2006 Freddie had 28/2/07 5,400 full-time and 135 part-time employees.⁵⁵⁸

OFHEO is paid by the GSEs, but via the federal budgeting and appropriations process:

«The business operations of OFHEO are not financed by taxpayer funds. The annual operating budget, however, undergoes the Federal budgeting and appropriations process and is constrained by the amount appropriated by Congress and signed into law by the President. The amount provided for by the appropriations process is offset by semi-annual assessments from Fannie Mae and Freddie Mac. [...]

OFHEO received its full Fiscal Year 2006 budget request of \$60 million on November 30, 2005».⁵⁵⁹

This can be compared with the amount the GSEs spent on lobbying:

«COMMISSIONER GEORGIOU: [...] I think that Fannie's lobbying expenditures, according to our staff investigation from 1998 to 2008 were roughly 80 million dollars, 8-0, which I suppose one could argue, in light of the enormous lobbying that goes on by financial services companies generally is modest, but it - but in a - in a - in an overall simply - simply viewed, 80 million dollars is a considerable amount of money to be lobbying. I mean, it was, in many instances, in some years, almost comparable to the entire budget of the regulator.»⁵⁶⁰

Obviously the amount of lobbying is excessive; and though comparison with the budget of a regulator is interesting, that budget is not a meaningful measure of a budget for lobbying.

The purpose of the OFHEO PAR is described in AR 2006:

«In November 2005, OFHEO published its first Performance and Accountability Report (PAR)

⁵⁵⁴ Wiki page Office of Federal Housing Enterprise Oversight (OFHEO) 16/5/12.

⁵⁵⁵ So attention is given to the boss, but not to the number of employees.

⁵⁵⁶ OFHEO PAR 2005 p. 17/19. The years are tax years.

⁵⁵⁷ Fannie AR 2006 p. 2.

⁵⁵⁸ Freddie AR 2006 p. 3/15.

⁵⁵⁹ OFHEO AR 2006 p. 13/18.

⁵⁶⁰ Official Transcript of the Commission Hearing Friday, April 9, 2010. Search for “8-0”.

which describes OFHEO's accomplishments and how OFHEO met its performance goals during the fiscal year. The PAR also contains the audited financial statements for Fiscal Year 2005. In prior years, OFHEO issued separate annual performance reports and audited financial statements. OFHEO elected to issue a PAR to improve transparency and the public's understanding of how OFHEO operates.»⁵⁶¹

OFHEO may make legislative recommendations.

The letter of submission of OFHEO AR 2004 to Congress includes the following sentence:
«Pursuant to Section 1319B(a)(3) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the Director of the Office of Federal Housing Enterprise Oversight (OFHEO) shall include any legislative recommendations to enhance the financial safety and soundness of Fannie Mae and Freddie Mac (the Enterprises) in this annual report to Congress.»

Mission.

According to the letter of transmittal of AR 2001:
«OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac.»

So at this point capital adequacy and financial safety and soundness are not considered as being identical.

According to PAR 2005:
«The mission of OFHEO is to ensure that Fannie Mae and Freddie Mac operate in a safe and sound manner and contribute to a stable and financially strong housing market. OFHEO met its performance objectives for the fiscal year 2005».⁵⁶²

Directors and signatures under annual reports (until 2007) and FHFA (as from 2008).

«OFHEO was managed by a Director, appointed by the President and ratified by the Senate. The final Director was James B. Lockhart III, assuming the position during a time of crisis as Acting Director April 28, 2006, when nominated, confirmed to the post on June 15, and sworn in June 26, 2006. The previous Director was Armando Falcon, Jr, confirmed September 29, 1999, and forced to resign February 4, 2003, over the release of critical oversight reports. However, the White House withdrew the nomination of his successor and he served as Director beyond the end of his term as provided by law.

On July 30, 2008, the Housing and Economic Recovery Act of 2008 combined OFHEO and the Federal Housing Finance Board (FHFB) to form the new Federal Housing Finance Agency (FHFA). OFHEO director James B. Lockhart III oversaw the agency at its conception, but departed after less than a year.»⁵⁶³

Directors of OFHEO:

29/9/99-May 2004 Armando Falcon Jr
May 2004-28/4/06 Stephen A. Blumenthal (acting director)
28/4/06-30/7/08 James B. Lockhart III (until 26/6/06 acting director)

Of FHFA:

30/7/08-Edward J. DeMarco (acting director).

As regards the annual reports, the reader should know that OFHEO AR 200N reviews the year 200(N-1), while FHFA AR 200N reviews the year 200N.

⁵⁶¹ OFHEO AR 2006 p. 11/16. (www.ofheo.gov/media/pdf/OFHEOPARNovember2005.pdf.)

⁵⁶² OFHEO PAR 2005 p. 2/4.

⁵⁶³ Wikipedia page OFHEO 16/5/12.

Directors responsible for the annual reports.

OFHEO AR 2002 (pdf of 14/6/02) is signed by Armando Falcon Jr as Director.

OFHEO AR 2003 (pdf of 5/6/03) is signed by Armando Falcon Jr as Director.

OFHEO AR 2004 (pdf of 24/6/04) is signed by Armando Falcon Jr as Director. In his "Message From the Director" he says that his 5-year term comes to an end.

OFHEO AR 2005 (pdf of 15/6/05) is signed by Stephen A. Blumenthal as Acting Director

His letter of transmittal says that Falcon "resigned May 20 [2004] after serving nearly six years".

OFHEO AR 2006 (pdf of 22/6/06) is signed by Lockhart III as Acting Director.

OFHEO AR 2007 (pdf of 31/10/07) is signed by Lockhart III as Director.

OFHEO AR 2008 (pdf of 9/4/09) is signed by Lockhart III as Director.

FHFA AR 2008 (pdf of 3/9/09) is signed by Lockhart III as Director.

The annual reports are "Report to Congress". They were published on 15 June.

In general the annual reports have the following structure:

- Letter of transmittal signed by the director.
- The year in review
- Fannie Mae annual examination
- Freddie Mac annual examination
- Charts, maps and tables

OFHEO AR 2002.

The pdf file is dated 13/6/02, and modified 14/6/02. The file has a badly structured linked table of contents.

After the letter of transmittal, there follows a letter with a legislative recommendation. It is quoted to show what it does and does not recommend:

«According to Section 1319B(a)(3) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the Director of the Office of Federal Housing Enterprise Oversight (OFHEO) shall include any legislative recommendations to enhance the financial safety and soundness of Fannie Mae and Freddie Mac (the Enterprises) in this annual report to Congress. Pursuant to that requirement, I am forwarding the following recommendation which was submitted to the Congress earlier this year through the Administration's Fiscal Year (FY) 2003 budget request.

As noted in the FY 2003 budget, the Enterprises continue to grow in both size and scope. As the safety and soundness regulator of the Enterprises, OFHEO must be adequately positioned to address this growth and any unforeseen contingencies. I concur with the Administration's position that OFHEO should be permanently funded to ensure adequate resources and flexibility, on par with all other financial safety and soundness regulators. Such funding would not come from taxpayer dollars, but rather through direct assessment on the Enterprises. Congressional oversight of OFHEO would continue as it currently does with the other financial regulators.

The legislative recommendation which is identical to that recommended by the Administration follows:

Section 1316(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4516) is amended in the first sentence by striking ", to the extent provided in appropriations Acts."»

«Average U.S. [house] appreciation was 7.41 percent»⁵⁶⁴

P. 5/12 defines two types of capital requirements and describes their background:

«Minimum Capital

OFHEO continued to enforce compliance with quarterly minimum capital standards for each Enterprise. The minimum capital requirements, which are required by the Federal Housing Enterprises

⁵⁶⁴ OFHEO AR 2002 p. 2/9

Financial Safety and Soundness Act of 1992 (the 1992 Act), are similar to a bank's leverage capital requirement. Since the test has been applied to the Enterprises (second quarter of 1993), both companies have exceeded their minimum capital requirements and have always been classified as adequately capitalized. The chart below illustrates each Enterprise's capital in terms of their minimum capital requirement and the core capital they held each quarter for the past year.

Risk-Based Capital

In addition to minimum capital, the 1992 Act requires OFHEO to establish risk-based capital requirements for Fannie Mae and Freddie Mac. The Office is required to use a stress test – a model that simulates the financial performance of the Enterprises under specified adverse economic conditions – to establish those requirements. On September 13, 2001, OFHEO published a final risk-based capital regulation. In addition to making minor technical corrections to the regulation, OFHEO also proposed changes to the risk-based capital regulation which were finalized March 15, 2002, after a public comment period. OFHEO continues to evaluate and analyze new financial instruments and new risk measurement techniques to improve the stress test and align the capital requirements more closely to each Enterprise's risk.»⁵⁶⁵

OFHEO AR 2004 gives additional information about the stress tests:

«The risk-based capital stress test assesses the ability of an Enterprise to withstand the two statutorily-defined scenarios involving interest rate and credit stress.»⁵⁶⁶

OFHEO concludes:

«Both Enterprises met their quarterly capital requirements in 2001.»⁵⁶⁷

The section “Fannie Mae Examination Results and Conclusions” on pp. 22-24/29-31 has ten paragraphs.⁵⁶⁸ The series of first sentences is the following:

1. «Fannie Mae's credit risk management and credit risk management framework exceed safety and soundness standards, and they have resulted in a high-quality portfolio and manageable credit exposure. [...]】
2. Fannie Mae's interest rate risk management exceeds safety and soundness standards. [...]】
3. Fannie Mae's liquidity management exceeds safety and soundness standards. [...]】
4. The information technology infrastructure and surrounding risk management framework exceed safety and soundness standards. [...]】
5. Fannie Mae's internal control framework and the management of that framework exceed safety and soundness standards. [...]】
6. The framework for business process controls and the management of that framework exceeds safety and soundness standards. [...]】
7. The audit functions exceed safety and soundness standards. [...]】
8. The Board discharges its duties and responsibilities in a manner that exceeds safety and soundness standards. [...]】
9. The framework used to produce timely, accurate and reliable reports exceeds safety and soundness standards and provides end-users with accurate and reliable information. [...]】
10. Key management processes that influence company-wide talent and behaviors exceed safety and soundness standards.»

Box 3.1 on p. 26 specifies or adds:

«Derivatives activity is governed by sound policies, procedures and effective internal controls and consistent with the prescribed purpose.»

⁵⁶⁵ OFHEO AR 2002 p. 5/12. Layout modified slightly.

⁵⁶⁶ OFHEO AR 2004 p. 37/43.

⁵⁶⁷ OFHEO AR 2002 p. 5/12.

⁵⁶⁸ At least if an empty line is inserted before item 9 in the list. As done in the presentation of the results for Freddie.

The box is continued on pp. 27-31. The text claims that nothing concerning derivatives at Fannie leaves anything to be desired.

Boxes 3.1-3.3 on pp. 25-42/32-49 specify OFHEO's examination activities regarding derivatives, internal auditing, and governance respectively. It would seem however that OFHEO examines little more than documents provided by the GSE.

Pp. 43-45/50-52 about Freddie Mac mirror the above list for Fannie.

In sum: all relevant examination items exceed safety and soundness standards for both GSEs.

The systemic risk report of February 2003.

The pdf file has a linked table of contents.

The full title of the report is:

SYSTEMIC RISK: FANNIE MAE, FREDDIE MAC AND THE ROLE OF OFHEO.

On p. 7 the report gives the following definitions:

«A systemic event is defined as a financial crisis that causes a substantial reduction in aggregate economic activity, such variables as housing starts, home sales, consumption, output and employment. Systemic risk is the possibility that a systemic event may occur. Mitigating systemic risk and responding to systemic events are major concerns of central banks and financial regulators, yet there is no consensus among government officials or economists about the definitions of those terms.»⁵⁶⁹

The report studies three scenarios. They are defined as follows:

- «Scenario #1: In a Period of Reduced Liquidity, the Enterprises Help to Mitigate Systemic Risk.
- Scenario #2: One Enterprise Develops Serious Solvency Problems But Remains Liquid, There are Few Adverse Economic Effects, and No Systemic Event Occurs.
- Scenario #3: One Enterprise Suffers Large Losses and Becomes Illiquid and a Systemic Event Results.»⁵⁷⁰

Footnote 360 on p. 100 reads as follows:

«Those estimates were calculated from data from the Federal Deposit Insurance Corporation, and reflect OFHEO's estimates that at year-end 2001 over 4,800 commercial banks—over sixty percent of the institutions in the banking industry—held GSE debt in excess of 50 percent of their equity capital. Nearly sixty percent of those banks have less than \$100 million in assets; over ninety-seven percent have assets of less than \$1 billion. Of banks with assets of more than \$1 billion, 123 institutions—over 30 percent of banks of that size—owned GSE debt in excess of 50 percent of their equity capital.»

So unless the GSEs have perfect risk management (not in the customary sense, but that of the present author, see the Analysis), they obviously cause significant systemic risk.

The following is excerpted from the section *Conclusions Implied by the Scenarios*:

«Scenario #3 illustrates how a severe deterioration in the solvency of Fannie Mae or Freddie Mac could heighten uncertainty about the viability of that Enterprise, the potential for credit losses to investors in their debt and MBS, and the liquidity of those securities. As a study of the financial sector written for the Department of the Treasury observed, “[t]he accumulation of uncertainty over time is a major, if not the major, element of systemic risk.” Scenario #3 also illustrates how heightened uncertainty about the liquidity of the debt of an undercapitalized Enterprise could lead to contagious illiquidity in the market for those securities. Such illiquidity could cause or worsen liquidity or solvency problems at other financial institutions and disrupt the housing markets and the financial system, potentially leading to a systemic event that could impose large economic losses.

Scenario #3 would not have been possible a decade or two ago, when the failure of Fannie Mae or Freddie Mac would have posed a much smaller systemic threat to the U.S. economy. If Fannie Mae

⁵⁶⁹ The report gives references. Section 1 of Chapter 1 on systemic risk gives a useful general overview of systemic events and financial crises.

⁵⁷⁰ Systemic risk report pp. 93/96 and following. Dots added by the present author.

had failed at year-end 1981, when the Enterprise was insolvent on a mark-to-market basis and had less than \$60 billion in outstanding debt and \$3 billion in guaranteed MBS, that failure would have imposed losses on investors, mortgage lenders, and related firms but probably would not have seriously threatened a collapse of the housing finance system or a disruption of financial markets generally. At the time the Federal Housing Enterprises Safety and Soundness Enhancement Act of 1992 was enacted, the outstanding debt of Fannie Mae was about one-fifth, and that of Freddie Mac was about one-twentieth, of the levels at year-end 2001. In addition, the Enterprises' debt and MBS were much less important in financial markets, and Fannie Mae and Freddie Mac were just beginning to use financial derivatives. Although OFHEO regulation of the Enterprises has reduced the likelihood of an Enterprise failure, the potential for such a failure, if it occurred, to contribute to disruptions in the housing market and financial system is much greater now than it was then.»⁵⁷¹

Given the mixing of mortgages of unknown or low quality in MBS and other derivatives, and the tremendous volume of this kind of security, and given the high probability of an end to the rise in home prices, if only by a rise of interest rates, losses of GSEs, and therefore systemic disaster, are a matter of time.

This is not noted in the systemic risk report however. The main conclusion, that under certain adverse conditions GSEs may pose systemic risk, is convincingly argued. But the report does not investigate or list possible causes of difficulties for the GSEs. This is the more regrettable because later on in the scenario OFHEO makes assumptions which are incompatible with possible causes (OFHEO is too optimistic). Certain risks are clearly underestimated:

«The market for [GS] Enterprise A's MBS is less likely to become illiquid than the market for its debt, however, as investors generally believe that, in the event of a default by Enterprise A, they would not incur large credit losses because the MBS are backed by mortgage collateral.»⁵⁷²

If the MBS contain a significant fraction of mortgages of dubious quality, "poison", the argument fails. Moreover, markets need not be as rational as OFHEO assumes.

Anyway, even the relatively optimistic assumptions of OFHEO result in a breakdown of the operation of the financial sector. The assumptions for the scenario are quite plausible. Which shows that the systemic risk is very real. The report certainly serves as a well founded warning.

Of course there is overlap with the GAO scenario's.

On pp. 107-115/110-118 the report lists actions and recommendations to mitigate systemic risk. In the eyes of the present author they are not convincing by far. There is no serious discussion of the relation between capital requirements and stress test parameters on the one hand, and risks on the other. This is made worse because the (false) suggestion of adequacy undermines market discipline. If investors are made to think that capital is adequate they will take no action with respect to their risk management. Also apart from this, the discussion about market discipline is defective. OFHEO should have concluded that by open reporting it can greatly contribute to the improvement of transparency it advocates. As the future shows, it misled by giving a far too rosy picture.

What it says of the third scenario in the Executive Summary is a first example:

«If Fannie Mae or Freddie Mac experienced financial difficulties the systemic implications might vary depending upon the circumstances. Any systemic disruption would likely be minimal as OFHEO took prompt corrective action and other market participants filled the short-term market void. Alternatively, in the unlikely circumstance that an enterprise experienced severe financial difficulties, they could cause disruptions to the housing market and financial system.»⁵⁷³

The suggestion that OFHEO can remedy (any) systemic disruption is false. In general, effective action will require lots of money, which OFHEO cannot provide. Just as misleading is the qualification "unlikely", since very probable developments- indicated above- can cause severe financial difficulties for the GSEs.⁵⁷⁴ On p. 108/111, in the list of OFHEO supervisory actions to reduce the risk of GSE failure, the report says in this connection:

⁵⁷¹ Systemic risk report p. 105/108.

⁵⁷² Systemic risk report p. 99.

⁵⁷³ Systemic risk report p.1/4.

⁵⁷⁴ The "unlikely" is neither specified nor proven.

[«Prompt Corrective Action Triggered by Declines in Capital.](#) Under the 1992 Act, an Enterprise not classified as “adequately capitalized” by OFHEO must obtain regulatory approval for, and carry out, a capital improvement plan and may be subject to a variety of regulatory restrictions and limitations deemed appropriate by OFHEO. The structure of OFHEO’s risk based capital stress test, which takes into account the likely effects on earnings over time of changes in Enterprise activities, home prices, and interest rates, implies that changes in an Enterprise’s risk will be quickly reflected in its risk-based capital requirements and, if appropriate, in its capital classification.»

One can use the annual reports of 2006, 2007 and 2008 to check whether this has been done. Home prices peaked in April 2006. Which is to say: from then on they declined.

The paragraph is an example of lack of analysis if not inconsistency. It creates and ignores a major problem. It requires the acquisition of new capital at a time when it is most difficult to get it. Loss of capital (value) will most probably occur when the general situation of the financial sector deteriorates. Such a situation will also hamper the acquisition of new capital. One should save in good times, in order to be able to withstand the bad times.

On p. 6 of its report “GOVERNMENT SPONSORED ENTERPRISES- A Framework for Strengthening GSE Governance and Oversight” of February 2004, the GAO describes the situation as follows:

«The GSEs also pose potential risks to the stability of the U.S. financial system. In particular, if Fannie Mae, Freddie Mac, or the FHLBank System were unable to meet their financial obligations, other financial market participants depending on payments from these GSEs, may in turn become unable to meet their financial obligations. This risk, called systemic risk, is often associated with the housing GSEs because of the sheer size of their financial obligations. For example, as discussed in OFHEO’s 2003 report on systemic risk, if either Fannie Mae or Freddie Mac were to become insolvent, financial institutions holding the enterprise’s MBS could be put into a situation where they could no longer rely on those securities as a ready source of liquidity. Depending on the response of the federal government, the financial health of the banking segment of the financial services industry could decline rapidly, possibly leading to a decline in economic activity. As another example, derivatives counterparties holding contracts with a financially troubled GSE could realize large losses if the GSE were no longer able to meet its obligations. If such a hypothetical event were to occur, widespread defaults could occur in derivatives markets.»

Searches in the pdf file of the FCIC report for “role of OFHEO” and “systemic risk: fannie” (not case-sensitive) produced no results. “Falcon” is mentioned 10 times, of which five times in references. In none of the corresponding places the systemic report is mentioned.⁵⁷⁵

The history of the report is very instructive nevertheless, and not only because of its content. In the hearings of the FCIC on 9/4/10, OFHEO head Falcon declared that Raines, head of Fannie Mae, tried to prevent publication of the OFHEO systemic risk report. Raines put pressure on Falcon, and tried to mobilize agencies and the Treasury department to do the same. Falcon did not budge. On the day of the release of the report, the White House announced Falcon’s replacement. «[The next day's news emphasized coverage of the personnel change and gave very scant coverage to the findings of the systemic risk report.](#)»⁵⁷⁶

A useful summary and discussion of the report, and context information, can be found in the paper “Official Axed, Exposed Threat Of U.S. Housing Bubble Crash” by Richard Freeman, in the Executive Intelligence Review (EIR) of 14/3/03. Its conclusion is quoted by way of a tragicomical intermezzo, and give some “couleur locale”. Don’t forget that this was published on 14 March 2003. The “bruised fights” refer to the covert activities of Raines and others indicated above.

⁵⁷⁵ They do show however that the FCIC majority quotes selectively and tendentiously, in obvious efforts to show that the affordable housing goals played no significant role in GSE conduct. Comparison with the transcript of the hearing is obligatory.

⁵⁷⁶ The next day was February 5, 2003. The source of this paragraph is the transcript of the FCIC hearing of 9/4/10. The relevant part is reproduced in the last section of this appendix.

«Watching these bruising fights, Edgar Allan Poe's [...] brilliant, anti-empiricist detective C. Auguste Dupin, would enjoy a hearty laugh. Dupin would recognize that the brutal firing of OFHEO Director Falcon, one day after OFHEO's report on "Systemic Risk," is the single biggest "piece of evidence" that Wall Street is hysterically scared, and has firsthand knowledge to confirm, that the OFHEO Feb. 4 report's warning of a systemic breakdown is correct. Dupin would rightly see Wall Street's behavior as validation of the OFHEO report's most severe warning, and know that the systemic event could unfold in the days directly ahead of us.»

OFHEO AR 2003.

The pdf file is dated 4/6/03, modified 5/6/03. The file has no bookmarked table of contents.

In the letter of transmittal, Falcon reminds congress of the legislative recommendation in AR 2002, and adds:

«OFHEO also recommends that the 1992 Act be amended to provide that the agency may appoint a receiver to close and wind up the affairs of an Enterprise that is not viable. OFHEO's existing authority to resolve the situation would be enhanced by this legislative action. Other federal safety and soundness regulators already have this explicit authority. Financial markets, the housing sector and creditors all would benefit from a final, predictable resolution of a non-viable Enterprise.»

On p. 10/17 the report presents Milestones in the Development of the U.S. Secondary Market for Single-Family Mortgages 1938-2003, and on pp. 11-21/18-28 a history beginning before the Great Depression..

The following is the first sentence of the section RESULTS AND ANALYSIS OF CAPITAL ADEQUACY:

«Both Enterprises, through the period ending December 31, 2002, have met or exceeded the capital requirements and are adequately capitalized.»⁵⁷⁷

Fannie Mae Examination Results and Conclusions.

The first sentences of the paragraphs of the section *Fannie Mae Examination Results and Conclusions* on pp. 33-6/40-3 of AR 2003 are the following:

1. «Fannie Mae's credit risk management and credit risk management framework are effective.
2. Fannie Mae's management of interest rate risk was effective.
3. Management has a meaningful methodology for quantifying and monitoring the level and nature of interest rate risk.
4. Fannie Mae's liquidity management is effective, and the company's liquidity access was stable throughout 2002. The policies, procedures, internal controls and management reporting relating to liquidity management are effective.
5. The information technology infrastructure and its surrounding risk management framework is effective. Operating processes are in place to ensure secure, effective and efficient data center processing and problem management.
6. Fannie Mae's internal control framework and the management of that framework are effective.
7. Management has an accurate and reliable process for identifying risks to business processes and implementing appropriate controls.
8. The processes and control environment used when Fannie Mae considers and/or develops new or substantially revised business initiatives are effective.
9. The audit functions are independent and effective and adhere with the standards that are evolving.
10. The Board of Directors discharges its duties and responsibilities effectively and in accordance with the leading practices that are evolving.
11. The framework used to produce timely, accurate and reliable reports is effective.

⁵⁷⁷ OFHEO AR 2003 p. 26/33.

12. Key management processes that influence company-wide talent and behaviors are effective.»

Too nice to be true, and indeed it wasn't: “[The \[...\] image presented \[by Fannie\] was false](#)”, it is said in the letter of transmittal of OFHEO AR 2006. But OFHEO relied on the false picture.

Freddie Mac Examination Results and Conclusions.

For Freddie a first indication of less than sound practices had already been discovered. But no more than a first indication. Witness the following list of the first sentences of the paragraphs of the section *Freddie Mac Examination Results and Conclusions* on pp. 36-8/43-5 of the present AR. The accounting/audit paragraph 10 however is quoted unabridged:

1. Freddie Mac's credit risk management and credit risk management framework are effective.
2. Freddie Mac's management of interest rate risk was effective.
3. Freddie Mac's liquidity management is effective, and the company's liquidity access was stable throughout 2002.
4. The information technology infrastructure and its surrounding risk management framework is effective.
5. The internal control framework and the management of that framework are effective.
6. The process and control environment used when considering or developing new or substantially revised business initiatives is effective.
7. The audit functions are independent and effective.
8. The Board of Directors discharges its duties and responsibilities effectively and in accordance with the leading practices that are evolving.
9. Management and the Board of Directors receive necessary reports on Freddie Mac's performance relative to established goals and objectives.
10. Examiners tracked the progress associated with the introduction of the new CPA firm in 2002.⁵⁷⁸

Subsequent to year-end 2002, Freddie Mac announced a delay in its certified 2002 financial statement and the reaudit of certain past financial statements. The delay in financial statements and the reaudit arise from specific accounting interpretations regarding the timing of income recognition. Freddie Mac agreed with its new external auditor that the previous accounting treatment, while agreed to by Freddie Mac's previous auditor, was incorrect.

OFHEO opined that a reaudit and delay in 2002's statements is prudent and appropriate under the circumstances. In addition, management and its Board of Directors initiated efforts in 2002 to enhance the expertise and controls in the areas of financial accounting and operational control. Examiners evaluated management's and the Board's actions and find these to be enhancements. We remain satisfied that the Board of Directors and executive management are taking the appropriate action.

11. Key management processes that influence corporate-wide behaviors are effective.

AR 2004 shows that “certain past financial statements” refers to the years 2000-2002.

In his testimony in the FCIC hearing Falcon spoke accusingly of the greed of the top of the GSEs.⁵⁷⁹ But on p. 7/57 of AR 2003 one reads: “[During FY 2002, no instances of excessive executive compensation were found.](#)”

OFHEO does not show that it has learnt lessons from its errors.

It is remarkable that the discovery of accounting irregularities didn't make OFHEO doubt its judgments about other examination subjects. AR 2004 shows that much more was amiss. All of the

⁵⁷⁸ CPA may stand for certified public accountancy, but is not explained in OFHEO AR 2003.

⁵⁷⁹ See the hearing transcript dated 20100409, and the article by Robert Scheer in *The Nation* dated 20100414.

following annual reports pay much attention to remedying various deficiencies in the GSEs. None pays attention to lessons OFHEO has learnt from its evidently dangerous errors.⁵⁸⁰

Intermezzo on improvement of GSE/ supervisor regulation.

At the end of July 2008 Congress passes the Housing and Economic Recovery Act (HERA), an amendment of the 1992 law regulating GSEs and their supervisor.⁵⁸¹ The history of the amendment dates back to 2001 at the latest. A White House press release of September 19, 2008 lists warnings and calls for reform on Congress by president G W Bush and other officials.⁵⁸² The Bush administration repeatedly warned of the risks, and asked for reform. Though not in 2006. A legislative proposal was submitted to Congress on 6 May 2004.⁵⁸³

The administration clearly was inconsistent. In the period of the warnings and calls, HUD prescribed higher and higher housing goals, obviously increasing the risks.⁵⁸⁴ Reform should have come first, and should have been conditional to continuation of the affordable housing policy. One of the conditions of course.

Still, much or most of the blame falls on Congress.

OFHEO AR 2004.

The pdf-file is dated 22/6/04, and modified 24/6/04. It has no linked table of contents.

The letter of transmittal, supervisor legislation, and some remarks.

The (short) letter of transmittal includes the following paragraph:

«Pursuant to Section 1319B(a)(3) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the Director of the Office of Federal Housing Enterprise Oversight (OFHEO) shall include any legislative recommendations to enhance the financial safety and soundness of Fannie Mae and Freddie Mac (the Enterprises) in this annual report to Congress. As a general matter, I continue to recommend enhancements to OFHEO's authority, particularly in those areas that would align the safety and soundness authority of the agency more closely to our fellow federal banking agencies. I also believe that permanent funding of OFHEO, outside of the appropriations process, is important to enable the agency to respond quickly should serious problems develop at either of the Enterprises.»

Other legislative recommendations could not be found in this report. However:

«On May 6, 2004, President Bush submitted to the Congress a legislative proposal that continued to support the transfer of all resources available to OFHEO to a new, strengthened housing government sponsored enterprise regulator in the Department of the Treasury, outside of the appropriations process.»⁵⁸⁵

This ultimately resulted in the HERA. It was signed by Bush on 30/7/08.

Because of an attempt to replace Falcon in connection with the publication of OFHEO's systemic risk report, it is noted that in his "Message From the Director" Falcon says: "as my five year term comes to an end". Without any comment.

⁵⁸⁰ See also the Performance and accountability reports (PAR). For a short overview of OFHEO performance see PAR 2005, pp. 24-5. The PAR does not discuss the (misleading) positive assessments in especially AR 2003.

⁵⁸¹ P. 9/11 of FHFA PAR 2008 gives some details, and a photograph of the signing by G W Bush on 30/7/08. With respect to the downplaying of the role of the GSEs it can be noted that according to the first paragraph of this same page the GSEs had a combined market share of 86.9 percent of new mortgages originated for the quarter ending June 30, 2008.

⁵⁸² See the press release *Just the Facts: The Administration's Unheeded Warnings About the Systemic Risk Posed by the GSEs*. It can be found in the directory USA/OFHEO & FHFA under 20080919.

⁵⁸³ OFHEO AR 2004 p. 53/59.

⁵⁸⁴ Nothing of this is said in the White House press release.

⁵⁸⁵ OFHEO AR 2004 p.53/59.

OFHEO's examination framework has the following six ("CAMELS") dimensions:⁵⁸⁶

1. Capital Adequacy
2. Asset Quality
3. Management
4. Earnings
5. Liquidity
6. Sensitivity (to risk).

On p. 16/22, in the subsection "Capital" of the section "Fannie Mae, 2003 Supervisory Report Of Condition", a concept "critical capital" is added to the minimum and risk-based capital mentioned in AR 2002:

«The critical capital level is the amount of core capital below which an Enterprise must be classified as critically undercapitalized and generally must be placed in conservatorship. Critical capital levels are computed as one-half of the portion of the minimum capital level requirement associated with on-balance-sheet assets plus five-ninths of the portion of the minimum capital level requirement associated with off balance sheet obligations.»

Fannie Mae, 2003 Supervisory Report Of Condition.

The report does not contain a list of conclusions. The following tries to fill the gap:

1. Capital Adequacy. On p. 19/25 the report concludes that Fannie Mae exceeded its capital requirements in each of the four quarters of 2003.
2. Asset Quality. «Based on OFHEO's examination activities to date, it is the overall conclusion of OFHEO that Fannie Mae has strong asset quality and prudent credit risk management practices.»⁵⁸⁷
3. Management. «Based on annual examination work conducted in 2003, OFHEO concludes that the overall management of operational risk by the Enterprise comports with applicable safety and soundness standards; however, OFHEO suggested certain enhancements to Enterprise practice.»
4. Earnings. «Fannie Mae's reported earnings were strong in 2003.»⁵⁸⁸
5. Liquidity.
«Foremost in OFHEO's assessment [of liquidity] was a determination as to the level of risk to the earnings of the Enterprise and capital that arose from its ongoing ability to meet obligations (contractual, market or business) without incurring unacceptable losses. Although subject to the findings and conclusions of the special examination currently underway, OFHEO's overall assessment included three primary conclusions:
 - (1) Fannie Mae has policies and procedures governing its management of liquidity risk,
 - (2) Fannie Mae demonstrated reliable access to sufficient sources of funds on cost-effective terms to remain liquid and meet its obligations throughout 2003, and
 - (3) Fannie Mae continues to evolve and refine its liquidity contingency plan with strategies and implementation procedures for event management that includes procedures under adverse market scenarios.»⁵⁸⁹
6. Sensitivity. «In 2002, OFHEO took prompt supervisory action in response to duration gap problems that were developing at Fannie Mae. In 2003, OFHEO concluded that action. In the remainder of the year, the sensitivity exposure of Fannie Mae was adequately managed and the effects of interest rate movements on financial performance and underlying economic value were within safety and soundness tolerances.»⁵⁹⁰ It is not clear however whether this is an overall conclusion. The subsection is little more than an inventory of what OFHEO does on the subject. A concluding presentation of results is missing. The term "house price" is not found in this

⁵⁸⁶ See for example the table of contents, on p. 4 of the pdf-file.

⁵⁸⁷ OFHEO AR 2004 p. 21/27.

⁵⁸⁸ OFHEO AR 2004 p. 26/32.

⁵⁸⁹ OFHEO AR 2004 pp. 27-8/33-4.

⁵⁹⁰ OFHEO AR 2004 p. 33/39.

subsection, or anywhere between the pages 13 and 68 of the pdf-file. So the management of risks due to falling house prices is not discussed either.

At some places the report makes reservations pending the result of the special examination being conducted at the time of writing.

Freddie Mac, 2003 Supervisory Report Of Condition.

1. Capital Adequacy.

«During 2003 and into early 2004, OFHEO took unprecedented steps in the supervision of Freddie Mac. Specifically, with respect to capital supervision, when OFHEO's special examination revealed significant operational weaknesses and risks at Freddie Mac, the agency took immediate action to direct Freddie Mac to increase its capital surplus over historic quantitative ratios. OFHEO directed Freddie Mac to maintain capital surpluses approximating 30% over the required minimum capital surplus beginning January 30, 2004 and until such time as timely financial statements are issued and operational risks decrease. OFHEO's directive further requires that Freddie Mac seek OFHEO preapproval for capital deployment initiatives to ensure the mandated surplus is maintained until the risks are minimized. OFHEO monitors Freddie Mac's core capital on a weekly basis. As of May 31, 2004, Freddie Mac has remained in compliance with this capital directive.

For all four quarters in 2003, Freddie Mac exceeded its minimum and risk-based capital requirements. [...] OFHEO concludes that Freddie Mac was adequately capitalized.»⁵⁹¹

«The minimum capital level requirement exceeded the risk-based capital requirement in all four quarters, and therefore represents the binding capital requirement.»⁵⁹²

2. Asset Quality. «Based on OFHEO's examination activities to date, it is the overall conclusion of OFHEO that Freddie Mac has strong asset quality and prudent credit risk management practices.»⁵⁹³

3. Management. «OFHEO conducted a special examination of the events leading to the public announcement on June 9, 2003, of the termination, resignation, and retirement of the three principal executive officers of Freddie Mac. The special examination was ordered to supplement an ongoing OFHEO examination of the financial condition of the Enterprise and the decision of Freddie Mac to restate its financial reports for 2000, 2001, and 2002. OFHEO released a report on the special examination detailing a pattern of inappropriate conduct and improper management of earnings that led to the restatement and management restructuring by the company.

Freddie Mac agreed to implement corrective measures and pay a civil money penalty of \$125 million as part of a consent order with OFHEO. The order sets forth specific actions for the Enterprise to implement that relate to:

- The Board of Directors and Senior Management
- Internal Controls
- Internal Audit
- Internal Accounting
- Risk Management Transactions
- Oversight and Reporting

The Board of Directors of Freddie Mac has elected a new chairman and hired a number of senior executives as its new management team. As this new management of Freddie Mac has been in place only a short time, OFHEO will defer assessment of their performance.»⁵⁹⁴

4. Earnings. «However [i.e. notwithstanding unreliable financial statements], based on analysis of internal reports of business activities and results, as well as risk positions taken during the year

⁵⁹¹ OFHEO AR 2004 p. 38/44.

⁵⁹² OFHEO AR 2004 p. 39/45.

⁵⁹³ OFHEO AR 2004 p. 41/47.

⁵⁹⁴ OFHEO AR 2004 pp. 43-4/49-50.

and their relationships with actual interest rate movements, OFHEO concludes that the underlying economics of the firm are sound and were substantially profitable in 2003.»⁵⁹⁵

5. Liquidity.

«Foremost in OFHEO's assessment was a determination of the level of risk to the earnings of the Enterprise and capital that arose from its ongoing ability to meet obligations contractual, market or business) without incurring unacceptable levels of losses. OFHEO's overall assessment included three primary conclusions:

- (1) Freddie Mac has formal policies and procedures governing its management of liquidity risk,
- (2) Freddie Mac demonstrated consistent access to funding sources and maintained positive spreads throughout 2003 (this access was demonstrated during a challenging and highly unusual operating environment for Freddie Mac), and
- (3) aspects of Freddie Mac's contingency funding plans for event management were tested in 2003 with successful results – and this contingency plan and its strategies are continuing to be revised and strengthened.»⁵⁹⁶

6. Sensitivity (to risk). «Based on OFHEO's review during the annual examination of the risk management activities and positions in 2003, OFHEO concluded that Freddie Mac's sensitivity exposure was adequately controlled and the attendant financial performance and the underlying economic value were not adversely affected from a safety and soundness perspective. Risk management activities were considered effective in managing the sensitivity position during a volatile operating environment.»⁵⁹⁷

At various places the report makes reservations pending the result of the special examination being conducted at the time of writing.

OFHEO AR 2005.

The pdf-file is dated 14/6/05, and modified 15/6/05. It has no linked table of contents.

It follows from this AR that the positive evaluations of the preceding AR were incorrect. It would seem therefore that the OFHEO evaluations were mainly based on GSE-documents, and that the reliability of these documents was not properly checked.⁵⁹⁸

SEC and Fannie.

Not only OFHEO, but the SEC too has a duty with respect to the GSEs:

«In December 2004, following an OFHEO report of special examination findings, the Securities and Exchange Commission (SEC) advised Fannie Mae that certain accounting practices followed for years 2001 through 2004 did not comply with Generally Accepted Accounting Principles [GAAP]. The SEC directed Fannie Mae to restate financial statements issued for each of those years. Accordingly, there are no audited financial data with which to gauge the financial performance of Fannie Mae for 2004.»⁵⁹⁹

Something similar is not said about Freddie

Fannie Mae: examination results and conclusions.

«Overall, Fannie Mae's condition warrants significant supervisory concern. The quality of policies, controls and communication varied among the business lines due to weaknesses in the program of

⁵⁹⁵ OFHEO AR 2004 p.45/51.

⁵⁹⁶ OFHEO AR 2004 p.45/51.

⁵⁹⁷ OFHEO AR 2004 p.50/56.

⁵⁹⁸ Remember that in the Dutch education ministry documents seem to have been written to expressly mislead potential external auditors. In many cases, there was no relation between text and reality.

⁵⁹⁹ OFHEO AR 2005 p. 2/8.

former executive management. The program failed to establish an explicit baseline of standards that ensured all Enterprise activities consistently met industry standards in policies, controls and communication. These weaknesses, coupled with a focus on expense control, impeded or prevented Fannie Mae from building aspects of the organizational structure and culture needed to effectively manage the company through significant business growth. Deficiencies noted during 2004 indicate Fannie Mae's program needs strengthening in several areas:

- The quality of policies varies due to the lack of standardization in their production and review.
- Reporting to the Board requires improvement.
- The lack of a centralized authority in operations and weaknesses in independent risk oversight prevented several deficiencies from being detected, reported, and corrected.
- The organizational structure failed to provide fundamental controls for the controller department.
- Deficiencies identified inadvertently or through reviews conducted by Fannie Mae and OFHEO indicate several areas in operations controls need strengthening.
- Information technology in the areas of business continuity planning, crisis management, data center, and e-business activities are managed satisfactorily.
- Credit risk management is satisfactory for processes concerning counterparty risk management, multifamily operations, and new product development. However, deficiencies noted in several areas indicate that business line management needs to strengthen its oversight functions.
- Liquidity management is satisfactory but requires strengthening in some areas of policies and procedures, contingency planning, and systems issues that impact some process efficiencies.
- Interest rate risk is managed satisfactorily, and risk levels remain within limits set by management.

The Board and management initiated actions to address the issues noted in this report, and have already devoted significant resources to correct the deficiencies noted in OFHEO's special examination of Fannie Mae released in September 2004.⁶⁰⁰

When one reads this annual report, one sees that the stress in "needs strengthening" should lie on "needs". Various things are too weak. This can be concluded from the discussions of the six "CAMELS" dimensions of OFHEO's examination framework:

Capital.

«Fannie Mae's capital is classified as significantly undercapitalized at year-end 2004.»

«OFHEO and Fannie Mae entered into an agreement on September 27, 2004, that required Fannie Mae to achieve a 30 percent capital surplus by June 30, 2005 to provide coverage for uncertainties in Fannie Mae's controls and accounting practices.»⁶⁰¹

Asset quality and credit risk management.

OFHEO notes weaknesses with respect to:

- «Management of mortgage fraud in seller/servicers.
- Systems integration and process efficiencies.
- Methodologies used in the loan loss reserve.
- Validation of some credit risk models.
- Policy review process.»⁶⁰²

Management supervision.

«Former executive management fostered a culture of excessive expense control that contributed to inadequate policies, controls, and systems in the controller department and other areas within the Enterprise. The excessive expense controls prevented several systems, processes and controls from being properly implemented or updated, and impeded the ability of business line management to

⁶⁰⁰ OFHEO AR 2005 pp. 10-1/16-7.

⁶⁰¹ OFHEO AR 2005 p. 17/23.

⁶⁰² OFHEO AR 2005 p. 15/21.

prepare for future growth in business activities and changes in Generally Accepted Accounting Principles (GAAP). Internal audit was also significantly understaffed.

Organizational structure and control deficiencies contributed to the use of accounting policies and practices that were overly aggressive or not compliant with GAAP. These deficiencies include:

- No policies or procedures to formally establish personnel responsibilities for the development, review, and approval of accounting standards.
- No Controller department procedures to formally detail actual practices in applying accounting methodologies, or recording transactions.
- Poor segregation of duties in the Controller department for the authorization and recording of transactions, the modeling and recording of transactions, and financial reporting and forecasting.
- Lack of accounting technical expertise in the CFO and many of the controller department's management and staff.
- The independence of internal audit was compromised through inappropriate reporting lines, and the CFO's undue influence over the general auditor's compensation. The general auditor was also responsible for auditing his prior work.
- Excessively low staff levels in the Controller department and internal audit.
- Systems limitations in the Controller department created by excessive expense controls over systems and staff resources.
- Inadequate communication with the Board and its audit committee on accounting policy, and the resulting impact on public disclosures and compliance with GAAP.»

Operations risk.

«Operations risk management for business lines managed by the CFO is weak based on:

- Accounting policies that are not compliant with GAAP.
- Inadequate systems used to record transactions and produce financial statements.
- The lack of a standardized or centralized program for business line controls.
- An operations risk management program that did not meet industry standards in several areas in organizational structure and communication.
- Former executive management began implementing a program to correct these deficiencies in 2004 but did not communicate the deficiencies to the Board.»

Earnings.

OFHEO's analysis «is based on financial statements that will be revised significantly at the conclusion of the ongoing restatement». ⁶⁰³

Liquidity risk.

«OFHEO cannot provide a liquidity rating until an evaluation is completed of the analysis of cash flow variances and stress scenarios by the management of the treasury department of the company». ⁶⁰⁴

Sensitivity to market risk.

According to OFHEO interest rate risk (IRR) is managed satisfactorily. But OFHEO cannot provide a final rating on the quantity of risk until a comprehensive review of the relevant factors is completed. ⁶⁰⁵

Freddie Mac: examination results and conclusions.

«Overall, the condition of the Enterprise is improving but continues to warrant supervisory concern. The Enterprise is in the process of implementing plans to address the matters in the wide-ranging Consent Order and is subject to a capital directive as a result of a combination of moderate to severe internal control weaknesses. Although the Enterprise reported 2004 financial results on March

⁶⁰³ OFHEO AR 2005 p. 15/21.

⁶⁰⁴ OFHEO AR 2005 p. 16/22.

⁶⁰⁵ OFHEO AR 2005 p. 17/23.

31, 2005, it does not have current financial statements in circulation, and does not expect to be a timely filer of 2005 financial information until the first quarter of 2006. Ameliorating factors include:

1. a significant capital surplus;
2. risk management strengths in key areas such as credit, interest rate, and liquidity risk that provide the Enterprise with the ability to withstand economic and market fluctuations; and
3. appropriately intensive efforts on the part of the Board of Directors and senior management to correct known control weaknesses.

During 2004 the Board of Directors and senior management made concerted efforts to correct extensive control weaknesses of the Enterprise. OFHEO examiners observed improvements in both financial reporting and general operational controls. Although the remediation of internal control weaknesses is not complete, action plans are in place, or are being developed and implemented, to address identified weaknesses. The successful completion of those plans will require the continued commitment and intensity of the Board and management throughout 2005 and beyond. Moreover, improvements to systems capabilities and the successful implementation of re-engineered business processes will be necessary to restore the overall control environment to a satisfactory condition. The process of validating the adequacy of controls and the actions taken to address significant control weaknesses will require substantial efforts on the part of Enterprise personnel and the independent auditor of the Enterprise.

Leadership from the Board and senior management has facilitated significant progress over the past year. The reconfigured Board and senior management committees and revised committee charters have provided a foundation for positive change.»⁶⁰⁶

OFHEO AR 2006.

The pdf-file is dated 14/6/06, and modified 22/6/06. There is no linked table of contents.

The letter of transmittal.

The “Letter of Transmittal” to Congress gives a summary of the report:

«This report primarily covers accomplishments in 2005 during the tenure of former OFHEO Acting Director Stephen Blumenthal who reassumed his Deputy Director position on April 28, 2006. As Acting Director I [= James B Lockhart III] thank him for [...] the completion of the Fannie Mae Special Examination Report.

Although the Special Examination Report was not published until May 23, 2006, much of the work was done in 2005. The report concludes that Fannie Mae senior management presented an image of the Enterprise as one of the lowest-risk financial institutions in the world and as “best-in-class” in terms of risk management, financial reporting[,] internal controls and corporate governance. The reality was that the image presented was false. The risks at Fannie Mae were greatly understated and senior management manipulated accounting and earnings. Fannie Mae also signed settlement agreements on May 23, 2006 with OFHEO and the SEC that include a \$400 million fine, growth limits and top-to-bottom remedial actions to enhance the safe and sound operation of the Enterprise going forward.

The annual examinations of both Enterprises state that progress was made in 2005, but that further work and several years are needed to fully achieve safe and sound practices. Although the Enterprises have differences, the key areas that need significant remedial attention are similar: accounting systems, internal controls, risk management, human resources, corporate governance and growth.

Due to the findings of operational inadequacies at both Fannie Mae and Freddie Mac, OFHEO required each Enterprise to hold 30 percent more capital than its minimum requirement. Capital levels are monitored weekly at both Enterprises by OFHEO’s examination teams.

During 2005, OFHEO continued to build its capabilities by strengthening its supervisory functions, and enhancing the agency’s infrastructure to support a stronger oversight program. In FY 2005 OFHEO increased its staffing by 30 percent over FY 2004. [...]

Pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the Agency once again recommends legislative enhancements to OFHEO’s authority, particularly in those

⁶⁰⁶ OFHEO AR 2005 pp. 19-20/25-6.

areas that would align the safety and soundness authority of the Agency more closely to the federal banking agencies. Key safety and soundness provisions include the ability to establish capital limits, place an enterprise into receivership, and approve new products. We also believe that permanent funding of OFHEO, outside the appropriations process, is critical to ensuring the agency can adapt and respond quickly to changing circumstances at either Enterprise.»

Now the AR itself.

The year in review.

The first section of the YEAR IN REVIEW gives a picture of the situation in the markets for mortgages and houses. The following is copied from this section:

«According to *Inside Mortgage Finance*, originations of single-family mortgages totaled \$3,120 billion in 2005, the second highest volume ever. Mortgage refinancings declined in 2005 as interest rates rose. Despite the narrowing of spreads between FRMs and ARMs, the ARM market remained strong in 2005, accounting for 31 percent of originations.⁶⁰⁷ That volume was supported by the continued strong demand by borrowers for affordable mortgage products such as adjustable-rate loans that do not require principal payments or even, in some cases, full payment of interest owed in the early years of the loan.

House prices, as measured by OFHEO's House Price Index, increased at a double-digit rate for the second consecutive year. It was the biggest jump since 1978. The average U.S. home price increased 13.3 percent from the fourth quarter of 2004 to the fourth quarter of 2005, compared to 12.0 percent the year before. All nine Census Divisions showed strong growth, but two (Pacific and New England) showed a deceleration in the rate of appreciation. Continued low mortgage interest rates, more affordable and innovative mortgage products, and an improved employment picture helped to keep the demand for and prices of U.S. homes high in 2005.

The National Association of Realtors' composite housing affordability index fell by 8.3 percent in 2005, to 114.6. The lower affordability index reflects higher appreciation in the median home price and the uptick in mortgage interest rates, which more than offset the increase in median family income. Continued higher home prices in 2005 may have contributed to a slight decline in the homeownership rate, from 69.2 percent as of the end of the fourth quarter 2004, to 69.0 percent one year later.»⁶⁰⁸

So “affordable mortgage products” are mortgages which seem to be affordable for the short term, but cause relatively high risks for the longer term. If “affordable” means: “just affordable”, then “affordable” also means: affordable only if no adverse winds arise.

In fact the quote describes a dangerous mixture: evidently more risky mortgages, a relatively large house price increase (and therefore relatively large mortgages), and a low interest rate (relatively high probability of a rate increase⁶⁰⁹). The mixture means that an increase in interest or fall in house prices will bring relatively many people in difficulties.

The second section of the YEAR IN REVIEW considers Fannie and Freddie. The first two paragraphs are the following:

«Fannie Mae and Freddie Mac both continued to suffer from accounting, systems, and internal control problems in 2005. Freddie Mac was unable to provide the public with even unaudited financial statements for the year until late May 2006 and does not plan to release any quarterly statements this year. Fannie Mae is working on restatements for 2002 and 2003, which it plans to release along with 2004 results sometime after mid-2006. Statements for 2005 will be more than a year late.

The need to focus on these problems inhibited the ability of the Enterprises to respond to changing

⁶⁰⁷ FRM= fixed (interest) rate mortgages, ARM= adjustable rate mortgages.

⁶⁰⁸ OFHEO AR 2006 pp. 1-3.

⁶⁰⁹ The rate was about 6%. That was low for the period 1992-2005, but of course not low in absolute terms.

markets. The popularity of ARMs and non-traditional loans continued to limit the Enterprises' share of the secondary mortgage market, and strong demand of other investors diminished investment opportunities. However, both Enterprises increased their outstanding totals of mortgages that they either owned or guaranteed, and based on available information, both were profitable in 2005.»⁶¹⁰

Why does OFHEO believe that the enterprises can reliably calculate profits or losses as long as the serious accounting problems have not been solved?

What follows is from the third paragraph:

«Fannie Mae's portfolio activities in 2005 were constrained by its need to build capital to meet regulatory requirements, which were increased in light of Fannie Mae's accounting and internal control deficiencies.»⁶¹¹

Chart 3 on p. 4 shows that the sizes of the portfolios of Fannie and Freddie did not change going from 2003 to 2004, and that in 2005 Fannie's portfolio fell back to approximately the level of 2001. That of Freddie had grown further, to almost the size of Fannie's portfolio.

«Freddie Mac's net income, measured in accordance with generally accepted accounting principles (GAAP), declined for the third consecutive year in 2005, about 20 percent, to \$2.13 billion. The decrease reflected lawsuit settlement, effects of hurricane Katrina, diminished margins, and accounting changes.

In light of the ongoing restatement of its financials, GAAP earnings in 2005 for Fannie Mae have not yet been disclosed.»⁶¹²

They are supposed to be "substantial".⁶¹³

Next OFHEO makes an interesting remark in connection with mark-to-market and fair value accounting:

«GAAP earnings as reported by Freddie Mac and as estimated by Fannie Mae continue to be highly erratic from quarter-to-quarter and year-to-year. That reflects, in part, GAAP's requirements to mark some balance sheet items to market, while other items are not, creating difficulties in interpretation. Analyses of fair value balance sheets and causes of changes in them from period to period, however, support the conclusion that the business of both Enterprises remains economically sound.»⁶¹⁴

But first of all, it would seem, because more objective, subject to high- and risky- volatility.
The following is said about credit risk:

«Credit risk at both Fannie Mae and Freddie Mac remained low in 2005, although delinquency rates rose following hurricane Katrina at both Enterprises. Freddie Mac's total single-family delinquency rate declined from 73 to 59 basis points in January to September, but rose to 69 basis points by year's end. Similarly, the single-family delinquency rate at Fannie Mae fell during the first nine months of the year, to a low of 59 basis points in September, but ended the year 14 basis points higher than it started, to 77 basis points.»

Nothing is said (here) about causes, or expectations.

Because of the accounting malpractices, OFHEO used its authority to raise the capital requirements of the enterprises:

⁶¹⁰ OFHEO AR 2006 p. 3.

⁶¹¹ OFHEO AR 2006 p. 3.

⁶¹² OFHEO AR 2006 p. 4.

⁶¹³ OFHEO AR 2006 p. 4.

⁶¹⁴ OFHEO AR 2006 p. 4/9, last sentences.

«Because of a high state of operational risk, OFHEO continued to require Freddie Mac to maintain core capital 30 percent higher than its regulatory minimum capital level. At year-end, the Enterprise's capital of \$36.0 billion exceeded its requirement by \$3.9 billion and amounted to 4.5 percent of its assets, up from 4.4 percent. After finding serious problems at Fannie Mae, OFHEO also required an additional 30 percent there. Accordingly, Fannie Mae raised its core capital to \$38.1 billion, \$1.1 billion above the adjusted requirement. That was 4.6 percent of estimated assets, up sharply from 3.2 percent of estimated assets a year earlier.»⁶¹⁵

In the year under review OFHEO strengthened regulation of corporate governance, mortgage fraud reporting, and various other activities. It requires a written code of conduct and ethics. It does not explain how compliance will be supervised.⁶¹⁶

Regarding penalties for misconduct by the top management the following gives reason to doubt the regulation's effectiveness- if not justice- in the prevention of misconduct:

«On December 9, 2005, OMB⁶¹⁷ returned, for further consideration by OFHEO, a draft proposed amendment to OFHEO's corporate governance regulation which would have prohibited the Enterprises from indemnifying directors and executive officers for civil money penalties and restitution or recoupment orders assessed against them in actions initiated by OFHEO. OFHEO continues to review approaches to addressing indemnification issues, including examination guidance.»⁶¹⁸

Fannie Mae examination results and conclusions.

The following is the table of contents of the chapter Annual report to Congress about Fannie Mae:⁶¹⁹

FANNIE MAE ANNUAL EXAMINATION	14
EXAMINATION AUTHORITY AND SCOPE	14
EXAMINATION RESULTS AND CONCLUSIONS	14
MATTERS REQUIRING BOARD ATTENTION	16
MANAGEMENT SUPERVISION	17
ASSET QUALITY AND CREDIT RISK MANAGEMENT	24
LIQUIDITY	28
SENSITIVITY TO MARKET RISK	29
EARNINGS	31
CAPITAL ADEQUACY	32

Examination authority and scope.

The following quotes are taken from the section Examination authority and scope:

«Examination Authority and Reporting Convention

The Report of Examination contains the results and conclusions of OFHEO's 2005 annual examination of the Federal National Mortgage Association ("Fannie Mae" or the "Enterprise") performed under section 1317(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 USC 4517(a)). The OFHEO annual examination program assesses the Enterprise's financial safety and soundness and overall risk management practices.»⁶²⁰

«Examination Scope

⁶¹⁵ OFHEO AR 2006 p. 5/10, last paragraph.

⁶¹⁶ OFHEO AR 2006 p. 7/12.

⁶¹⁷ OMB= Office for the Management of the Budget.

⁶¹⁸ OFHEO AR 2006 p. 8/13.

⁶¹⁹ It is copied from the table of contents of the AR. In reality, the chapter has another title.

⁶²⁰ OFHEO AR 2006 p. 14/19.

This report is structured so that the first few paragraphs in each section provide an overview of the conclusions and scope, and the following paragraphs provide the detail and support for the overview.»⁶²¹

Examination results and conclusions.

The section begins with the following paragraph:

«The Enterprise is a supervisory concern due to the enormity of issues that management must prioritize and address to improve data, systems, controls, communication, risk measurement and management as well as process efficiency and systems flexibility to remain competitive in the future business environment. The pervasive deficiencies stem from past management actions that deemphasized internal controls and risk management, focused on expense control, established an organizational structure that impeded internal controls, and employed too few personnel who emphasized or understood industry standards for internal controls and risk management.»

Follows a list of the 13 most serious deficiencies. They seem so wide and deep that one can ask oneself whether one can allow such an enterprise to continue operating, instead of proposing to unwind it, or replace it (and OFHEO) with an entirely new organization (without personal overlap) and a supervisor with far more power. Many people and much money are involved, and at risk. The present author would very much like to know and understand how such a mess could develop while there was a seemingly active and positive supervisor. See the preceding annual reports. The present author does not understand how OFHEO and can justify some relatively positive conclusions, such as the following from the second point, and why it doesn't keep silent:

«Despite these deficiencies, the major risks in interest rate, liquidity, and credit were controlled at reasonable levels.»

For:

«Management's and staff's knowledge and practice of financial industry standards for controls, risk management, and operational discipline vary widely throughout the Enterprise, and contributed to deficiencies in operational, performance, and risk management. Cultural change throughout the Enterprise will require continuing effort.»

Another relatively positive conclusion is the tenth:

«Processes and controls for obtaining asset liquidity in a stress environment are satisfactory but inefficient.»

In the eyes of the present author the other conclusions are quite deadly. The following two examples give the idea.

The last sentence of point 4: «Consultants addressing restatement and organizational structure issues represent more than 40 percent of the Enterprise's workforce, and are approaching the maximum level that can be effectively managed.»

Point 9: «Critical components of the methodology used to estimate loan loss reserves were not complete at year end 2005.»

Follows the concluding paragraph of the section

«Many milestones should be achieved in short and mid-term timeframes in such areas as management policies, written procedures, risk metrics, interim controls, staffing levels, and deficiencies and inefficiencies in reports, processes and controls associated with stand alone information technology

⁶²¹ OFHEO AR 2006 p. 14/19.

systems. However, full correction of issues impacted by the main database, platform, and systems integration are expected to require three to five years.»⁶²²

Management supervision.

The first paragraph of the section is the following:

«Past executive management established an organization that provided insufficient monitoring, control, and coordination of business units. These deficiencies led to significant issues in operations controls, information technology (IT) effectiveness and flexibility, and risk measurement, management, and communication throughout the Enterprise. The quality of management and controls varied widely due to the lack of corporate standards and the relative autonomy of the business units. The ability to communicate within the Enterprise was impeded by an insufficient committee structure, poorly defined authority and responsibilities, deficient risk metrics, and a lack of a common language or universal understanding of terms used to communicate risk and performance.»

Follows a list of issues noted in 2005. Which supports and specifies the conclusions of the overview.

That past executive management performed very badly does not mean that the present management is better or good. The top has not been fully replaced. CEO Raines is gone. But in June 2005 he was replaced by Daniel Mudd.⁶²³ From February 2000 to December 2004 Mudd was vice-chairman and chief operating officer, and Fannie's second in command.

Inspection of Fannie's AR 2003-2006 shows that in 2006 about half of the top already worked for Fannie in 2003, and at least a quarter of the directors and executives.⁶²⁴ Shouldn't these people have noticed and informed OFHEO of the malpractices or mess of their own accord? (Supposing they did not partake in them). Can they be honorable and competent? How can this be proven, notwithstanding the recent history of the enterprise? Note that according to Raines they has signed a code of conduct. See below, under OFHEO AR 2007, in the section about the report of the special examination of Fannie Mae.

Liquidity.

The following is said about the source of liquidity:

«Liquidity is strong based on the ample level of liquid assets in the mortgage-backed securities and liquidity investment portfolios available for sale or repo to cover a stress event to cash flows as well as the stability in funding costs and availability due to the company's status as a government sponsored entity. Asset liquidity, the strongest source of liquidity, amply covered short term liabilities. Treasury management consistently met the non-mortgage asset liquidity guidelines, and Liquidity Investment Portfolio (LIP) assets exceeded 5 percent or more of total assets throughout 2005.»⁶²⁵

The section gives several examples of deficiencies which seem to be as many risks.

The two last paragraphs of the section (too) give rise to questions. The one but last reads:

«The Board formally approved a new liquidity policy in January 2006. Management policies for the Liquidity Investment Portfolio are in the process of completion, and address the purpose and management of the portfolio, and provide limits on credit and interest rate risks. Policies did not provide limits for the distribution of liability maturities, although informal guidelines exist.»⁶²⁶

⁶²² OFHEO AR 2006 p. 16/21.

⁶²³ Fannie AR 2004 p. 214/219. Mudd is president and CEO.

⁶²⁴ One has to go back to AR 2003 because that was published in 2004, and because the AR about 2004 and following years date from 12/06 and later, and were adapted to the human resources situation at the date of publication.

⁶²⁵ OFHEO AR 2006 p. 28/33.

⁶²⁶ OFHEO AR 2006 p. 29/34

It is remarkable that the sentence with “did” is the last. Did the draft read “do”, and was this replaced at a later stage by “did”? Anyway: what is the present state of affairs?

«In the past, systemic market events have not significantly impacted Fannie Mae’s liquidity because of the market’s perception of Fannie Mae’s debt as a “flight to quality” product. In addition, recent and past company-specific events have generated only a small impact to the cost of and market access to funding.»⁶²⁷

Again a rather dubious remark. It assumes the existence of risks, but says nothing about the risks expected in the coming year(s), or the preparedness for them.

Capital adequacy.

This section asserts that Fannie satisfies all legal and OFHEO requirements. But it says nothing about the adequacy of these requirements.⁶²⁸

Freddie Mac examination results and conclusions.

The following is the table of contents of the chapter Annual report to Congress about Freddie Mac:⁶²⁹

FREDDIE MAC ANNUAL EXAMINATION	33
EXAMINATION AUTHORITY AND SCOPE	33
EXAMINATION RESULTS AND CONCLUSIONS	33
MATTERS REQUIRING BOARD ATTENTION	34
BOARD AND MANAGEMENT SUPERVISION	35
ASSET QUALITY AND CREDIT RISK MANAGEMENT	38
LIQUIDITY	40
SENSITIVITY TO MARKET RISK	40
EARNINGS	41
CAPITAL ADEQUACY	41
CONSENT ORDER	42

The following is the unabridged section Examination results and conclusions:

«The Enterprise remains a supervisory concern, although efforts toward improvement are underway. The Board and management are continuing to revise and implement comprehensive plans to strengthen senior management, improve controls, and balance priorities, initiatives, and risks. Leadership from the Board and senior management will be challenged during 2006 to reshape the corporate culture, build long term sustainable processes, further improve overall governance, enhance risk management capabilities, stabilize the organizational structure, reduce turnover, and clarify responsibilities.

While concerted efforts by the Board and management have been made to address the myriad of concerns, progress during the second half of 2005 was slowed as the volume and complexity of issues became more apparent. The Enterprise continues to experience a number of significant operational issues, high turnover, and weaknesses in entity and process level internal controls. During 2005, efforts to implement sustainable processes to permit the issuance of timely and accurate financial statements were less than fully effective. Although necessary, the high level of business and process change throughout the organization has stressed the existing infrastructure, risk management systems, and operating practices. Long term resolution of identified issues will require substantial efforts on the part of Enterprise personnel. Improvements to systems capabilities, information processing controls,

⁶²⁷ OFHEO AR 2006 p. 29/34

⁶²⁸ OFHEO AR 2006 p. 32/37. Note that in the beginning of the immediately following *Examination results and conclusions* for Freddie, OFHEO does look forward towards 2006. So why not here?

⁶²⁹ It is copied from the table of contents of the AR. In reality, the chapter has another title.

and the successful implementation of re-engineered business processes will be necessary to restore the overall control environment to a satisfactory condition.

While the resolution of internal controls remains an on-going concern, the Enterprise has:

- (1) a qualified and active Board of Directors,
- (2) a senior management team committed to resolving weaknesses,
- (3) a significant capital surplus;
- (4) strong asset quality, and
- (5) effective management of interest rate and liquidity risks.

During 2005, the Enterprise has developed an integrated multi-year business plan that recognizes the need to improve accounting and financial management capabilities, enhance operating controls, and enhance risk management activities.»⁶³⁰

What can explain the fact that both Fannie and Freddie are a “supervisory concern”? Are we to believe that this is merely accidental? Shouldn’t the supervisor give an analysis and explanation of this remarkable observation? Especially since it has a large responsibility with respect to the safety and soundness of the GSEs. At least after September 2008 it is often said that the business model of the GSEs is inadequate. This observation seems 1. insufficiently argued, 2. not to take account of the misconduct of principal managers, and 3. not to explain the degeneracy into a supervisory concern. The facts are in any case compatible with the hypothesis of false pretensions as a cause of failure: managements and a supervisor who neither of them can do what they are supposed to do.

OFHEO AR 2007.

The pdf-file is dated 6/4/07, and modified 31/10/07. There is no linked table of contents. Remember that this annual report reviews 2006.

The letter of transmittal.

«Since the last report, OFHEO published a new five-year strategic plan that contains three strategic goals in support of the agency’s mission, to ensure the safe and sound operation of Fannie Mae and Freddie Mac. These goals are:

1. Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements;
2. Provide support for statutory reforms to strengthen our regulatory powers; and
3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.»

The last goal may necessitate compromises with the first, and therefore weakens the first (as the first may weaken the last). But letter nor report pays any attention to potential conflicts.

The letter continues:

«The 2006 annual examinations of both Fannie Mae and Freddie Mac, contained in this report, detail the current condition of both Enterprises. OFHEO concludes that both companies remain a significant supervisory concern. OFHEO also concludes that in 2006 both companies made progress in correcting their problems, especially in systems, controls and financial reporting. Nonetheless, it has taken much more time and money to correct them than either the Enterprises or OFHEO expected. Both companies are complying with a 30 percent additional capital requirement due to operational risk problems, and both are subject to specific limits on the growth of their portfolios. Despite these constraints necessitated by their operational weaknesses, their support of the mortgage market grew by 8 percent in 2006 to \$4.3 trillion as their guaranteed mortgage-backed securities (MBS) outstanding grew at double-digit rates.»

The work on goal 2 is summarized as follows:

«As part of our second strategic goal, OFHEO has been working with the Congress and the Administration on legislation to reform the regulatory oversight of the housing government-sponsored

⁶³⁰ OFHEO AR 2006 p. 33-4/38-9. As noted in the main text, the section is quoted unabridged.

enterprises (GSEs). I am pleased that the House Financial Services Committee has drafted, debated and passed out of committee a strong reform bill that strikes a balanced approach to needed statutory reforms. H.R. 1427 provides the basic building blocks of a strong, bank-like regulator for the GSEs.»
(The basic building blocks are listed).

The work on goal 3 is summarized as follows:

«One of the ways in which OFHEO expands the national discussion of housing and homeownership is through its analysis of mortgage market developments and Enterprise activities. OFHEO's quarterly House Price Index (HPI) and related products provide important information about the state of the housing markets. As measured by the HPI, the nation's housing and mortgage markets experienced a marked deceleration in home prices in 2006. After two years of double-digit rates of appreciation nationally, house prices increased at a more moderate pace, 5.9 percent, from the fourth quarter of 2005 to the fourth quarter of 2006. That was the lowest appreciation rate since 1999.»

Neither letter nor report notes that this rate is an average, or the net result, of a rise until April and a fall since then. It does not discuss the risks and potential consequences of a fall in house prices, or refer to such a discussion.

The year in review.

The first section “Housing Sector Retreats After Years of Solid Performance” discuss the general economic development and the house market. P. 2 shows a graph of home sales. It shows a rather sharp turnaround and fall in 2006. From 1991 until 2006 it had increased without interruption.

The second section has the title “Financial Performance of the Enterprises in 2006”. The first sentence sets the tone: «Fannie Mae and Freddie Mac both continued to work on issues related to their accounting, systems and internal control problems in 2006 and some progress was made.»⁶³¹ The remainder of the section reports mostly quantitatively about all kinds of financial performance. Since accounting, systems and internal control are not yet up to standard, the reliability seems doubtful. The text certainly is not positive about the GSEs, and is not reassuring. But OFHEO does not seem to be willing to acknowledge that it does not have a good idea of the true state of affairs.

As a member of Congress I would ask OFHEO how reliable its assessments are, and what its reliability estimate is based on. How does it explain the fact that solution of various elementary problems takes years? The first report of the problems is given in OFHEO AR 2003!

Supervisory Actions in 2006.

P. 9 reports that «OFHEO entered into a Consent Order with the Enterprise» Fannie. The order means that Fannie comes under a kind of guardianship:

«The May 23, 2006 Order commits Fannie Mae to a significant number of remedial steps, including halting growth in its retained mortgage portfolio; reviewing current and former employees for disciplinary actions and possible restitution; implementing plans to resolve accounting, internal control, corporate governance and risk management weaknesses; maintaining the capital surplus requirement; agreeing to oversight by OFHEO of senior officer appointments; and committing to cooperate with OFHEO on any enforcement actions. Fannie Mae agreed to pay a \$400 million penalty to the government.

The Consent Order is organized into 12 Articles, as shown in Table 1, having a total of 81 separate requirements. These requirements were developed by OFHEO to correct or eliminate specific deficiencies revealed during the Special Examination of Fannie Mae.»⁶³²

P. 11 informs about the state of affairs regarding the requirements.

⁶³¹ OFHEO AR 2007 p. 5.

⁶³² OFHEO AR 2007 p. 9.

Freddie too has been issued a consent order. According to p. 12 Freddie is “in satisfactory compliance”, except in one provision, the separation of the CEO and Chairman of the Board positions. A transition plan for this has been submitted.

P. 13 concerns supervision of executive compensation. The footnote remarks that «in early 2007, as part of its review of issues raised by OFHEO’s Report of the Special Examination (May 2006), the Enterprise [= Fannie] acted to eliminate bonus payments to certain executives and to take disciplinary action against a number of individuals.»

Report of the Annual Examination of Fannie Mae.

Pp. 14-5 present the Examination Conclusions. The first sentences are:

«The Enterprise remains a significant supervisory concern. Although progress has been made in correcting deficiencies, significant issues remain and are centered in data, systems, controls and risk measurement and management.»

The first sentence of the second paragraph reads as follows:

«Management has devoted substantial effort to address the Enterprise’s deficiencies, but corrective programs are in varying stages of completion and many are in their initial stages.»

The final paragraph of the section looks like an overview of the situation:

«The Enterprise has:

- (1) a qualified and active Board of Directors and senior management team with a supervisory program that is incomplete but improving;
- (2) operations with significant control deficiencies that adversely impact risk management and expansion into new products;
- (3) weaknesses in several areas of credit-risk management but strong asset quality;
- (4) a minimally satisfactory interest-rate risk management program with deficiencies in interest-rate risk measurement;
- (5) satisfactory management of liquidity;
- (6) fair earnings; and
- (7) adequate regulatory capital.

Current and future earnings are adversely impacted by declining net interest margins and competitive pressures. Structural and economic issues in the mortgage markets and the Enterprise’s desire to expand activities in higher-risk products heighten the importance of developing economic capital measures to better quantify risks and performance, as well as stronger financial performance measurement and attribution analysis.»

What exactly is meant by “qualified and active”? What follows suggests that it may not mean more than formally sufficient. But this need not be sufficient for the jobs to be done.⁶³³

The section Liquidity on p. 27 sees no serious risks.

The section Sensitivity to Market Risk (pp. 27-8) gives the reader the idea that Fannie is not ready for what it does. That too much is not in order, and that it should not be allowed to operate, certainly not at a large scale. But OFHEO does not conclude this, and only gives a list of what seems to go well and what deficiencies remain.

In the section Capital on pp. 29-30 OFHEO declares that Fannie is adequately capitalized, without making any reservations. It is remarkable that point (7) of the conclusions on p. 15 (quoted above) speaks of “adequate regulatory capital”, and that p. 29 uses another terminology:

⁶³³ Compare the situation regarding capital requirements: compliance with formal requirements does not guarantee safety and soundness.

«OFHEO formally classifies capital adequacy quarterly in accordance with Subtitle B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and with the requirements set forth in OFHEO's minimum and risk-based capital regulations.»⁶³⁴

and does not mention any other capital requirement. Nowhere does the report say that in this or that respect Fannie's capital may be insufficient, or that the given leveraging implies certain risks. In the light of the systemic risk report of a few years ago this seems rather surprising. The more so since the letter of transmittal clearly asks more of OFHEO than just checking compliance with formal requirements: «OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.» It should therefore investigate whether formal capital requirements are sufficient for safety and soundness.

Report of the Annual Examination of Freddie Mac.

Examination Conclusions (quoted in full).

«The Enterprise remains a significant supervisory concern. While efforts toward improvement are underway, senior management continues to revise plans and reengineer processes to strengthen internal controls and remediate six material weaknesses and a number of significant deficiencies. Leadership from the Board and senior management is challenged as they strive to reshape the corporate culture, publish accurate and timely financial statements, implement long-term sustainable processes, improve overall governance and risk management capabilities, enhance information technology controls and stabilize the organizational structure.

Intensive efforts by the Board and management have been made to address internal control weaknesses; however, several key initiatives to remediate the control environment have not progressed as planned. Progress throughout 2006 was adversely impacted by the volume and complexity of issues, less than effective project management capabilities, and inconsistent execution in key segments of the comprehensive plan.

Long-term resolution of identified issues will continue to require substantial efforts on the part of Enterprise personnel. The Board and management must continue to focus on needed cultural and organizational improvements identified in the internally-prepared, rootcause analysis to ensure historically weak operating practices are strengthened. Improvements to systems capabilities, information processing controls and the successful implementation of re-engineered business processes will be necessary to restore the overall control environment to a satisfactory condition.

The Enterprise has:

- (1) a qualified and active Board of Directors;
- (2) a senior management team committed to resolving internal controls weaknesses and returning to timely financial reporting;
- (3) adequate capital;
- (4) strong asset quality and credit risk management;
- (5) effective management of interest rate and liquidity risks; and
- (6) adequate earnings.

During 2006, efforts to improve the risk management capabilities across the Enterprise commenced, and the new governance structure should provide the ability to better manage risk across the organization. Earnings volatility continues and results primarily from mark-to-market gains/losses on the guarantee asset and the elimination of hedge accounting for financial derivatives. Longer-term earnings prospects may be adversely impacted by declining net interest margins and competitive pressures. Structural and economic issues in the mortgage markets heighten the importance of continuously refining economic capital measures to better quantify risks and assess financial performance returns.»⁶³⁵

As in the case of Fannie, one wonders why Freddie nonetheless is assumed to be able to operate responsibly. Such an assumption seems far from self-evident. It is quite remarkable that OFHEO does

⁶³⁴ OFHEO AR 2007 p. 29, first paragraph of the section Capital.

⁶³⁵ OFHEO AR 2007 p. 31-2. Layout modified slightly by the present author.

not try to defend its opinion that Freddie can be allowed to continue, even if it gives the reader plenty of reasons to doubt this.

And isn't it rather misleading to say that “[efforts toward improvement are underway](#)”, without adding that these efforts began four years ago, and without explanation of the very long recovery period (let alone the deterioration in the preceding period)?

Operations.

As often in the OFHEO AR, the first paragraph is or looks like a summary or conclusion of the remainder of the section:

«Operational risk is high and continues to be a primary supervisory concern. Throughout 2006, Freddie Mac was not able to produce accurate and timely quarterly financial statements. All internal control-related material weaknesses and significant deficiencies identified during 2005 or prior years' annual audits remain outstanding. The internal control structure remains fragmented, incomplete, and in some cases, undocumented. In addition, current systems limitations did not permit an effective and reliable quarterly close process. Remediation of control weaknesses including independent testing is required (controls must be complete and documented) before management and OFHEO can opine on the effectiveness of the control structure.»⁶³⁶

In the discussion of each of the subjects mentioned in this summary, OFHEO remarks that weaknesses have to be remedied. Clearly, much work remains to be done before Freddie can be said to operate competently and adequately.

Asset Quality and Credit Risk Management

On this subject OFHEO has relatively few negative remarks. The following quote gives the first two paragraphs of the section:

«The Enterprise's overall asset quality is strong. All portfolios currently exhibit favourable quality and performance metrics. The Enterprise prudently manages exposures to significant counterparties (e.g., seller/servicers, mortgage insurers and derivatives counterparties) and monitors top seller/servicer and mortgage insurer concentrations.

There are no immediate signs of significant deterioration in credit performance trends; however, expected default costs are increasing. Over the past several years, significant shifts in the mix of mortgage originations and the composition of the retained portfolio have occurred as the market continues to produce mortgages with higher-risk profiles. As the portfolio seasons, adverse changes in house price appreciation, mortgage rates or unemployment levels could negatively impact future performance.»⁶³⁷

Note that OFHEO says that «the market continues to produce mortgages with higher-risk profiles». Regrettably, this is somewhat ambiguous: does the market produce the same mixture with relatively many high risk securities, or is the fraction of higher risk securities increasing?

The last sentence of the quote is quite correct. OFHEO fails to note whether Freddie's risk management can cope, or not, with such events.⁶³⁸

Liquidity and Contingency Portfolios.

The following is the full text of this subsection:

«At December 31, 2006, the liquidity and contingency portfolio contained assets with credit-ratings of AAA (50 percent), AA (33 percent), and A (17 percent), exhibiting the high credit quality necessary in a liquidity portfolio. Credit quality of marketable securities in the liquidity and contingency

⁶³⁶ OFHEO AR 2007 p. 35.

⁶³⁷ OFHEO AR 2007 p. 38.

⁶³⁸ The next paragraph treats another subject.

portfolio remained consistently strong with more than 99 percent of the asset-backed securities at AAA and less than 1 percent rated A.»⁶³⁹

But AAA is not without risk either, and AA and A are certainly riskier. The real point is: what are the remaining risks? Especially in relation with the size of the portfolio. About which nothing is said.

Liquidity.

The section Liquidity on p. 41 begins with the following paragraph:

«Management adheres to sound practices for managing liquidity. The Enterprise is not vulnerable to funding difficulties at this time, and earnings and capital exposure from the liquidity risk profile is low. The Enterprise has access to sufficient sources of funds to meet present and anticipated liquidity needs.»

What is “low”?

“anticipated”: under what conditions?! (Continuation of the decrease in house prices?)

What about the scenarios in the systemic risk report, and those indicated by the GAO?

The following quotes come from the same page 41:

«A satisfactory liquidity contingency plan is in place.»

«Risk limits are in place to ensure sufficient liquidity levels, and an independent risk oversight group evaluates limits, exposures and pertinent metrics on a daily, weekly and monthly basis. Management conducts liquidity event testing on a periodic basis, and the results indicate that the Enterprise should be able to withstand severe liquidity events.»

«Management adheres to sound practices for managing liquidity.»

This is explicitly reassuring. Given its assessment mistakes of the past years and the fact that even the best risk management practices of the time do not eliminate risks by far, OFHEO should be much more careful. The remark about “daily, weekly and monthly” is strange, because sizable losses and devaluations certainly cannot be accommodated or remedied on short notice. Only small risks can be managed in the short term. Where sizable and small are relative to the enterprises capital.

Sensitivity to Market Risk. (pp. 41-2).

According to OFHEO this is managed effectively. As always it is not clear however if the enterprise’s risk analyses take account of indirect effects of say interest rate increases, a fall in house prices, or a rise in delinquencies. Of causal relations and logical sequences of events. Since there is no indication of an awareness of other than direct effects, this seems unlikely.

Capital.

The text of this subsection strongly resembles that in AR 2006. The most vital remark undoubtedly is:

«The Enterprise is adequately capitalized and maintains satisfactory cushions above statutory, regulatory and OFHEO-directed capital levels.»⁶⁴⁰

This suggests that OFHEO believes that the capital requirements are not only formally relevant, but are also sufficient for safety and soundness.

Accounting.

This is a new chapter, and not a part of the annual examinations. It nevertheless concerns the enterprises (and not OFHEO itself).

⁶³⁹ OFHEO AR 2007 p. 40.

⁶⁴⁰ OFHEO AR 2007 p. 43.

The chapter opens with the following:

«During 2006, neither Enterprise [i.e. neither Fannie nor Freddie] was able to provide the public with timely financial information. Freddie Mac has been unable to produce timely financials since 2002 and Fannie Mae since 2004. Both Enterprises continued to suffer from problems with accounting systems and internal controls. Fannie Mae is currently working to produce 2005 and 2006 financial information by the second half of this year, while Freddie Mac is working to produce quarterly statements in 2007.

The need to focus on internal control and systems problems continues to inhibit the Enterprises' ability to respond to changes in the market, the economy and accounting standards.»⁶⁴¹

The remainder of the chapter describes the past and present, and the work that remains to be done.

Regulation for record retention.

The first paragraph of the section Regulations suggest one of the things that went wrong and caused OFHEO to make erroneous assessments:

«On October 27, 2006, OFHEO published in the Federal Register a final regulation requiring the Enterprises to establish and maintain record retention programs to ensure that complete and accurate records are readily accessible by OFHEO for examination and other supervisory purposes. The regulation also requires the Enterprises to establish internal controls, procedures for holding documents and controlling their production and training programs to ensure the adequacy and effectiveness of the record retention program. In addition, the regulation directs Enterprise management to evaluate the program for its adequacy and effectiveness at least every three years and to report findings to the Boards of Directors and OFHEO.»

OFHEO Research and Publications.

The report of the Special Examination of Fannie Mae.

«In May 2006, OFHEO issued its Report of the Special Examination of Fannie Mae. The report was the product of more than two years of in-depth review involving nearly eight million pages of documents. The report found the following:

- Fannie Mae senior management promoted an image of the Enterprise as one of the lowest-risk financial institutions in the world and as “best in class” in terms of risk management, financial reporting, internal control and corporate governance.
- Fannie Mae reported extremely smooth profit growth and hit announced targets for earnings-per-share precisely each quarter between 1998 and 2004. Those achievements were illusions deliberately and systematically created by the Enterprise’s senior management with the aid of inappropriate accounting and improper earnings management.
- During that period, a large number of Fannie Mae’s accounting policies and practices did not comply with Generally Accepted Accounting Principles (GAAP). The Enterprise also had serious problems of internal control, financial reporting and corporate governance.
- By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders.
- Fannie Mae’s Board of Directors contributed to those problems by failing to be sufficiently informed and failing to act independently of its chairman and other senior executives; by failing to exercise the requisite oversight over the Enterprise’s operations; and by failing to discover or ensure the correction of a wide variety of unsafe and unsound practices.
- The Board’s failures continued in the wake of revelations of accounting problems and improper earnings management at Freddie Mac and other high-profile firms, the initiation of OFHEO’s special examination and credible allegations of improper earnings management made by an employee of the Enterprise’s Office of the Controller.

⁶⁴¹ OFHEO AR 2007 p. 45.

- Senior management did not make investments in accounting systems, computer systems, other infrastructure and staffing needed to support a sound internal control system, proper accounting and GAAP-consistent financial reporting. Those failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and changing accounting and legal requirements.)⁶⁴²

This is quite clear. A question is: who selected and appointed the top managers of Fannie? Why is there no analysis of how such a situation could develop unnoticed by supervisor OFHEO? Why did it take OFHEO so long to find out, and to find out how wide and deep the problems were? What explains the apparent absence of signals from Fannie employees?

Why doesn't OFHEO say that continuing with Fannie is a high risk option?

Mudd was vice president since February 2000. How could the FCIC take him seriously?

Don't forget that p. 5/7 of Fannie's AR 2002 (two thousand and two) said the following:

«Integrity. To ensure trust in Fannie Mae, Fannie Mae must be trustworthy.

Every individual at Fannie Mae- from our Board of Directors to the Chairman and CEO to senior management to every employee- is held to the highest standards of honesty and integrity. Integrity is woven into the Fannie Mae culture. As CEO, I strive to establish the highest standards of integrity by policy and by example. Our highly independent Board of Directors holds me, as CEO, as well as senior management and the entire company, accountable for our high standards of integrity. The Board of Directors and each employee sign explicit Codes of Conduct, which are available on our corporate Web site, fanniemae.com.)»

As a consequence of the mismanagement, the CEO, Franklin Raines, and the CFO, Timothy Howard left the enterprise.⁶⁴³ Raines on 21/12/04. He called it "early retirement".⁶⁴⁴

OFHEO Performance and Program Assessment.

In November 2005 OFHEO published a 2005 Performance and Accountability Report (PAR).⁶⁴⁵ It reviews fiscal year 2005. In May 2016 a PAR for FY 2006 could not be found. The following is the summary of this PAR in the AR 2007:

«Significant findings included the following:

- In recent years, OFHEO's program has improved its effectiveness in identifying and addressing significant and systemic issues at the Enterprises that need attention.
- The program's effectiveness is restricted by limited statutory authority. OFHEO lacks express powers similar to those of other safety and soundness regulators.
- One of the factors affecting OFHEO's PART rating is that, as of Fiscal Year 2006, OFHEO had not yet implemented certain bank regulator-like risk measures. OFHEO is now using such measures and will report at the end of Fiscal Year 2007 on how the Enterprises performed.
- OFHEO is the only safety and soundness regulator whose funding is subject to the timing and amount approved in an annual appropriations bill. Budget flexibility is critical to ensuring the agency can adapt and respond quickly to changing circumstances at either Enterprise.)»⁶⁴⁶

Regrettably neither this nor the 2005 PAR explains why OFHEO's supervision left so much to be desired. They do not explain how OFHEO could give virtually unqualified positive assessments while in reality very much had to be remedied, and correction would take more than 5 years.

⁶⁴² OFHEO AR 2007 p. 56-7.

⁶⁴³ A brief history of the housing government-sponsored enterprises, FHFA/OIG, dated 20110826, p. 6.

⁶⁴⁴ Wiki page Franklin Raines, 30/5/16. The page gives interesting information about various lawsuits.

⁶⁴⁵ According to the FHFA website on 25/5/16, there is such a report for 2005, 2007 and each of the following years. But not for 2006, 2004, and earlier years. If the AR 2007 is correct, then the 2006 PAR must have been removed from the website, or never placed there.

⁶⁴⁶ OFHEO AR 2007 p. 60.

Legislation and supervisor authority undoubtedly were insufficient, but neither AR nor PAR specifies the deficiencies and specifies and argues the necessary corrections or improvements. None of the reports contains a section “Recommendations for the various actors”, and references to something like this are not given.

OFHEO does not tell what it could or would have done if the law had been as it wanted, and does not show that this would have prevented the problems. Unqualified judgments like “exceed safety and soundness standards” (2002) and “are effective” (2003) and “is strong” (2004), the identification of formal norms with what they supposedly intend to ensure, the lack of discussion of the formal norms, and the complete neglect of the systemic risk report suggest that more authority and another budget process would not have created a totally different world. OFHEO’s mission was to ensure financial safety and soundness of the GSEs. It is evident that compliance with formal norms is not sufficient to ensure financial safety and soundness.

OFHEO AR 2008.

The pdf-file is dated 29/5/08, and modified 9/4/09. The pdf-file is provided with a bookmark-table of contents. The table of contents in the text is not linked.

In 2007, house prices declined by 0.3% on the average.⁶⁴⁷

«In 2008, OFHEO was one of only 17 agencies to win the CEAR award for its FY 2007 Performance and Accountability Report.»⁶⁴⁸

Remember that this OFHEO report reviews 2007. The letter of transmittal is dated 15/4/08. This is well before the GSEs are placed in conservatorship.

OFHEO AR 2008 reports that in 2007:

«For the first time in four years, the Enterprises filed their annual financial statements on a timely basis.»⁶⁴⁹

The letter of transmittal.

Once more the letter very much resembles a summary.

«Last year was a very eventful and challenging year for Fannie Mae and Freddie Mac and the housing markets that they serve. To a large extent, the Enterprises rose to those challenges.

For the first time in four years, the Enterprises filed their annual financial statements on a timely basis. Significant progress was made in the remediation process, but OFHEO concludes that both companies remain classified as significant supervisory concerns. The primary reason for this classification has changed from previous years. The extraordinary declines in the housing and mortgage markets have greatly increased their credit and interest rate risks, which have put additional pressure on their credit management, interest-rate risk management and financial modeling processes.»

«Despite large losses in the second half of the year, the Enterprises were able to fulfill their key mission of providing stability and liquidity to the conventional conforming loan market. Their support of the mortgage market grew by 15 percent in 2007 versus 8 percent growth in 2006, to a total of \$5.0 trillion in guaranteed mortgage-backed securities outstanding and mortgage investments. Their market share of total mortgage originations grew from 37.4 percent in 2006 to 75.6 percent by the fourth quarter of 2007.»

«In last year’s report, I wrote that a key indicator of remediation progress at the two Enterprises would be the timely filing of their annual reports with the Securities and Exchange Commission

⁶⁴⁷ OFHEO AR 2008 p. 5.

⁶⁴⁸ FHFA AR 2008 p. 98/104.

⁶⁴⁹ Beginning of the letter of transmittal, p. i.

(SEC), with a clean audit opinion based upon a controls-based audit. In February 2008, Fannie Mae achieved that goal and Freddie Mac produced timely financial statements with a clean audit opinion. Freddie Mac expects to register with the SEC this summer.»⁶⁵⁰

«OFHEO believes that to better fulfill their mission of providing stability, liquidity and affordability to the housing market the Enterprises need to raise additional capital. Therefore, in mid-March, we reached an agreement with Fannie Mae and Freddie Mac to lower the “OFHEO-directed” 30 percent additional capital requirement to 20 percent and, in return, both companies agreed to raise significant capital.

OFHEO still believes that a stronger GSE regulator is needed to ensure their ability to fulfill their mission and help restore confidence to the mortgage market. In the March agreement both Fannie Mae and Freddie Mac agreed that a “world-class regulatory structure” is needed and “renewed a shared commitment to work for comprehensive GSE reform legislation.” The time to act on the legislation is now.

The challenges of 2007 are still present this year. The problems in the housing markets are continuing. OFHEO expects that Fannie Mae’s and Freddie Mac’s Consent Agreements will be lifted in the near-term and all major internal control issues should be remediated this year. It is my hope with the completion of their remediation efforts, significant additional capital and an enhanced regulatory regime we will end 2008 with the stakeholders in the nation’s housing finance system much stronger than today.»⁶⁵¹

It seems quite remarkable that the conclusion that more capital is needed is followed by the information that the capital topping-up requirement has been lowered from 30 to 20%. And that the 10% is replaced by the vague “significant”. Why not from 30 to 40%, and why no percentage instead of “significant”? Why no remark about the relation between capital and the size of the risk?

The assessment “To a large extent, the Enterprises rose to those challenges” and the concluding paragraph show that the risks of the given situation are badly underestimated. It seems rather inconsistent that AR 2008, like the earlier AR, tacitly assumes that OFHEO is in control and can manage, and at the same time complains about inadequate legislation and authority. OFHEO never indicated what difference more authority would make. For that reason it is far from obvious that more authority will have a significant positive effect. Changing the law for the GSEs (and other laws!) may be much more beneficial.

Executive Summary of the Annual Examinations of the Enterprises.

The second paragraph gives a summary of the summary:

«Fannie Mae and Freddie Mac made progress in remediating many of their operational issues including timely filing of their financial statements. However, they remain significant supervisory concerns.

They both experienced poor financial performance in 2007 largely due to the rapid deterioration in credit performance associated with house price declines and disruption of the mortgage markets. Market value declines in derivatives caused by falling long-term interest rates also generated substantial losses.»

The section *Risk and Risk Management* suggests that in the year under review the risks have increased. Instead of noticing that risks which already existed for a long time, are been realized due to the growth of the corresponding destabilizing disturbances. And that this may be the start of a crash or other unwanted scenario. Some risks have been realized, and the probability of various scenarios has changed. Those of harmful scenarios increased at the detriment of those of positive developments.

The second half of the section reads as follows:

⁶⁵⁰ OFHEO AR 2008 p. ii. Note that the text assumes that annual reports are important.

⁶⁵¹ OFHEO AR 2008 p. ii. The layout has been changed slightly. In the original “OFHEO still” does not begin a new paragraph.

«OFHEO found interest-rate risk management at both Enterprises generally to be satisfactory, although Fannie Mae's risk management strategy is somewhat aggressive in light of higher and increasing credit-related losses. OFHEO identified shortcomings with certain risk measurement systems at both Enterprises.

Liquidity risk management was satisfactory at both Enterprises.

Both Enterprises significantly improved their model risk management in 2007, but rapidly changing market conditions significantly increased model risk, particularly for credit and prepayment models. Given the lack of historical precedent for current conditions and the fact that models are estimated based on historical experience, Enterprise models have become less reliable and require greater management judgment, increasing the potential for error in pricing and other metrics.»⁶⁵²

“Lack of historical precedent”? Haven't there been bubbles and crises before? Many actually! Have such events been left out of consideration? As being too improbable? Or too complicated to take into account? “Less reliable” or “unreliable”? “Management judgment” or “theoretical estimates”?!

What about the GAO and systemic risk scenario's? Because of their crucial importance for the reliability of the outcomes of the model calculations, assumptions like this should have been included in the annual report (and in those of the GSEs).

After this discovery, what is the reader to think of the “satisfactory” interest-rate risk management and liquidity risk management?

The GSEs both accomplished their principal accounting tasks.

In both enterprises there remain internal control issues however. Continuation of the improvement efforts is necessary.

«Capital.

Consistent with requirements of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, OFHEO classified both Enterprises as adequately capitalized for year-end 2006 and all four quarters of 2007. Given the losses the Enterprises sustained in 2007, the regulatory core capital of each declined at an accelerating pace through the year, with Freddie Mac failing to meet the OFHEO-directed capital requirement at the end of November (without year-end accounting adjustments). To ensure ongoing capital adequacy, both took aggressive action in the latter part of the year, including reducing dividends and issuing preferred stock, as well as controlling growth and actively managing balance sheet composition. Improved capital planning and income forecasting are necessary to ensure that the Enterprises' capital needs are comprehensively assessed and capital maintained at an adequate level.»⁶⁵³

Is it plausible that the GSEs will be able to do so?

It is furthermore strange that OFHEO does not wonder what will happen if the negative development continues, and is not reversed. There is after all no sign of improvement, and even less of lasting improvement. OFHEO is silent about these things. Is it reasonable to assume that the GSEs can survive a continuation of the present situation, or a worsening? What if not?

OFHEO shows no signs of critical thinking, and of a proactive attitude.

Home prices decline. According to this AR, decline in home prices means more foreclosures:

«The Highlights article associated with the third quarter HPI [house price index] release studied the correlation between mortgage foreclosures and house price appreciation. The article discussed the bidirectional association between the two, noting that relatively intense foreclosure activity causes and is caused by home price declines. The close association between home value changes and foreclosures was illustrated for states and the 100 largest MSAs. A brief empirical study was then undertaken to determine whether, within select cities, high-foreclosure ZIP Codes had experienced greater price declines than other areas.»⁶⁵⁴

⁶⁵² OFHEO AR 2008 p. 1/7.

⁶⁵³ OFHEO AR 2008 p. 2/8.

⁶⁵⁴ OFHEO AR 2008 p. 71. The Highlights articles accompanied the 2007 house price index (HPI) releases.

So a fall in home prices will cause a fall in derivatives values, as visible in dramatic fall of the ABX index. As pictured in the graphs shown in the Chronicle, under 2006.

OFHEO fails to see current events in the light of its own systemic risk report of 2003:

«The structure of OFHEO's risk based capital stress test, which takes into account the likely effects on earnings over time of changes in Enterprise activities, home prices, and interest rates, implies that changes in an Enterprise's risk will be quickly reflected in its risk-based capital requirements and, if appropriate, in its capital classification.»⁶⁵⁵

Instead, the capital top-up is reduced from 30 to 20%, and for the capital to be raised by the GSEs themselves no amounts are mentioned. The capitalization qualification is not downgraded («OFHEO classified both Enterprises as adequately capitalized for year-end 2006 and all four quarters of 2007»), and no warning is given.

FHFA AR 2008.

The pdf-file is dated 8/4/09, and modified 3/9/09. Unlike the custom of OFHEO, the report concerns 2008.

The FHFA was created 30/7/08, to replace OFHEO.⁶⁵⁶ It may be assumed that only the name and formal framework have changed, and that the people who work at the FHFA are those who worked at OFHEO.

The GSEs were placed in conservatorship on 6/9/08.⁶⁵⁷

The FHFA AR 2008 has no (Executive) Summary as the OFHEO AR 2008. It does have a chapter *Year In Review*, with on p. 17/23 a section *Enterprise Conservatorships and Treasury Support*.

The letter of transmittal.

The letter is signed by James B Lockhart III. In the second paragraph he asserts:

«Although this is my first report as Director of FHFA, I previously submitted three reports as the Director of the Office of Federal Housing Enterprise Oversight (OFHEO). In each of these reports, I called for regulatory reform of Fannie Mae and Freddie Mac, including greater authority over the Enterprises' capital requirements and portfolio size.»

The «greater authority over the Enterprises' capital requirements» is hard to reconcile with the reduction of the top-up requirement from 30 to 20% which he allowed according to OFHEO AR 2008.⁶⁵⁸ And the total absence of any critical discussion of any capital requirement in the AR up to now. The next paragraph in the letter seems to have forgotten what OFHEO did in 2007:

«In July of 2008, the Federal Housing Finance Agency was created by HERA after years of debate and discussion by Congress.⁶⁵⁹ Unfortunately, the legislation came too late to prevent the over-leveraging of the Enterprises. Even with OFHEO's extra capital requirements and portfolio restraints, the Enterprises legally held total mortgage credit over 90 times the second quarter shareholders' equity.»

OFHEO (Lockhart) could always have written in the AR that it considered GSEs over-leveraged. It could have noted that the present formal requirements guaranteed nothing. OFHEO could and should always have been much more restrained in its formulations, and have avoided unqualified approval.

Lockhart could have noted too that his predecessors Falcon and Blumenthal had made legislative recommendations already as from AR 2002. In his first AR he simply copied what his predecessor had written.

⁶⁵⁵ OFHEO Systemic risk report p. 108/111.

⁶⁵⁶ FHFA AR 2008 p. 98/104

⁶⁵⁷ FHFA AR 2008 p. 17/23.

⁶⁵⁸ The request of regulatory reform is meaningless if nothing is known more specifically. Change is not always for the better.

⁶⁵⁹ HERA= Housing and Economic Recovery Act of 2008. It amends the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. See the letter of transmittal.

Especially in the light of even the recent past, the most important paragraph of the letter would seem to be the following:

«Throughout 2007 and 2008, OFHEO encouraged the Enterprises to conserve and raise additional capital to fulfill their mission as the risks in the mortgage market grew. By the summer of 2008, FHFA had serious concerns about safety and soundness weaknesses at the Enterprises related to credit risk, earnings outlook, capitalization, and the substantial deterioration in the market for their equity, debt, and mortgage-backed securities (MBS). The Enterprises' capital was threatened by increasing credit losses in their guaranteed and investment mortgage portfolios, which totaled \$5.2 trillion at year-end. In particular, their private-label MBS holdings, which represented 19 percent of their investments, deteriorated rapidly. Working closely with the Treasury Secretary and the Chairman of the Federal Reserve, I decided there was no other choice than to put Fannie Mae and Freddie Mac into conservatorship if they were going to be able to continue to fulfill their mission of providing stability, liquidity, and affordability to the market. If we had not put the Enterprises in conservatorship, we believe the downward spiral in the economy would have accelerated, because the Enterprises would have had to pull back dramatically from the housing market.»

Was it the conservatorship or taxpayers money that saved the day?

The wikipedia explains the concept of “conservatorship” as follows:

«In the United States, in some states, corporations can be placed under conservatorship, as a less extreme alternative to receivership. Whereas a receiver is expected to terminate the rights of shareholders and managers, a conservator is expected merely to assume those rights, with the prospect that they will be relinquished. Robert Ramsey & John Head, law professors who specialize in financial issues, suggest that an insolvent bank should go into receivership rather than conservatorship to guard against false hope and moral hazard.

At the federal government level in the United States, in July 2008, the failing IndyMac Bank was taken into administrative receivership by the Federal Deposit Insurance Corporation (FDIC) and its assets and secured liabilities transferred to a specially-established bridge bank called IndyMac Federal Bank, FSB which was placed into conservatorship, also by the FDIC.

Again, in the U.S. at the federal level, in September 2008, the chief executive officers, and board of directors Fannie Mae and Freddie Mac were dismissed, and the companies were placed into the conservatorship of the Federal Housing Finance Agency (FHFA) via the determination of its director James B. Lockhart III, with the support and financial backing of U.S. Treasury via Treasury secretary Hank Paulson's commitment to keep the corporations solvent. The intervention leading to the conservatorship of these two entities has become the largest in government history, and was justified as necessary step to prevent the damage to the financial system that would have been caused by their failure. Entities like this are considered too big to fail.»⁶⁶⁰

The letter says nothing about the far too positive picture OFHEO had given in its previous annual reports. The report has a section *Performance and Program Assessment*. It is discussed concisely below, after the summary of the examination reports.

Report of the Annual Examination of Fannie Mae.

«Summary.

At year-end 2008, the Enterprise had

- (1) a new Board and chief executive officer working with the conservator to restore the Enterprise's long-term viability;
- (2) depleted capital but a substantial backstop from the United States Treasury;
- (3) poor earnings from unprecedented credit expenses and declines in loan and securities prices;
- (4) high and increasing credit risk, primarily from declining performance in the single-family business line and concentrations in counterparties;

⁶⁶⁰ Wikipedia 26/5/16. The references have been dropped.

- (5) high market risk from aggressive interest rate risk limits and hedging strategies compounded by significant model risk; and
- (6) high operational risk that can be improved through additional automation of the control environment and a fully developed operational risk oversight function.»⁶⁶¹

Report of the Annual Examination of Freddie Mac.

«Summary.

At year-end 2008, the Enterprise had

- (1) new management and a new Board working with the conservator to stabilize the Enterprise;
- (2) depleted capital but a substantial backstop from the United States Treasury;
- (3) losses from unprecedented credit expenses arising from loan losses and declines in the value of securities;
- (4) rapidly growing credit losses and the declining financial capacity of counterparties;
- (5) high market risk from reduced liquidity, interest rate risk limits and significant model risk-leading to the need for on-top adjustments in hedging; and
- (6) heightened operational risk from growing transaction volumes in defaulted loan processing, combined with recent management and organizational changes.»⁶⁶²

Neither summary mentions the amount of money involved in the risks. Everything said is qualitative, even though money is quantitative.

The summaries do not tell whether the GSEs are adequately prepared for foreseeable and possible developments. What has to be done to improve the probability of (autonomous) survival, or to minimize the costs for the taxpayer?

At the end of the section *Examination Conclusions* of both examination reports, OFHEO lists *Matters Requiring Oversight*, which require “strong management and Board oversight” The formulations are imperative: “Adopt and implement...”, “Revise...”, “Strengthen...” (inside the GSEs). It is not clear what doing all this will yield.

Performance and Program Assessment.

The annual report has a chapter FHFA Operations and Performance. The chapter has two sections, Performance and Program Assessment, and Financial Operations. The first section is supposed to assess what FHFA accomplished in 2008. There is however no evaluation deserving of the name. Neither does the section look farther back than 2008. So as regards FHFA, no significant lessons are learnt.

In 2008 OFHEO engaged an independent auditor to verify and validate the performance information and to assist FHFA in preparation for an Office of Management and Budget (OMB) Circular A-123 audit. This audit must have the same character as that of accounting audits, which check the accounting without much regard for what the numbers and documentation stand for or hide. And whether the performance is sufficient to realize the goals or mission.

The section refers to FHFA PAR 2008.⁶⁶³ This PAR includes the 2008 PAR of both FHFA and OFHEO. The FHFA chapter describes and considers only the situation and activities, especially the placing in conservatorship, and the future (“management challenges”). There is no evaluation. Although according to p. 10 strategic goal 1 of 3 is:

«Enhance supervision to ensure that Fannie Mae, Freddie Mac and the Federal Home Loan Banks operate in a safe and sound manner, are adequately capitalized and comply with legal requirements.», and although it is obvious that the GSEs did not «operate in a safe and sound manner».

⁶⁶¹ FHFA AR 2008 p. 23/29.

⁶⁶² FHFA AR 2008 p. 39/45.

⁶⁶³ Pp.86-7/88-9 of FHFA PAR 2008 give a useful description of the role of Fannie and Freddie in the (secondary) mortgage market.

Neither does the PAR (or any other document consulted) discuss the potential conflict between goal 1 and goal 2:

«Promote homeownership and affordable housing and support an efficient secondary mortgage market.»

Nothing is said about the compromises this was and is thought to require.

The chapter with the OFHEO PAR includes a subsection *OFHEO Substantially Achieved Its Performance Goals*. This is a kind of evaluation. It is no better than the applied “performance measures”.

«OFHEO achieved or substantially achieved all but one of its performance goals in FY2008. The performance section outlines in detail the agency’s performance goals for each strategic goal and its accomplishments related to each goal and performance measure. Performance goals are achieved when targets for all performance measures have been achieved. Substantially Achieved indicates that at least one performance target has not been achieved, although a substantial majority of the targets related to the goal were met. In FY2008, OFHEO achieved 76 percent of its performance measures, compared to 82 percent in FY2007. The agency substantially achieved 5 percent of performance measures in 2008 versus 15 percent in 2007, and did not achieve 16 percent in 2008 compared to 3 percent in 2007. Data for one performance measure in 2008 were not available at the time of publication. The majority of measures not achieved in FY2008 were affected by changing priorities at the agency, the passage of HERA and the deteriorating market conditions throughout the year.»⁶⁶⁴

The need to place GSEs in conservatorship and use lots of taxpayers money to keep them afloat shows unambiguously that the GSEs were not safe and sound. Given OFHEO’s past performance as witnessed by its annual reports, one has to conclude that for many years OFHEO failed terribly and structurally. (It even failed to remember, and act upon, its own 2003 systemic risk report). The annual reports moreover give no reason to believe that regulation is to blame. Regulation certainly was inadequate. But even good regulation works well only in combination with a honorable and competent supervisor. OFHEO failed to analyze competently, and report honestly. In fact, OFHEO contributed to a false feeling of safety and soundness.

The overwhelming problems of the GSEs, and the incompatibility of this fact with the performance as measured using the performance measures should have been reason to conclude that the performance measures are inadequate, and to find the deficiencies. The report doesn’t.

Strategic goal 1 and measure 1.1 are a case in point. They show that a non-formal goal which is OK in itself is identified with a formal goal, which obviously does not adequately represent the informal goal. To enable the reader to judge the significance of the individual goals, we quote the three strategic goals:

1. «Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements.
2. Provide support for statutory reforms to strengthen our regulatory powers.
3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.»⁶⁶⁵

Attainment of goal 1 is split into the following subgoals:

1. «The Enterprises comply with safety and soundness standards.
2. Ensure the Enterprises are adequately capitalized.⁶⁶⁶
3. Ensure the Enterprises comply with applicable laws, regulations, directives and agreements, including executive compensation, corporate responsibility and disclosure.
4. Strengthen regulatory infrastructure to enhance the supervision of the Enterprises.»

The problem is that given the (non-formal) strategic goal 1, it is assumed that the formal norms 1, 2 and 3 are a reliable representation, or rather guarantee, of safety and soundness.⁶⁶⁷ The assumption is

⁶⁶⁴ FHFA PAR 2008 p. 99/101. Note that performance is thought to be quantifiable.

⁶⁶⁵ FHFA PAR 2008 p. 98/100.

⁶⁶⁶ OFHEO means: adequate in the formal sense.

⁶⁶⁷ How can one speak of safe and sound without a guarantee?

not analyzed or discussed. Worse, the catastrophic events do not lead OFHEO or FHFA to the conclusion that the formal requirements are inadequate.

Note that a good score on subgoal 3 would mean that the problems at the GSEs are solved, or almost. (If not, the subgoals do not sufficiently cover the duties of the supervisor). This would seem to contradict the results of the various examinations.

These observations support the conclusion of the insufficient critical attitude of OFHEO/FHFA.

Testimony of director Falcon before the FCIC on 9/4/10.

The following is quoted from Falcon's opening speech at the hearing.

«Before OFHEO's budget request even went to the Congress for consideration, the agency's request first went to the office of management and budget for review and approval. We received very large budget cuts at OMB, until about 2003, when our requests began to receive more favorable consideration. A few years later, when OFHEO needed additional resources to conduct a special examination of Fannie Mae's accounting practices, we encountered more difficulty and delay. Fannie's lobbyists were on the Hill spreading misinformation about my motives and asserting that the special exam was unnecessary. We eventually received the funding and finally we had the resources to dig deeply into Fannie Mae's accounting. It wasn't long before we realized that Fannie Mae's problems were even worse than Freddie Mac's. The enterprise's arrogance manifests itself into many efforts to obstruct the regulatory process. Let me describe just a few. The first involves the circumstances around my forced resignation, on February 4th, 2003, a year and a half before the expiration of my term. At that time the agency was preparing to release a new research report that analyzed the systemic risks created by the enterprise's growing portfolios, debt, and role in the mortgage market. We needed to be sure the agency and others in government fully understood the nature of their systemic risks, how to minimize it, and how to deal with it if the companies ever experienced financial problems. The enterprises did not want the agency conducting such a study and certainly did not want it released to the public. At that time they were doing everything possible to convince the public and policy makers that their operations did not pose any systemic risk to our financial system. A few days before the agency was scheduled to release the systemic risk report, the Chairman of Fannie Mae, Franklin Raines, called me to protest about the release of the report and its conclusions. He urged me to not to release it, and when I reaffirmed my plans, he threatened to bring down me and the agency. Our call was over and I soon received another call from a Treasury official who stated that Fannie Mae's lobbyists were calling other agencies to urge them to press OFHEO not to release the systemic risk report. He asked for a copy, which I provided, and he respected my decision not to delay its release. A few days later, on February 4th of 2003, I was in New York to give a speech on the findings of the report, which was being released that day. In the morning, as I was waiting to give my speech, I received a call from the White House personnel office, who informed me that the White House was issuing an announcement on the nomination of someone to replace me as director of OFHEO. By the way, it was not Director Lockhart, it was someone in between. I informed the personnel official that their announcement would seem odd since there was not a vacancy in the position. I asked the official to withhold the announcement for a day while I considered my options. They declined and I issued a resignation letter later that day. The next day's news emphasized coverage of the personnel change and gave very scant coverage to the findings of the systemic risk report. This was, of course, exactly the result intended by those who engineered the timing of the announcement of my replacement. The White House eventually withdrew its nominee and I remained in office for two more years. In 2004, as OFHEO began its special accounting examination of Fannie Mae, the political attacks and efforts at obstruction intensified. Fannie was uncooperative with document requests and they engaged their supporters in Congress for assistance. And as described in OFHEO - in the OFHEO - OFHEO special exam report, in April of 2004, Fannie Mae executives acted on a plan to have a key senior - key senator initiate an investigation of OFHEO by the HUD Inspector General. The goal was to try to discredit the agency in advance of its report on Fannie's accounting practices. The intrusive nature of the IG review was clearly designed to intimidate OFHEO personnel and distract them from their work. The IAG eventually concluded that the agency had done nothing improper but wrote a very biased report designed to curry favor. Later, in September of 2004, the Senate Appropriations VA HUD

subcommittee passed the bill that provided funding for OFHEO's budget in 2005. The bill included specific language stating that 10 million of the agency's 2005 budget could not be spent until I was removed from office. The language was later removed from the final appropriations bill. Also in that same month, OFHEO released its risk report on the accounting misconduct at Fannie Mae and we took supervisory actions to correct the problems. I was summoned before the House Financial Services Committee to testify on the findings of the report. It was a vast understatement to say that I was met with a well-orchestrated effort to discredit the report and my character. One member of the committee even accused me of conducting a, quote, political lynching. It was a shameful day in the committee's history, which I worked at that committee for eight years and another example of the dangerous political power Fannie Mae had amassed.»⁶⁶⁸

The dossier contains an article about this hearing which appeared in *The Nation* on 14/4/10. The article calls Falcon a whistleblower, apparently on the basis of this testimony. Falcon is supposed to have been fired because of a too critical attitude. This may be true. But the critical attitude does not appear in OFHEO AR 2002 and 2003. In these reports Falcon asks Congress for more authority, but the reports do not explain the reasons why. There is nothing else in the reports that can be called critical. The reports claim that all goes well at the GSEs. If the critical attitude refers to the special examinations which OFHEO held 2002-5 (!) (see AR 2003-6) and in which it discovered accounting and other malpractices and shortcomings, then Falcon's testimony cannot be called whistleblowing. OFHEO only did its job, though late, if not too late. And even during the special examinations it published falsely reassuring examination reports. It seems clear nonetheless that excessive pressure was exerted on Falcon and OFHEO, and that their situation was complicated and very difficult. Still, the text of the annual reports remains misleading and unexplained. In any case, the article in *The Nation* confirms that responsible officials can successfully use the hearings to exculpate themselves, and that the FCIC supports these efforts by not rigorously trying to find the truth, and by not correcting half truths or lies.

The article is an example of journalism of the day, which neglects to do its homework, and fails to place new events in the context of relevant (historical) information. The example shows that homework is necessary for proper evaluation of a day's events. Note that the article in *The Nation* does not restrict itself to the facts, but passes judgment as well.

At this point the text of the chronicle for especially the weeks between 22/8 and 4/9 could be inserted. As noted under the Summary and conclusions of the present appendix, in these weeks OFHEO/FHFA made a complete turnaround in its opinion about the GSEs. A turnaround which it did not explain, and which the FCIC noted but did not try to explain. It is easy to list a number of factors which may play a part in an explanation, but such a list does not constitute an explanation. The turnaround anyway is in agreement with, and underlines, the ambiguity and inconsistency of the opinions voiced by OFHEO and FHFA in the annual reports discussed above.

The situation seems to allow for one very important conclusion though. And that is, that neither lack of authority, lack of budget, or inadequate regulation can explain the inconsistencies. Neither can they explain the failure to account for the turnaround, and the absence of a will to explain it.

⁶⁶⁸ Transcript of the FCIC hearing on 9/4/10.

19. OTS: the annual reports 2007 and 2008.

Note. The US tax year runs from 1 October until 30 September. This is the year the OTS annual reports refer to.

OTS is the abbreviation of Office of Thrift Supervision.

Conclusions.

1. OTS is a bag of unmitigated false pretensions. OTS makes no mistakes.
2. Realism and modesty are completely absent.
3. This attitude precludes internal criticism and improvement. It means repressive management.
4. The annual reports report only very sketchy. No problems, threats, or worrying events or developments are reported until after the crash. No warnings are given.
5. After the crash no analysis is given of any of the events or developments which were or are most relevant to OTS. There is no explanation or accounting of its own conduct in the past. There is no acknowledgement of errors.
6. The crisis is explained by an economic downturn and by weakening of the home market. It is not noted that this implies that the risk management was insufficient.
7. On the basis of OTS AR 2007, at the latest, Congress and Administration should have intervened. (There is no OTS AR 2006 for example). The appointment of Reich may have been sold as a solution of earlier problems, but Reich was obviously unsuitable, and both Reich and OTS should have been closely monitored.
8. The annual reports do not show how the institutions were supervised. No general rules, methods, or practices of supervision are mentioned. There is no reflection on OTS methods, not even after the crash. No weak or strong points are identified.
9. In accordance with the “we wash our hand in innocence” conclusion and attitude no lessons are learnt.
10. With organizations like OTS, catastrophes are assured.

About OTS.

1. According to OTS AR 2007.

«OTS Mission

To supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America’s financial services needs.»⁶⁶⁹

«The OTS is the federal bank regulator and supervisor of a dynamic and diverse industry of savings associations and their subsidiaries across the nation. The OTS also oversees domestic and international activities of the holding companies and affiliates that own these thrift institutions.

The OTS is an office within the Department of the Treasury. The agency oversees 831 thrift institutions with assets of \$1.57 trillion, as well as 470 thrift holding companies with U.S. domiciled assets of about \$8.5 trillion.»⁶⁷⁰

«The OTS examines each savings association every 12-to-18 months to assess the institution’s safety and soundness, and compliance with consumer protection laws and regulations. In addition, examiners monitor the condition of thrifts through off-site analysis of regularly submitted financial data and regular contact with thrift personnel. OTS examinations and its ongoing supervisory oversight are tailored to the risk profile of each institution.

The OTS receives no appropriations from Congress; the agency’s operating budget is funded by

⁶⁶⁹ OTS AR 2007 p. 2.

⁶⁷⁰ OTS AR 2007 p. 9.

periodic assessments to the thrift industry.»⁶⁷¹

«The OTS has a highly skilled staff of more than 1,000 employees operating out of its headquarters in Washington, D.C., and five regional offices in Jersey City, Atlanta, Chicago, Dallas and San Francisco.»⁶⁷²

2. According to the Wikipedia (7/2/13).

«The Office of Thrift Supervision (OTS) was a United States federal agency under the Department of the Treasury that chartered, supervised, and regulated all federally chartered and state-chartered savings banks and savings and loans associations. It was created in 1989 as a renamed version of another federal agency (that was faulted for its role in the savings and loan crisis). Like other U.S. federal bank regulators, it was paid by the banks it regulates. The OTS was initially seen as an aggressive regulator, but was later lax. Declining revenues and staff led the OTS to market itself to companies as a lax regulator in order to get revenue.

The OTS also expanded its oversight to companies that were not banks. Some of the companies that failed under OTS supervision during the financial crisis of 2007–2010 include American International Group (AIG), Washington Mutual, and IndyMac.

The OTS was implicated in a backdating scandal regarding the balance sheet of IndyMac.

Reform proposals from Henry Paulson, President Barack Obama, and the U.S. Congress proposed to merge the OTS with the Office of the Comptroller of the Currency. Section 312 of the Dodd-Frank Wall Street Reform and Consumer Protection Act mandated merger of OTS with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board of Governors, and the Consumer Financial Protection Bureau (CFPB) as of 21 July 2011. The OTS ceased to exist on 19 October 2011.»⁶⁷³

History repeats itself. Or rather: those responsible repeat the errors of their predecessors:

«The OTS was established in 1989 in response to the savings and loan crisis. On television, President George H. W. Bush said, “never again will America allow any insured institution operate without enough money”, and “trashed” the predecessor Federal Home Loan Bank Board; soon thereafter, the sign was changed to the “Office of Thrift Supervision”.»⁶⁷⁴

OTS was paid by those being supervised:

«OTS did not receive a government budget; instead, they were paid by the banks they regulate, like other U.S. federal bank regulators. Other regulatory agencies like the OTS include the Office of the Comptroller of the Currency, the FDIC, the Federal Reserve System, and the National Credit Union Administration.»⁶⁷⁵

The director of the OTS was nominated by the president of the US. In this case G W Bush. The nominee is confirmed by the Senate (or not).

«Reich took the oath of Director of OTS on August 9, 2005 and continued in that capacity as well as serving as a member of the FDIC Board of Directors until he resigned on February 12, 2009 and stepped down February 27, 2009.»

His previous job was that of director of the FDIC.

The wikipage about John M Reich says the following:

«Under Director Reich, the Office of Thrift Supervision saw the failure or near-failure of at least five major institutions - IndyMac Bank, AIG, Washington Mutual, Downey Financial and Country-wide Financial. These constituted some of the largest financial failures in modern history to that point.

⁶⁷¹ OTS AR 2007 p. 10.

⁶⁷² OTS AR 2007 p. 9. I could not find a more precise number in this report.

⁶⁷³ Wikipage OTS 7/2/13.

⁶⁷⁴ Wikipage OTS 7/2/13.

⁶⁷⁵ Wikipage OTS 7/2/13.

OTS later acknowledged that in the case of AIG it failed to take regulatory actions it should appropriately have taken as early as 2004. In the case of IndyMac, after Director Reich and OTS both denied responsibility for the failure, the Office of Inspector General of the United States Treasury found that OTS both inappropriately failed to act and inappropriately and knowingly allowed regulatory misconduct.»⁶⁷⁶

OTS AR 2006.

There is no annual report for 2006. The first paragraph of the *Message from the Director* in OTS AR 2007 gives an explanation:

«This Annual Report is the first such report from the Office of Thrift Supervision in many years, just one of several “firsts” since I came on board as OTS Director in August 2005.»

The paragraph is symptomatic for the vanity of this Director.

Note that the absence of annual reports was visible for everyone with eyes in his head, and should have alarmed every other financial supervisor, not only in the US. If not made them inquire and/or act.

OTS AR 2007.

(The file is dated and modified 19/12/07. There is no linked table of contents).

«It is reassuring to know that one can depend on our federal government and people such as yourself in those rare instances when the system fails the individual. — Letter from consumer to the OTS»⁶⁷⁷

To err is human.

Evaluative conclusions.

1. OTS is one and all false pretension.
2. Realism and modesty are entirely absent.
3. It reports only very sketchy about its activities, policies and so on. No problems or worrying developments are reported. No warnings are given.
4. Nothing is said about the problems at Countrywide, and its take over by Bank of America in October 2007.⁶⁷⁸
5. There is no analysis of the events, and no explanation of, and accounting for, OTS activity and passivity.
6. For these reasons Congress and Administration could and should have intervened.⁶⁷⁹
7. The AR does not describe the way(s) OTS supervises. How OTS monitors, investigates, and evaluates a representative institution. Let alone a critical discussion of this: strong and weak elements, uncertainties and risks remaining.⁶⁸⁰

Tabel of contents (“On the Inside”).⁶⁸¹

⁶⁷⁶ Wiki page of 20130207, in the directory USA/OTS.

⁶⁷⁷ OTS AR 2007 p. 33.

⁶⁷⁸ In OTS AR 2007 Countrywide is mentioned twice. Once is a list, and the second time in the following sentence on p. 23: «Major developments in the region in the past two years included the conversion of the nation’s largest mortgage lender- Countrywide- to a thrift.»

⁶⁷⁹ Of course, there was no need to wait for AR 2007. They should not have accepted the absence of annual reports in the preceding years. Note that the events and the annual report are compatible, and that the inadequacy of the AR is representative of the OTS.

⁶⁸⁰ This also applies to OTS AR 2008.

⁶⁸¹ Layout modified slightly. But the order page number - chapter title is retained. Other page numbers than those quoted are not given in the AR.

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Year in Review. (Possibly meant as an introduction to the reports per region).

The first paragraph reads as follows:

«Although 2007 has been a busy year, we all should have a deep sense of satisfaction that our work has made a difference for the institutions we supervise and their customers. The unprecedented turmoil in the mortgage market in 2007, and the resulting impact on our thrifts, has showcased our remarkable talent within the agency. We have more work to do, though, and 2008 will be an exciting year as we continue our hiring initiatives and expand our outreach efforts. Our goal remains to position OTS as both a premier regulatory agency and a great place to work.»⁶⁸²

This is not just too optimistic or rose-colored. This is a pack of lies, and completely misplaced self adulation. This is not just ridiculous by hindsight. The claims are not supported by any evidence. Rather the contrary. The most serious problem is however, that such propagandistic language (reminding one of the worst dictatorships of the 20th century) makes criticism and every process of self-correction impossible. This kind of language is actually repressive, especially towards conscientious employees.

Strategic Focal Points.

The introduction declares that the “thrift charter” has seven focal points. In this chapter of the annual report they are described concisely. Below all of them are mentioned. But only those parts of the descriptions are quoted which seem to be necessary for explanation or in a wider context.⁶⁸³

⁶⁸² OTS AR 2007 p. 13.

⁶⁸³ In the AR every focal point is followed by two key sentences in different layout, followed by some text. Here the key sentences are quoted in full. If text is copied at all, it is copied unabridged.

«1 Consolidated Supervision.

Consolidated Supervision of Savings Associations and Their Holding Companies Streamlines Regulatory Oversight.

Seamless supervision of both entities minimizes regulatory duplication.

The OTS utilizes a flexible and seamless approach to its supervisory oversight. Thrift holding companies and affiliates, which range from noncomplex companies with limited activities to large, internationally active conglomerates, are examined concurrently with their thrift subsidiaries. OTS examinations are supplemented by off-site monitoring. For the most complex holding company structures, we conduct continuous supervision. We also streamline our process by coordinating our examination and supervisory efforts with other bank regulatory agencies and functional regulators of related entities, such as securities firms and insurance companies.»

«2 Preemption.

Unsurpassed Strength of Federal Preemption Authority.

Uniform national framework under federal thrift charter permits conducting nationwide operations under a single set of federal laws and regulations for lending and deposit taking.

Federally chartered savings institutions operate under a nationwide scheme of oversight and supervision that is free from the duplication and burden of overlapping regulations by state and local governments. This nationwide lending and deposit taking authority is provided directly by federal statute and has been consistently upheld by the courts, including the U.S. Supreme Court. Pursuant to this authority, the OTS occupies the field with respect to the oversight of the lending and deposit taking activities of federal thrifths. The OTS administers this authority to ensure maximum flexibility for thrifths to deliver low-cost credit and other services to the public, consistent with strong and appropriate consumer protections, and safe and sound banking operations»

A monopoly needs thorough supervision. Experience shows that unsurpassed power is extremely risky. As the OTS case underlines.

«3 Branching.

Nationwide Branching Offers Room for Growth.

The thrift charter provides the freedom to establish branches across state lines without restriction or condition.»

«4 Diversity.

The Flexible Framework of the Thrift Charter Appeals to a Wide Range of Business Operating Strategies.

Modern business strategies venture far beyond the traditional thrift model.»

«5 Mutuality.

Mutual Ownership of Thrifths Supports America's Communities.

People who work together and live together can combine financial resources for a brighter economic future.»

«6 Regulatory Approach.

The OTS Is Dedicated to Expert, Responsive Supervision.

Regulatory approach defines clear boundaries while minimizing burden.»

«7 International

The Thrift Industry Is Part of a Global Financial Marketplace.

Worldwide financial conglomerates supervised by the OTS operate in more than 100 countries.

OTS-supervised holding companies hold about \$8.5 trillion in U.S. domiciled assets. As these enterprises continue to expand their international operations, OTS officials are further extending their

coordination with international regulators to ensure effective supervision with minimal regulatory overlap. In a striking sign of how well other nations regard the quality of OTS supervision, the OTS has achieved the designation under European law as the equivalent consolidated supervisor for GE Capital Services, Ltd., AIG Inc. and Ameriprise Financial Group. With the growing globalization of financial services, the OTS works with fellow regulators across the world to gain a broad international perspective on each commonly-supervised firm's risk profile and financial performance».

Please take note that “the OTS has achieved the designation under European law as equivalent consolidated supervisor”. This obviously was a major error. Who gave this “designation”?

OTS Regions.

In this part of the annual report supervisory work is touched upon, but most of the pages are devoted to subordinate activities, such as staffing and outreach meetings with CEO's of supervised institutions, to discuss problems and possibilities of improvement.

The section about the northeast region includes the following paragraphs:

«The region is also distinguished by firms such as ING, which have an international focus, and Wall Street companies, such as Lehman Brothers and Morgan Stanley, which have been major participants in the mortgage securitization market. These large, complex institutions own OTS-chartered savings institutions.

OTS Northeast Region examiners travel to small towns in upstate New York and West Virginia to examine traditional community-based institutions. They also travel abroad to examine the diverse activities of thrift holding companies in countries such as India, France and the Netherlands. The complexity of these international firms and their activities requires a highly-trained, experienced staff with specialty expertise in many financial services products.»

So OTS also supervised (parts of) the Dutch bank ING. This bank would later need taxpayers money because of its large Alt A portfolio (of which the risks had been underestimated).

The next quote is taken from the section about the West Region:

«The OTS West Region supervises institutions that hold about half of all thrift assets nationwide, including the top three federally regulated thrifts in asset size: Washington Mutual Bank (WAMU), World Savings Bank, FSB, and Countrywide Bank, FSB. The region expends significant resources to supervise these and other large thrift institutions. Yet the region is also responsible for small thrifts like Del Norte Federal Bank in southern Colorado, as well as other institutions of varying sizes across the American West and as far away as Alaska, Hawaii and Guam.

The complexity of the large institutions that have pioneered new kinds of mortgages demands a regional examination staff with deep expertise in innovative products and the ability to keep pace with rapid change. Examiners frequently must find innovative approaches to supervision. Ensuring sound loan underwriting, adequate disclosures and strong risk management has been particularly challenging for OTS West Region examiners in the current competitive, aggressive financial services marketplace.

Some thrifts in the OTS West Region have been offering non-traditional mortgage products for decades, including adjustable-rate mortgages and interest-only mortgages. OTS examiners are well-versed on how institutions can manage and mitigate the risks associated with these products to keep their operations safe and sound, and provide consumers with adequate disclosure and protection.

Examiners apply this specialized knowledge to their work with smaller thrifts and growing regional institutions. Regional officials also apply this expertise to help the agency's policy-makers craft industry guidance and address emerging challenges of national significance, such as the recent interagency guidance on nontraditional mortgage products. The OTS West Region also plays a leadership role in developing and implementing new tools to improve supervision and examination processes, such as using electronic loan data to analyze risks in loan portfolios, creating enhanced financial monitoring tools and implementing electronic tools to analyze Bank Secrecy Act risks.»⁶⁸⁴

⁶⁸⁴ OTS AR pp. 22-3.

Don't forget that the "innovative products" were already in use for over a decade. Note the nonsensical arrogance of "OTS examiners are well-versed on how institutions can manage and mitigate the risks associated with these products to keep their operations safe and sound, and provide consumers with adequate disclosure and protection".

The claims and assurances of this text are untruthful, uncritical, and utterly misleading. The "safe and sound", and the "adequate disclosure and protection" were simply untrue. The pdf file of the annual report dates from December 2007. In spite of what had already happened, we see no trace of doubt and prudence, and no awareness of the possibility that the supervised institutions are not as safe and sound as needed, and of the fact that the supervisors (examiners) don't see and understand everything (risk management!). And of the relativity of the concepts of safe and sound.

The above quote is everything the section reports about the execution of the supervision. The two other pages are devoted to the same subordinate matters as discussed for other regions.

The West Region was managed (until and including 2008) by Darrel W. Dochow. According to the wiki page OTS this person played an important role in the "savings-and-loan scandal of the 1980s". He permitted "IndyMac to backdate a capital infusion of \$18 million from its parent company so that the bank would appear "well capitalized" in its 10-Q [form for the SEC] for the period ending 31 March 2008". Among other forms of misconduct. How does OTS explain that it appointed and kept this man in a top position?

OTS Operations- **Supervision and Consumer Protection** (pp. 25-35).

«Condition of the Thrift Industry.

The thrift industry performed well during fiscal 2007 and measures of financial condition remained sound, despite challenges for home lenders.»⁶⁸⁵

This seems to be meant as a summary. The next paragraph notes that since 2005 the US housing market is "weakening". But

«Despite these pressures, earnings for the year were positive and capital levels remained strong.»⁶⁸⁶

The next section discusses:

«Risk Modelling.

[...] OTS recently completed a major enhancement to the Net Portfolio Value (NPV) Model and began producing new reports using the Enhanced NPV Model. [...] The Enhanced NPV Model solidifies OTS's position as an industry leader in the high quality measurement of interest rate risk.»⁶⁸⁷

The section only discusses interest rate risk. Other risks seem not to exist or be seen. This is consistent with what one can read between the lines of this annual report. To wit: that there are only independent unrelated institutions, without interactions. The OTS seems to have no notion of risks run by OTS institutions due to relations with other parts of the financial system.

On p. 26, in the middle of the left column, it is noted that net loan charge-offs have doubled in just one year. The possibility that this could have more than direct effects, especially if the trend continues, for example on the value and tradability of ABS and derivatives, is left unmentioned.⁶⁸⁸ Insufficient attention seems to have been paid to risks. OTS seems to have argued simplistically and mechanically: if capital is sufficient in the sense of the formal rules, then the institution is safe and sound. Which of course meant disregarding GAO, OFHEO and CGFS reports and warnings, common sense, and therefore incompetence for the job.

OTS AR 2008.

Supervising Through the Economic Crisis.

⁶⁸⁵ OTS AR 2007 p. 25.

⁶⁸⁶ OTS AR 2007 p. 25.

⁶⁸⁷ OTS AR 2007 p. 26.

⁶⁸⁸ In a very strict sense this may not be important for the OTS. But if so, and given the ambiguous and opaque organization of US financial supervision, it should at least have been noted.

(The pdf file was created and modified on 18/12/08. There is no table of contents with links. Take note: the subtitle speaks of an economic crisis, not of a financial crisis).

There is a graph of a time series 2004-2008 of OTS staff on p. 44/46 of this AR. (It doesn't give units: fte or persons for example). The number increases monotonously from 882 in 2004 to 1069 in 2008.

Conclusions.

1. According to this AR, the crisis was caused by an economic downturn, and/or cooling of the market for homes.
2. The bankruptcies of WaMu and IndyMac are mentioned, but the course of events is supposed to be known⁶⁸⁹ There is no analysis or explanation of the fact that this happened notwithstanding perfect supervision by OTS.
3. OTS doesn't take the bankruptcies to heart. Instead of self-criticism and self-evaluation there is self-adulation: most of the thrifths are still safe en sound, and this is due to the terrific devotion of the excellent OTS employees.
4. There is no sign of reflection on possible errors in the run-up to the crash. There is no evidence of lessens learnt. None at all.
5. OTS has a very limited idea of "risk". It doesn't treat the concept and phenomenon in a systematic way. The AR shows little or no awareness of other vulnerabilities than those for changes in interest rates. The crash could have drawn attention to the risks of worsening of asset quality. It should have made aware of the fact that the given formal capital requirements do not guarantee safety en soundness.

Table of contents.⁶⁹⁰

1	The OTS Supervising Through the Economic Crisis <i>Year of change and challenge</i> Introduction Message from the Director In Focus Year in Review OTS Profile and History
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⁶⁸⁹ OTS AR 2008 p. 6, 4th text block, beginning with "By the nature".

⁶⁹⁰ The layout has been simplified somewhat. The order pagenumber – chapter title is that of the original. The OTS AR like slogans. Under each of the the focal points in AR 2007 (on pp. 5 and following) one sees two slogans, each with its own layout. In AR 2008 even the part-titles in the table of contents has subtitles, in red italics (p. 3).

Financial Management

Message from the Director. (pp. 2-3/4-5).

There is no trace of awareness or acknowledgement of errors or failure. Rather the contrary: it is suggested that the causes lie outside OTS and the OTC domain of supervision.

«The crisis has centered on housing, so it has had a disproportionate impact on the segment of the industry the OTS regulates — a sector that by law focuses on home mortgages and other retail consumer lending activities. This impact has been severe enough to topple Washington Mutual, the largest OTS-regulated thrift, and IndyMac Bank. Both of these institutions were headquartered on the West Coast and much of their operations were in California, so their demise sent a shock wave through an already reeling regional economy.

Since the inception of the OTS in 1989, the story of the agency has been one of fortitude and resilience. Born in the aftermath of the S&L crisis of the 1980s, the OTS has defied periodic predictions of its demise and persevered in its mission of ensuring the safety and soundness of an industry that helps to keep alive the American dream of homeownership.

The next Presidential Administration and Congress will surely make an in-depth examination of the regulatory framework for insured depository institutions, securities firms and perhaps insurance companies. As I have emphasized in remarks during public appearances throughout the year, there are gaps in our regulatory coverage that must be closed. If we don't close them, unregulated segments of the market will continue to generate pressure that pushes everyone toward the bottom.

Although I have always been a voice against unneeded regulatory burden, I think the federal government has a clear responsibility to define the boundaries of the field within which all players in the home mortgage arena must compete and to banish any player who refuses to remain within those boundaries.»⁶⁹¹

There may be truth in this, but it is definitely not the whole truth. Are the causes of the problems of WaMu and IndyMac purely external? Was the problem only the existence of gaps in supervision, and not the quality of the supervision there was? How about the risk management of WaMu and IndyMac? Does Reich really mean to say that OTS worked well, and couldn't have done better? This seems logically impossible: it is obvious that at least the risk management of WaMU and IndyMac was inadequate. The conclusion must be that OTS failed in its mission “of ensuring the safety and soundness of an industry that helps to keep alive the American dream of homeownership”.

By the way: the gaps in supervision are old. They affect the business of OTS institutions. So when did OTS bring the danger of the gaps to the attention of Congress and/or the Administration?

In Focus: Supervising Through the Economic Crisis. (pp. 4-5/6-7).

The point of view of OTS is shown in a block of text in large type under the chapter title:

«FY2008 was a tumultuous and historic year that had a disproportionate impact on the thrift industry, exposed gaps in government regulation of the financial services industry and defined the topics of debate for the proposed restructuring of the federal financial regulators in FY 2009.»

As Reich's message suggested, supervision needs no attention, but the government should fill the gaps in regulation.

More factual is the following remark:

«During the savings-and-loan crisis of the 1980s and early 1990s, about two-thirds of the troubled assets of thrift institutions were in commercial real estate loans. During the current crisis, more than 80 percent of thrift institutions' troubled assets are in single-family mortgages.»

The following sentences explain the turmoil:

«When investors lost confidence in investments tied to home mortgages in the summer of 2007, a

⁶⁹¹ OTS AR 2008 pp. 2-3/4-5.

defining moment occurred- the credit markets froze. That event set in motion powerful forces that took the financial services industry and the global economy by storm, driving to failure two of the nation's largest thrifts, including home lending giant Washington Mutual [= WaMu].»

Nothing is said about what OTS could or should have done better or differently.

It should be noted that in AR 2007 nothing was said about the events of summer 2007. The timeline on pp. 8-9/10-11 of the present AR confirms nevertheless that in 2007 events took place that were highly relevant for OTS. Beside 2007 in the timeline one can read:

«Credit markets seize up, home prices continue to decline and thrift industry suffers negative earnings.»

OTS proposes two reforms:

«It is clear that a uniform set of rules must apply to the underwriting of all mortgage loans, not just the mortgages originated by federally regulated depository institutions. Allowing loosely regulated mortgage brokers to play by a less restrictive set of rules had a corrosive effect on the entire market and exerted competitive pressure for the weak underwriting that helped propel the crisis.

Secondly, borrowers must have a clear understanding of the terms of their mortgages and investors must have a clear view of the risks inherent in mortgage related investments.»

Finally Congress and the Administration are asked to consider the wisdom of the system of two types of bank institutions that is said to have developed in the course of time:

«one enormous in complexity, focused primarily on commercial lending, the other much simpler in operation, focused on consumer and community retail lending.»

Year in Review. (p. 6/8).

This title is misleading. In actual fact the section turns around the OTS staff.

Nothing is said about errors, dysfunctioning or similar failings. The failure is mentally converted into a fantastic success:

«As a worldwide economic storm gathered from the massive downturn in housing finance- the main business of the nation's thrift industry throughout its history- the OTS workforce collectively strived to minimize the damage and safeguard the industry's ability to continue to serve America's financial services needs.

The effort has been valiant and I am exceptionally proud of every OTS employee who is responsible.

By the nature of our work, the failures during the year of three thrift institutions- including our largest, Washington Mutual- are well documented, but the successful results of working tirelessly to save other imperilled institutions remain out of the public eye. Those success stories are largely known and appreciated only by the thrift institutions in question and among the employees themselves.»

The denomination "thrift institutions" implicitly shows and acknowledges the failure of OTS. As underlined by the following paragraph:

«Next year, we will continue hiring entry-level examiners in all OTS regions, but the loss of Washington Mutual and other West Coast thrifts will require a realignment of examiner resources. In some cases the changes will mean more travel and, in others, provide opportunities for voluntary relocations. Our West Region, which in the past needed additional resources from other regions, will become a resource for other regions.»⁶⁹²

It is completely ignored that tens of thousands of employees of WaMu and other banks lost their jobs.⁶⁹³ Something OTS should have helped preventing.

OTS Regions- Regional Overview. (pp. 10-22/12-24).

We restrict ourselves to the West region (pp. 20-22/22-4).

Most of the text on p. 20/22 describes events. The following quote shows how it zooms in on OTS:

⁶⁹² OTS AR 2008 p. 6/8.

⁶⁹³ According to the Wiki page WaMu of 19/5/12, WaMu alone already had almost 50,000 employees.

«In this stressed environment, the financial performance of West Region thrifts declined dramatically. Ripple effects from the housing crisis hit auto lending, consumer loans and commercial lending, manifested in the form of growing problems in asset quality, increased need for allowances for loan losses and reduced earnings. Compared with a year ago, nonperforming assets tripled, troubled assets doubled and return on assets declined by half.

This deteriorating performance required the supervision staff of the West Region to intensify its financial monitoring and examination efforts throughout the fiscal year. These efforts resulted in downgrades in many institutions' safety-and soundness ratings and upticks in the number of supervisory actions and enforcement actions, formal and informal, taken by the OTS. Regional managers worked closely with financially distressed thrifts to develop and execute strategies for raising capital and otherwise resolving their difficulties. Although supervising thrifts during the crisis posed an extreme challenge, the West Region's seasoned, experienced workforce and recently hired specialists rose to the occasion by meeting the demand for sensible and responsive oversight.»

It is rather amazing that OTS gives no indication of the nature and size of the difficulties, and only shows responsibility (and admiration) for its own employees. There is no trace of realization of the fact that large institutions under OTS's supervision were not safe and sound at all, and that the events have shown that OTS' assessments were wrong. OTS' attitude precludes the learning of lessons.

The text does not acknowledge that OTS could and should have prevented difficulties. That safe and sound means resilience, and that events have shown the institutions not to be resilient. OTS has the duty to prevent, not to solve problems. Downgrades of safety and soundness? As if OTS were a rating agency. Why didn't we read about risks and vulnerabilities before? Or about OTS' assumption of ever increasing home prices?

Stressing and admiring supposedly superhuman efforts of OTS employees after the crash can be seen in the FCIC report too, by the way.

Just like stressing “unprecedented times” (p. 21/23). Smoke screens.

Pp. 21-2/23-4 describes various actions which are more or less crises related. It is impossible to estimate their significance, relevance or effectiveness.

Supervision and Consumer Protection. (pp. 24-31/26-33).

«Condition of the Thrift Industry.

The economic downturn and persistent decline of the housing market had pronounced negative effects on the operations of the OTS-regulated thrift industry during fiscal year 2008.»

So the troubles of the thrift industry are caused by the economic downturn. Instead of the other way around.

The section is about the performance of the institutions on the average. In 2008 the industry lost money. Most institutions were nevertheless safe en sound, according to OTS.

20. On the SEC annual reports 2006-2008.

This appendix should be seen as a supplement to what the FCIC reports about the SEC in connection with the subprime crisis.

According to SEC AR 2006 almost 50% of the US households owns shares.⁶⁹⁴

Conclusions.

1. The annual reports of the SEC are deficient in several respects. Necessary information is missing, they draw misleading, illogical conclusions, do not give due attention to risks, and wrongly suggests that the financial system is safe and sound.
2. Already at the time of publication of the SEC AR their deficiency could and should have been noted. It could and should have been noted too, that the optimistic picture was insufficiently substantiated, to put it kindly.
3. The AR give no delineation of the duties of the SEC with respect to the other supervisors.
4. The hypothesis that the markets, the (insufficient) securities-information, and the conduct which caused the crisis are not- at least partly- the responsibility of the SEC, is incompatible with the phraseology of the AR (in combination with the absence of definitions or a glossary), and with the Message from the chairman in AR 2008. The Message in AR 2008 assumes that many if not all of these matters directly concern the SEC.
5. Nothing in AR 2006 suggests that there are other securities markets than NYSE, NASDAQ and the like, and of other securities than common shares. For example asset backed securities and credit default swaps are not mentioned.
6. Comparison of AR 2006 and 2008 shows that the top of the SEC is an example of false pretensions and lack of integrity.
7. The conduct of the SEC is incompatible with the norms and values it advocates.
8. The failure of the SEC is not explained. No effort is made to find causes. Errors are not acknowledged, and apologies are not made. Nothing is said about measures (to be) taken to prevent repetition of the same errors.⁶⁹⁵
9. The large differences between the summarizing “Messages from the chairman” are symptomatic. The Message from the chairman in SEC AR 2006 can be used to define the concept of “misleading”. With very much ado the chairman suggests that thanks to the SEC there is no reason to worry. Your money is safe. The Message is written in a style that would make it seem insulting to doubt the truth of its pretensions.
10. The Message in SEC AR 2008 is of a very different character. A conformity between 2006 and 2008 is that the 3500 “top-flight professionals” of the SEC “work tirelessly” “to sustain trust in our markets”. Although in 2006 and 2008 they did very different things. In 2006 they protected the safety and soundness, in 2008 they were busy trying to brake or stop the implosion which had occurred notwithstanding their supposedly excellent and tireless work.
11. AR 2008 is silent about the nonsense in the Message of AR 2006.
12. The most prominent difference between annual reports of 2006 and 2008 is the difference in lengths of the Messages. That of 2006 is two pages long, that of 2008 five. In a sense, this tells the whole story. If a lot could or should be told after the crash, a lot could and should have been told and discussed before.

⁶⁹⁴ SEC AR 2006 p. 55/57.

⁶⁹⁵ In accordance with the saying “spare the rod and spoil the child”. Inquiry commissions like the FCIC (USA) and CDW (Netherlands) are largely responsible for this. They were far to soft. In the first place by giving only incidental attention to the failure of supervisors, instead of investigating the supervisors systematically and thoroughly. In the second place by undue downplaying of the importance of the supervisors (or conversely, by one-sided attention to, and exaggeration of the role of banks). Errors which have not been clearly and explicitly identified are rarely or never corrected. Replacing a dishonorable and incompetent boss by another doesn't help in the least.

13. Notwithstanding the events and the obvious failure of the SEC, the “Performance section” of AR 2008 differs only little from that in AR 2006. A discussion of the performance measures and indicators in the light of the crisis is missing. The conclusion that the relevance of these measures turned out to be small at best, and did not provide a reliable picture of the performance of the SEC, and even less of the health and/or stability of the financial system, is missing as well.
14. There is evidence of continuing complacency, and no evidence of lessons learned.

About the SEC.

Overview.

On 23/7/12 the Wikipedia said the following about the SEC:

«Overview.

The SEC was established by United States President Franklin D. Roosevelt in 1934 as an independent, quasi-judicial regulatory agency during the Great Depression that followed the Crash of 1929. The main reason for the creation of the SEC was to regulate the stock market and prevent corporate abuses relating to the offering and sale of securities and corporate reporting. The SEC was given the power to license and regulate stock exchanges, the companies whose securities traded on them, and the brokers and dealers who conducted the trading.

Currently, the SEC is responsible for administering seven major laws that govern the securities industry. They are: the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes–Oxley Act of 2002 and most recently the Credit Rating Agency Reform Act of 2006.

The enforcement authority given by Congress allows the SEC to bring civil enforcement actions against individuals or companies alleged to have committed accounting fraud, provided false information, or engaged in insider trading or other violations of the securities law. The SEC also works with criminal law enforcement agencies to prosecute individuals and companies alike for offenses which include a criminal violation.

To achieve its mandate, the SEC enforces the statutory requirement that public companies submit quarterly and annual reports, as well as other periodic reports. In addition to annual financial reports, company executives must provide a narrative account, called the "management discussion and analysis" (MD&A), that outlines the previous year of operations and explains how the company fared in that time period. Management will usually also touch on the upcoming year, outlining future goals and approaches to new projects. In an attempt to level the playing field for all investors, the SEC maintains an online database called EDGAR (the Electronic Data Gathering, Analysis, and Retrieval system) online from which investors can access this and other information filed with the agency.

Quarterly and bi-annual reports from public companies are crucial for investors to make sound decisions when investing in the capital markets. Unlike banking, investment in the capital markets is not guaranteed by the federal government. The potential for big gains needs to be weighed against equally likely losses. Mandatory disclosure of financial and other information about the issuer and the security itself gives private individuals as well as large institutions the same basic facts about the public companies they invest in, thereby increasing public scrutiny while reducing insider trading and fraud.

The SEC makes reports available to the public via the EDGAR system. SEC also offers publications on investment-related topics for public education. The same online system also takes tips and complaints from investors to help the SEC track down violators of the securities laws. The SEC adheres to a strict policy that it never comments on the existence or status of an ongoing investigation.»

Organization and size.

AR 2006 says the following about the organization and its size:

«ORGANIZATIONAL STRUCTURE AND RESOURCES.

The SEC is an independent federal agency established pursuant to the Securities Exchange Act of 1934. It is headed by a bipartisan five-member Commission, comprised of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate. The Chairman serves as the chief executive officer. The SEC is organized into four main divisions: Corporation Finance, Market Regulation, Investment Management, and Enforcement. It also has 19 functional offices. The Commission's headquarters are in Washington, D.C., and it has 11 regional and district offices throughout the country. In FY 2006, SEC received authorized funding of \$888 million. At September 30, 2006, the SEC had 3,590 staff, including 3,549 permanent staff and 41 temporary staff.⁶⁹⁶

So the top consists of members of the two main political parties.

Chairpersons of the SEC.

- Arthur Levitt. His term expired in 2003. He must have been chairman in 1998, because in that year he joined the efforts by Greenspan, Rubin, and Summers to eliminate CFTC chairperson Born when she proposed to reconsider the regulation of OTC derivatives.
- According to p. 94 of AR 2003 William H Donaldson became chairman of the SEC on 18/2/03. He signed SEC AR 2004. In a FCIC hearing he declares to have been chairman until June 2005.
- Christopher Cox. His first SEC AR is that of 2005. He signed it in November 2005.
- Mary L. Schapiro (D) was sworn in January 27, 2009. Her term expires in 2014.

Introduction to the annual reports of the SEC.

The SEC calls its annual reports "Performance and Accountability Reports". They open with a "Message from the Chairman". The Message seems to be a summary of the most important activities of the past year. Below it will be shown that a comparison of AR 2006 and 2008 is revealing. After having studied AR 2006, a study of AR 2007 has no added value. Apart from exactly this observation. For this reason the discussion of the AR 2007 is limited to a few remarks.

The unsystematic character of the observations in this appendix is a consequence of its origin. It has been checked however that the observations are representative. But it didn't seem worth while to spend more time on the SEC. The character of the organization is too obvious.

SEC AR 2006.

(pdf created 16/11/06, modified 21/11/06).

Vision, mission, values, and goals.

The pages following the Message present the vision, mission, values and goals of the SEC:

«Vision:

The Securities and Exchange Commission aims to be the standard against which federal agencies are measured. The SEC's vision is to strengthen the integrity and soundness of U.S. securities markets for the benefit of investors and other market participants, and to conduct its work in a manner that is as sophisticated, flexible, and dynamic as the securities markets it regulates.

Mission:

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Values:

- Integrity
- Resourcefulness

⁶⁹⁶ SEC AR 2006 p. 7/9.

- Accountability
- Teamwork
- Fairness
- Commitment to Excellence»⁶⁹⁷

Goals:

- Enforce compliance with federal securities laws [...]
- Promote healthy capital markets through an effective and flexible regulatory environment [...]
- Foster informed investment decision making [...]
- Maximize the use of SEC resources [...]⁶⁹⁸

Where [...] indicates skipped text (in this case elucidation).

The “Vision” is not a vision but a set of pretentious goals. What matters is the safe operation of the securities markets. (It need be assured, not strengthened). A vision on securities, markets, the financial system, and its supervision, seems indispensable for the adequate operation of an organization like the SEC, but is missing. Whether the SEC is an exemplary organization is of subordinate importance. Exactly how it conducts its work is not of primary importance either, as long as the true goals are realized effectively and efficiently. It would have been better if not the vision but the mission had been presented first. But secondary goals may indeed have gotten priority over the primary goal: see below, under AR 2007.

The relation between mission and goals is not clear.

The listed values⁶⁹⁹ are obviously important. But it is not clear why commitment to excellence is necessary. And can it be shown that the values mentioned are necessary and sufficient to protect the investor? Supposing they fully determine the conduct of the employees, and are treated as inviolable.⁷⁰⁰ Is this guaranteed somehow? No, it isn’t. In the SEC too, as regards internal operation, judicial and executive power coincide. In spite of the first value “integrity”. For these reasons, and given the SEC’s performance, the main question seems to be whether the listed values are really the most important in the practical operation of the SEC, or whether crucial values are actually left unmentioned. Such as compliance with government policies, or blind adherence to financial-economical dogmas.

Implementation of the mission requires for example understanding financial institutions and markets. And openness: saying everything that is of importance. Which includes the willingness and ability to give unpleasant information or judgments when necessary to realize the mission. As the GAO did in its reports of 1994 and 1999.

The style of the remainder of AR 2006 is the same as that of this page.

It is remarkable that definitions and/or specifications of central concepts like security and market are missing. The duties or responsibilities of the SEC are not specified either, and it is not explained where they can be found. This is not trivial at all: AR 2008 discusses securities and markets which had not been discussed in the earlier annual reports, and which should have been supervised by the SEC. But they weren’t, or insufficiently, and became part of the cause of the crash. Something similar applies to the delineation of duties of the SEC in relation to those of the other supervisors. This could have been clear to anyone reflecting on the presence of several financial supervisors. Clear descriptions would have obviated the observations about regulatory gaps in AR 2008, and maybe elicited actions which reduced the risk or size of a crash.⁷⁰¹

The Message from the chairman.

⁶⁹⁷ SEC AR 2006 p. 5/7.

⁶⁹⁸ SEC AR 2006 p. 6/8, SEC AR 2008 p. 8/10.

⁶⁹⁹ A “value” is defined as something that is considered to be important.

⁷⁰⁰ As always in this report, the concept of employee includes the managers.

⁷⁰¹ In SEC AR 2006 the word “gaps” is used once, on p. 29, in de combination “security gaps”.

The Message from the chairman is dated November 2006. It covers 2 pages, and begins with this sentence:

«The prosperity of 300 million Americans and six billion people around the world relies on trustworthy U.S. capital markets.»

The 2nd-4th paragraphs read as follows:

«The U.S. Securities and Exchange Commission [= SEC] serves you by working to secure the trust in our markets that undergirds our nation’s continuing prosperity in an increasingly global economy. The level of trust in our markets has enormous economic consequences—affecting everything from the affordability of food, clothing, and shelter to the creation of new jobs, increases in wages, and the protection of our retirement security. This Performance and Accountability Report helps explain how the SEC works to sustain trust in our markets.

First and foremost, the SEC is a law enforcement agency. This follows from the SEC’s threefold mission to protect investors, to ensure fair and orderly markets, and to promote capital formation. These highly complementary objectives each requires a tough cop on the beat. [...]

Americans can take pride in knowing that tough, predictable enforcement is not only an essential aspect of investor protection, but also an important contributor to our nation’s economic health. This past year, an unprecedented high level of collaboration with our counterpart state and federal regulators and criminal authorities ensured that our mutual efforts were even more effective, and gave America’s investors even more protection for their hard earned money.»

This is followed by reports of a more factual nature.

In AR 2006, the word fragment “derivat” occurs exactly once, in the following context:

«*Cross-border exchange affiliations*.

[...] During the past several months, Nasdaq has acquired a 25 percent stake in the London Stock Exchange, and the NYSE has entered into a combination agreement with Euronext, which includes the U.K. derivatives exchange Liffe. The SEC and the College of Euronext Regulators are currently taking the necessary steps regarding the regulatory approval processes for the proposed combination of NYSE and Euronext.»

AR 2006 does not contain the word fragments “collater”, “subprime” and “swaps”, and the acronyms CDO en CDS. It seems as if the SEC sees only part of the field it has to supervise, and of what affects the safety and soundness of all securities (and other) markets.⁷⁰² Due to the lack of clear definitions, the reader of AR 2006 might hypothesize that the SEC has nothing to do with things like collateral and swaps. But this is impossible for logical reasons: markets affect one another. AR 2008 moreover shows that it isn’t true in fact. Perhaps the SEC was misled into thinking that the part which GAO had shown to be insufficiently transparent and regulated was unimportant. That what is irritant or invisible does not exist.

But lack of transparency and regulation is one thing; suggesting that the supervision is adequate something entirely different. Chairman Cox and the SEC could and should have known that the verbiage in the beginning of the Message of 2006 (and other years) airs pretensions which due to gaps in supervision and regulation are impossible to realize, and can only be false. Notwithstanding three and a half thousand employees. Of whom two, Michael Macchiaroli and George Lavdas, participated in the Joint Forum on Credit Rate Transfer, held in Basel in March 2005.⁷⁰³

To prevent misunderstanding and unfounded illusions, the SEC should have explained in an introductory section what it can and is allowed to do, and what not. Especially too what it can and cannot see and know. That the SEC supported proposals from the GAO made in this and that report, but that, due to this or that, these proposals were not implemented. This is no more than doing what goal 2 requires: “Promote [...] an effective and flexible regulatory environment”. The SEC should have been clear about what it can and cannot guarantee.

⁷⁰² Or feels no need to account seriously about its activities.

⁷⁰³ “Credit Rate Transfer” does not occur in SEC AR 2006 (case insensitive search).

The self-evaluation.

The report has three parts. The second is the “Performance section”. It consists of a list of ratings on a set of “performance measures” and other indicators. That certain matters are considered important and are measured is one thing, that this yields a reliable picture of the performance of the SEC is quite another. In this case it is pure self-delusion, and a false pretension in addition to many others. Logic is hard to find in the performance section. It is entirely unclear why the outcomes of the measurements would say something about the safety and soundness of the system being supervised by the SEC. The section can best be seen as a warning: as a sign of an organization that deceives itself, and understands neither that it does, nor what really matters.

For each “strategic goal” “outcomes” are reported.

«*Outcome 1.1 Potential problems or issues in the securities markets are detected early, and violations of federal securities laws are prevented.*»

(The facts will show that this is incorrect). It is not explained how this outcome is inferred from the given performance measures. Supposing that the text represents a conclusion, and not a desired outcome. In important respects, the impressionistic character of this part of the annual report detracts from its clarity. In the surrounding text the present author sees nothing that justifies the conclusion. The conclusion would seem to go a long way farther than what the presented facts and analyses imply.

Deficient eyesight is also shown by the following:

«*Outcome 3.1. Investors have accurate, adequate, and timely public access to disclosure materials that are useful and can be easily understood and analyzed across companies, industries, or funds.*»

This may be true for some securities, but not for derivatives. Just remember the (only partly supervised⁷⁰⁴) ratings. Which many people claim to have been incorrect, and are badly defined anyway.

Information about financial institutions too will turn out to have been insufficient (if correct).

Note furthermore that the “*accurate, adequate, and timely*” refer not to the information but to the accessibility. The accessible information is indeed useful, and no more. Even more than the other concepts, the “*timely*” needs specification and explanation. SEC should indicate the limitations on its possibilities to inform timely.

«*Outcome 3.2 Investors have a better understanding of the operations of the nation’s securities markets.*»

Better need not be good or sufficient. The suggestion that the markets are well understood is nonsense. Even the understanding by the SEC and Fed was fatally deficient. Possibly the SEC has markets like the NYSE and NASDAQ in mind, but the concept “market” is much wider (even when restricted to the financial system). There are markets for various kinds of derivatives, and last but not least repo markets.

Like outcome 1.1, the outcomes 3.1 and 3.2 go much farther than the presented facts and analyses permit. Indeed, as the comments show, the conclusions (outcomes) are illogical and untenable. This could have been seen already in 2007. This means that the report is misleading. It has an optimistic bias.

The facts of the crisis too have shown that most of this annual report was no better than misleading, self-praising tattle.

It is thinkable that the SEC understood concepts like “market” and “investor” not in a general, but in some restricted sense. But this is only speculation, since definitions and glossary are missing. Especially awkward is the lack of a useful and easily understood description of the duties and authority of the SEC, also in relation to those of other supervisors. The vision, mission, values and goals pages suggest generality and mention no restrictions. They are incompatible with a restricted interpretation because markets, securities etcetera strongly affect one another. Finally the restricted

⁷⁰⁴ See FCIC report, p. 119/147.

interpretation is unambiguously falsified by SEC AR 2008.

According to the FCIC, the regulation of supervision was very defective. No supervisor could give any guarantee, and not even together they could have given it. The SEC could have done (much) better, but it could not have ensured safety and soundness, not even for its own part of the system (if that could be defined). The point is that it could and should have said so in its annual reports. It could have pointed out the gaps, problems and risks. It certainly should not have tried to create a completely unfounded and misplaced feeling of security.

SEC AR 2007.

(pdf created 16/11/07, modified 19/3/08. There is an almost useless linked table of contents).

P. 2/C2 of AR 2007 reproduces a “CERTIFICATE OF EXCELLENCE IN ACCOUNTABILITY REPORTING” awarded to the SEC AR 2006 by the AGA⁷⁰⁵.

The Message from the Chairman covers two pages. The style is less exuberant than that of AR 2006. But the text still calls forth the image of a sturdy, strong watchdog, which uses this Message to show how well it sees and understands everything, and nips all suspicious developments in the bud. The text first of all wants the reader to know that the SEC makes sure that he or she need not worry, and can invest safely. Ideas like threats, danger, and risk are alien to this text. It only mentions relatively innocent phenomena. There is no trace of developments which led to the subprime crisis. No mention is made of the serious difficulties in the MBS market and the ensuing problems of various large banks.⁷⁰⁶ In fact, the AR can be seen as part of the proof of the statement: “The supervisors continue to underestimate risks and potential consequences” in November 2007.

The Message concludes with the following paragraph:

«As we have for 74 years, the SEC will continue waging battle in favor of investors and markets-and we will never lose sight of our objective of high-quality standards tailored to the new, global marketplace. The SEC will continue to lead a global conversation with our counterparts around the world to increase investor confidence, make regulation more effective and efficient, and safeguard the integrity of our markets. Our objective is as ambitious as it is important: to make the lives of every one of our citizens better, and to make the world a better place.»

The word “conversation” appears nowhere else in this AR, and no report or results of the conversation could be found.

The signature of chairman Chris(topher) Cox is dated 15/11/07.

The *Management discussion and analysis* only discusses a small number of selected minor SEC-matters. It gives no attention to developments in the financial system which regard the work (vision, mission, values and goals) of the SEC. It does not refer to other (annual) reports for this either.

Because AR 2007 learns nothing more than SEC AR 2006 we leave it at this.

SEC AR 2008.

(pdf created 14/11/08, modified 30/6/09).

Christopher Cox is still chairman.

The Message from the chairman.

Cox signed his Message on 14 November 2008.

⁷⁰⁵ AGA= Association of government accountants.

⁷⁰⁶ See the (any) chronicle of the crisis, in particular the graphs of the ABX indices.

p. 2/C2 of AR 2008 is a reproduction of the next "CERTIFICATE OF EXCELLENCE IN ACCOUNTABILITY REPORTING", now for SEC AR 2007. This fact can be seen as a symptom of the uncritical complacency of the SEC. It has not learned, or not enough, of the crash. If only modesty.

The Message from the Chairman in AR 2008 covers five (5) pages. It begins with an overview of the new duties of the SEC in the framework of the crisis measures. Assertions like those of the first paragraphs of the Message of AR 2006 are absent. Nothing reminds the reader of the fact that unrestrained assurances about the safety of the financial system were given until moments before the crash.

In the following, the Message is discussed page by page.

Page 2.

The following quotes give an idea of the extent of the duties and authority of the SEC. They were numbered by the present author.

1. «When the auction rate securities market froze early in 2008, the Enforcement Division immediately commenced investigations of potential securities law violations by the largest sellers of these instruments. [...]
2. As of the close of FY 2008, the Commission had over 50 pending subprime-related investigations involving lenders, investment banks, credit rating agencies, insurers, and broker-dealers.
3. During the past year the SEC charged the managers of two Bear Stearns hedge funds in connection with last year's collapse of those funds.
4. The Commission returned \$356 million to investors harmed when Fannie Mae issued false and misleading financial statements.
5. And the Division of Enforcement is currently in the midst of a nationwide investigation of potential fraud and manipulation of securities in some of the nation's largest financial institutions through abusive short selling and the intentional spreading of false information.
6. As part of this aggressive law enforcement investigation into potential manipulation during the subprime crisis, the Commission approved orders requiring hedge funds, broker-dealers and institutional investors to file statements under oath regarding trading and market activity in the securities of financial firms. The orders cover not only equities but also credit default swaps. To assist in analyzing this information, the SEC's Office of Information Technology is working with the Enforcement Division to create a common database of trading information, audit trail data, and credit default swaps clearing data. Our Office of Economic Analysis is also supporting this effort by helping to analyze the data across markets for possible manipulative patterns in both equity securities and derivatives.
7. During FY 2008, the Enforcement Division also brought the highest number of insider trading cases in the agency's history. In addition, the SEC brought a record-high number of enforcement actions against market manipulation in 2008, including a precedent-setting case against a Wall Street short seller for spreading false rumors.»

Page 3.

In the year under review the SEC published a report of an evaluation of rating agencies:

«In July, we released the findings from extensive examinations of the three largest credit rating agencies: Moody's, Standard & Poor's, and Fitch. Our examinations included hundreds of thousands of pages of the rating agencies' internal records and emails relating to their ratings of subprime residential mortgage-backed securities and collateralized debt obligations. SEC staff also analyzed the ratings history of thousands of structured finance products.

The examinations uncovered serious shortcomings at these firms, including a lack of adequate disclosure to investors and the public, a lack of policies and procedures to manage the rating process, and insufficient attention to conflicts of interest.»

The SEC made proposals for improvement. Note that proposals may be inadequate, and that even

good proposals may be implemented inadequately. And why were these examinations made so very late, if not too late? Why were they not made years before?

Page 4.

Together with the CFTC and Fed, the SEC works on better rules and practices for the CDS-market:

«In coordination with the CFTC and the Federal Reserve, the SEC in FY 2008 worked with the financial services industry to develop one or more central counterparties, clearance and settlement systems, and trading platforms for credit default swaps, as an operational step toward bringing additional transparency to this \$55 trillion unregulated market. We also entered into separate Memoranda of Understanding with the Federal Reserve and with the Commodity Futures Trading Commission to make sure that key federal financial regulators share information more efficiently and coordinate regulatory activities in important areas of common interest.»

This is more or less what the GAO recommended 10 years ago, and was deemed unnecessary by Fed, SEC and Treasury.

About the organizational structure of Lehman, SEC AR 2008 says the following:

«The holding company in the case of Lehman Brothers, for example, consisted of more than 200 significant subsidiaries—including OTC derivatives businesses, trust companies, mortgage companies, offshore banks, and reinsurance companies. The SEC was not the statutory regulator for 193 of them.»

This observation too could have been made years earlier. Because of its duties, the SEC should have made it. It should have noted the risks, and made proposals to eliminate or at least reduce them. If the quote is relevant now, it was even more relevant in 1994-2007.

Another belated endorsement of GAO recommendations:

«There is no public disclosure nor any legal requirement for the \$55 trillion market in credit default swaps to report to the SEC or any other agency. Congress needs to pass legislation that would not only make credit default swaps more transparent but also give regulators the power to rein in fraudulent or manipulative trading practices and help everyone better assess the risks involved.»

This recommendation could and should have been made at least as from the LTCM mini-crisis. SEC should have made it because it cannot do its job properly without adequate information (and authority). It should have indicated the risks and potential consequences of lack of transparency and appropriate regulation.

The SEC notes regulatory gaps, and the failure of an effort at inappropriate solution:

«Still other regulatory gaps persist, including a statutory divide between the supervision of broker-dealers under the Securities Exchange Act of 1934 and that of investment advisers under the Investment Advisers Act of 1940. One of the agency's significant efforts to reconcile the supervision of these overlapping financial services was struck down by the courts last year. Congress has an important opportunity to modernize the more than half-century old legislation in this area in any comprehensive overhaul of the regulatory system, and the SEC stands ready to provide its expertise.»

These remarks may be correct and relevant. They could and should have been made a long time ago.

Municipal disclosure should be improved.

«The multi-trillion dollar municipal securities market falls in yet another regulatory black hole. It entails many of the same risks, and is subject to the same abuses, as other parts of the capital markets. As the economic slowdown makes it increasingly difficult for many states and localities to meet their obligations, and as many municipalities continue to use interest rate swaps in ways that expose them to risk that the financial institution on the other side of the contract may fail, investors need to know more about what they own.»

So municipalities should be more transparent, just like corporations. SEC AR 2008 gives examples of extensive cases of bankruptcy and fraud. This remark too could and should have been made a long time ago.

Page 5.

The section *Improved Disclosure* only regards disclosure by individual enterprises. The crisis shows that for investors information about individual enterprises is insufficient. An investor also needs to know about essential risks due to its environment. (Less about opportunities). It would already be nice, if not sufficient, if an investor could rely on supervision and government. Very many investors lost very large amounts of money only because they trusted supervision and government.

Information about risks, their causes, size and potential consequences, is already included in (annual) reports of the enterprises. But open analyses of supervisors are a necessary complement, since they and only they are in a position to clearly see all market parties, and to see mutual dependencies and collective effects. Disclosure of enterprises without regard to environment and relations is fundamentally deficient. As became clear in the crisis, especially with respect to the financial institutions. They too needed reliable supervisor information. A discussion that disregards environment and mutual relations is fundamentally deficient and dangerous.

Page 6.

International conferences are important enough to be mentioned in the Message:

«As Chairman of the Technical Committee of the International Organization of Securities Commissions, and Co-Chair of its Subprime Task Force and of its Credit Rating Agency Task Force, I coordinated the SEC's regulatory responses with regulators from every major world market.»⁷⁰⁷

The annual report does not explain the policy or operation of the SEC in the years before the crisis. There is neither denial nor acknowledgement of failure. It is not explained why many remarks that the SEC now seems to find useful to make, and could have been made years ago, are only made after disaster struck. The failure did not even make the SEC more modest. Witness the conclusion of the Message:

«Today our mission—to protect investors, maintain fair and orderly markets, and facilitate capital formation—is more important than ever before. As described in this annual report, the thousands of dedicated professionals at the SEC continue to work tirelessly towards these ends in behalf of the American people. Attracting and retaining the top-flight professionals that make the SEC what it is remains a top priority—which is why we are so proud that our agency has been rated in the top three best places to work in the federal government, our highest ranking ever. The men and women of the SEC are committed to doing everything they can, every day, to protect your investment in America's future.»⁷⁰⁸

The Message shows that the SEC did have duties and authority which were highly relevant for the prevention and course of the subprime crisis. SEC AR 2008 implicitly admits that it should have reported much earlier about gaps in regulation, duties and authority.

Other remarks.

The performance section gives no outcomes any more, and has a different format. But apart from some appearances it strongly resembles that of 2006. There is no trace of lessons learned. There is little or no attention for other markets than NYSE, NASDAQ and the like, and other investors than private persons or households. There is little or no attention to markets and factors which (strongly) influence the NYSE, NASDAQ, etcetera.

Two general notes.

1. All of the present observations directly or indirectly implicate the US government. Both as regards

⁷⁰⁷ SEC AR 2008 p. 6.

⁷⁰⁸ SEC AR 2008 p. 6.

- regulation and supervision of the financial supervisors.
2. AR 2008 gives the idea that people in the SEC have been thinking, and are saying what they think. At least to a certain extent. However, they may be have been led by the same wrong principle as before: to say what is politically correct or desired. After all, there is no self-criticism.

Frequencies of keywords in AR 2006 and AR 2008.

The following table compares the number of occurrences of some keywords and word fragments in the SEC AR 2006 and 2008:

	2006	2008
“CDO”	0	0
“CDS”	0	0
“collater”	0	4
“derivat”	1	2
“repo”	0	0
“subprime”	0	20
“swap”	0	10

(In the case of “repo”, only occurrences of the word repo were counted, so that “report” was not included in the count).

21. A.H.E.M. (Nout) Wellink.

Miscellaneous.

The motivation for a rather long Wellink appendix.

One of the most important conclusions of the present report is that people differ more and in more important respects than generally thought. Top functionaries are found to follow norms and values which differ greatly from those they claim to follow, and are expected and required to follow. Without exception they are found to lack the integrity and competence they claim to have, and which are necessary for properly doing their job.

Reliable knowledge and understanding of this kind of people is of the greatest importance for the (re)organization and future of human society. But it is extremely rare at best. For this reason it seemed useful to study at least one of these people somewhat extensively. One person seemed to be sufficient, because as far as seen up to now, the differences among these people are of subordinate importance. Which is not to deny that studies of other such people remain very welcome.

Wellink was chosen because of his importance, the availability of relevant information, and because the results could be used to support a request to persecute Wellink for perjury.

Some of the information about Wellink in this appendix is presented not because it is necessary as regards content, but to show that as regards Wellink's functioning it is all very similar. It is different only in details which have no significance for the understanding of Wellink as official. Much need not really be read. It is made available to convince yourself, to facilitate checking things, and to obviate study of the sources.

The appendix is rather extensive because the DNB annual reports and the CDW hearings reports provide a unique collection of evidence. They are a treasure trove for the historian, and an opportunity not to be missed to get reliable insight into someone from the governing top of society in the 21st century.

The appendix contains a lot of quotes, because it wants to show that in Wellink, misleading and lying have a structural character. Still, no effort is made at completeness, nor at a full evaluation of Wellink as president of DNB. As shown by combining the pertinent parts of this chapter, that would be a waste of time.

Abbreviations and preliminary remarks.

- AAB means ABN AMRO Bank. (One of the largest Dutch banks).
- AR means annual report (as everywhere in the present report).
- CDW means Commission De Wit, the Dutch parliamentary inquiry commission financial system, mentioned after its chairman Jan de Wit. The commission held two sets of hearings, and published two reports.
- DNB means De Nederlandsche Bank (= The Dutch Bank). DNB can be understood as approximately the Dutch version of the combination of the US Fed and some other US financial supervisors.
- ING means Internationale Nederlanden Groep. (One of the largest Dutch banks).
- Like the other appendices of the chapter Financial crises, the present appendix is a report of a study made prior to writing that chapter.
- The present appendix is not only aimed at logical sufficiency, like most of the others. It is aimed at thoroughness and overkill. Since there are no exceptional sections, the reader need not read from beginning to end, but can choose what he likes. To help him or her, there is a fully-linked and detailed table of contents.
- This appendix should be seen as one half of the pair of appendices about DNB and Wellink. The appendices on DNB and Wellink complement one another. The reader is advised to start his study of these two appendices with that about Wellink, and use the DNB appendix, the Chronicle and the Analysis to check Wellink's answers.

Curriculum vitae of A H E M ((Ar)Nout) Wellink.⁷⁰⁹

27/8/43	Born in Bredevoort (in the Achterhoek, the easternmost part of the province of Gelderland, bordering Germany).
1961	Diploma gymnasium B.
1961-1968	Studies Dutch at Leiden University. Member of the very conservative Leidsch Student Corps.
1965-1970	Student-assistant & scientific co-worker economics at the faculty of law of Leiden University.
1970-1982	Career in the ministry of Finance. Climbs to directorship of the department of General financial and economic policy, and treasurer-general. ⁷¹⁰
1975	Ph. D. economics Erasmus University Rotterdam.
1/1/82	Member of the executive management of DNB.
1/7/97-30/6/11	President of DNB. He was appointed by minister Zalm/ the cabinet Kok I, and reappointed in 2004 by minister Zalm/ the cabinet Balkenende II. ⁷¹¹
1997-2011	Member of the Group of Ten Governors and a Governor of the International Monetary Fund (IMF). ⁹
1997-2012	Director BIS (= Bank of International Settlements at Basel, Switzerland), beside other directors, among whom Geithner and Greenspan/ Bernanke. ⁷¹²
1999-2011	Member of the Governing Council of the ECB.
1/3/02-28/2/06	Chairman of the Board of Directors, President of the BIS. ⁷¹³
1/7/06-2011	Chairman of the Basel Committee on Banking Supervision (BCBS).
1/10/2012	Becomes member of the Board of Directors of the Bank of China.
1/7/13	Becomes vice-president of the Board of Commissioners of PricewaterhouseCoopers.

Wellink was member of the CDA, a center right political party. The C stands for Christian. In the period 1960-2010, the CDA often was part of the cabinet. He was a member of the trilateral committee.⁷¹⁴

Feats of arms and a preliminary conclusion.

⁷⁰⁹ Source: Wikipedia 26/6/12 “Nout Wellink”.

⁷¹⁰ Zalm was born in 1952, and worked at this ministry from 1975-1988.

⁷¹¹ A president DNB is appointed for a term of 7 years.

⁷¹² For information on BIS and associated organizations see for example BIS AR 2007, pp. 155/165 and following, or the BIS appendix.

⁷¹³ BIS AR 2002 p. 173 (for 1/3/02). BIS AR 2006 p. 185/195:

«Changes among the Board of Directors and senior officials

At the Extraordinary General Meeting held on 27 June 2005, it was decided to abolish the position of President of the BIS. Nout Wellink, President of the Netherlands Bank, who had been re-elected as Chairman of the Board of Directors and President of the BIS with effect from 1 March 2005, continued to serve in his capacity as Chairman of the Board before stepping down on 28 February 2006. At its meeting in January 2006, the Board elected Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, as Chairman of the Board of Directors for a period of three years commencing on 1 March 2006.»

On p. 166/167 of the same AR:

«Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision, chaired by Jaime Caruana, Governor of the Bank of Spain, strives to strengthen banking supervisory frameworks and to promote risk management best practices in the banking industry. With effect from 1 July 2006, Jaime Caruana will be succeeded as Chairman by Nout Wellink, President of the Netherlands Bank.»

⁷¹⁴ The Trilateral Committee (TLC) is a private organisation instituted in 1973 at the initiative of David Rockefeller. Together with Zbigniew Brzeziński and some others. Rockefeller organised the first conferences, which would evolve into the Trilateral Committee. The first conference was held in Tokio in October 1973. The organisation consists of about 300-350 private persons from Europe, South East Asia and North America. It promotes the political and economic cooperation between these regions. Among the members are managers from business, politicians of all major parties, academics, and managers of trade unions. Members who participate in the government of their country temporarily leave the TLC. Source: Wikipedia 1/10/12.

- Because of his long tenure as executive and president of DNB, and his directorship and presidency of the Bank of International Settlements (BIS) in Basel, Wellink had relatively much authority and many possibilities, and therefore a relatively large responsibility for the financial crises of 2008-2015.
- AAB: As president of DNB he shares responsibility for the necessity of takeover by the state. For a timeline see pp. 89 and following in the 2nd CDW Report (2012).
- ING. Needed lots of tax-payers' help too. For a timeline see pp. 183 and following in the 2nd CDW Report.
- The Icesave-debacle. Unprofessional conduct caused the need for taxpayers' money. For a timeline see pp. 292 and following in the 2nd CDW Report.
- DSB. Bankrupt in October 2009. The failure is mostly crisis-independent. For a chronicle see chapter 2 on pp. 37 and following of the report Onderzoek DSB Bank of the commission Scheltema (2010). Like SNS and LIBOR, see below, this case shows that DNB/Wellink also failed outside the framework of the subprime crisis.
- SNS, a bank.⁷¹⁵ Had to be nationalized in February 2013. For a chronicle see pp. 383 and following in the report of the Evaluation commission nationalization SNS Reaal (2014).
- Perjury in the hearings of the parliamentary inquiry commission De Wit on February 1, 2010 and December 2, 2011.⁷¹⁶
- The fraud of the Rabobank with LIBOR and Euribor.⁷¹⁷

(All reports mentioned are included in the dossier).

Taking account of the influence of his two very crucial positions, his actions could have prevented all of these disasters, including the crises. As shown in the DNB appendix and below, Wellink did not do his duty, not by far, and failed utterly as a consequence. And without acceptable explanation and acknowledgement of culpability.

Note that the list of feats is fully compatible with the passive aloof attitude and incompetence manifested by the annual and stability reports discussed in the DNB appendix. A clean slate would have posed a mystery.

How could Wellink become president of DNB?

Wellink worked in the ministry of finance in 1970-1982, Gerrit Zalm in 1975-1988.

The career of Wellink is similar to that of Zalm. Zalm appointed Wellink president of DNB, and extended his appointment. During Wellinks presidency of DNB, Zalm was appointed president of the board of directors of ABN-AMRO bank.

The present appendix shows that Wellink:

- Frequently misleads and lies;
- Is very egocentric;
- Lacks the knowledge, understanding and attitude, to do his job responsibly;
- Was unable to lead and manage DNB.

The present author was unable to find out when Wellink became member of the political party CDA. Was his membership the most important cause of his floating to the top of the ministry?⁷¹⁸ Experience shows at any rate that the top jobs at ministries also require negative qualities (and that these qualities dominate the operation of an organization).⁷¹⁹ There is no evidence of any remarkably

⁷¹⁵ I could not find what SNS stand for. It probably is completely irrelevant.

⁷¹⁶ In the hearings of 2010 Wellink was not under oath. But according to the present author, being head of a public organization always requires timely, truthfull and complete accounting. Irrespective of (other) interests.

⁷¹⁷ «For nearly six years, from at least mid-2005 through early 2011, Rabobank, through the acts of certain traders and managers located throughout the world, engaged in hundreds of manipulative acts that undermined the integrity of LIBOR and Euribor.» This is quoted from the CFTC order dated 29/10/13. Also consulted were similar letters of DNB and the UK FCA (Financial Conduct Authority) of the same date.

⁷¹⁸ Alternatively (for example), his membership may have the same causes as his floating upwards.

⁷¹⁹ See the chapters about the education ministry, the sections about whistleblowing in the chapters 4 and 8, and the sections about hierarchical organization in chapter 9.

positive quality. Wellink nevertheless was appointed president of DNB. According to the people in power he was suitable and the most suitable for the job. They did not admit their mistake after it had become clear that the passivity and misconduct of Wellink and DNB were part of the causes of the worst financial crisis in 90 years, and necessitated large amounts of taxpayers' money to be spent on saving more than half of the Dutch banks. According to the present author, Wellink and DNB could have prevented the financial crises. If only by accepting and being open about the conclusions of the GAO of 1994-1999. That would have broken the closed front of stupid dogmatism (or worse), forced open discussion, and the taking of adequate measures.

Wellinks use of the word "honest".

40 of the 178 occurrences of "eerlijk" (= honest) in the two hearings reports of the CDW are in Wellink hearings. The hearings of Wellink cover 179 of the 2378 pages. So Wellink occupies 7,52% of the pages, and has 22,47% of the use of "eerlijk". That is three times the average.⁷²⁰

The hearing of Friday, February 1, 2010.

10u-12u30.

Source: Commission De Wit, Report of the first set of hearings, pp. 349-370.⁷²¹

Conclusions about Wellink and the inquiry commission.

1. Wellink claims to have warned for years. Without specifying what exactly he warned for, and without telling what should be done about it;
2. Wellink claims that in many respects he was a forerunner;
3. Wellink claims that nobody understood the risks: "Wir haben es nicht gewusst";⁷²²
4. Wellink claims that the failure of those responsible was mainly due to defective forecasting abilities;
5. These claims are incorrect:
 - a. The warnings of Wellink and DNB were at best very low-key, and overshadowed by optimistic conclusions;
 - b. DNB did not differ in any relevant sense from other supervisors. It was passive and reassuring;
 - c. All relevant risks were known and understood already in the 20th century. The supervisors actively rejected appropriate recommendations. Wellink and DNB make no mention of the relevant reports;
 - d. Defective forecasting was not the problem. The crash and crisis had been forecasted (as a risk for a disastrous scenario). The problem was that supervisors, Wellink and DNB included, claimed to know better, and suppressed deviating opinions.
6. The claims about warnings and lack of understanding are incompatible, or at least hard to reconcile. If a danger is not known or even denied, why warn against it?
7. Wellink claims to have played a far more positive role than justified by the contemporary documents in the dossier. In reality the actions of Wellink and DNB were so utterly insignificant as to warrant saying that they were passive;
8. Wellink admits vaguely that something went wrong with supervision. He blames this on supervision being part of society and the novelty of the risks. He didn't elaborate, and the commission didn't investigate. Neither Wellink nor the commission elaborates on how influential supervisors could have been if they had been more honorable and competent;

⁷²⁰ Assuming applicability of the normal distribution, subtraction of $40^{1/2} = 7$ from the 40 would still yield a use which is two times more frequent than the average.

⁷²¹ When compared with the facts, the reports of the hearings are a treasure trove of information about the conduct of top officials.

⁷²² The "Wir haben..." was added by the present author to put the misconduct of Wellink in historical perspective, and to add Wellink to the class of people helping themselves with this kind of tattle to hide misconduct and incompetence. Wellink is a heavy case because he was independent, and had to fear no repression or terror.

9. Wellink falsifies history by suggesting that everyone was surprised and could not have seen a crisis coming, and by implicitly suggesting that the crisis was caused by the banks;
10. Wellink does not present a single original idea or point of view, and no indication of more than journalistic insight;⁷²³
11. Nowhere in the hearing does Wellink show that he is able to think constructively about risks or risk management. (The annual reports show no risk management at all);
12. If Wellink makes an impression of competence, this can only be based on appearances, by his use of technical terms. In combination with the annual reports of DNB the hearings show that Wellink is incompetent and a swindler. The annual reports show that Wellink and DNB neglect to do what they can do and what their duties require them to do;
13. Wellink does not acknowledge substantial errors or responsibility;
14. He leaves important facts unmentioned. Important examples are mentioned in the next section;
15. His explanations boil down to falsification of history. His fairy tales leave crucial causes of the crises unidentified. If his testimony would be taken as the basis for the formulation of measures, crucial causes would not be tackled;
16. Neither this nor the other hearings discuss or discover the causes of the passiveness of Wellink and DNB in 1997-2007. As a consequence it remains unclear how such passivity can be remedied;
17. Wellink does not base his defense on lack of authority;
18. Wellink hardly makes any reproaches. Even though financial institutions apparently reacted insufficiently to his supposed warnings;
19. Inside DNB Wellink must have been repressive.⁷²⁴ DNB had over 1500 employees. It is unbelievable that nobody ever requested action on the basis of GAO or similar reports, the Born/CFTC affair, or on the basis of dangers seen by him or herself.⁷²⁵ If nobody ever requested action, or if managers refused to forward signals and/or take appropriate action, then the personnel management was very insufficient;
20. Wellink exudes complacency, heroism and sadness. He did everything possible and better than everybody else, but nobody would listen;
21. Wellink shows no trace of modesty. No awareness of having failed;
22. Wellink says nothing about differences of opinion inside DNB, and about decision making inside DNB;
23. The inquiry commission left most untruths and misleading tattle uncontradicted. If it wanted to find the truth, it should have confronted Wellink with the DNB annual reports and other reports;
24. The inquiry commission should have been prepared for unacceptable answers, and the impossibility of meaningful continuation of the hearing. But it didn't show anything like it;
25. The inquiry commission did not correct this defect in its report;
26. The inquiry commission made itself accomplice in falsifying history, and helped an incompetent and dishonorable person to retain his harmful influence and power;
27. Hearings are permissible and meaningful only if they can and will be checked against other evidence, such as annual reports. If this had been done, the commission's report would have been very different;
28. There is no evidence showing that the inquiry commission has studied the annual reports and/or Overviews Financial Stability in the Netherlands;⁷²⁶
29. The evaluation by the inquiry commission of the role of Wellink and DNB in the financial crisis is found to be utterly insufficient, unreliable and misleading;

⁷²³ This is not meant to compliment journalists.

⁷²⁴ Subordinate managers must have collaborated uncritically. Or of course have been selected for slavishness.

⁷²⁵ For example by reproducing the logical reasoning of GAO.

⁷²⁶ They are absent from appendix 2, the list of literature, of the first report of the commission. That the commission did not consult the annual report may be a consequence of their incompetency as researchers. But it can also be a manifestation of malicious intent. Namely because the AR posed an insolvable problem for the commission. Confrontation of the words of Wellink with the AR would be the end of Wellink. The report of subinquiry 2 into the supervisory system does not betray knowledge of the DNB reports mentioned either. This subinquiry has many more defects by the way. It certainly cannot be accepted as an evaluation of the supervisory system.

30. Wellink cannot have been appointed president DNB because of suitability, for he isn't, and not by far. He doesn't even report reliably, and again: not by far. His appointment, and even more the prolongation of the appointment, are very blamable;
31. The DNB annual reports are perfectly compatible with the events. What Wellink claims in the hearings is not.

By not referring in any way to DNB annual reports, let alone in a systematic way, the inquiry commission supports the reprehensible ideas, that annual reports are not meant to account for what was done and not done in the year under review, and that stories told after a failure suffice. Instead, the commission should have confronted Wellink with the annual and other reports of DNB. This would undoubtedly have the effect of substantially improving the quality of the (annual) reports.

Relevant facts, unmentioned in the Wellink hearings.

Although essential for the truthfulness and completeness of the answers to the questions of the inquiry commission, Wellink left the following facts unmentioned:

1. Highly relevant and important reports from 1994-2006. Especially those of the GAO, OFHEO and CGFS about scenarios for crashes and crises, and the recommendations of these reports.⁷²⁷ If Wellink and DNB had done their duty when these reports were published, Wellink could have told that he and/or DNB had studied the reports, and reacted appropriately. But DNB did not react appropriately, and has not explained its neglect of the reports.
2. The belief of the intolerant Fed and US financial top in self-regulation, and the 100% neglect of systemic risk by the Fed.
3. The fact that vital defects of the US financial supervisory system were ignored by all other supervisors. (They did not have to guess this, or infer it in a difficult way. They could easily see it if they only superficially read the annual reports of the US supervisors. Their observations could be confirmed by reports mentioned under 1).
4. The fact that the supervisors, without exception, bet on one and the same lame horse, self-regulation, and took no account whatsoever of the possibility of a mistake. This should have been mentioned because it helps to explain their passivity with regard to risk increasing developments and with regard to the recommendations of the reports mentioned earlier.
5. The Born affair: the extremely intolerant refusal by US supervisors and the top of the US finance ministry to even discuss better regulation of OTC, and their repressive action with respect to Brooksley Born. This event should have been noted because the repressive nature of the US authorities must have been reflected in the “cooperation” between supervisors of different countries. The event shows that the world of financial supervision lacks freedom of opinion and tolerance. Did foreign supervisors try to bring their US colleagues to reason? Fear is a bad advisor, for supervisors as well as other people. Anyway, fear for people like Greenspan and Summers can very well explain why supervisors remained passive. As regards the Netherlands: if Wellink and DNB had done their duty, they would have openly supported Born, preferably together with other supervisors.
6. The affordable housing policy of succeeding US governments, and the recklessness and risks of that policy. Which steadily increased the risks of mortgage backed securities.
7. The actions Wellink wanted those concerned to take in reaction to his supposedly oft-repeated warnings. What did he want them to do, and what would that have meant for them?

Quotes and analysis.

According to p. 29/25 of the first report of the commission, “Schippers” is mrs. E.I. Schippers (of the political party VVD⁷²⁸).

⁷²⁷ GAO= Government Accounting Office, OFHEO= Office of Federal Housing Enterprise Oversight, and CGFS= Committeee on the Global Financial System. See BIS AR 2006 p. 168/178.

⁷²⁸ Since the full name has no real meaning, and can only mislead, the abbreviation is left untranslated.

According to Wellink, deep imbalances in world economy are deepest cause of crisis.

«Mrs. Schippers: Good morning, mr. Wellink. Sincerely welcome. You are responsible for safeguarding the stability of the financial system. What went wrong?

Mr. Wellink: In the first place I want to thank you for the invitation. Much went wrong. In the USA a kind of multi-headed monster has grown up. Since then much went wrong in the financial sector indeed.

Mrs. Schippers: You refer to the USA, but the Dutch institutions too sailed close-hauled.

Mr. Wellink: This is partly true, but I refer to the USA. If you ask me about the deepest causes of this crisis, I point to the large deviations from equilibrium in the world economy which have arisen in the last ten years.»⁷²⁹

1. In the given context, what is “equilibrium”, and what is an “imbalance”?
2. Wellink gives no proof, and no logical reasoning which shows that, how and which imbalances in the world economy cause crises, or caused this one. He does not show that in this context “imbalance” is an appropriate term. All kinds of differences can be termed “imbalance”.
3. The USA is not the world. Did “large deviations from equilibrium in the world economy” generate a “multi-headed monster” in the USA? Has the world economy ever been in equilibrium?
4. Whatever the relevance of imbalances, for Wellink and CDW the main questions are: could and should Wellink, DNB and/or others have done something about them? Could they have prevented or eliminated causes? Could he have warned other authorities, and recommended remedies? Did DNB do what it could and they should have done?
5. The system crashed fatally. Responsible heads of key organizations may have contributed to the causes, or may have had the duty to eliminate or reduce them. They are suspects. It cannot be excluded that they will try to exculpate themselves. They may think that the goal of exculpation justifies misleading or lying. For this reason they cannot and should not be treated as experts and reliable, at least not before proven innocent.
6. Wellink’s answer is an example of divertive reasoning, by jumping to phenomena that seem far removed from his own duties and authority.
7. Wellink could more appropriately have mentioned human weaknesses as “the deepest cause” of the crisis.
8. DNB AR 2007 mentions losses in MBS as cause of the “turbulence” in financial markets.⁷³⁰

Wellink claims to have warned since 2000.

«Mr. Wellink: I think that I started to warn for developments in the field of real estate as from the year 2000, at an internal international conference. I did so on the basis of experience in the Netherlands. In internal meetings I have very systematically warned against, in my opinion, a somewhat ample monetary policy of the large central banks of the world. In many speeches- some of them were sent to you⁷³¹- and actually in all annual reports of this millennium, warnings were given against certain developments which could have a destabilizing effect. In 2006 I became chairman of the Basel Committee on Banking Supervision. The first thing I did as chairman- more than a year before the crisis- was to tell my fellow-members that we should identify the weak points in the system. In December 2006 we directed the work program of the Basel Committee on these weak points. During the crisis in August 2007 exactly these points turned out to be the most important weak points in the system.»⁷³²

1. In the annual reports of DNB no emphatic warnings can be found. See the DNB Appendix.
2. The word “subprime” cannot be found in any of the DNB AR 2000-2006. In that of 2007, published April 2008, it occurs 26 times.
3. The suggestion of the sentence “The first thing I did as chairman...”, that Wellink was the first to request identifying the weak points, is incorrect. The weak points were already known for more than 10 years. For example from reports of the GAO 1994-1999. Attention should not have been

⁷²⁹ Hearings report p. 349 left.

⁷³⁰ DNB AR 20007 p. 115/107.

⁷³¹ The list of references of the first report of CDW mentions only one speech of Wellink, of 19 November 2009.

⁷³² Hearings report 1 p. 350 left.

- directed at their identification, but at actions to eliminate them. Both GAO and CGFS had presented recommendations for action. The supervisors ignored them.
4. The paragraph does not show the head/manager of a large organization, but a soloist. He refers to personal speeches which have not the least formal significance, if any. What he says is incompatible with the DNB AR.
 5. What publication reports about the results of the search for weak points? In the BIS AR 2006 and 2007 nothing of a non-general character can be found. No mention is made of a meltdown scenario à la GAO, no (new) proposal to increase the Basel capital requirements, to increase transparency, or other measure. In short: here too CDW should have requested evidence.
 6. What Wellink claims about all AR of the millennium is untrue. There are all kinds of warnings, but all of them are low-key, and none of them is accompanied by proposals for measures, and none of them gives an indication of what will happen if nothing is done. In DNB AR 2006, “destab” does not occur.
 7. The section “Basel Committee” on p. 93/91 of DNB AR 2006 reads as follows:

«Basel Committee

The Basel Committee on Banking Supervision is an international committee of the central banks and banking supervisors of the financially most important countries. The Basel Committee tries to strengthen the quality of the worldwide banking supervision by increasing cooperation between supervisors. On 1 July 2006 DNB-President Nout Wellink became chairman of the Basel Committee for a period of three years. In 2006 the Basel Committee made a final ‘Quantitative Impact Study’ of the change in capital requirements for banks under Basel II. To improve efficiency and efficacy of supervision on banks which operate internationally, principles for cooperation have been formulated. The Basel ‘Core Principles’, a worldwide standard for prudential banking supervision, were revised. Finally in 2006 Guidance Papers were published about the use of ‘fair value option’ and ‘sound credit risk assessment and valuation for loans’. In the coming period the Basel Committee is closely involved with the extensive implementation of the Basel II framework. Other challenges for the Basel Committee are liquidity management of institutions, compliance, and the strengthening of further cooperation and information exchange between supervisors.»

Nothing about weak points. On the contrary: what for example GAO identified as a major risk, liquidity, is obviously very much underestimated. There is no sense of urgency.

8. In BIS AR 2007 (about the period 1 April 2006–31 March 2007) nothing resembling Wellink’s claims can be found.
9. In sum: Wellink’s claims are a pack of lies.

Wellink claims to have warned in “various annual reports”, speeches, and DNB publications against the imbalance between risk and yield.

Mrs. Schippers: Did you see the increasing yields as a systemic risk?

Mr. Wellink: I saw the increasing yields as an incentive for taking ever more risk. I also saw the growing yields as a reflection of risk. In various annual reports, in many speeches and in articles published by DNB, I warned against the imbalance between risk and yield. When I say I did, I also mean DNB. There is no doubt about our repeated information about this, during a sequence of years.»⁷³³

1. Wellink does not answer the question.
2. His claims do not agree with the AR. The AR do not give serious warnings. The word “imbalance” cannot be found in DNB AR 2006. The quotes in the DNB Appendix speak a very different language.
3. Wellink should show how he warned whom.
4. Did Wellink warn Dutch parliament and government? Not by means of an AR, which describe the state of affairs and the financial outlook, and where relevant warnings should be reported.
5. What did Wellink do when there were no adequate reactions to his warnings?

⁷³³ Hearings report 1 p. 350 left.

6. Is giving warnings enough for an institution with the duties and authority of DNB? Of course not. So what recommendations did he make, what more did he do, and why didn't and doesn't he report?
7. Why did he do nothing with the CGFS 2003 report, and why isn't this report mentioned and discussed in a DNB AR?⁷³⁴
8. Last but not least: in this case (as often) the half-truth covers a lie: the annual reports do not conclude that there are serious systemic (or other) risks, and that the financial system is on the verge of collapse. Instead, they assert that the system is robust (see the DNB Appendix on AR 2004).
9. In the DNB Appendix, see the section with quotes with "derivat". It shows the total passivity of DNB. In other words: Wellink paints a misleading and incorrect picture.
10. The stress tests of DNB (see AR 2006 and AR 2007) turned out to be inadequate.
11. Why does Schippers ask Wellink this question after the crash, instead of checking the reports (including the AR) of DNB of 1997-2006? As someone responsible for the safety and soundness of the financial system, Wellink is a prime suspect.

Wellink claims that DNB imposed rules for investing in "intransparant products".

«Mr. Wellink: [...] To give another example: we were the first in the world to impose rules for investments in what we call "intransparant products" by financial institutions: private equity funds and hedge funds. More examples can be given, by the way.»⁷³⁵

The rules turned out to be insufficient. The documents in the dossier suggest that they were invented during the hearing:

1. The claim does not agree with the annual reports of DNB. Perhaps Wellink was thinking of the following subsection in AR2006:

«Hedge funds en private equity-funds.

Hedge funds and private equity-funds are not subject to supervision. However, an ever-increasing number of financial institutions which are subject to supervision is active with these alternative investments. In its current supervision and in periodic investigations DNB therefore pays attention to the risk management with respect to these funds (see section 7.3 and 7.4).

Because of the lack of transparency of these funds and the lack of experience of the financial institutions with these funds it is relatively hard to get a clear picture of the risks of these alternative investments. Since the institutions do not possess the same expertise, there is a risk that the risks accumulate in the institutions which are badly prepared. DNB is of the opinion that the financial institutions have to strengthen their risk management in this regard. For this purpose DNB has developed guiding principles. On 1 March the principles were presented and published in order to contribute to improving awareness in this area of the financial sector.»⁷³⁶

So the text mentions (non-committal) guiding principles, not (binding) rules, prescriptions or requirements.

2. What Wellink claims is hard or impossible to reconcile with the following in DNB AR2007:
«Because of its vulnerabilities⁷³⁷ it seems in any case important that the conditions for the model-transparency, good risk management, proper incentives- are strengthened. With such an adjustment the OTD-model can also promote efficient intermediation in the future.⁷³⁸ This will

⁷³⁴ See the BIS Appendix.

⁷³⁵ Hearings report 1 p. 350 left+right. The Dutch text speaks of requirements (eisen). In Dutch this sounds severe.

⁷³⁶ DNB AR 2006 p. 85/83. Compare p. 124/122: «In 2006 principles were developed for improvement of supervision of risk management of complex and intransparent investments, such as hedge funds and private equity».

⁷³⁷ Those of the OTD-model. OTD= originate to distribute. The most important example was: mortgages which were not kept by the bank which sold them, but bundled together with other loans into securities which were sold to investors.

⁷³⁸ If "intermediation" sounds esoteric, so does the original "intermediatie": the word actually does not exist in Dutch.

have to be realized primarily by the sector itself, where the supervisors can stimulate the necessary market discipline by promoting transparency about risks of securitized products.»⁷³⁹
The measures of DNB did not prevent the losses of billions of euros on these products (and on Madoff) by at least two major Dutch banks, AAB and ING.

3. “rule” is an elastic concept: it may mean next to nothing, and can also be prohibitive.

Whatever DNB did, it did not prevent AAB and ING to lose billions on intransparent securities. Including the Ponzi-scheme of Madoff.

Wellink says he was worried about risks and risk management.

«Mrs. Schippers: I return to the rising yields. You say that our financial institutions could not stay behind financial institutions elsewhere.

Mr. Wellink: Yes.

Mrs. Schippers: Do you find yields of 20% normal for a bank?

Mr. Wellink: No. I have to repeat what I said before. These yields were coupled to large risks, and we were worried about these risks. So we said every time that one should try to keep the risks under control. In the course of the years we as supervisor have done quite a lot on the risk management of banks. [What? The DNB AR of 2005 and 2006 only express wishes. The fate of AAB and ING in the crisis shows that the supervisor failed utterly].

Mrs. Schippers: If there are yields of 20%, then it is obvious that there must be risks.

Mr. Wellink: This is what we stressed every time. [Only in speeches, or also in places and at times where it really mattered? See the DNB Appendix, the quotes from AR 2004: DNB is very happy about its performance, and calls the system stable]. I have to say that I felt this to be a very unfortunate part of the international developments. Due to my professionalism I sometimes get irritated. Not in the sense of getting very emotional, although in this case I almost did. We had landed in a quarter of the world with institutions which took irresponsibly large risks- this was beyond our authority- and made very large profits. Which enabled them to buy the rest of the world. I still think AAB is one of the examples. They could mobilize so much money because the risk profile was much too high, that those who behaved more decently- I’m not judging AAB but the process- stayed behind in yield. They fell a prey to these cowboys. This sometimes made me feel exasperated.»⁷⁴⁰

1. What did Wellink do about this? What is reported about these actions in the annual reports of DNB? The answer is: at best Wellink and DNB expressed pious wishes. Before 2007, they did not even show uneasiness.
2. If international competition was a problem, why didn’t DNB discuss the problem in international organizations, and/or ask the assistance of the ministry of finance? Wellink had a prominent position in the international BIS! Why not use it?
3. Why doesn’t the DNB AR report about the “irresponsibly large risks”, and their potential consequences?

Illustration: DNB as passive onlooker of CRMPG.

That the hypothetical actions of Wellink and DNB cannot have amounted to much, can be concluded from searching for “risk management” in the pdf-files of the DNB annual reports. Several instances are compatible with the hypothesis that Wellink and DNB remained passive, did nothing. None shows action, let alone vigorous. The following example is incompatible with awareness of serious danger and/or an active attitude:

«In July a report was published of the Counterparty Risk Management Policy Group II (CRMPG-II, also called the ‘Corrigan-rapport’, an initiative of a number of large market parties) with recommendations for making the different risks of new financial instruments more transparent. It was concluded that this introduces new requirements for risk management of financial institutions, the financial infrastructure, and supervising methods. It is important that these recommendations get a follow-up, in the first place from the institutions. Supervisors and lawmakers can play a stimulating role, e.g. by indicating the risks and promoting ‘best practices’ to manage them.»⁷⁴¹

⁷³⁹ DNB AR 2007 p. 121/113.

⁷⁴⁰ Hearings report 1 p. 350 right hand side.

⁷⁴¹ DNB AR 2005 p. 96/94. CRMPG-II is in the dossier.

This quote is from DNB AR 2005. DNB AR 2006 reports as follows about the follow-up:

«The limited information provided by hedge funds and private equity-houses makes it difficult for financial institutions to estimate and manage the risks with respect to these parties adequately. In the year under review this was confirmed by a survey of DNB among the large Dutch banks, in pursuance of the second report of the Counterparty Risk Management Policy Group (CRMPG II) from 2005.»⁷⁴²

And eleven pages later:

«In September 2006 the Overview Financial Stability (OFS) was published (see chapter 7 [of the AR]). Its most important results were discussed with the large Dutch financial institutions. As a follow-up of the OFS an inquiry was made into the way in which Dutch banks implemented the recommendations of the Counterparty Risk Management Policy Group (CRMPG II), and into the involvement of the most important banks and pension funds with private equity.»⁷⁴³

These are all paragraphs with “CRMPG”. In other words: DNB says nothing about follow-up activities, and does not tell us how it promotes ‘best practices’. DNB seems to assume that the financial system regulates itself sufficiently. In DNB AR 2007 “CRMPG” does not occur.

Hollow sympathy for Bair.

«Mr. Wellink: [...] In 2006 I chaired a meeting in Merida in Mexico. Sheila Bair, the chairperson of the FDIC, proposed to establish a so-called leverage ratio.⁷⁴⁴ The rest of the meeting jeered her away. As the chairman, I joined her next morning at breakfast. I told her that I had found the jeering rather unpleasant, because I thought she had a point. I said that we could not get it accepted, and proposed to look around for substitutes of the leverage ratio. In the end some studies of substitutes were made by the Basel Committee, but without success. By now we have come back on the leverage ratio. In the proposals which my committee submitted at the end of December to the G20, the leverage ratio is presented as a valuable element of future regulation for limiting leverage in the system. So the whole international community, except mrs. Bair, had been wrong. I have to admit it.»⁷⁴⁵

1. If Wellink really agreed with Bair, why didn't he support her in the meeting? Doesn't his cowardice detract from his ability to lead a meeting (or organization)? The more so if we are to believe him to be convinced of great risks for the system.
2. Wellink's attitude is compatible with what can be inferred from the DNB annual reports: that DNB was passive, took no initiative, and no action. The attitude Wellink demonstrates here is incompatible with his oft repeated claims about warnings for risks.
3. The phrase “the leverage ratio is presented as a valuable element” is a nice example of an inadequate advice, because empty and noncommittal. This is the worse for being given in the probably very short time window of opportunity, before the return to business as usual.

Wellink speculates about causes of neglect of warnings: groupthink and a dislike of nagging.

«Mrs. Schippers: [...] As from 2003 you warned against a number of developments we are discussing right now. [It is not entirely clear what she has in mind. Wellink mentioned 2000 instead of 2003. Anyway: the DNB AR never warned emphatically for anything]. Did people listen sufficiently?

Mr. Wellink: It sounds so pathetically when I say that I was a voice in the wilderness. [Worse: it is untrue: Wellink nor DNB were voices in the wilderness: they were practically silent]. That would be a bit childish. There were many warnings. Not only by DNB, but also by all central banks of the world. [The Fed for example? No, the Fed did not warn at all, and it need not, because it believed in self regulation. Neither did the other financial supervisors, excepting OFHEO, somewhat. CGFS did warn indeed, but in that case it was DNB that did not listen]. I think people heard, but did not listen. One can be terribly pathetical about this, but it is a fact of life. When we say something about salaries, there is a group in the Netherlands which says: here they are again with their worn gramophone record. If we say something about the government budget, they have a similar reaction. [Wellink falsifies

⁷⁴² DNB AR 2006 p. 123/121.

⁷⁴³ DNB AR 2006 p. 134/132.

⁷⁴⁴ FDIC= Federal Deposit Insurance Corporation. «Independent federal agency charged primarily with insuring deposits at financial institutions, examining and supervising some of those institutions, and shutting down failing institutions.» FCIC report p. 540/568.

⁷⁴⁵ Hearings report 1 p. 351 left.

history. In resp. 1994-1999 and 2003 GAO and CGFS were voices, and the central banks did not listen. Including DNB].

Mrs. Schippers: What do you think is the reason for this?

Mr. Wellink: I have given this a lot of thought. We are part of society too, and I think that this is why supervisors partly went astray. In times of progress some messages are almost impossible to convey. When trees are growing into the sky, and the supervisor or the central bank says that they cannot go on like this, the message falls on rocky soil. I remember a Dutch prime minister saying: there comes the bank again. Autumn is coming, the leaves are falling. That didn't fit. Perhaps we were not strong enough. We have discussed this at international level too. [At Merida for example!?] Perhaps we become a little bit part of the culture in this sense that we do warn when things go well, but feel the urgency less. After all, everything goes well. Let me give you one example. I may have written for about ten years of the dangers connected with the large deficit on the balance of payments of the USA. I did not keep an exact count of the years. In the eleventh year- forgive me that I do not know exactly how many years it was- I think: we should stop complaining about the deficit on the balance of payments, for nothing happens. That is the risk you are confronted with: nothing happens, but underneath... One gets less critical, and then it turns out that the risks accumulated, as in this case. All of a sudden they seem to explode.»⁷⁴⁶

1. DNB has specific social duties, which don't allow it to let it be rocked asleep by sentiments in society. A watchman should not go to sleep because everyone else does. People who do are unfit for the job of watchman.
2. Giving substantiated warnings, and showing the consequences of their neglect, is his duty, whether or not parliament and government listen. He should moreover explain that non-realization of a risk does not mean that it does not exist or is insignificant and can be ignored. (He didn't).
3. He should also take necessary action himself, and be clear about why others should do what. (Wellink and DNB did neither)
4. To avoid misunderstanding: DNB positively said that things would remain going well:
«Taking everything together the perspective is not unfavorable, but the risks in the macro-economic forecast, as indicated earlier, are not negligible. However, the financial system is sufficiently robust to absorb accidental set-backs.»⁷⁴⁷
5. Warnings of DNB were never emphatic. Not recently, not ten years ago.
6. Neither Wellink nor DNB did what it could.
7. It is true that imbalances in balances of payments are often called untenable by DNB. Contrary to what Wellink suggests, DNB never tired of saying so. But DNB never explained why the imbalances are untenable, and to what kind of (other) problems they may give rise. This is the more important since the observation does indeed seem to be contrary to experience: the imbalances exist already for a long time.
8. The risks did not accumulate, and neither did it explode. Accumulation is irrelevant: it is not necessary for a crisis or other disaster. Even a small risk, in the sense of small probability, can be disastrous. Wellink demonstrates that he doesn't understand the concept of risk.

Wellink claims pioneer ship in regulating OTD, hedge funds en private equity.

«Mr. Wellink: [...] Perhaps I don't have the ability to explain its extent, but it was very essential that we interfered in the undisturbed operation of the "originate to distribute"-model. As a consequence, banks took risks and assets from their balance, and transferred them to those special [purpose] vehicles. That was fundamental, and in this we were the pioneer. What we did in the field of hedge funds and private equity was fundamental as well. It was followed by very many countries in the world.»⁷⁴⁸

The words "originate" and "OTD" do not occur in DNB AR 2004, 2005 and 2006. The most important ("tell-tale") paragraph in DNB AR 2007 (dated 2/4/08, after problems had manifested themselves) seems the following:

«What is the future of the OTD-model? Because of its vulnerabilities it seems at any rate important

⁷⁴⁶ Hearings report 1 p. 352.

⁷⁴⁷ DNB AR 2004 p. 31, the last sentences of the General Overview.

⁷⁴⁸ Hearings report 1 p. 353 middle right.

that the conditions for the model- transparency, good risk management, proper incentives- are strengthened. With such an adjustment the OTD-model can also promote efficient intermediation in the future. This will have to be realized primarily by the sector itself, where the supervisors can stimulate the necessary market discipline by promoting transparency about risks of securitized products. The new supervision framework, Basel II, moreover strengthens the risk management and specific capital requirements for liquidity promises to entities off the bank balance. Liquidity management can be strengthened further by regular stress tests.⁷⁴⁹ Macro-stress tests for the system as a whole, organized by a central bank or supervisor, can contribute to the awareness of risks of system-wide shocks by institutions.⁷⁵⁰»⁷⁵¹

So in fact, DNB relies on self-regulation.

In connection with the silence of the AR 2004-2006 about OTD and Wellink's claim to pioneer ship, it should be noted that Basel II was published in 2004, and would be introduced 1/1/2008. So the quoted remark could have been made already in AR 2004. Obviously, both the AR-text and its date are incompatible with the words of Wellink or with vigorous action by DNB. Without an amazing explanation it has to be assumed that Wellink is lying.

Wellink has no ideas about better instruments for supervision of the system as a system.

«Mrs. Schippers: As regards systemic supervision, do you think you have enough instruments? This specifically concerns supervision of the system.

Mr. Wellink: Let me begin with the remark that it is very clear that there is no systemic problem that only concerns the Netherlands. Systemic risks can spill over from other countries. This means that we must begin by tackling a number of international problems. We are doing so in the context of Europe, so there we do actually have enough instruments. In all honesty I say that at the moment we do not have enough instruments in the Netherlands. A law for crisis resolution is in the works. It is a strange word, but this law is meant to solve problems in the system, without undue harm for the tax payer. So this is being done, but in that respect the instruments were insufficient.»⁷⁵²

9. Note that specifics are entirely absent, and that any amateur could say the same. What instruments are missing? Only something with respect to crisis resolution?
10. Why do we need a law for crisis resolution? What does it regulate, and why? Why are we to believe that it will work as intended? (Supervision didn't, for example).
11. Why resolution, and not prevention?
12. “so there [= in Europe] we do actually have enough instruments”. Why the “so”? What instruments do we have in Europe? Does all of Europe agree with Wellink?
13. Is there no need for international agreement? What do we have to do as long as there is no (satisfactory) agreement?
14. The AR show that an announcement of DNB that work is being done on a topic means nothing.
15. If there were not enough instruments, and problems in other countries could spill over, why didn't DNB communicate this earlier, together with proposals for remedies?

Wellink opposes a yearly systemic assurance statement.

«Mrs. Schippers: Mr. Jules Muis last week recommended that supervisors make a systemic assurance statement. Which means that DNB yearly makes a formal declaration saying that there are no systemic risks large enough to have a substantial influence on the orderly operation of the financial markets. What do you think of this proposal?

Mr. Wellink: [...] Suppose you issue a systemic assurance statement, and say that there is nothing the matter. Then the risk that you elicit irresponsible behavior is devilishly large. For we may operate

⁷⁴⁹ This is untrue. The tests do not strengthen. Appropriate action has to be taken if the stress test somehow fails. And how strong and reliable is the test? Where is the testing described and accounted for?

⁷⁵⁰ Again, awareness is insufficient. Adequate measures should be taken. The supervisor should say what is adequate, and check implementation. Without this, and given the performance in 1994-2007, we have no more than words.

⁷⁵¹ DNB AR 2007 p. 121/113.

⁷⁵² Hearings report 1 pp. 354-5.

in an environment without exceptionally large risks. You have to take this seriously into account. [...] I understand the motivation, but wouldn't do it.»⁷⁵³

1. Effectively Wellink (and all other financial supervisors) gave such assurances. His annual reports were unmistakably reassuring. They did mention risks, but never suggested serious danger. They gave no indication of possible consequences. For an example of a DNB conclusion, see above, point 4 under "Wellink speculates...";
2. The proposal of Muis is debatable because of the instability of the system. Small disturbances may have large consequences. The disturbance can come from another country or unnoticed source. Therefore, the assurance can at most be given by all financial supervisors together, and with conditions attached;
3. In the DNB AR a list of risks is missing. The risks the reports do observe are hard to find;
4. The DNB AR do not mention conditions for smooth and safe development, as opposed to development with serious disturbances.

So what Wellink says seems perceptive and reasonable, but it does not agree with what he did. And the explanation of his rejection of the proposal is invalid.

DNB and other supervisors should try to make a description of the financial system (in a broad sense), its instruments, processes, conditions for smooth operation, and mechanisms which can injure conditions.⁷⁵⁴ It should be complete with respect to the types of products and processes (contracts). Even if products and processes were to be free of regulation and supervision, they should always be defined and registered. Either this or liability and punishability. A properly specified inventory as indicated can greatly help identification and reduction of risks. But as noted before, the causes for instability are related to subjectivity of valuation, and therefore very fundamental. This means that it may not be possible to eliminate the risk of financial crises altogether.

According to Wellink, banks and supervisors were not aware of certain risks.

«Mrs. Schippers: Let us consider microprudential supervision. Some people drew attention to shortcomings in the risk management of financial institutions. That is considered to be one of the most important causes of the crisis. Do you share this point of view?

Mr. Wellink: Yes.

Mrs. Schippers: How is this possible? Isn't risk management a core activity of banks?

Mr. Wellink: Yes, for an important part this is a consequence of the fact that a number of risks simply wasn't seen.»⁷⁵⁵

1. Earlier in the hearing Wellink has said "In the course of the years we as supervisor have done quite a lot on the risk management of banks". Clearly not enough;
2. How does Wellink know that certain risks were not seen by (some, all?) banks? How does he specify and substantiate his claim? And what exactly does he mean? Which risks did they fail to see?
3. Did he discover this blindness only after the crash? If not, why didn't he take action? If yes, then what about his bragging about warnings, promoting risk management, etcetera? What exactly did he warn for, and what is the use of general, vague warnings?
4. The dossier shows beyond any doubt that the risks could (and should) have been known. Only dogmatism, stupidity and similar deficiencies can explain ignorance or neglect;
5. DNB AR 2006 says: "Limited information by hedge funds and private equity firms hinders financial institutions in estimating and managing risks with respect to these funds and firms." Already in 1999 the GAO had noted the same, and the CGFS had repeated the warning in its 2003 report. Representatives of DNB contributed to the last report, but didn't mention it in its AR. DNB should have acted upon the recommendations of the GAO and CGFS reports, but it ignored them;
6. With Wellink in the chair, Bair pointed to risks, but Wellink left her out in the cold;

⁷⁵³ Hearings report 1 p. 355 right.

⁷⁵⁴ A kind of big fat manual, or a financial system wiki. Given the importance, the large number of supervisor employees, and the positive influence such a manual would have on effectiveness and efficiency, this project is both feasible and accountable.

⁷⁵⁵ Hearings report 1 pp. 355 below right and 356 above right.

7. Earlier Wellink suggested that the abnormal profits were related to risks, and that DNB discerned these risks: “[This is what we stressed every time](#)” (see above). If this is true, how can the banks have failed to see the risks?
8. Both the financial institutions and many supervisors seem to have made unwarranted and erroneous assumptions about the size of changes or fluctuations, and underestimated amplifying effects. Although institutions in the narrow sense may have counted on supervision...
9. The CDW should have requested specification of “certain risks” and of the supervision of risk management. What assumptions and requirements did DNB make, and why?

Obviously, Wellink contradicts himself, and part of what he says must be untrue. Moreover: if his claims about warnings against risks concerned the relevant risks, then the financial events in the Netherlands are explicable only by utterly defective supervision. What Wellink claims is incompatible with the DNB AR. And the DNB AR are perfectly compatible with the events. What Wellink claims here is not.

Wellink persists in his claim that he couldn't know essential things.

«Mrs. Schippers: Of course, risk management is a core activity of the banks themselves, and it is a core activity of supervisors to supervise it. What responsibility do you take as supervisor for the fact that the risk management apparently has turned out to be quite inadequate?

Mr. Wellink: I think you should first of all talk about the characteristics of risk management in the future. That is what we are fully responsible for. Now we know that the risks of a bank can be correlated. We know that one should adopt an integral approach, so for that we are fully responsible. We know much more about risks in banking. Of course, as supervisor we were responsible for risk management, namely for the supervisory part. No doubt about that. We gave it lots of attention. About this too, we would gladly give you more information, if you want that, showing what we did in the course of the years. But a number of risks we failed to see. People speak with the benefit of hindsight. As a supervisor I would like to live in a world where it was possible to take decisions today with the knowledge of tomorrow. That would be my ideal world.»⁷⁵⁶

1. Wellink is seen to claim the right to tell the inquiry commission what questions it should ask (“I think you should...”), and the freedom to ignore inconvenient questions;
2. Earlier Wellink claimed to know the risks and to have warned for them. He made no distinction between risks. Now he denies knowledge of fatal risks, and to have discovered their existence only by the crisis;
3. Correlation must be assumed unless their absence can be proven. Correlation is normal, not exceptional.⁷⁵⁷ This is known from theory- from probability to social science, and from experience. Crashes would be impossible without correlations. In the financial system, there was absolutely no reason for assuming absence of correlation. Wellink is misleading;
4. This nonsense is uttered by someone with a PhD in economics;
5. The claim that “we” are fully responsible (only) for the future is misleading nonsense. Wellink was fully responsible for DNB from 1997-2011. He was its president;
6. In essence, Wellink is claiming to be not guilty because he couldn’t know things which were essential to know. But he could and should have known. At least from the GAO reports of 1994 and 1999, and those of CGFS and OFHEO of 2003. He also could have known from his own or DNB’s analysis of the financial system or the LTCM crisis, as GAO had made.
7. GAO and OFHEO had given clear descriptions of the risks that were to cause the subprime crisis. Wellink moreover has claimed several times to have warned against risks. If these were not the relevant risks his merit evaporates;

⁷⁵⁶ Hearings report 1 p. 356 below left.

⁷⁵⁷ It was known for over five decades that risks can be correlated. In the disciplines of probability and statistics this was part of the standard undergraduate curriculum since the sixties or earlier. Different probabilities can be independent or not. This is of crucial importance when one wants to know (compute) combined probabilities. Correlation is a form of mutual dependence. Every expert and responsible person could and should know these things. In the case of the financial economic system a minimum of reflection is sufficient to understand that financial economic risks in general are correlated. Namely because prices of many products are causally correlated, and because confidence of different people in many things is correlated as well. And because confidence is important for all kinds of valuations and processes.

8. What does Wellink mean by “supervisory part”? Isn’t it obvious that he is responsible only for DNB duties and claims, and not for all problems in the world? Or is he suggesting that part of risk management lies outside the scope of supervision?
9. «we would gladly give you more information [...] showing what we did in the course of the years». The information should have been in the DNB annual reports. That is what annual reports are for. Important things should not have been omitted. But the annual reports do not report what Wellink is talking about;
10. The sentences about hindsight are misleading and falsify history. The systemic risk was already known for over 10 years. It cannot have been ignored because it was unknown. It must have been ignored for political reasons (affordable housing, deregulation), stupidity (belief in self regulation) and/or laxness. By DNB too;
11. The conclusion is that Wellink is lying.
12. Wellink does not explain how DNB supervised risk management. The CDW did not ask him to.

Wellink lies to exculpate himself.

«Mrs. Schippers: I understand that in your ideal world nothing can go wrong. However, risk management is the core activity of a bank, and therefore of the supervisor too. If that can derail so badly, isn’t this coupled to responsibilities?

Mr. Wellink: No, I don’t think you can say that the risk management derailed. The risks derailed. That is something different. The question is whether the risks could be foreseen. If they were not, the risk management was regrettably not adapted to them.»⁷⁵⁸

1. Wellink gives a nonsensical answer. Facts are that the risks were understandable and visible and didn’t derail, but were ignored and underestimated. By Wellink too. In good risk management risks are estimated, but never assumed to be known exactly. Good risk management assumes uncertain risk estimates.
2. The risks became reality. Contrary to what some people say they believed, even small risks and “tail risks” can be realized, and can have major consequences.
3. The risks were foreseen, and therefore foreseeable. They could not be calculated precisely, but this is the rule, and nothing exceptional.
4. Wellink or DNB never gave any estimate of any risk at all. Neither quantitatively nor qualitatively. If you have no estimate, how can you speak of derailing? Wellink’s defense is sheer fantasy.
5. Remember the black-box of Madoff, in which AAB had dumped billions. How did AAB’s manage the risks of this “investment”? What did DNB do about this crazy gamble? Why didn’t CDW ask?
6. It seems possible that Wellink understands the concepts of risk and risk management only a little, or not at all. But in that case too he is unsuitable for his job, and his implicit claim of suitability a false and extremely harmful pretense.
7. Schippers should have confronted Wellink with the GAO, OFHEO, and CGFS reports.

Wellink did not know and did not understand that everything (in the financial system) is related to everything else.

«Mrs. Schippers: Mr. Doctors van Leeuwen said last week: we had the risk of a cow pretty well in our sights, but not that of a whole herd of cows. About the risk management he said that it had never become clear to him whether these risks had to be added, multiplied or whatever. In other words: the risk management simply wasn’t good enough.

Mr. Wellink: I think Doctors van Leeuwen expressed himself very well, about adding, multiplying and whatever of risks. The crisis has taught us, me too, that in a crisis everything is related to everything. That is an entirely new experience.»^{759, 760}

⁷⁵⁸ Hearings report 1 p. 356, the transition from left to right.

⁷⁵⁹ Hearings report 1 p. 356 above right.

⁷⁶⁰ Doctors van Leeuwen was head of the AFM, the supervisor of financial markets. In the Netherlands, there were two financial supervisors, DNB and AFM.

1. The comparison of Docters van Leeuwen lacks a basis. What Docters van Leeuwen and Wellink say is the bla bla of nitwits who falsely claim to know something about probability. The bla bla seems invented to mislead the commission (and the uneducated public).
2. Like Docters van Leeuwen's "observations", Wellink's answer is misleading nonsense. That everything is related to everything can be seen by everyone having eyes and brains in his head, if he uses them.
3. The systemic risk, a consequence of the interconnectedness, had already been seen and described in 1994 by the GAO. That it saw correctly was shown by the LTCM-crisis.
4. Both Wellink and Docters van Leeuwen are seen to be incompetent liars. Both with respect to content and management. They don't know what they have to know, and don't know how to get the relevant information out of their large organizations.

The lack of understanding of these two top supervisors need not surprise. Docters van Leeuwen studied law, and Wellink Dutch. Neither of these studies comprises mathematics. After his study of Dutch Wellink became an assistant in economics at the law faculty of the Erasmus University of Rotterdam. In this position he cannot have picked up much mathematics. And as shown in the Analysis (and by the fact of the financial crisis!), economics is not about reliable knowledge.

Wellink continues falsifying history by suggesting that this crisis is a new phenomenon.

«Mr. Wellink: [...] During the credit crisis I became aware of the interconnectedness of all risks taken together, and of the fact that the connections backfired at the individual institutions. Before that time we never had this experience. This was the first crisis in history where all risks in the world began to get connected to each other.»⁷⁶¹

1. Risks can be correlated because phenomena are related (or correlated). Which is obvious, and nothing new. Wellink is misleading if not lying. He seems to think that repetition creates belief;
2. Which is not meant to suggest that all risks are or were interconnected, or that in the subprime crisis «all risks in the world began to get connected to each other»;
3. The crash of 1929 shows that then too coherence played an important role. Witness concepts like bubble, domino-effect, and downward spiral. There is nothing fundamentally new in the subprime crisis. See the articles about the crash and depression in the Encyclopaedia Britannica 2002 (written when the subprime crisis was unknown) and in the Wikipedia. Both are included in the dossier.
4. The report of the Joint Forum on Credit Risk Transfer (CRT) of March 2005 explicitly mentions correlations. Even in a recommendation: «Correlations: Firms should thoroughly understand the sources for and roles of correlation assumptions in models used for valuation and risk management of CRT instruments». Klaas Knot, director supervision policy of DNB, participated in this Forum. So it is proven that the top of DNB personally knew of correlation as a phenomenon.

Wellink claims that fundamental adjustment of the financial sector is necessary.

«Mr. Wellink: [...] In August 2007, when the crisis became a fact, I have, I think publicly too, said in a number of places, that the financial sector should start a very fundamental adjustment process, that could have major consequences for the real economy. In that period I and the bank got the idea that the risks were far greater than we always thought.»⁷⁶²

1. Once again an egocentric opinion. Wellink seems not to be aware of other people and other supervisors, and their opinions.
2. On pp. 23-4/20-1 DNB AR 2007 has a section "Measures to be taken". The measures are of an incremental nature. Nothing suggests "that the financial sector should start a very fundamental adjustment process, that could have major consequences for the real economy".⁷⁶³

⁷⁶¹ Hearings report p. 357 above left.

⁷⁶² P. 357 in the middle of the left column.

⁷⁶³ In DNB AR 2007 the word fragment "fundament" is found six times. Never in connection with adjustments of the financial system. In DNB AR 2008 9 times. Never in connection with adjustments of the financial system. Once to report that BIS BCBS has put "a more fundamental revision of supervision" on its agenda. This is the nearest to the claim in the quote of all instances found in the DNB AR 2007-2010. In DNB 2009 there are 6

3. Wellink gives no outline, let alone specifics, of the required adjustment.
4. The size of a risk need not say anything about the consequences of the risk.⁷⁶⁴ Wellink clearly has an unprofessional, muddled idea of risk. His bla bla about tailrisk shows that he does not include consequences in his risk concept. But if the crisis has shown him anything, it may be that the consequences were larger than he and DNB had thought (without proper attention to what better people had said).
5. The myopia and passivity of Wellink and DNB as manifested in the annual reports and stability reports, and their utter failure in safeguarding the safety and soundness of many Dutch banks, show that Wellink and DNB cannot claim significant competence in the field of finance and economy. They are dangerously unreliable.
6. This is made worse by the lying of Wellink, and the failure of DNB to correct him. This makes them even more unreliable.
7. Note that this proven nitwit and liar feels called, and competent, to advise about reform of the financial system.
8. As the analysis of the financial crises shows, it is in the first place the law, supervisors and government (including parliament) that have to change, in the sense indicated there.

According to Wellink, top bank managers cannot be blamed: the products were new, there had been innovation, and there were unknown risks.

«Mrs. Schippers: A report of the Institute of International Finance shows that most top managers of banks did not know that so many complicated new constructions and products with unknown risks had been made. Do you support this conclusion?

Mr. Wellink: I support the part saying that they didn't know the risks of these constructions and products. That is what I subscribe to: the banks relied on the rating institutes, like we did where external ratings were concerned, and they relied on the models made by their own people, in general honorably and conscientiously, but with imperfect knowledge of the world.

Mrs. Schippers: Isn't that conclusion a little bit too easy?

Mr. Wellink: Well, I don't know if you can...

Mrs. Schippers: That you introduce products in the market, and say: we did know what these products were, but not really what they did in the market?

Mr. Wellink: I think this is a very difficult point, and I will explain why. Once upon a time I used the example of the Wright brothers, the first people to fly. That was innovation. You could say that they should have had a license to fly, and that they should have been fully aware of the risk they ran. On the one hand that is a very sympathetic point of view, since flying was a very dangerous activity. What I want to say more generally with this example is, that innovation brings risks, anywhere.»⁷⁶⁵

1. Wellink implicitly claims to know what top managers of banks knew and knew not. He says that they had and sold products of which they did not know the risks. Did Wellink and DNB have no problem with that as supervisor? Did Wellink and DNB try to understand the risks? If they tried, did they understand, or understand they didn't? Etcetera.
2. One can think about the risks of new products. They can be analyzed. If not quantitatively, then qualitatively. For new products one obviously should assume a wide margin of uncertainty, and manage the risks with more than normal care. Any suggestion of "all or nothing" is misleading nonsense.
3. DNB nor other supervisors told society that it had to accept new, unknown risks, in exchange for innovative new products. On the contrary: they suggested that the new products made the system safer by spreading risks and made it more resilient.
4. Honorably and conscientiously do a job that you should know far exceeds your abilities? (As proven by the facts).
5. "With imperfect knowledge of the world". This is an open door. All of us have to live with that. It is an irrelevant remark. The point is that they ignored risks they could and should have known.

instances, all of them irrelevant as regards the present claim. In DNB AR 2010 there are only 3 instances, all of them irrelevant as regards the present claim. I did not look any further.

⁷⁶⁴ Assuming that the concept refers to the probability only, and not to the consequences of realization.

⁷⁶⁵ Hearings report p. 357 below right.

6. The rating institutes only gave relative risks, and predictions are imperfect (!) and may change.
7. The banks must have relied on supervision too... They would have been right to rely on supervision even more, since supervision has the duty to maintain the stability of the financial system and contain systemic risk. Rating institutions don't.
8. Supervisors are not meant to foster innovation or passively observe experiments. They are to ensure the safety and soundness of the financial system. In particular they should do what they can to prevent avoidable harm for innocent outsiders.
9. The comparison with the Wright brothers is false. The Wright brothers caused only risks for themselves. And they did not sell tickets or planes. The bankers did sell the risky products, and caused risks for everyone.
10. Is Wellink kind towards top bank managers in order to avoid tempting them to tell what they know about Wellink and DNB?
11. The “new” products were not new at all, but are already listed in the GAO report of... 1994.

Variation on the theme “new and unknown”. Wellink warned for risks of which he had no idea.

« Mr. Wellink: [...] If I learnt one lesson, it is to be extra on the alert when new waves of innovation are coming. Periods of innovation are dangerous, because innovation is coupled with unknown risks.

Mrs. Schippers: So as supervisor you had no idea of all these risks either?

Mr. Wellink: No. Look, one of the things we have learnt is that the risks were correlated. Allow me to give another example. I remember a meeting of years ago in Basel, I think in 1998. As visiting guest we had Robert Merton, of Long-Term Capital Management (LTCM), the US hedge fund that went bankrupt. Robert Merton is a Nobel prize winner who did all kinds of learned things in economics, and who came to explain us, central bankers, how he handled complicated, sophisticated products. He claimed that there was no risk at all.⁷⁶⁶ In the meantime we were looking at walls full of graphs. I remember Alan Greenspan saying after two days: “Gentlemen- there was another Nobel prize winner present- you are extremely learned, and have calculated exactly how small the risks in the system are. As supervisors we are only interested in the tail risks; can you give us some more erudition about tail risks?” In my [= Wellink’s] opinion this was a great moment. The answer was: No, because it never happens.⁷⁶⁷ They [the experts] went back to the US, and the following week a tail risk was realized, and LTCM failed. This is what I mean by risks we haven’t seen. We knew that the system contained risks, but didn’t know their size; we didn’t know where the tail started, and didn’t know what the tail looked like. By now academic work is done on this, and supervisors at central banks too try to see whether we cannot get better control of tail risks.»⁷⁶⁸

1. The story is no explanation or excuse of Wellink’s “No”. His claims that innovation brings unknown risks, and that correlated risks are something new or amazing are nonsense. As noted earlier, one can analyze risks. One should assume a wide margin of uncertainty. The suggestion of all or nothing is misleading nonsense.
2. For Wellink’s lying about correlation see above, under “Wellink persists...”.
3. Several of the most important risks had been described and analyzed in the GAO reports of 1994 and 1999 and the OFHEO report of 2003. Wellink and DNB could and should have known the GAO report LTCM- Regulators Need to Focus Greater Attention on Systemic Risk from 1999, and act upon it.⁷⁶⁹
4. Note that Wellink claims to remember something of 1998. This is one more reason- beside job requirements- that he cannot use the excuse that the GAO reports and the Born elimination are from a long time ago.
5. The financial institutions were only responsible for themselves. DNB also for the system as a system. DNB should (and could) have known everything about the relevant risks and correlations.

⁷⁶⁶ It seems quite implausible that Merton really claimed this. Nevertheless, this is what Wellink said.

⁷⁶⁷ Does Wellink quote Greenspan correctly? The answer could have been: No, because it never happened. Though even this is not correct: one could for example extrapolate from known risks or events.

⁷⁶⁸ Hearings report p. 358 left.

⁷⁶⁹ GAO-GGD-00-3, in the dossier under 19991031.

6. Stupid remarks of a Nobelprize winner prove nothing. (Supposing Wellink's report of the meeting is essentially correct, which is doubtful, given his frequent lies).
7. The risks were not new. There was plenty experience with them. For example from the LTCM crisis of 1998, and the events eliciting CFTC Born's proposal to review OTC regulation.
8. The annual reports of DNB mention new products (even when they were not new at all). But they give no indication of efforts by DNB to obtain the insight necessary for its supervisory job, especially in the risks they create.⁷⁷⁰
9. The suggestion that innovation is restricted to specific periods may be convenient for Wellink and DNB, but is nonsense. Innovation is a permanent process.
10. What does Wellink want to say with the remarks around "tail risk"? Especially in an unstable system, the size of risks is not very important. Small risks can have large consequences. As shown in the LTCM crisis.
11. The evidence is incompatible with the interpretation that Wellink disagreed with Merton, and realized the importance of tail risks. In spite of the failure of LTCM, Wellink and DNB took no action, and ignored the warnings and recommendations of GAO and CGFS.
12. It is nonsense to suggest that one can or should know risks precisely.⁷⁷¹
13. DNB and its president should always be on the alert, and act when necessary.
14. As regards the safety of the financial economic system, the additional academic work is a misleading waste. The problem was not a lack of knowledge and understanding, but the system that allowed their complete neglect, including the selection of heads lacking both integrity and competence.
15. Wellink ridicules Merton for having underestimated risks, while saying that he himself did not see far more important risks, and denying that he could have known them.

According to Wellink, supervisors have said for 10 years that there are risks in the system "we can't get a grip on". That they left it at that is not an omission.

«Mrs. Schippers: [...] but when we look back, we can note that the supervisor didn't see or understand the risks, and actually supervised the unknown. Isn't that a reasonable conclusion?

Mr. Wellink: I think that supervisors and central banks were the only ones who said for over ten years: "There are risks in the system that we can't get a grip on". The others simply said: "There are no risks in the system". When you ask whether we could quantify these risks, the answer is: "No, we had imperfect knowledge of the way the world is built, just like everyone".

Mrs. Schippers: All right, but this is the core business of risk management. You say that neither managers nor supervisors actually saw the tail risks, the risks, in the system. So then we can conclude that there was an important omission.

Mr. Wellink: No. You call this an omission. [...] It always is the same point of the ideal world versus the world where decisions are made today, and real knowledge comes tomorrow.»⁷⁷²

1. Nothing like "There are risks in the system that we can't get a grip on" was said for over ten years in the annual or stability reports of DNB, CGFS, IMF, OECD, or any of the US financial supervisors. Fears about the uncertainty of certain risks, such as due to concentration, was the exception, not the rule. The rule was: we believe in self-regulation.⁷⁷³
2. Who said that there was no risk in the system? Greenspan and others relied on resilience and self regulation, but did not say that there were no risks.
3. None of the annual reports of DNB (or any other supervisor) gives any quantification of any risk whatsoever. In general, precise estimates are unnecessary.

⁷⁷⁰ See above, search for "crmpg", for a proof of the extremely passive attitude of Wellink and DNB.

⁷⁷¹ If one had to know the size of a risk before being able to act, one could never cross a street. One can never know the precise risk of crossing that street on that time of that day etcetera. Nonsense. One just has to be careful. For the same reason it doesn't really matter what the tail looks like (whatever it may be!). Moreover, if you need more information, you try to get it. But Wellink and DNB too did nothing to make the institutions and processes more transparent.

⁷⁷² Hearings report p. 358, around the transition from the left to the right column.

⁷⁷³ Remember Born: there was no need to review OTC regulation.

4. Once again: the claim that the realized risks were insufficiently known is a lie. See the GAO 1994-1999 and BIS CGFS 2003 reports, and think a minute about the steadily increasing affordable housing goals of the US government.
5. Does Wellink deny that it was an omission that the supervisors didn't try to get a better grip on only vaguely known risks for over ten years?
6. The answers in the present section are hard to reconcile with the "No" in the preceding section ("Variation on...").
7. Of course, and again, Schippers should have demanded documentary proofs.

Wellink saw no danger in the asymmetric compensation system.

«Mrs. Schippers: How do you judge the developments in the compensation policy in the financial sector?

Mr. Wellink: This actually means a return to a discussion we had earlier. Before the credit crisis we did not pay much attention to this subject, because we didn't feel there was a direct link between compensation policy and our job, to wit: from a prudential point of view ensuring a sound and safe banking system.

Mrs. Schippers: You saw no risks in the development of the compensation systems?

Mr. Wellink: No. [...]»⁷⁷⁴

1. The addition "from a prudential point of view" is an invention of Wellink. The Dutch Banking law of 1998⁷⁷⁵ does not include such a restriction;
2. Because of his duty, Wellink and DNB should have understood that an asymmetric compensation system increases risks for the environment (= the world outside the financial system). Namely because it promotes asymmetric weighing of costs and benefits in decision making. Costs are weighed too lightly, promoting irresponsible risk taking.⁷⁷⁶

Excessive compensation systems give wrong incentives.

«Mrs. Schippers: By now you have formulated a compensation policy. Is it based on the risks you now see in compensation systems?

Mr. Wellink: [...] It is interesting by the way that initially, when the supervisors, but the ministries of finance and the central banks too, started the discussion about incentives of compensation policy on corporate activities, the feeling was that these incentives are relatively small. Initially there was something like a phase of denial. The idea that the incentives were not very significant was proven on the basis of the fact that different financial institutions had the same compensation system, although some institutions failed while others had no problem at all. [...] By now [...] we think that excessive compensation systems give the wrong incentives for what people do in their job.»⁷⁷⁷

1. Wellink does not answer the question. He does not show that his proposal eliminates or reduces the risks.
2. There is no evidence of a phase of denial.
3. Wellink does not provide proof of the influence of asymmetric compensation, and no measure of its size.
4. Wellink does not notice that reduction of bonuses does not eliminate the asymmetry. He does not show that reduction of bonuses helps (proportionally?). It seems quite thinkable that a small bonus, or a non-financial reward (promotion!), has the same effect on behavior as a large (financial) one.
5. It is anyway obvious that bonuses are not the only relevant factor. An organization is more than a compensation policy, and procedures are not only about bonuses.
6. The main problem would seem to be the absence of "negative bonuses" in the case of losses for the organization or innocent outsiders. This absence is what causes asymmetry, not the height of the bonuses. Symmetry means equal sharing of both benefits and costs.

⁷⁷⁴ Hearings report p. 359 the middle of the left columns.

⁷⁷⁵ The version valid from 30/10/04 is included in the dossier. See especially article 3.2. Article 5 gives DNB almost complete freedom of action.

⁷⁷⁶ "Too lightly" includes not at all.

⁷⁷⁷ Hearings report p. 359 middle right.

Wellink cannot specify how DNB supervision could be improved. He announces a yearly letter to the government about financial law.

«Mrs. Schippers: Does DNB have sufficient formal supervision and enforcement instruments for micro prudential supervision?

Mr. Wellink: I think this is a terribly difficult question. I think that some instruments could be improved.

Mrs. Schippers: What instruments do you have in mind?

Mr. Wellink: It often begins with regulation. If we have to look at the operation of a board of directors, we think we should be able to evaluate the competence of that board. That seems to be obvious. But we don't have any instrument for this job. The reason being that according to the law, only the reliability of a director is evaluated. Some matters are very important. I give the example of a supervision measure; there is a number of them. We intend to send the minister every year a regulation letter, with a list of everything that should be improved.»⁷⁷⁸

1. If they saw a need, Wellink or DNB could have sent such a letter anytime.
2. If the instruments really were a problem, it must have been known already for a long time. How then can the question be difficult?
3. The evaluation of reliability clearly wasn't adequate. (Especially in the case of DSB).⁷⁷⁹
4. How does Wellink intend to test reliability and competence?
5. Obviously Wellink has never thought about possible improvements.⁷⁸⁰

The unmasking of the professionals and the fiction of the unpredictability of the crisis.

«Mrs. Schippers: Do you agree with what ex-minister Zalm has told us, that this crisis is the unmasking of the professionals?

Mr. Wellink: Yes, but I refer all the same and once again to my central note. You can call it the unmasking of the professionals, but it is simply true that we don't know the world of tomorrow. Tomorrow we will be confronted with new problems once more, and will be able to tell the same story.

There will be a new crisis. I think it will be different from the present one. By now we know the present crisis, and we are building all kinds of dikes to prevent repetition. There will however be a new crisis; and one that we didn't see coming.»⁷⁸¹

1. Wellink once more implies that we couldn't know and didn't know. Which is a lie.
2. The fact that we don't know the world of tomorrow (at least not precisely) is a reason for thinking hard about risks, and for proper risk management. Not for passivity.
3. Taking account of the work of GAO, OFHEO, and CGFS and the analysis of chapter 7, one has to conclude that Wellink's analytical competence is zero. He doesn't even know what he could know by reading the relevant literature. He doesn't ask himself: couldn't we have seen this coming, or how could we have seen this coming? How could we have ignored the signals? What could we have done if we had been warned in 1998? He doesn't even see the possibility that crises have important things in common. That they differ only in details, and that key phenomena in their run up are the same.
4. Wellink is 100% defensive and denying, and 0% constructive.
5. Wellink's explicit answer is yes, but his implicit answer is no.
6. Does everyone in DNB agree with Wellink?
7. Is he saying this to save his professional friends?
8. As long as humanity accepts this kind of people in top positions there will be crises (and wars, and other catastrophes). That much is predictable with 100% certainty.

⁷⁷⁸ Hearings report p. 359 below right.

⁷⁷⁹ See the Scheltema report referred to earlier.

⁷⁸⁰ Nothing of the kind was seen in the annual or other reports of DNB. Note that when you believe in self-regulation as understood by Greenspan and the like, including Wellink, there is no need to improve supervision.

⁷⁸¹ Hearings report p. 367 left.

- Wellink gives the impression of a wise man, speaking on the basis of many years of experience. But upon analysis he is unmasked as an incompetent liar, with a negative fatalistic attitude to boot.

According to Wellink, the accountants took their responsibility too narrow.

«Mrs. Schippers: I want to go with you to the last question regarding the investigation. The question concerns the adjustments of supervision which are desirable to strengthen the stability of the financial system. In the past weeks both Hans Hoogervorst and Dick Korf have noted that the triangular meetings with the banks and the accountant functioned insufficiently. Do you agree?

Mr. Wellink: I think this is true.

Mrs. Schippers: Why does this surface only now, that this functions insufficiently?

Mr. Wellink: It doesn't surface only now, but discussion is easier now. It is clear for example that accountants didn't like our asking questions- I happen to have seen a paper about this- because it gave them a feeling of being tested by the schoolmaster. In our position we wondered whether these accountants couldn't tell us something of their own accord, and whether their responsibility didn't go any further.»⁷⁸²

Where and when did this surface earlier? Not for example in the DNB AR 2006 and 2007.

Irresponsible passivity of accountants was also found in the inquiry of the construction fraud. See chapter 8.

About the duties of directors.

«Mr. Wellink: In the first place the directors [of corporations] have to be really competent. That should be the beginning. In the second place the directors should be much more keen on it. [...] They shouldn't only be competent, but also have the attitude that they ask questions, want to know exactly, and persevere. Directors should be much more active than they were. [...] They should therefore have much less directorships, for otherwise that is impossible.»⁷⁸³

So the directors should have characteristics which Wellink and his employees should have had as well, but didn't show.

It is obvious that the evaluation of the directors cannot be left to Wellink and DNB.

Could nobody have prevented the crisis?

«Mrs. Schippers: To conclude, also because we haven't much time left, I would like to discuss the question about the responsibility for the financial crisis. Several people have compared it with a tsunami. We were lying on the beach, we had never heard of it, and it befell us. In short: nobody could help it. What do you think of the simile, and the conclusion that nobody could help it?

Mr. Wellink: I prefer an other simile, though I'm not sure it is better. I used the simile of the inundation disaster of 1953 in the Netherlands. It was the effect of two things: a high tide, the position of the moon and the wind coming from an unexpected direction- things that we could not control- and dikes that were too low.⁷⁸⁴ The first part came from outside, which is the tsunami story. But for the dikes we are responsible together. At the time the Dutch authorities were responsible too. Then you can say that it happens once every ten thousand years and that you don't feel responsible for the dikes being too low, but there were dikes that were too low. Then I am not talking about guilt, for that implies something blamable, and some things we simply didn't know. But it is clear that in several fields the dikes were too low, regulation was incomplete and insufficient- we discussed Basel II- the rating institutes didn't do well. Perhaps supervisors have been sleeping somewhat sometimes. According to me, the policy of monetary authorities was far too expansive. So we should certainly take the responsibility for the low dikes to heart.

Mrs. Schippers: I am interested in the responsibilities. What responsibility has the financial sector for the making of this crisis, according to you?

⁷⁸² Hearings report p. 367 transition from left to right.

⁷⁸³ Hearings report p. 368 above left.

⁷⁸⁴ The position of the moon (known already for centuries) and the wind direction (not unexpected either) caused the extra high tide.

Mr. Wellink: In any case the crisis originated in the sector. The financial sector should simply accept this responsibility, not in the sense of culpability, but in the sense of responsibility. In the same way we have to accept responsibility for the way in which similar events in the future will be prevented.»⁷⁸⁵

1. Responsible together? Equally? There was and is no distribution of duties and authority?
2. What exactly corresponds with the dikes? What were the deficiencies exactly? Does he mean to say that Basel II, better ratings (=?), less napping by supervisors, and less expansive monetary policy would have prevented the crisis? Why didn't he mention and argue the measures more explicitly (much) earlier?
3. Very serious crises do not occur once in ten thousand years, but several times a century. This makes quite a difference for the blameworthiness of ignoring the possibility;
4. Here Wellink (almost) explicitly says that there is no blame and guilt because certain things were not known;
5. Is sleeping not blameworthy for supervisors? But it is worse: they didn't sleep, they told reassuring stories;
6. What does that mean: accept responsibility?
7. What does he mean by "we"? (Does he mean that "we" should have voted differently? How? Isn't it obvious that voting behavior doesn't make the least difference in the present respect?).
8. According to the present author the simile is invalid. The financial system is man-made entirely. For an explanatory history and an analysis of responsibilities see the analysis of the financial crises.

The responsibility of DNB.

«Mrs. Schippers: What responsibility does DNB have as supervisor for the origination of the financial crisis?

Mr. Wellink: As supervisor we have on the one hand seen a number of phenomena and warned for them, but on the other hand we did not fathom the concrete consequences for the Dutch system. The responsibility we have now is to ensure that it does not simply happen again in the same way.»⁷⁸⁶

1. There is no evidence for Wellink or DNB having seen the relevant risks. The available evidence shows complete neglect of the warnings by GAO, OFHEO, and CGFS, and a complete lack of adequate analysis.
2. There is no evidence for efforts by Wellink or DNB to fathom the consequences of any risk.
3. Wellink doesn't really answer the question. Wellink and DNB don't only have the duty "to ensure that it does not simply happen again in the same way", but should have prevented the crisis (and any disruption) in the first place.⁷⁸⁷
4. If he is responsible for prevention of repetition, then he is responsible for what happened.
5. Being responsible and not knowing what you could and should know makes you culpable and blamable. In addition to the often mentioned reports, the hearings of Muis and White show that the dangers were known indeed, and that Wellink is deceiving the commission;
6. The attitude manifested by "to ensure that it does not simply happen again in the same way" is incompatible with the duties of Wellink and DNB, which do not mention repetition or other restrictions. The statement means insubordination, and proves unsuitability.
7. Of course, CDW should have noted this.

The authority of DNB and the responsibility of Wellink.

«Mrs. Schippers: Do you think that DNB has lost authority?

Mr. Wellink: That DNB lost authority- which has something to do with the word "authority"- I always found an erroneous formulation. For if you lose authority, the answer seems to be that you restore it. Ultimately however the problem is that the possibilities to make the world are much more

⁷⁸⁵ Hearings report p. 369 left.

⁷⁸⁶ Hearings report p. 369 right.

⁷⁸⁷ What was the comment of DNB on the euro-treaties and the admission of countries to the euro-zone? Was DNB just an extension of politics, or did it do its duty? DNB AR 2000 calls Greeces accession per 1/1/01 successful, and doesn't give a single warning. See especially pp. 57/55 and 84/82.

limited than we think. People assumed that authorities can make the world. These authorities lost authority because they did not do what society expected of them. One of our duties at this moment is to explain that the possibilities to make the world are much more limited than people assumed. This is a simple fact. One of the remarks in the Icesave-report, which I think is a very well-balanced report, is that a supervisor should explain that something can go wrong with financial institutions. Everyone assumes that the world is makable, and if this is assumed, the authority of authorities decreases if something goes wrong.

Mrs. Schippers: What responsibility do you feel personally?

Mr. Wellink: For myself I find the process we went through very sad. By now I have been working for 40 years in the public sector, regarding the financial sector. The first 13 years I worked at the ministry of finance, and the following 27 years at the bank. I always stayed in the public sector. I have had many offers for the private sector, and to profit from bonuses. You should realize that it is a great disappointment if this happens after so many years and you have always devoted yourself to a healthy and sound sector which is important for the Netherlands. I do not blame myself.⁷⁸⁸

1. The remarks about the making of the world by authorities are completely irrelevant and can only be meant to amplify the false impression made by Wellink's earlier remarks, that he and his kind couldn't help it. It is baseless nonsense that people assume that authorities, such as supervisors, can make the world. People may have assumed the authorities to be open and honest, and competent, but that is something entirely different.
2. The problem is not "that the possibilities to make the world are much more limited than we think."
3. The nonsense of Wellink hides the very relevant fact, that the supervisors could have been much more reliable and careful, could have done very much more, and could probably have prevented the subprime crisis.
4. The real problem is that the authorities are neither honorable nor competent, and didn't do their duty. Their annual reports are stark witness and proof of this.
5. Wellink did not truly devote himself to a healthy and sound financial sector. He kept Dutch supervisory policy in line with that of the US. Which meant: acceptance of the dogma of (short-sighted) self-regulation, and sit back as much (and as long!) as possible.
6. Wellink may say that he is very disappointed and pitiable, but he doesn't answer the question of Schippers regarding his responsibility.
7. He omits to mention that as president of DNB he had one of the highest salaries in Dutch public administration, a salary which is about twice that of the prime minister.
8. Wellink is blamable and one of the main causes of the crises, because as president of DNB and BIS he did not do what he could and should have done to prevent the crisis and the failure of several of the most important Dutch banks. It is highly probable that he could have prevented the crisis on his own, personally, if he had acted honorably and competently.

The hearing of Monday, February 4, 2010.

10u00-12u20.

The transcript of this hearing can be found on pp. 469-489 of the report of the first series of hearings.

This section is divided in the following three parts:

1. Part 1. The declaration of no objection (DNO) for the take over of AAB by a banking combination.
2. Part 2. Icesave.
3. Some conclusions.

Part 1. The declaration of no objection for the take over of AAB by a banking combination.

«The chairman: Mr. Wellink, welcome. There are two things we want to discuss with you today, to wit: the take over of ABN AMRO [bank] and the ruin of Icesave. For completeness I note that for both subjects this inquiry commission has a limitation. This is connected with the terms of reference which

⁷⁸⁸ Hearings report p. 370 left.

we received from the Second Chamber [of Parliament]. The subject ABN AMRO is focused on the declaration of no objection. With respect to the subject Icesave we restrict ourselves to the developments until the beginning of October 2008. The remainder of these subjects will be treated in the second phase of our inquiry.

ABN AMRO will be discussed with you by mrs. Koşer Kaya, and Icesave by mr. Cramer. [...]

Mrs Koşer Kaya: Welcome, mr. Wellink. Together with you I will look into the way the Dutch Bank has acquitted itself of its supervisory duty in making the declaration of no objection for the take over of ABN AMRO.»⁷⁸⁹

«Mr. Wellink: [...] We didn't want to split [Dutch banks]. With take overs we never had any problem.»⁷⁹⁰

Wellink doesn't give arguments. Although a little bit farther on he claims that in case of a split, Dutch government and taxpayers would have to bleed. P. 470 too gives a lot of opinions, but no arguments.

The following is quoted because it shows how Wellink sees the duty of DNB.

«Mrs. Koşer Kaya: Can you please explain [that you remained within your legal authority]?

Mr. Wellink: My pleasure. We are a prudential supervisor and have to watch over the stability of the system. Indirectly we therefore have to make sure that not too much money of the taxpayer will have to be coughed up for the financial sector. This warning certainly befitting our prudential responsibilities.»⁷⁹¹

About "Europe":

«Mr. Wellink: [...] It is true that Brussels reacted sharply and fiercely. I have to tell you that I think that a European commissioner [McGreevy] is acting quite irresponsibly if he doesn't even try to find out the contents of the objections of a supervisor. I tried to contact this commissioner. An appointment was made. Then he postponed this appointment, and postponed it again. Then I thought to myself: it has been enough.»⁷⁹²

«Mrs. Koşer Kaya: Could you briefly sketch the distribution of responsibilities between the Dutch Bank [= DNB] and the Treasury Secretary in the evaluation and granting of the declaration of no objection?

Mr. Wellink: I understand this has been discussed before. We look at aspects like the healthy operational management and transparency of the organization that is created by the take over. If we say: "no, it can't be done", the secretary has to follow suit. If we say yes, the secretary can still form his own opinion. Where financial stability is concerned, the secretary has the primary responsibility.»⁷⁹³

P. 472, below left, gives a proper substantiation by Wellink of worries about the take over of AAB by the combination consisting of Fortis, RBS and Santander.⁷⁹⁴

The right hand side column of p. 472 says that experience with this kind of operation was defective, and that this was a good reason for at least being very careful. The lack of experience substantially increased the risk of the operation.

P. 473. Fortis had to emit 13,4 G€ new shares and borrow 10 G€ to finance its part of the deal. According to Wellink the price the combination was willing to pay for AAB was high and risky.

On p. 474, above right, Wellink shows that he knew that Fortis' possessed securities of which the value was dropping. Therefore he should have realized that liquidity was or could become a problem at Fortis. Already in February 2007 ABX indices had dropped substantially. There was no reason to

⁷⁸⁹ Hearings report 1 p. 469 left.

⁷⁹⁰ Hearings report 1 p. 469 below right.

⁷⁹¹ P. 471 above right.

⁷⁹² P. 471 below right.

⁷⁹³ P. 472 in the middle of the left text column.

⁷⁹⁴ Santander= Banco Santander.

assume that the trend would reverse anytime soon.⁷⁹⁵ Wellink suggests that he was aware of the risks. On the other hand he asserts that some things (losses) came to light only after the DNO: «when it is said that about the balance things have come to light which we do not know, then these are things which have come to light by developments after granting the declaration of no objection.»⁷⁹⁶ This is misleading, because the risk was already generally known before the granting of the DNO, and did not come to light later. It became an immediate practical problem after realization of the risk. (Less than a minute earlier, Wellink had said: «The main problems were not discovered later, but manifested themselves later.»⁷⁹⁷ Problems have to be distinguished from risks).

P. 474 below right. According to Bruggink (RABO), Streppel (Aegon) and Timmermans (ING), in August 2007 the financial markets were locked, did not function. So it was evident that there was a high risk of a liquidity problem. This is easily seen to be compatible with the chronology of events. Wellink's optimism (recklessness) is not.

In the following, mention is made of the three criteria for the declaration of no objection against a bank take over. The criteria are:

- A. sound and prudent management
- B. transparent distribution of authority
- C. consequences for financial stability.

In the procedure for the DNO, the minister decides about criterion C, see p. 478 below right. After he decides positively, DNB decides about A and B.

«Mrs. Koşer Kaya: If DNB saw so many risks, why did it advise positively with respect to the criteria A and B?

Mr. Wellink: Because our analysis showed these risks to be manageable, and because the remaining risk was too small to say no.

Mrs. Koşer Kaya: You indicate that you made inquiries. Do you think, that given these inquiries, you could have motivated “No”?

Mr. Wellink: If I, within our duty and authority, had only seen a very minor hole enabling me to say no, then I would have said “No”. This is what I can assure you, for everything inside me resisted instinctively against granting the requested declaration. At the same time, and that has been a heavy battle for me during the process, and colleagues too said this to one another, we have to do what we have to do. We should not aim at what we feel, but simply apply the strongest possible test we can think of. That is what we did.»⁷⁹⁸

In the following Wellink asserts that there was no such minor hole. Of course, there was a hole indeed, and not a small at that: the understandably falling ABX. The fall was understandable because of the falling home prices and the growing number of people failing to make their mortgage payments on time. The assertion about the manageability of the risks cannot be true. It is not explained.

The DNO was given on 17/9/07.

«Mr. Wellink: [...] There was a liquidity problem.»⁷⁹⁹

So he knew. Earlier he had said that the risks seemed to be manageable. See the quote above. The manageability was sheer fantasy.

Asked about the risks, Wellink replies with nonsense:

«Mrs. Koşer Kaya: But you did indicate very many risks. Couldn't you motivate “No”?

Mr. Wellink: No, we did indicate many risks, and wherever we saw risks we took risk-mitigating measures. I don't know what exactly the commission was given, but we have uncountably many full color graphs showing the risk according to category. Then you see the risk mitigating measures, and then you see the colors change.»⁸⁰⁰

⁷⁹⁵ Nobody mentions any.

⁷⁹⁶ Hearings report 1 p. 474 above right.

⁷⁹⁷ Still the right hand side column on p. 474.

⁷⁹⁸ Hearings report 1 p. 476 below left.

⁷⁹⁹ Hearings report 1 p. 476 above right.

⁸⁰⁰ Hearings report 1 p. 476 above right.

What measures did DNB take? What assumptions were they based on? How could the risks of MBS be mitigated?

The chronicle shows that in August there were already large problems. In August Countrywide for example ran into serious liquidity problems.

Koşer Kaya continues with another element of the same decision making process: criterion C, the stability test.

«Mr. Wellink: [...] As central bank we have a natural tendency to interpret it [= the financial stability criterion] broadly, because in part we feel ourselves watchmen of financial stability.»⁸⁰¹

«Mr. Wellink: For criterion C we considered the question whether, independent of the criteria A and B, independent risks could arise in the area of financial stability. So we also considered what was happening at that moment in the world, and the question whether developments in financial markets could not wreck a plan which seen on its own was prudentially healthy. That is why it is so important to observe that this judgment was passed on 17 September, when the crisis had not yet erupted to its full extent.»⁸⁰²

This is a misleading and irresponsible (yes-no) representation of the situation. As if a crisis can only be on or off.

And can a banking plan be seen on its own? Can a banking plan ever be independent of financial markets? This would seem to be extremely hard to imagine. Even the simplest banks have to take account of interest rate developments.

«Mrs. Koşer Kaya: As outlined also by a number of people from practice, one of the problems in the financial market of August 2007, was that certain parts of the interbanking market did not function properly any more, and actually were locked up. This would entail problems for certain off-balance activities, in particular for financing conduits. It is known that both ABN AMRO and Fortis were heavily involved in this kind of activity. Did DNB have a good and complete picture of the exposures of ABN AMRO and Fortis with respect to conduits and SPV's (Special Purpose Vehicles)?

Mr. Wellink: I know that on the anniversary of my mother, 14 August, I asked what exactly had to be written off on this kind of things at Fortis. That is one. Two, and I will say it anyway: during the crisis the conduits of ABN AMRO turned out to be an asset, and the funding of these conduits could continue normally. So the problem at ABN AMRO had nothing to do with that. The problems- I just referred to them when I mentioned the name Jiskoot- were in the book of trade, in CDO's (collateralized debt obligations), CDO warehouses, negative basis trades and that kind of things. I will not tire you too much with this, but there, in the special and more complex products which one still had for one's own account for one's own book, were the problems, not in the conduits.

Mrs. Koşer Kaya: So DNB had a complete picture of the exposures of ABN AMRO?

Mr. Wellink: Yes, and that complies with the fact that in 2003 we required that the credit lines of our institutions should be sufficient to finance the whole conduit. So we had consolidated liquidity supervision.

Mrs. Koşer Kaya: And you did have good insight in that?

Mr. Wellink: So we had good insight in that. Since then the liquidity position of ABN AMRO has remained excellent.»⁸⁰³

Of course, confirmation of these statements by a reliable source is necessary.

Even if AAB was healthy, there also was the combination of banks. At least the liquidity of Fortis was threatened.

Wellink should have explained why further decrease of the ABX would do no harm, or how the risk and consequences could be neutralized.

«Mrs. Koşer Kaya: Why is there no reference in the declaration of no objection to the possible risks due to the uncertain situation in the financial sector at that moment?

⁸⁰¹ Hearings report 1 p. 476 below right.

⁸⁰² Hearings report 1 p. 477 above left.

⁸⁰³ Hearings report 1 pp. 477-8.

Mr. Wellink: Because that is included in the criterion that the financial solidity [sic] of the institution should still satisfy the norm before we would give permission to take ABN AMRO apart and to integrate the parts with others. That was simply included in the criterion. It is really a very large handle for us to keep matters under control.»⁸⁰⁴

Nothing here contradicts the stupid illusion that supposedly healthy institutions, healthy according to insufficient norms, guarantee a healthy system. Nothing contradicts the belief in the sufficiency of evaluation of separate institutions according to theoretical, but logically insufficient, norms. It is tacitly and incorrectly assumed that the influence of the environment has been adequately incorporated in the norms. Which is nonsense, as could have been understood.

P. 479. Wellink says that the prudential consequences of splitting ABN AMRO could be estimated adequately, notwithstanding the uncertain market situation:

«Mrs. Koşer Kaya: Could the prudential consequences of splitting be estimated adequately, considering the uncertain market situation?

Mr. Wellink: Yes, I still think so. There were indeed uncertainties. But at a certain moment the uncertainties developed in a way we did not foresee. One tends to forget that we entered the worst financial crisis of the last 100 years. We had not foreseen that, but we had a safety net. If things went wrong, we could disentangle them.

Mrs. Koşer Kaya: Could the large uncertainty have been ground for refusal?

Mr. Wellink: Not in my opinion, otherwise we would certainly have done so. I have already told you that if I had only seen a minor hole which I could have used to refuse, I would certainly have done so.»⁸⁰⁵

Earlier in the hearing, Wellink also asserted that he had taken account of the remaining risks. As noted before, he may not understand the concept “risk”, or may be unable to reason properly with it. The remark “There were indeed uncertainties. But at a certain moment the uncertainties developed in a way we did not foresee” is internally inconsistent. The second part implies that the “uncertainties” of the first were not really uncertain but well behaved, and at least partially known. In other words: the uncertainties were uncertain, and the word is used incorrectly and misleadingly. It would probably have been more honest to have said: we underestimated the risks, or did not see certain risks.

The most important thing would seem to be that in the given situation Wellink could and should have said: not now. There is too much liquidity risk. We will review the question when this “turbulence” is over. (The word “turbulence” is copied from DNB AR 2007).

On 7/10/08, the UK central bank gave RBS 36,6 G€ emergency aid. Because of liquidity problems. According to Wellink:

«That was a very crucial moment, because in that week we had just extracted ABN AMRO and Fortis from the Fortis-concern.»⁸⁰⁶

P. 480 above left, Wellink speaking: «I note that we worked with exceptional care, but that our information had gaps which were rather fundamental.»

Earlier in the hearing he had said that he had all information. The main point seems to be that there was a lot that DNB didn’t understand, or was dogmatic about (and couldn’t competently reason about). It may have believed in erroneous theories of self-appointed authorities, and put facts, experience and common sense in the second place at best.

Wellink continues with the claim that there is a need for a European financial supervisor, who can see through all internal boundaries.⁸⁰⁷ But only a worldwide supervisor can see everything (in principle!). So why not at least a European-American supervisor? Or is that something for after the next crisis, after it has turned out that The Supervisor should be able to look across the Atlantic? Etcetera. But the most important point seems to be that a European supervisor need not help in the least if he behaves like the national supervisors did in 1994-2007, or like the Fed, which after all is the

⁸⁰⁴ Hearings report 1 p. 478 below right.

⁸⁰⁵ Hearings report 1 p. 479 above left.

⁸⁰⁶ Hearings report 1 p. 479 below right.

⁸⁰⁷ Hearings report 1 p. 480 above left.

equivalent of a European supervisor. On the other hand, if the national supervisors do their duty, including informing one another reliably, then a European supervisor is not necessary. The more so since such an organization requires a division of duties, and increases the risk of gaps. And last but not least, don't forget or underestimate the language/communication difficulties.

Part 2. Icesave.

Wellink is questioned about this topic by mr. Cramer, member of the CDW.

«Mr. Cramer: [...] Mr. Wellink, as noted I will discuss the Icesave case with you. The case continues until the beginning of October 2008, when the problems with Icesave manifested themselves very clearly. We try to review the process from the request until October. In this way we try to get a structured picture. On 20 September 2007 Landsbanki requested additional participation in the Dutch system of deposit insurance. On 23 May [2008] participation was approved, while Icesave is launched on 29 May 2008. These dates are separated by three quarters of a year. What did the Dutch Bank do with the request between 20 September 2007 and 23 May 2008?

Mr. Wellink: First the request was left alone for quite some time, until a more general policy had been formulated. It was the first topping-up-exercise. There was one more request. So we had to formulate a policy first.»⁸⁰⁸

P. 481 below right. Cramer tries to show that DNB had good reason to work more carefully than it did. Wellink claims that that was done, but fails to make a credible impression because he doesn't refute Cramer's arguments adequately. Too often Wellink refers to an unavailable document, without indicating their contents. (On p. 482 above left, Wellink makes an incorrect comparison with a football match).

«Mr. Wellink: [...] This question [whether there was reason to ignore European rules] remains coupled to the question whether you expected that calamity in October. In that case, presumably you would have been the only institution. For the ECB did not expect it, and accepted Icelandic paper as collateral. All kind of banks did business with Icelandic banks.»⁸⁰⁹

Indeed unimaginable, being the only one. (Rather: the first one). Terrible!

One only needs to fear calamities. You need not expect them at a certain time in order to be more careful and to take account of the possibility of their realization.

«Mr. Wellink: [...] «At a given moment we combined the disciplines which I just mentioned: the supervisors, the regulators, the lawyers, and people of our bank who supervise financial stability. These people met on 20 May. Together they concluded that the situation was not that threatening that a raise was not warranted. The question is whether this conclusion was justified. Afterwards of course it turned out not to be correct. But was it justified? I can only say, to give an example, that on 17 September Moody's still evaluates the Icelandic economy and declares: the Icelandic economy is not only able to withstand a crisis in the real area, but also a crisis in the financial sector. I can only say that on 6 September 2008 a new branch was opened in Europe, in Austria, and that this was accepted. I can only say that in this period the ECB still accepted collateral from these banks, until a certain moment. On the basis of this I can say that the ECB too apparently did not have the opinion...

Mr. Cramer: Mr. Wellink, you are speaking about Moody's. Moody's increased the rating to AA in February 2007. This was criticized strongly by the market. The upgrading is reversed already a short time later. In front of me I have some A4 pages with examples. What matters to me is that in the financial world a picture is painted that at least gives rise to doubts about the tenability of the Icelandic economic system.

Mr. Wellink: Nobody of the large institutions which are responsible for the stability, neither the IMF, nor the ECB, nor I, has foreseen that it would crash. That is different from saying that almost nobody had worries.»⁸¹⁰

⁸⁰⁸ Hearings report 1 p. 481 above left.

⁸⁰⁹ Hearings report 1 p. 482 halfway left.

⁸¹⁰ Hearings report 1 p. 483 above left.

So Cramer shows that Wellink gives a one-sided, incomplete and misleading picture. Of course, a little bit of thinking would have helped Wellink and his combined disciplines out of their dreams.

Why didn't the inquiry commission ask for the minutes of the meeting of 20 May?

A piece of information about the cooperation between supervisors.

«Mr. Wellink: We received positive information from the Icelandic supervisor. By the way, on 23 Augustus 2008 the Icelandic supervisor still announced that all of the stress tests had succeeded very well. Then you have the problem that the guideline, I think in Consideration 7, explicitly requires European supervisors have to be able to trust one another.⁸¹¹ Information exchange has been arranged. Consequently one should be able to rely on the information which is exchanged. You cannot look behind it.»⁸¹²

The last remark is not true generally. There may be public sources which enable one to check, if only for compatibility.

About obligatory mutual trust see also p. 488, right hand side.

Didn't Landsbanki have an annual report?

«Mr. Wellink: I have no objection against telling you what I did. In the middle of July I concluded, with information from other sources, that there should be increasing worries about the Icelandic banking system. I immediately bombarded my people with questions. I asked them whether there were possibilities for getting rid of the topping up. There were no such possibilities, neither de facto nor de jure. On 5 August we concluded that we really should take action. We saw that the picture differed greatly from what was told the public. [And so on: after the drowning of the calf DNB begins to try and stop expansion by means of verbal force.]

On 8 September I go to my Icelandic colleague [= the Icelandic central bank president, whom he sees in Basel] and ask him: is it really true, that everything is sound? Again, I did not have failing banks in mind. I had worries about these banks, big worries. Whereupon that Icelandic colleague replies: I have warned [the Icelandic government] already six months ago.»⁸¹³

Wellink concludes that DNB had been cheated.⁸¹⁴

But Wellink is not very different.

«Mr. Cramer: The Banking Guideline has been discussed adequately by now. We conclude that the worries did not become sufficiently clear, and that Iceland sent positive information, also about geysers, fish and whatever you mentioned more. Then there must come a moment that DNB can give a directive. On 8 September the president of the Icelandic central bank tells you: we already warned the Icelandic government. When this is added to the worries which DNB already had, didn't the information justify giving a directive as meant in article 1:75 of the law on financial supervision?

Mr. Wellink: You know the interpretation of mrs Grundmann. I had expected another question about it, in spite of what mrs Grundmann already told about it. I have requested new legal advice about the question whether we and mrs Grundmann interpret the matter correctly. I asked new advice. That advice, by a truly eminent expert in the field of European law, Michel Tison, leaves nothing to be clarified. I have the advice in my inside pocket, but need not read it aloud. I had imagined to take it out, and recite it pathetically. The last sentence of the advice asserts that if the liquidity is OK, and those numbers were OK, and on the basis of information obtained from the home-supervisor you have no indications of something being amiss with the general financial situation of the institution in that country, then you have no possibility to give a directive.

Mr. Cramer: I have article 1:75 of the law in front of me. The second paragraph of that article reads literally: DNB can also give a directive as meant in the first paragraph if it observes signs of a development which may endanger the capital, the solvability, or the liquidity of that financial institution. We agree about the liquidity. That need not have been an immediate problem. But there were many other signals which could have made you assume that the danger was becoming imminent.

⁸¹¹ The Dutch original has: "op elkaar moeten mogen kunnen vertrouwen".

⁸¹² Hearings report 1 p. 484 below right.

⁸¹³ Hearings report 1 p. 485 left below.

⁸¹⁴ Hearings report 1 p. 485 above right.

So there was reason to give a directive on the basis of article 1:75 of the law on financial supervision.»⁸¹⁵

Note that in this case too the CDW does show Wellink to be lying and misleading. By misrepresentation and omission.

It seems impossible that liquidity was not endangered by current developments.

DNB could and should have asked questions on the basis of the market for MBS and CDS and other securities. (It should not have asked “Is it safe?”, but: “what are the constituents of its capital?”). It should have received replies showing that the banks ran the risk of insolvency and bankruptcy.

More is said about the matter, and it looks like a game of cat and mouse, but one thing is clear: Wellink is thoroughly unreliable. You never can tell whether he has omitted essential information, but must expect it. As he also omitted mention of the GAO reports and the elimination of Born. The “truly eminent experts” are only presented as a soporific.

Wellink also contradicts himself: after having shown that a directive cannot be given it turns out that he did give one (6/1/08).

Wellink’s argument about a liability claim for causing a bank run doesn’t seem valid because the judge will accept the defense of DNB.

Somewhat farther on in this discussion:

«Mr. Wellink: [...] when our actions could no longer cause harm, we were extraordinarily active and protected Dutch interests.

Mr. Cramer: At that moment the damage for the savers had been done.

Mr. Wellink: Regrettably, large part of the damage had already been done. Indeed. That is a great pity.»⁸¹⁶

Mrs. C.M. Grundmann-van de Krol is professor of securities law at the Radboud University Nijmegen. Cramer doesn’t let himself be misled by Wellink.

Some conclusions about the hearing of February 4, 2010.

The questions and answers in this hearing show that DNB systematically took the compliant and optimistic decision, in spite of information about negative market developments which exacerbated the liquidity- and solvency risks for the banks involved. Wellink and DNB did not choose a safe course but a very risky one. Wellink’s explanations are unconvincing. He regularly needs lies to defend himself.

The chronicle shows that in the years of Icesave and the take over of AAB, the state of the markets was unsettling and deteriorating. If an expert (a real one) had looked at the books of the banks, he would have seen that they might not be able to survive continuation of the present downward trend. In other words: that survival was at risk. To see this one didn’t have to know the GAO and similar reports. One only needed to know the types of assets of the banks, and the market developments. Even though the system had not yet crashed, all relevant developments were in full train.

Wellink claims that the decisions were only wrong by hindsight. He doesn’t describe the internal decision making process at DNB. The commission doesn’t inquire about it, and Wellink only makes an isolated and incomplete remark about it: «At a given moment we have combined the disciplines which I just mentioned: the supervisors, the regulators, the lawyers, and also people of our bank who supervise financial stability. These people met on 20 May. Together they concluded that the situation was not that threatening that topping up was not warranted.»⁸¹⁷ Why didn’t the commission request the minutes of this meeting? How can one responsibly make an inquiry into future-relevant causes, without a study of internal documents which are an essential part of the decision making process? Isn’t it unimaginable that DNB had no employees who knew the market situation and had reservations? Isn’t it of crucial importance to know how their reservations were thrown into the dustbin?

⁸¹⁵ Hearings report 1 p. 486 left.

⁸¹⁶ Hearings report 1 pp. 486-7.

⁸¹⁷ Hearings report 1 p. 483 above left. This concerns Icesave. About internal decision making about the DNO nothing is said.

There is the following agreement with the other hearings of Wellink: Wellink and DNB act as if the risks for which Wellink claims to have warned repeatedly, have no practical significance. The decisions regarding the DNO and Icesave clearly show that Wellink and DNB are not aware of great danger. In this context, he does not even once refer to his own warnings.

Wellinks formalistic legal (quasi) arguments are unconvincing because they strongly suggest opportunistic selectivity, and are highly sensitive to omissions. They are consistent however with an absence of awareness of serious danger. It would seem that the correct decisions were perfectly defensible before a judge. And even should have been taken irrespective of the risk of conviction, because it is obvious that the damage due to bankruptcies is very much larger than that of a mistaken interpretation of the law. It would seem that if the instruments mentioned cannot be used as indicated in these cases, they can never be used. Collateral damage cannot be used as counter arguments. It must have been clear to the law maker that this will in general be unavoidable. And in this area arguments are never hard as diamond.

Wellink shows no trace of doubt or need to think or reconsider.

Apart from what is said in the quotes, much of what was said in the hearing cannot be checked, or not in an easy way.

Wellink's harping about knowledge by hindsight confirms that he understands very little of risk. Someone aware of a risk cannot be amazed about its realization. Knowing a risk is knowing that it can be realized.⁸¹⁸ Accusing a person of talking by hindsight if that person talks after the realization of and about a known risk, betrays the false belief that risks are not real, and are not supposed to be realized. One can be accused of talking by hindsight if the possibility of a phenomenon could not have been foreseen. But in 2007-2008 more than enough was known to be happening. Wellink simply failed to take developments and risk seriously, and take them into account properly.

The simplest and most logical explanation of Wellink's failure to withhold the permissions is his self-taught neglect and repression of danger signals, due to his trust in self-regulation, and possibly his passive character.⁸¹⁹ The annual reports of DNB prove that this has been the attitude of DNB for a decade or longer.

At least twice in the quotes, Cramer shows explicitly that Wellink gives an incorrect picture by withholding information. A picture that exculpates himself and DNB. While full information shows that they could or should have taken another course, the safe one.

Koşer Kaya fails to puncture inadequate answers.

The hearing of Friday, December 2, 2011.

13u00 - 16u38 in the Enquêtezaal of the Logement in The Hague.

Commission De Wit, Report of the second set of hearings, pp. 1257-1310.

In the hearings of December 2011 and January 2012 Wellink was under oath. The hearing is about the causes of the subprime crises and the fate of AAB and ING in that crisis.

Conclusions.

1. Both questions and answers are superficial. Wellink provides very little information and insight that cannot be found in many other places.
2. Wellink often gives the impression of lecturing, or an authoritarian attitude towards the commission. Which is irritating due to the banality of his remarks, and his frequent misleading and lying.

⁸¹⁸ This includes the risk that trends continue. This kind of risk might require somewhat different terminology and sentences. For brevity's sake the text is restricted to the standard kind of risk: the possibility, with a certain probability, of a certain harmful event.

⁸¹⁹ The most logical because it assumes the same attitude as shown in the annual reports 1998-2007. A different attitude would require additional explanations, both external and internal (psychological). Without such explanations it would mean inconsistency.

3. The term “risk management”⁸²⁰ does not occur in the report of the hearing. In other words: it is not used by either the commission or Wellink.
4. None of the hearings of Wellink gives evidence of understanding of risk and risk management. Rather the contrary: there are several indications of grave misunderstanding.⁸²¹
5. Wellink tells about (late) warnings given personally. Why not about warnings in DNB reports, especially annual reports? Why can stern and unambiguous warnings not be found in the DNB annual reports? Why don’t these reports criticize the Basel agreement? Wellinks personal reaction to the (hypothetical!) warnings of others was marginal or zero. See the previous hearing!
6. Much of what Wellink says seems new, changed and/or acquired in the period of almost two years between the first and second series of hearings. For a supposed expert this is quite remarkable.
7. Wellink does not refer to DNB reports or other reports.
8. The pretended importance of better forecasting is incompatible with the blind rejection of prophets. There is no evidence showing that Wellink is interested in phenomena and understanding. He does not consider remarks on their own merits. If he had listened to the prophets and/or used his brains, supposing the quantity and quality of his brains are adequate, he would have known all he needed to know to prevent the crises.
9. Wellink is only interested in keeping up appearances, as in these hearings.
10. The commission remains passive under Wellinks false testimony (facts, reconstructions, explanations). Which means that outsiders have to conclude for themselves that Wellink is a swindler.
11. Didn’t the commission understand that it was misled and lied to?
12. The commission does not investigate the interaction between Wellink and DNB. It does not investigate the influence of Wellink on DNB. Wellink himself says nothing about these subjects.
13. The unacceptable answers should have been reason for the commission to investigate DNB: were all employees just as stupid and blind as Wellink?
14. Wellink presents contradictory assertions about the supposed incompatible requirements of a safe financial system and a working economy. The commission does not investigate the influence of these ideas on the conduct of DNB in the prehistory of the crisis, even though they may have had far reaching consequences. The fear to cripple the economy may explain DNB’s passivity.
15. Wellink’s claims about warnings cannot be reconciled with DNB’s declaration of no objection against the take over of ABN AMRO Bank, and with Wellink’s understanding attitude towards the reckless conduct of ING in (and before) 2007-2008.

Quotes claiming that the crisis was unforeseen and Wellink had given ample warning.

Boldface is by the present author.

Wellink was taken by surprise by the liquidity phase, and failed to understand that it might become a systemic crisis.

Mr. Wellink: «In the crisis one can distinguish three phases: a liquidity phase, a solvability phase, and a systemic crisis phase. I think one has to conclude that all of us were taken by surprise by the liquidity phase in August 2007. This phase lasted well into 2008, and gradually evolved into a solvability crisis in individual countries, of individual corporations. During this phase it was not understood that it would evolve into a systemic crisis. Not only we ourselves have not seen this. Apart from the DNB, the Dutch government didn’t see it, for on 16 September 2008 it still submitted a budget to parliament which assumes an economic growth of 1,25% for 2009. But it wasn’t seen worldwide.»⁸²²

⁸²⁰ Actually, the word fragments “risicomanege” and “risico manage”. Not even in the complete report of the 2nd series of hearings.

⁸²¹ “Grave misunderstanding”= misunderstanding which may cause or causes erroneous and harmful decisions.

⁸²² Hearings report 2 pp. 1257-8. Bold by JFCvV.

1. Since the relevant risks had been noted already in the GAO report of 1994, had been seen in the LTCM crisis, and are mentioned in several (later) reports of GAO, OFHEO and CGFS, this is both untrue and misleading.⁸²³
2. Both the analyses of the GAO and the LTCM crisis show how major financial institutions can get into fatal difficulties, and bring others into similar difficulties. That is: they show that there is a risk of a general, systemic, breakdown. In other words, a (systemic) crisis. It is therefore untrue that the risk had not been seen worldwide.
3. There was no tenable ground for the assumption that the system would return to normal of its own accord. The information shown in the chronicle for the period 6/07-12/08 gives plenty of reasons to fear that in August 2008 the crisis had not yet run its course. There was no sign of a return to normal. (Wellink nowhere mentions anything of the kind).
4. Precise or specified predictions have indeed not been made. (And could not be made, and never can). But the subprime crisis could have been prevented by acting responsibly upon what was known.
5. The term “risk” is used when there are uncertainties. In the present case, the uncertainties concerned the nature of the triggering disturbance(s), the time and speed of realization, and the extent of the consequences.

According to Wellink, nobody foresaw the systemic phase either.

«**Mr. Wellink: In the second half of 2008 the financial institutions were capitalized up to the norms of the time, simply up to the standards.** When we came in the systemic crisis phase... I already said that nobody had foreseen this phase. **There are always prophets who know what the world of tomorrow looks like, but except for the prophets...**

Mr. Haverkamp: They also warn for the seven meager years and the seven fat years.

Mr. Wellink: I have warned too. Look at the press conference of 2008. In April 2008 I explicitly said: the credit crisis is not over by far, and the picture will worsen further. In December 2008, when the forecasts of the Central Planning Office showed a recession of – 0,75%, I said: it is not over by far. To be honest I should add that none of us thought it would get so far out of hand as it actually did. In the fall of 2008, when the crisis started, the market began to perceive that the capital level of the banks was too low. Of course, we had the same perception.»⁸²⁴

1. A repetition of the lies.
2. “nobody had foreseen this phase” misleadingly suggests that only part of the development had not been foreseen by supervisors like Wellink.
3. Since there had even been prophetic government organizations, it is untrue that nobody had foreseen etcetera. Wellink moreover gives no grounds for out of hand rejection of the prophecies, and no details about the basis of their predictions, and of the reasons why Wellink and DNB ignored them.
4. Why doesn’t the commission ask for these details? It seems impossible to reject the GAO, OFHEO, and CGFS reports without making a fool of oneself.
5. What exactly did Wellink warn for? Or did he only predict continuation? And what is the significance of a warning after or during the fact?
6. Wellink does not refer to any DNB or other report. Worse: what he says is incompatible with DNB AR 2007, dated 2/4/08. The AR expects negative consequences for the economy, but: «**the effects of a strongly cooling American economy are not expected to become visible in the Dutch economic growth of 2008 but in that of 2009.**»⁸²⁵
7. “Norms of the time”: DNB was not only responsible for enforcement of the relevant norms (“up to the norms of the time”), but also for financial stability. The norms can be too low for that. What were the norms based on? Why were they supposed to be sufficient? Doesn’t Wellink know that

⁸²³ Proof is easy to find. To show that there was no reason to be surprised about liquidity problems, search the often mentioned GAO, OFHEO and CGFS reports for “liquidity”. Beginning with the GAO 1994 report. This alone is sufficient to prove incompetence (what the GAO says is logical, given minimal knowledge of the facts of the system) and/or lying. That solvability was in order follows from the sharp fall in the values of securities which were vital for the capital position of most banks.

⁸²⁴ Hearings report 2 pp. 1259-60.

⁸²⁵ DNB AR 2007 p. 25.

not all of the financial system was regulated, and subject to norms? Wellink does not explain the policy of DNB with respect to the norms. Did he set higher standards? The annual reports of DNB never warned that the norms were too low, and dangerous. The commission should have asked about this.

Again: «We did not foresee the liquidity phase».

«Mr. Wellink: I mentioned two phases of the credit crisis. **We did not foresee the liquidity phase**, but we did intensify the liquidity supervision.»⁸²⁶

It seems possible that Wellink invents or borrows new categories, like phases of the crisis, in order to be able to say that nobody predicted them. Which may be true because the category was not defined, and did not exist, before. However, such trickery is not permitted under an appropriate oath. The FCIC asked its witnesses an affirmative answer to the following question: «**Do you solemnly swear or affirm under penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?**». This forbids wriggling and mystification, obviously not representing the best of one's knowledge.

Did nobody in DNB see the risk of liquidity problems, and of them running out of control, evolving into a systemic crisis? As said before, the inquiry commission should have made a thorough inquiry of DNB.⁸²⁷

Wellink didn't prepare for a systemic crisis.

Mr. Wellink: «**We didn't prepare for the systemic crisis. Again, nobody did.** In my opinion the question should not really be what you did in April or May, but why you didn't see in April or May what would happen later. For that is the point. If you look at it this way you draw different conclusions. Then you will not conclude that they have been dozing or weren't sufficiently alert. **Then you conclude that we didn't see the systemic crisis in April and in May**, and that it seemed that other things were going on, that we had insufficient data to be able to understand that in the financial sector, and between the financial sector and the economy, interactions were at work which would have disastrous consequences. So if you look at it this way: insufficient data, insufficient analytical framework, without any doubt. This resulted in...

Mr. Haverkamp: In spite of the fact that you may not have had that analytical framework, you did take action. If we study the documents, then we see that in April 2008 DNB was investigating crisis instruments.

Mr. Wellink: Yes, we were one of the first in the world working on that, that's right, while we didn't foresee the credit crisis.»⁸²⁸

1. There is no excuse for the unpreparedness. Even if the exact date of the onset of the crisis and its exact nature were unknown, it could and should have been understood from especially the GAO and OFHEO reports, from recent history, and from general characteristics of the financial economic system, such as its instability, that a crisis could happen any time.
2. The repeated “nobody did” and equivalent phrases make one wonder: was there perhaps a conspiracy?⁸²⁹ “If nobody does anything, we can cover one another, and maintain the position that nobody knew”, etcetera. This is compatible with the immediate concerted action against Born in 1998.
3. It seems that “**they** [= the supervisors] **have been dozing or weren't sufficiently alert**” still applies in April and May 2008. Having seen what had happened by then should have made them thinking, checking the literature (the prophesies!) etcetera. A professional search would have solved all relevant “mysteries”.
4. “**we were one of the first in the world**”. This is utterly misplaced bragging. In spite of this (hypothetical) international first, the damage done to the Dutch financial system and Dutch economy by the crisis was at least as serious as in any other country.

⁸²⁶ Hearings report 2 p. 1260.

⁸²⁷ The Dutch general accounting office and ministry of finance didn't make such an inquiry either.

⁸²⁸ Hearings report 2 p. 1260.

⁸²⁹ Or did all financial supervisors submit to the chairman of the US Fed?

We didn't see the systemic crisis coming.

«Mr. Haverkamp: What I'm interested in is an announcement by DNB that it made an analysis. "We see something coming." At that moment the crisis...

Mr. Wellink: **No, as repeatedly noted, we didn't see it coming. We didn't see this systemic crisis.»⁸³⁰**

One is tempted once more to suspect trickery, a conscious and concerted effort at misleading: Wellink only admits to not having seen “this systemic crisis”, leaving open the possibility of having seen all other kinds of crisis. But the truth is that there is no shred of evidence that he saw any crisis or disaster coming.

The only question is: is the use of “we” correct? Does it refer to the employees of DNB, or only to His Highness Wellink. Had nobody in DNB read the various reports, and seen the risk of a crash?

Wellink wonders why people didn't see it.

Mr. Wellink: «When you look at the past, you can ask yourself why some things were not done at that moment. **You can also wonder why people didn't see it.** If one had seen what would happen in September and October, one would undoubtedly have taken measures. If we had seen it, we would undoubtedly have done different things. The crucial question therefore is: why do we fail to see certain things? That is what we should focus on. For if you succeed in seeing all these things, you take different measures.»⁸³¹

1. LTCM, GAO, OFHEO, and CGFS reports had shown what could happen, but measures were not taken. So what Wellink says about September and October is simply untrue.
2. These reports made well-argued recommendations. But Wellink and DNB (and the Fed etcetera) ignored them. They took no measures. Because of self-regulation measures were not necessary.
3. So the question and problem is not why “we” fail to see certain things. The question is why not “we”, but those responsible and supposedly expert, reject sound analyses and recommendations. (The answer is: because they think they know better, cannot distinguish sense from nonsense, and have the power to ignore everyone outside the top).
4. It was just the same before world war 2, and is just the same with climate gas emissions.
5. The problem therefore is: how do we appoint honorable and competent people instead of incompetent repressive liars? (And get rid of swindlers like Wellink).

According to Wellink, the crisis surprised every relevant actor in the financial system.

«Mrs. Koşer Kaya: I understand that this is a subject that should be studied properly, but the point is the following. Such an institution [bank] has all kinds of clever employees who are specialized in this. They know the rules very well. Is it then stupid to ask you whether you think that the behavior of ING was wise, given its total package at that moment? I'm asking you this in part because of your own speech of 2008, which, as you indicated, warned for the crisis. In addition you had requested an analysis because something was coming.

Mr. Wellink: I am still happy about having said and done that, but have to add in all modesty that, with all the formulations which I used, **I didn't see this crisis, which began with the fall of Lehman Brothers.** I refer once more to the Budget which was presented to you in Dutch parliament on 16 September. It predicted an economic growth between 1% and 1.25%. That is a very modest growth, but not bad for a country with an average annual growth somewhere between 2% and 3%. But in reality it was -4%. That is a dramatic worsening. If you do not take this into account, I think you cannot judge correctly what has happened. The world has seen a dramatic worsening. **This has surprised governments, this has surprised international organizations, and this has surprised banks. It is as simple as that.»⁸³²**

1. It can only have surprised someone who did not try to keep himself well-informed, and who did not try to keep in touch with what was going on.
2. Or relied blindly on the (other) financial supervisors.
3. And what is the relevance of this “answer”? Risk management is not about what you expect, but

⁸³⁰ Hearings report 2 p. 1261.

⁸³¹ Hearings report 2 p. 1283.

⁸³² Hearings report 2 p. 1284.

about what may possibly happen, about uncertainties and eventualities. Crises have happened before, so why not again (as asserted by Wellink himself, elsewhere in the hearings)? The possibility of a crash and crisis should be taken into account by everyone whose welfare depends on “normalcy” (stability).

4. And what about Wellink’s warning, as indicated by Koşer Kaya? Could ING still be surprised after his warning? Does Wellink say: even after a warning, you are allowed to be surprised?
5. If one is not allowed to be surprised after a warning, then Wellink doesn’t answer Koşer Kaya’s question.
6. Again, what Welink says is incompatible with him having warned for anything relevant. He cannot have warned for something he didn’t see.
7. Koşer Kaya is right about the employees. Her remark gives rise to the question: what happened inside ING? How did its top management decide? Did nobody warn it? Why didn’t the CDW try to find out?

Wellink repeats: nobody had foreseen it.

«Mrs. Koşer Kaya: Then you must tell me whether you understand the behavior of ING in the light of the developments outlined before.

Mr. Wellink: I understand. I don’t say they acted appropriately. The portfolio was a point of concern. It became a point of anxiety. If we had seen the watershed, and if ING had seen it- **nobody had foreseen it**- one would have done something earlier.»⁸³³

1. The facts have shown that the risk management of ING had been insufficient. Therefore DNB failed its supervisory duty.
2. One will never be able to foresee everything. That’s why one should manage one’s risks, and adequately. What Wellink says is beside the point. He doesn’t seem to understand the concepts of probability and risk, and to be aware of an ever-present need of risk management.
3. It is no more than logical that the value of Alt A securities is highly sensitive to a fall in home prices.
4. How can Wellink understand? Why didn’t ING act appropriately? How can Wellink understand inappropriate conduct? Is he saying he can understand everything? Remember that Wellink claimed to have warned since 2000!

Wellink varies the theme.

«Mr. Wellink: [...] The question, also for the supervisor, not only the bank, should not be “what should you have done in May, knowing what happened afterwards?” We didn’t foresee this crash of the system. I can also say it differently, perhaps simpler. If this crash of the system had not taken place, we would not have had these problems with ING. That is the most simple answer.»⁸³⁴

Since it is obvious that one will never be able to foresee everything specifically, one wonders what according to Wellink is the use and purpose of risk management. (I guess he has no idea). In fact, risk management is necessary exactly because people cannot foresee everything of importance.

Wellink is talking irrelevant nonsense, and should have been cut short and reprimanded by CDW. Maybe he should also have said that the Basel norms were insufficient (for logical reasons).

Before Lehman, Wellink didn’t foresee the systemic extent.

Mr. Wellink: «**We concluded that we didn’t foresee it.** [...] Let us especially- for me this is gigantically important lesson- increase our ability to forecast crises. Then we touch macro prudential policy, interactions between institutions and the economy. We simply know too little about this. The economy is a complex system that we have understood insufficiently.

Mr. Grashoff: You stick to your claim that you could not foresee it.

Mr. Wellink: **We didn’t foresee it.**

Mr. Grashoff: Could you foresee it?

Mr. Wellink: Allow me to give a very crazy example. I read some documents about guarantee provisions. I saw that in 2008 Ireland and Greece were the first two countries which gave a full

⁸³³ Hearings report 2 p. 1284.

⁸³⁴ Hearings report 2 p. 1309.

guarantee for their balance. At that moment it suddenly dawned upon me. It was 2008. I thought: dammit. Shouldn't this have been a signal showing that these countries were possibly the weakest countries in our region because they had to give this guarantee so quickly? Two years later they were the first to enter the major crisis. Our ability to handle these signals better and to see them in a wider context, should be increased substantially. We have found institutional solutions for this. I don't know whether this will produce enough results in the first years already. But for example in Europe we created the European Systemic Risk Board [ESRB]. This committee will occupy itself with these matters. In America they found an institutional solution, as in the central bank of England. This is very essential, for we can of course keep on asking why something wasn't done. I think it is all right to ask yourself this question. But it is even more important to ask why you didn't see it. All of us are intelligent people. If we had seen it, we would have done it.

Mr. Grashoff: But you didn't see.

Mr. Wellink: **Before Lehman Brothers I didn't see this credit crisis was a systemic crisis.** To be honest, I have to say that I am in good company, to wit, the rest of the world.

Mr. Grashoff: Thank you.»⁸³⁵

1. Note the "we". If it refers to the employees of DNB in general, it definitely needs proof.
2. Wellink refuses to admit that it could have been foreseen.
3. Refusal to say what you know or understand is perjury in the sense of the FCIC oath. Wellink certainly does not tell the full truth; not even the truth.
4. There was no need for a balance guarantee to see that Greece and Ireland could cause major problems. A look at the budget deficit and government debt tables in the OECD Outlooks was enough for that.
5. Again, the bla bla about a supposed need of better forecasting is irrelevant. It is a smoke screen. Since it is sheer fantasy, it is probably said to support the false suggestion that "we didn't and couldn't know", and to mislead attention to formal causes instead of dysfunctional people and organizations (under admittedly imperfect, but essentially adequate regulation).
6. Why didn't the commission ask whether Wellink didn't know crises as a phenomenon? Why didn't it ask about causes of risks and crises, and about means to defuse crises before they could grow to unmanageable proportions and do great harm? About ever increasing house prices, and about what would happen if they started falling (as could be expected, and certainly was a possibility and risk)?
7. Why didn't the commission ask: shouldn't you and DNB have known the aforementioned GAO reports, and publications like those of OFHEO, CGFS, and IMF? Did nobody in DNB read them? Did nobody communicate the main points upwards in the hierarchy? How is this possible?
8. Why doesn't the commission check this directly in DNB, instead of exclusively questioning the top brass?
9. Did nobody in DNB see that the Fed completely ignored its duty to maintain system stability, irrespective of the warnings of the GAO, OFHEO, and CFTC (Born)?
10. Wellink misleads, and doesn't answer the commission's questions ("Could you foresee it"). Does he do so consciously? Probably:
 - As regards the financial system, he is one of the best-informed people anywhere on earth (and paid for that).
 - DNB has about 1500 well-trained employees, and in Basel, at BIS, Wellink had a well-informed and highly trained additional staff. It is extremely improbable that nobody knew or understood any of the comments made by the present author. Employees must have tried to communicate their ideas upwards. If they did not reach Wellink, Wellink must have actively contributed to repression.
11. The text about the European Systemic Risk Board is no more than an (expensive) smokescreen. IMF, ECB, the Irish, Swiss and other central banks and even DNB already published stability reports for years. That wasn't the problem at all. But the analyses were made by insufficiently able people, who probably were given insufficient leeway. Inside the supervisory organizations, there was (and clearly is)⁸³⁶ no openness. In these organizations too, foolish dogmatic and

⁸³⁵ Hearings report 2 pp. 1309-10.

⁸³⁶ Given this hearing, and the commissioners and Wellink and others retaining their positions of power.

- political goals had inviolable priority, not risk management. The repressiveness of the US top brass is proven by the facts,⁸³⁷ and the other central banks and supervisors have not offered any noticeable opposition. That is the problem. Not mankind's lack of knowledge or understanding is the problem, but the lack of integrity (openness) and competence of the various authorities.
12. It is quite incredible that nobody in the central banks, supervisors and international financial-economic organizations had any inkling of the risk of a crash and crisis triggered by the reversal of the trend in home prices. The internal functioning of these organizations should have been investigated thoroughly.
 13. The quote shows how a faulty analysis of a real problem can result in its non-solution (the ESRB), and waste of manpower and money.
 14. As shown before, it is untrue that the rest of the world did not foresee a crisis.
 15. It is obviously untrue that "All of us are intelligent people".

According to Wellink risks were generally underestimated.

Mr. Wellink: «During all these phases- I have to add this for honesty's sake- none of us thought that it would run out of hand as it did.»

1. "None of us"? What does he mean by "us"? His approximately 1500 employees? If so, then many people at DNB are unsuitable for their jobs. The commission should have been surprised, and asked questions. Better still, it should have investigated DNB.
2. How could Wellink think that he could keep things under control? Is this idea based on more than false pretensions (arrogance and stupidity)? But even if you think you can manage, you should take serious account of the possibility of failure. Manage risks. What plans did Wellink have available (none), or did he really think he was almighty?
3. It would be very surprising if people who are unable to even see the risk of a crisis and did not manage risks would be able to keep events under control.

Other subjects.

Wellink and crisis management.

«Mr. Wellink: I am quite sure that working groups must have said "we are busy with this and with that". If by "an exchange of thoughts" you mean that concrete plans have been discussed in these working groups, the answer is undoubtedly "no".»⁸³⁸

So there were no plans. How is this fact to be reconciled with Wellink's bragging about "crisis instruments"?

How Wellink proves complexity.

Mr. Wellink: «The complexity can be inferred from the following. In April we began, and in December we had something. Then it takes from December 2008 to March 2011 before the minister of finance tells parliament that he will present something. In 2011 a consultation document is produced. That document will go to parliament, I assume. It is a very complex matter. If I look at it objectively, the only thing I can say is: DNB began early with its analysis, certainly in the international context, persevered with the project notwithstanding the great workload, did not allow it to be temporized, and submitted it to parliament as soon as the work on individual institutions gave a little bit more room.»⁸³⁹

1. This does not prove complexity. It may be complex for Wellink's limited abilities, but that is quite another matter.
2. Wellink is complimenting DNB for questionable achievements. For somebody who has convinced himself that history has shown that DNB has failed utterly in 1998-2008, Wellink does not explain how DNB suddenly can have become competent and effective.⁸⁴⁰

⁸³⁷ Especially those about Born (CFTC) and Falcon (OFHEO).

⁸³⁸ Hearings report 2 p. 1261.

⁸³⁹ Hearings report 2 p. 1262.

⁸⁴⁰ See the list of feats of arms in the beginning of this appendix.

Wellink looks back in astonishment.

Mr. Wellink: «When I look back in time, I am astonished that this small organization of DNB could do all these things in such a short time.»⁸⁴¹

But DNB had 1500 employees, and therefore not small at all. And its achievements are insufficient at best.

Lies about AAA and inadequate risk management.

«Mr. Wellink: I think you summarized correctly. There were problems, growing problems. The institution [ING Bank] complied with all of the norms. Neither the institution nor we foresaw the crisis. The Alt-A-portfolio was indeed weakening fast. You know too that it included 15% credit announcement. Which means that the first 15% of the risk was for others. As supervisors we took a closer look at ING in that period, actually already from the beginning of the liquidity crisis, but definitely closer since the beginning of 2008. In this period we assessed quite a lot. Until the systemic crisis they [ING] satisfied the requirements without any reservations. If the systemic crisis had not come, we would not be sitting here. That underlines the great importance of discerning the watershed of mid September 2008.

Mrs. Koşer Kaya: And if you look now at the total picture, not only at the buy back of their own shares, do you still think that ING acted correctly?

Mr. Wellink: If I replace myself- I have to do that- in the moment at which the acts were decided upon, the answer is yes. The essence of the problem is the following, as I told you in the beginning. If you look at the past, you can ask yourself why certain things were not done at the time. You can also ask yourself why they didn't see the things. If they had seen what happened in September and October, they undoubtedly had taken measures. If we had seen it, we undoubtedly had done other things. The crucial question therefore is: why don't you see certain things? That is what you should concentrate your attention on. For if you manage to get so far, that you see all those things, you take different measures. Then we would not have ended up in that quarter.

Mrs. Koşer Kaya: You very well know the stipulations of Basel, mr. Wellink. Basel II stipulates that you have to acquire much more capital if your portfolio is devalued. When a bank sees that its negative revaluation reserves steadily increase, and its own assets steadily decrease, doesn't it have the responsibility to look farther, and to anticipate changes in the value of the portfolio?

Mr. Wellink: It is true that a bank should look farther. But you can't see beyond the horizon. In this case the horizon was Lehman Brothers. We didn't know where the horizon was. This portfolio had- and now I'm coming to your point of Basel- a triple A-rating, as you know. This portfolio had not only a triple A-rating, but a risk for others of 15%. It is true that for a long time people felt safe with the rating and the credit announcements. If for a moment you forget the watershed, you ask yourself with hindsight whether the rating was up to the standard in the preceding period. Did you see everything correctly? After Lehman this triple-A portfolio was downgraded at a quick rate- this is your Basel point- and at an unknown scale. The explosive development of the capital requirements can be blamed on that. I heard that it has been said here that for triple A the capital requirement for one euro was one half of a cent, and that for B+ it had become a euro for a euro. This touches on a problem which I think- this also applies to the valuation you mentioned- deserves deep further reflection.»⁸⁴²

1. Wellink seems to be lying, or try to, for ING had (mainly) Alt-A, and AAA ≠ Alt A. See the 2nd report of the CDW, p. 189. The glossary of the 1st report says that there is a fundamental difference:

«AAA

The valuation by a rating agency of the credit-worthiness of a bank, enterprise or financial product is expressed in a combination of letters. AAA, “triple A”, is the highest rating.

[...]

Alt-A

In the United States a customary indication of the credit-worthiness of a borrower. In the Netherlands it is known from the American mortgage portfolio of ING. The conditions for Alt-A

⁸⁴¹ Hearings report 2 p. 1262.

⁸⁴² Hearings report 2 pp. 1282-3.

loans are weaker, and the loans require less income data from borrowers, than for standard mortgages, which are called “prime”.)»^{843, 844}

According to the FCIC:

«In the end, companies in subprime and Alt-A mortgages had, in essence, placed all their chips on black: they were betting that home prices would never stop rising.»^{845, 846}

Wellink may be simply mistaken, but as noted, the difference is essential: triple A is the safest one can have, Alt-A means risk (= significant risk, always!).

2. The lie or mistake makes it easier for Wellink to defend ING and the passiveness of DNB. ING had taken a serious risk. The facts seriously undermine Wellink’s defense. A conclusion should have been that ING’s risk management was insufficient.
3. Even if the simile of the horizon were valid, Wellink should have noted that his own (supposed) warnings, and ING’s own analyses, should have helped ING to see what might lie beyond the horizon. Neither bank nor supervisor managed risk competently.
4. Remember that in an earlier hearing Wellink said: «In various annual reports, in many speeches and in articles published by DNB, I warned against the imbalance between risk and yield». How then can he say that ING acted correctly? Does he mean to say that one is free to ignore his warnings with impunity?
5. By presenting the Lehman demise as an excuse Wellink implies that a bank is free to leave certain risks out of consideration. Given insufficient liability and Basel norms, this means: at the expense of the taxpayer.
6. If society does not accept this risk, liability law has to be changed fundamentally, making banking much less profitable for bankers, and more profitable for outsiders.
7. By not correcting Wellink, the CDW proves its lack of integrity and/or competence.
8. Wellink has had many years to reflect deeply about everything discussed here. And 1500 highly educated employees to support him.
9. The quote shows once again that Wellink does not think in terms of possibilities, uncertainty and risks. He seems to be unable to think in terms of an uncertain future. He thinks in terms of perfectly visible vs. invisible, white or black, with nothing in between. A way of thinking which is incompatible with the reality of the financial economic system and government, and for that reason very dangerous.
10. The simile of a horizon underlines the point. You cannot look beyond the horizon, but a responsible traveler should be prepared for all relevant possibilities. He should find out what might lay ahead, and manage the risks.

The next Great Achievement of Wellink and DNB.

Mr. Wellink: «But to be honest, if I look at the measures, both the capital facility and the guarantee facility, then nobody can say that they were not ready in time. And according to me, that is the ultimate test.»⁸⁴⁷

⁸⁴³ CDW, First report, p. 263/259.

⁸⁴⁴ The FCIC report does not give a definition. On p 71/99 it says: «In this report, ratings are generally presented in S&P’s classification system, which assigns ratings such as “AAA” (the highest rating for the safest investments, referred to here as triple-A), “AA” (less safe than AAA), “A,” “BBB,” and “BB,” and further distinguishes ratings with “+” and “-.” Anything rated below “BBB-” is considered “junk.”

Moody’s uses a similar system in which “Aaa” is highest, followed by “Aa,” “A,” “Baa,” “Ba,” and so forth. For example, an S&P rating of BBB would correspond to a Moody’s rating of Baa.»

FCIC report p. 102/130: «The nonprime loans soon became the biggest part of the market—“subprime” loans for borrowers with weak credit and “Alt-A” loans, with characteristics riskier than prime loans, to borrowers with strong credit.»

⁸⁴⁵ FCIC report p. 111/139.

⁸⁴⁶ As regards the relation between Alt-A, subprime and nonprime, the FCIC report says on p 555/583: «[Note] 62. 2009 Mortgage Market Statistical Annual, 1:4, “Mortgage Originations by Product.” Nonprime = Alt-A and subprime combined.»

⁸⁴⁷ Hearings report 2 p. 1272-3.

The ultimate test was that none of the important Dutch banks would get into difficulties, and nobody would need such a facility. Making facilities with money of the taxpayer is not so difficult. And the initiative for the facilities didn't even come from DNB.

Honest bragging continued.

Mr. Wellink: «To be honest- I have to be very open about this- I don't see the importance of that. Only one thing went wrong a very little bit. For it would have been quite easy if we had known on 26 September that they were working on it. Having said that, I immediately have to say «mea culpa». For we sometimes forget it. If you imagine yourselves in our very pressing situation of the time... The number of pans we had in the fire... That isn't the cooker at my home with four burners. There were hundreds of fires. We were running from one pan to another. Looking at that I have to say that I think it all went amazingly fast.»⁸⁴⁸

(This is still about the plan mentioned earlier).

More tattle, including a demonstration of false pretensions.

«Mrs. Koşer Kaya: Apart from supervisor you are also advisor of the Dutch State [=, in practice, the Dutch government].

Mr. Wellink: Yes, that's right. I'm also a member of the European Central Bank. That is not being discussed here. In that period we had- I'm speaking for myself- three lives to live, one in Frankfurt and one in Basel too. Very much was happening. Some things someone else does a day earlier, and other things we do a day earlier. But all of us were in time, all of us had reached the finish before things went wrong.

Mrs. Koşer Kaya: In such a situation I can imagine that DNB and the ministry of finance meet very quickly and discuss how the crisis can be tackled, instead of making plans independently without knowing what plans the other is making.

Mr. Wellink: Yes, but as a rule we knew what the other was doing. Of course, you should not waste time by sitting in one another's lap all the time.»⁸⁴⁹

1. Koşer Kaya doesn't ask a question but makes a remark, and Wellink only reacts with a supplementing remark. A remark that shows the extent of his pretensions.
2. Note that it is completely unclear what Wellink means by "we". Himself, DNB, BIS, and ECB (all of these together)? The commission does not inquire what he means.
3. It is even less clear what he means by "all of us were in time, all of us had reached the finish before things went wrong". This claim would only have been justified if the supervisors had prevented the crisis. Does he mean: we did not prevent the catastrophe, but we are proud of everything else?
4. It seems rather clear that certainly in times of a crisis the three jobs cannot be combined in an accountable way.⁸⁵⁰ But the risk of a crisis or otherwise difficult times is significant, and such times require not very small, so the jobs simply should not be combined. On the basis of historical evidence,⁸⁵¹ the probability of a crash in any given year can be estimated at several percent, and the probability of a major crash, starting a crisis lasting of the order of 10 years, at more than 1%.
5. The annual reports of DNB do not bear witness to any form of coordination.

Another example of tattle and wriggling by Wellink.

«Mr. Wellink: Because the Dutch government realized that there was a "first-mover-problem".

Mrs. Koşer Kaya: Was that the only problem?

Mr. Wellink: Yes, that was the only problem. We wanted to prevent a situation in which banks would hold up the milk too long and would react too late. The only thing I can say is that it didn't go

⁸⁴⁸ Hearings report 2 p. 1273.

⁸⁴⁹ Hearings report 2 p. 1273.

⁸⁵⁰ Even if one would claim that each of the three functions separately is feasible by the given people, which the present author denies.

⁸⁵¹ See an encyclopedia such as the Wikipedia, under financial crashes and crisis. Between 1800 and 1900 the wiki page of 22/6/12 counted about 13 financial crises, and between 1900 and 2000 about 12 crises. The "about" indicates variation depending on the definition. Return to normalcy mostly took less than 10 years, at least for most people.

that way. The banks which finally applied, applied in time. The instrument worked. Of the 200 billion we had 50 billion outstanding debt. At present somewhat more than 30 billion is outstanding. Everything went exactly according to plan. They only began a little bit later than we thought. Perhaps you have to conclude now that it wasn't really bad that it began a bit later, because it wasn't really necessary as from the first second.

Mrs. Koşer Kaya: So when on 23 October the guarantee provision came into operation, it was not necessary yet?

Mr. Wellink: You didn't hear me saying that, "not necessary yet". I said: perhaps you can conclude now that it wasn't urgent yet. I simply don't know. [bla bla omitted] How urgent it was... I think it is quite useless to say: on 23 October it wasn't necessary yet, but on 27 October it was. We simply don't know.»⁸⁵²

Please note: "exactly according to plan".

Wellink lies to justify ING's risk taking.

«Mr. Wellink: I understand what ING did. They created ING Direct in America and of course in other countries too. In America they were confronted with very specific regulation and a rapid growth of savings money. They had to do something with that. Then you are bound by the requirement that 65% is invested in home-related products.»⁸⁵³

As explained on p. 189 of the second report of the CDW, what Wellink says is untrue. The 65% does not refer to home-related products, but to consumer credit. And it could have been spent on AAA instead of Alt-A. ING preferred to take more risk. Note that the mistake favors ING and Wellink.

Wellink understands that ING ignores his repeated warnings and increasing risks.

«Mrs. Koşer Kaya: Now we zoom in on the period that the problems of ING with its Alt-A portfolio increased seriously. I sketch some developments, in the first place the falling market value of the Alt-A-portfolio. In the beginning of 2008 it had fallen to 85%. In the second quarter it fell to 82%, and in the third to 71%. As a consequence a large revaluation reserve was kept. It grew continuously. Next there were reinvestments in Alt-A until June 2008, the fall in the value of ING's assets between the summer of 2007 and the summer of 2008, the buyback program of 5 billion [euro] of its own shares, and in August 2008 moreover an interim-dividend of 1,5 billion [euro]. In June/July the market value of ING was about a third less than it had been a year earlier. All this happened in the period from January to July/August 2008. When I ask you once more how you evaluate the behavior of ING in this period, what is your reaction?

Mr. Wellink: Yes, you mentioned a number of things of which I think it is important that they are discussed separately. Let me begin with the buyback program. You have to begin somewhere. As far as I know, the buyback program was decided upon in May 2007. It began in June 2007 and would take a year. A very real question- that underlies yours- is whether this buyback program was a good idea, and whether it should have lasted so long. When I replace myself to May 2007- and I don't mean the question about the formal position of the supervisor at that time- I can understand that. [...]

Mrs. Koşer Kaya: I'm asking you about 2008.

Mr. Wellink: I will come to that automatically. I wondered how you have to tackle this. I have no answer.»⁸⁵⁴

And so on.

1. Remember that the US home prices peaked in April 2006, and since then were slowly but steadily decreasing.
2. The supervisor has no answer. He seems to have forgotten that earlier in the hearings he declared that «I started to warn for developments in the field of real estate as from the year 2000, at an internal international conference» and «In many speeches- some of them were sent to you- and actually in all annual reports of this millennium, warnings were given against certain developments which could have a destabilizing effect.»⁸⁵⁵ Didn't he expect an appropriate

⁸⁵² Hearings report 2 pp. 1276-7.

⁸⁵³ Hearings report 2 p. 1280.

⁸⁵⁴ Hearings report 2 pp. 1281-2.

⁸⁵⁵ Hearings report 1 p. 350 left. This is a reminder of earlier quotes.

reaction from the banks? His imaginary replacement in the situation of 2007 seems to assume that no relevant warnings had been given at all.

3. Wellink apparently also assumes that the decreasing home prices had no consequence for the Alt-A portfolio. That causes had no relevant effects.
4. Wellink implicitly refuses to make logical critical remarks about the irresponsible acts of ING mentioned by the commission. Acts which clearly betray inadequate risk management. He makes it seem as if he tries to whitewash everything, to make everything “understandable”. He overlooks the fact that an explanation is not an excuse.
5. Obviously, Wellink too would have run the bank aground.
6. Because of his hammering on his warnings on the one hand, and acceptance of complete neglect of these warnings by a bank that was directly involved on the other hand, his declarations are inconsistent.
7. Possible solutions of the inconsistency being that he did not give any relevant warnings, and/or is a bag of incompatibilities, disqualifying him as an interlocutor. He must be lying anyway.

Koşer Kaya doesn't let go, and Wellink becomes repetitive.

«Mrs. Koşer Kaya: Then tell me whether you understand what ING did given the developments indicated.

Mr. Wellink: I understood. I did not say that they did well. The portfolio was a subject of worry. It became a subject of increasing worry. If we had seen that watershed, and if ING had seen it- nobody had foreseen it- one would have done something about it.»

1. Murderers too can often be understood.
2. “Subject of worry”: the terminology is symptomatic for the structural passive attitude of DNB.
3. Even without true understanding everyone could and should have known that risk management was necessary, if only because crises are a recurring phenomenon.
4. In other words: once more Wellink shows that he doesn't understand the concepts of risk and risk management.
5. The “nobody had foreseen it” has been refuted earlier.
6. Did ING count on DNB and other supervisors to give timely warnings? Is this perhaps a reason for Wellink not to accuse ING of recklessness? (Knowing he did not warn).

Stupidity continued.

«Mrs. Koşer Kaya: Did you ask ING to strengthen their buffers?

Mr. Wellink: The buffers of ING were sufficient. As regards capital, ING has never had problems.»⁸⁵⁶

1. This is nonsense. From a practical, survival, point of view, the buffers were insufficient. There was an urgent need for action. Wellink could have pointed to other, adequate, actions by ING, but the implied answer that nothing had to be done is obvious bullshit. This could have been understood already at the time. (Even without the GAO, OFHEO, and CGFS reports).
2. The “answer” is incompatible with ING's need of tens of billions euros tax payers money. And again: did Wellink warn without requiring appropriate action?
3. Wellink may mean that ING complied with Basel I or II. He should have said so, and should have added that these norms were inadequate. There was no theoretical ground for believing that they were adequate, and the crisis has proven this empirically.

Sitting on top of it, indeed, and doing nothing.

«Mrs. Koşer Kaya: Mr. Harryvan [of ING] said something about a recommendation. In 2008, did you in any case suggest to get rid of the rotten parts of that portfolio?

Mr. Wellink: It would be nice if customers would immediately line up when you offer rotten apples for sale. Of course, possibilities to get rid of such a portfolio have been considered. However, in the developing climate the potential buyers have relatively few possibilities, and later certainly even less. You have devaluation problems which can be very large, and you have buyers' problems.

Mrs. Koşer Kaya: Mr. Wellink, as supervisor you also observe developments.

⁸⁵⁶ Hearings report 2 p. 1286.

Mr. Wellink: We did, as I already told you.

Mrs. Koşer Kaya: Did you suggest at any time in the direction of ING...

Mr. Wellink: Of course we told ING: where possible the risk profile should be reduced.

Mrs. Koşer Kaya: Reduce the risk profile? What did that mean concretely?

Mr. Wellink: That depends on the possibilities at the moment. For a specific answer you have to ask the supervisors who were busy with executive policy. We had been working all year, from the beginning of the year, on this portfolio. We followed this portfolio continuously; we were sitting on top of it. It all happened within the norms which applied to ING as a healthy corporation. After 15 September something happened. If that is not taken into consideration, the developments on 1 October will never be understood. It was a watershed.⁸⁵⁷

1. “Working on/ following this portfolio” = ?
2. “as a healthy corporation”: what does Wellink mean? A healthy corporation if you disregard the environment and state of the world? If you do not require a corporation to assure its survival by adequate risk management?
3. The recommendation to reduce the risk profile is extremely trivial, almost vacuous. In the given circumstances it was rapidly becoming impossible,⁸⁵⁸ and would anyway create other risks.⁸⁵⁹ Why don’t Wellink or Koşer Kaya say what could best be done at a late moment, with the least risks (with arguments)?
4. If in 2008, even before Lehman, it was too late, why doesn’t Wellink say so? (Otherwise he should tell the commission what ING should have done).
5. In the course of the Wellink hearings the conclusion that his supposed warnings were not accompanied by any useful recommendation or instruction becomes ever more inescapable. This conclusion is of course in full accordance with the DNB annual reports.

Wellink suggests that the ratings institutions are to be blamed, not the fact that ING preferred more risky securities.

Wellink: «It is true that the supervisor cannot see exactly what the rating agencies have done. It has turned out that they didn’t do well. In that sense you are right in saying that we didn’t have sufficient knowledge of what exactly was contained in those portfolios. [...] Rating agencies play a role in all this. They grade a portfolio and you rely on that. At a given moment your instinct may tell you «I don’t trust it». It helps if you have the good instinct. I think- I am quite willing to let you consider this- that people thought and believed for a remarkably long time in the triple A-rating. At the same time there is that instinct in me, which isn’t knowledge. After all, I can’t look inside the portfolio. I did repeatedly ask mr. Tilmant: do you really believe what you say about that portfolio? Then every time he came with the story... In essence that is inferred knowledge, that is why it is so important that something changes drastically in the role of the rating agencies, their way of operating and the methodology they use. That has therefore been set in motion.»⁸⁶⁰

1. Wellink claims that the rating agencies didn’t do well, without telling, here or elsewhere, what they should have done instead, and what constitutes a good rating.
2. Wellink shows that he has insufficient knowledge and incorrect understanding. He talks as if a small risk is no risk and can safely be ignored, and as if a rating should be a precise forecast. He doesn’t think in terms of risk (probabilities) at all. That is what is wrong, not so much the ratings. Ratings can never offer certainty.
3. Here too he speaks of AAA, while the portfolio of ING actually contained the substantially more risky Alt-A. This fact reduces his reproaches at the address of the rating agencies in the present context to irrelevance. Because ING consciously chose the more risky (and potentially more profitable) investments. And because risks never can or should be ignored.
4. It is a mystery how DNB can have evaluated risk management if it did not know what securities banks possessed. Did it only check paper procedures? Wellink doesn’t say what he would have done if he had known what kind of securities ING possessed. He doesn’t say that the crisis, and

⁸⁵⁷ Hearings report 2 pp. 1287-8.

⁸⁵⁸ Banks did not trust each other anymore, and loans (or low risk securities) were more and more difficult to get.

⁸⁵⁹ In the given circumstances, the price of risk reduction was increasing rapidly.

⁸⁶⁰ Hearings report 2 p. 1291.

the fact that ING needed taxpayer's money, shows that supervisors should get precise information about the securities portfolio of supervised institutions.

5. What Wellink says is incompatible with the assumption that he is able to think about risks, and able to manage risks.
6. Why doesn't Wellink note that ING got its deserves, because «in many speeches and in articles published by DNB, I warned against the imbalance between risk and yield.» Why doesn't he note that banks willingly take more risk when this is coupled with the possibility of a higher yield? That ING knew that Alt-A is riskier than AAA, accepted the larger risk, and that apparently the specifics of the rating were irrelevant for ING?⁸⁶¹

Investigating how to fill up the well after the calf has drowned.

«Mr. Wellink: In any case I know [...] that the discussion with ING about this [Alt-A] portfolio was reopened, and that ING has been asked to look at it. We asked ING to submit its own report. They did. When it appeared, I think it was by Blackwell, we ultimately said: they should dig deeper. On 25 November [2008] we asked Dynamic Credit to do so. Because the dynamics of the market became worse and worse we concluded: we have to dive deep under the surface, for when we go back to the government, we have to take account of the fact that the government will rightly ask: what are the risks for the taxpayer of your proposed solution?⁸⁶² That's why we turned to Dynamic Credit.

Mr. Grashoff: You turned to Dynamic Credit, but really only in December.

Mr. Wellink: To the best of my knowledge we contacted them on 25 November.

Mr. Grashoff: On 25 November?

Mr. Wellink: The time difference is not unimportant. These are short periods in which other things have happened, periods in which they themselves have looked at the portfolio...

Mr. Grashoff: For clarity: the weekend is concluded on 19 October, and on 26 November you turn to Dynamic Credit.

Mr. Wellink: For clarity too: in the meantime we have been busy with the portfolio, and ING has been busy with it as well.

Mr. Grashoff: ING has been busy with it. ING had something investigated. According to me the name of the advisor has been mentioned, but that is not very important. They have had themselves advised. One can imagine that at that moment there are different alternatives, for ING too. One could have found solutions outside government. For the government had said that it wouldn't do it. That is therefore a fact until further notice.»⁸⁶³

1. ING and DNB needed external help to get information which they deemed necessary for decision making about this ING portfolio. This assumes that they themselves didn't have, and could not generate, this information. In other words: the risk management of ING was insufficient, and the evaluation of this risk management by DNB was inadequate.
2. Why the need of metaphors like diving and digging? What do they mean? They are very far from clear. What exactly was the problem? What does this "deeper" mean? And "busy with"? What possibilities did ING have at this moment, and what was the perspective of their possibilities?
3. What did Dynamic Credit find? (See below).
4. Wellink seems to be aware of the taxpayer. In (at least) 1995-2007 he wasn't in the least.

The interaction of Wellink with his organization (DNB).

«Mr. Grashoff: Dynamic Credit has investigated this [portfolio]. This has been discussed thoroughly in an earlier hearing. Mr. Gast [co-owner of Dynamic Credit partners] said: I contacted DNB in the beginning of October. You therefore knew of his existence and his abilities, I think.

Mr. Wellink: I didn't know that he contacted DNB in the beginning of October. So I didn't know of his existence and his abilities.

Mr. Grashoff: No?

⁸⁶¹ Did ING defend itself by saying: if the rating had told... we would not have bought these Alt-A securities?

⁸⁶² Quite generally Wellink speaks of "the state" instead of the government. The report writes "State", with capital S. Wellink's terminology may or may not be correct, but in practice it is the government which represents the state.

⁸⁶³ Hearings report 2 p. 1294.

Mr. Wellink: No, I don't know mr. Gast at all.

Mr. Grashoff: In his hearing he declared that he has contacted DNB in the beginning of October.

Mr. Wellink: Yes, but I don't wait at the entrance of DNB.

Mr. Grashoff: No, I understand. But you have not been told of this? It wasn't that important at that moment? It was nevertheless the moment you were fighting with the finance ministry about Alt-A.

Mr. Wellink: I don't know whom he contacted. The question should be submitted to the person who spoke with him. Perhaps one of the considerations for advising by the bank organization was that somebody had called who probably had a better feeling of what was happening in the American market.⁸⁶⁴ However, I don't know mr. Gast.

Mr. Grashoff: He also had a meeting at DNB.

Mr. Wellink: That is very well possible, but there are 1000 [thousand] people who have a meeting at DNB, and this estimate certainly is far too low.⁸⁶⁵

Mr. Grashoff: He has spoken with mr. Bulsink; I think of a reasonable level.

Mr. Wellink: So he has spoken with mr. Bulsink, not with me. That wouldn't surprise me. I have the perception that afterwards, in this respect mr. Gast did a good job for his firm, mr. Bulsink has proposed Dynamic Credit, of which I had never heard.

Mr. Grashoff: For us this remains interesting. The discussion that you had with ING starting on 2 October, shows that the problem of the Alt-A-portfolio is central. It is immediately followed by the problem with the finance ministry: "we're not going to do it that way, for we don't have enough insight". You say: we actually had some superficial insight, though based on the rating agencies. You had no insight of your own, at least not under the surface. Then the question arises: why not figured out at once?

Mr. Wellink: The answer, I think, is very simple. The minister has chosen a solution in which a reservation was made for the Alt-A portfolio. Actually this didn't deviate much from the total risk emerging from the calculations of Dynamic Credit. This was a solution. We supported it. Because we thought that from our point of view it might not be optimal, but was at least practicable. We started working as soon as we got the feeling that "this isn't going well". Once again: all this happened in the dynamics which changed every day. I think we handled this quite energetically, to be honest.

Mr. Grashoff: That is indeed the question: energetic or sufficiently energetic. You say: Dynamic Credit ultimately came with a risk estimate which didn't differ substantially from the amount that within the 10 billion had been reserved for the risks of the Alt-A portfolio. I can imagine that in that case it would have been even more interesting to have the report available in October. Then we might have come a few steps farther.

Mr. Wellink: If you ask me whether I would have liked to have all reports on 1 October, I say "yes". At the same time, when I look back afterwards at what we have done with a relatively small organization in the period between half September and the end of December, then I find it inconceivable, I must tell you. I am very grateful towards my former people. We had to solve the Fortis-problems, we had problems with Icesave ... »⁸⁶⁶

1. If Dynamic Credit was of importance, then mr. Gast was important as well.
2. Obviously the communication of Wellink with his organization was insufficient. Note that Wellink demonstrates a very negative attitude, and no interest at all. He does not explain the position of Bulsink, and what must have happened inside DNB.
3. All problems mentioned or implied could and should have been prevented instead of solved or handled.
4. Wellink cannot stop bragging. Count the number of pats on the back on the one hand, and the statements expressing modesty on the other.
5. DNB has about 1500 employees. According to the present author this can better be called relatively large than relatively small.

⁸⁶⁴ The meaning of the original sentence is unclear (too).

⁸⁶⁵ Note that a few paragraphs later, Wellink will say that DNB is relatively small.

⁸⁶⁶ Hearings report 2 pp. 1296-7. Of course the problems were of DNB's own making. Even if Wellink and DNB could not have prevented the crisis, their supervision had been very insufficient. Had it been adequate, they would not have had serious problems after the fall of Lehmann.

- The quote supports the hypothesis that Wellink is too arrogant and/or lacks the brains and/or training to understand things by himself and/or to let himself be properly instructed by his organization.

About the events of the last months of 2008.

«Mr. Wellink: [...] We never experienced such circumstances. We didn't know precisely what was the matter. We didn't know enough about the interactions between the institutions. We had insufficient data. I can imagine that this makes someone somewhat nervous. I always told my people: keep your head cool and your feet warm, try to keep the main lines in view.»⁸⁶⁷

- Repetition of the great lie.
- He could and should have known already many years ago about the interactions.⁸⁶⁸ They had been described by institutions like GAO, CFTC (remember 1998!), OFHEO, and CGFS, and maybe IMF. Recommendations had been made. Wellink did nothing. He didn't even try to get more information.
- Wellink doesn't know the literature he should be acquainted with (or simulates). His 1500 employees don't know it either, or Wellink and his “managers” didn't listen or react adequately (as a consequence of arrogance, repression, and/or stupidity). Whatever the case may be: fatal errors, and manifestations of incompetence.
- Wellink and DNB had more reason than outsiders to be nervous: they had reason to fear to have to account for failure, if not responsibility.

Wellink says that he wants the financial system to be as safe as possible.

«Mr. Wellink: We [DNB and the government] have different lines of approach, that is evident. We are the prudential supervisor, and we want a financial system that is as safe as possible.»⁸⁶⁹

- This statement is flagrantly incompatible with his failure by omission in (at least) 1995-2007.
- He really said “as safe as possible”. This contradicts his claim that a safety of 100% has to be sacrificed to preserve economic activity (see below). So at least one of the statements is untrue. And of course he never did what it takes to keep the system as safe as possible. According to the present author, he could have prevented the crisis on his own (supported by DNB of course).

Pp. 1301-2 strongly suggest that Wellink lied about a meeting he had with prime minister Balkenende (of the political party CDA, like Wellink). Wellink repeatedly suggests that he doesn't remember a very unique and important event at the end of 2008, not very long ago. While author Janssen, author of a Wellink biography, and widely supposed to know Wellink very well, claims that Wellink has the memory of an elephant.⁸⁷⁰

Wellink claims an attitude which he evidently did not have in 1995-2007.

Mr. Wellink: «Most people have no idea of what would happen if a systemic bank would collapse. They have no idea of the devastating effect, economical and otherwise, it would have. That is what we stand for, and that is a noble goal. That is what we fight for. In this respect we want to be on the safe side.»⁸⁷¹

- What happened in the subprime crisis included the collapse of one of the largest systemic banks, Lehman. It did indeed have a devastating effect. That is why this hearing is held.
- Wellink's last three sentences are utterly incompatible with his indefensible and unaccounted for misconduct in 1995-2007. He misbehaved as if nothing were at stake at all.
- If very much taxpayer's money hadn't helped them out, Wellink would have been responsible, by omission, for the collapse of several Dutch systemic banks.
- So again Wellink is practically if not formally lying.

⁸⁶⁷ Hearings report 2 p. 1298.

⁸⁶⁸ Remember that he was appointed president of DNB in 1997.

⁸⁶⁹ Hearings report 2 p. 1300.

⁸⁷⁰ In the book “Wellink aan het woord” (“Wellink speaking”. Bezige Bij, Amsterdam, 2011). For more information about this book see below.

⁸⁷¹ Hearings report 2 p. 1304.

Wellink rejects a safe financial system, but doesn't show what level of risk and unsafety is justified to keep the economic system "working".

Mr. Wellink: «Some time ago an article was published by Charles Goodhart. Goodhart says: every idiot can make the financial system safer. He is right. You only have to ask for a capital quote of 100% and some similar things, and you have a safe system. But then you have an economic system that doesn't work. You have to find a balance somewhere. I always did this in consultation and agreement with [finance minister] Wouter Bos.»⁸⁷²

1. Note that someone endeavoring to make the financial system safer is classified as an idiot without any more ado. Wellink did indeed say “safer”, not “safe”.
2. Calling a class of opponents “idiots” is a rhetorical trick to cover the absence of sound arguments.
3. Wellink's use of the word “idiot” resembles his use of the word “prophet”. Both are intended to disqualify a class of (legitimate) opinions.
4. Wellink gives no indication of proof or arguments showing that the economy will come to a standstill if the financial system is made safe. He does not even show that it has a negative net economic effect. He gives no references, and the commission doesn't ask for them.
5. What exactly did Wellink and Bos agree about the balance? What proof or arguments do they have for the chosen balance? Why didn't Wellink publish such an important agreement in the DNB annual reports and why didn't Bos publish it in his budget?
6. What did Goodhart say about the balance? What proof or arguments did he provide for the proposed balance? (If any!)
7. Is the passivity of DNB the consequence of the agreement with Bos (and Bos' predecessors!) about the balance?
8. The present author does not believe Wellink at all, and thinks it most probable that no balance was discussed with Bos, and agreed upon.
9. Wellink's record and bla bla anyway prove that he cannot be considered competent in the field of finance or economics, and furthermore lies when it suits him. He should not be listened to.

The hearing of Thursday 8 December 2011.

13u00 - 17u22 in the Enquêtezaal of the Logement in The Hague.

The stenographic report of this hearing covers the pp. 1577-1631 of the report of the second series of hearings of the Commission De Wit.

The first part of this hearing discusses Icesave and ING. On p. 1588 the chairman begins a discussion about ABN AMRO (AAB).

On p. 1577 mrs. Neppérus notes that there is a book with the title *Wellink aan het woord* (*Wellink speaking*):

«In the book *Wellink aan het woord* one can read that you have the memory of an elephant, and an almost inexhaustive amount of ready knowledge. I read the book, and I hope that as a commission we can benefit from that again today as we did last time.»

The book is supposed to be autobiographical, but written by a journalist. It is not written from an independent point of view. The following quote is taken from bibliographic information about the book in the public library of Zoetermeer (Netherlands):

«By way of parting gift the bank [DNB] gave him [Wellink] the opportunity to give his vision in the form of a book, and to refute some of the criticism. For this purpose the experienced journalist Roel Janssen, known from his book 'Grof geld' ([Big money,] 2011) about financial scandals in the Netherlands, held a series of interviews with Wellink, and rewrote them into a clear story. Five chapters discuss the recent controversies: ABN AMRO, the euro, the crisis, Icesave and DSB. In addition Wellink discusses the cooperation in Basel, the always difficult supervision policy, and the pressure to change the bank by the ministry of finance. Finally Wellink reminisces about his youth. The book presents interesting information about opinions of a principal actor in the recent events and

⁸⁷² Hearings report 2 p. 1304.

therefore fits well in the series of publications concerning them.⁸⁷³ A glossary offers support to readers who are no experts in the matter. This third edition has been updated by the addition of a new introductory chapter about the political developments around the euro in the last months of 2011.»⁸⁷⁴
⁸⁷⁵

Mrs. Neppérus: «I begin with Icesave. Last week we discussed the problems with Icesave, and the opinion of DNB about the Icelandic deposit insurance system with mr. Schilder.⁸⁷⁶ Mr. Schilder elaborately indicated that DNB was mainly occupied operationally. According to his memory DNB had no scenario's in which Landsbanki would fall, and in which an appeal would have to be made on the Icelandic deposit insurance system. Is this correct?

Mr. Wellink: That is correct.

Mrs. Neppérus: That is correct. Nevertheless, if you look back in time for a moment, the whole period of Landsbanki is not very long, when that Dutch money was parked there for a few months, but was it realistic to assume that the Icelandic deposit insurance system would be able to cope with the consequences of a bankruptcy?

Mr. Wellink: I think that this is not the right question. I think that the question is whether we could foresee that Landsbanki in Iceland could go down. About this question and at the last moment, until mid-September, the IMF was of the opinion that Iceland and the Icelandic banking system had good perspectives. Moody's came with the same opinion. In a certain sense we did not reach the question about adequate capitalization of the Icelandic deposit insurance system, because just like the Netherlands they were financed with 1% of the deposits. If something went wrong, they would have insufficient money by definition.»⁸⁷⁷

The well-known style. Yes-or-no thinking instead of thinking in terms of possibilities and probabilities. In terms of risks and risk management. And suggesting that a supervisor need not be aware of, and be actively on the lookout for, risks.

Wellink is supposed not to know about the GAO, OFHEO, and CGFS reports, and the Born-CFTC scandal and what it shows. Why does he trust, and is he allowed to trust, the IMF blindly?

The last sentence of Wellink is remarkable: suddenly formal capital requirements are said to be practically meaningless. This is not explained or discussed in what follows.

«Mrs. Neppérus: Alright, but then I take a step backwards. You assumed that the Icelandic system would not be able to accommodate it?

Mr Wellink: No, no, that is not how I said it. The essence of what I said is: that system as such is, just like the Dutch system and that in other countries, not able to withstand systemic crises. That is included very clearly in the Basel principles, that is understood and acknowledged. If the system crashes, the deposit guarantee system is insufficient, and governments have to come to the rescue. What I said is that the situation in Iceland was that, if something would go wrong, in our opinion and also that of the UK authorities and the EFTA supervisor authority, the Icelandic government was responsible.⁸⁷⁸ That is very clear, and that is indeed crystallizing now very clearly.

Mrs. Neppérus: Alright. But Iceland is an island with 350 000 inhabitants. The town of The Hague, where we are sitting at this moment, has [many] more inhabitants. How real is it to expect that the Icelandic government would be able to cope with this?

Mr. Wellink: I think you should submit this question to the European lawmaker, including the Dutch lawmaker. We have the system of the European passport. That means that institutions based in a European country may operate in all of Europe. There is no legal provision about the extent to which this is done, there is only the obligation for these countries to have a deposit insurance system, and that's it as far as the legal framework is concerned.»⁸⁷⁹

⁸⁷³ This is only correct if Wellink speaks the (full relevant) truth. After having seen that he lies even under oath, this can only be assumed after checking.

⁸⁷⁴ Hearings report 2 p. 1577.

⁸⁷⁵ Why didn't Wellink write such a book, or a real autobiography, himself?

⁸⁷⁶ Mr. prof. dr. A. Schilder RA was director Supervision Banks at DNB.

⁸⁷⁷ Hearings report 2 pp. 1577-8.

⁸⁷⁸ Note that for once, responsible is supposed to mean liable.

⁸⁷⁹ Hearings report 2 p. 1578

1. Wellink practically denies what he said in the context of decision making about permission for Icesave and the topping up, or what he implied there. Here he says that only an idiot could have given Icesave permission, and allowed the topping up.
2. He makes governments explicit part of the financial system.
3. He implies that moral hazard is no hazard, because banks can always count on government assistance in case of need.
4. The conclusion is that either Wellink or the European lawmaker, or both, acted irresponsibly. They encouraged irresponsible behavior.
5. Wellink could have said: I had a job which simply cannot be done responsibly, and I was therefore bound to fail.

On p. 1579 Wellink repeats the question he wants us to see as fundamental:

«So the question remains: could we have predicted that the Icelandic financial system would crash. That is always the fundamental question.»

But even though the answer may be yes, this is not the correct question for someone who is responsible and represents potential victims. The question is whether or not there is a non-zero risk, and if there is a non-zero risk, to manage it in such a way as to prevent and/or limit damage to the utmost.

The simpler questions raised by mrs. Neppérus, as to the credibility of a population of 350.000 people supporting a banking system of the given size, and whether someone responsible for the safety and soundness of Dutch financial system is acting responsibly when he gives a terribly oversized bank permission to operate in the Netherlands, remains unanswered.

The course of events, including the inquiries, has shown that there simply is no compelling reason to manage risks responsibly,⁸⁸⁰ and take adequate measures.

Wellink: «We have an obligation to have a kind of risk management. We ask that of all corporations, and we ask it of our own organization too.»⁸⁸¹

This obviously is incompatible with the facts and the annual reports. The assertion shows that Wellink doesn't know the meaning of risk management (or lies). He can never have thought seriously about it, or is unable to. (There is no evidence showing that he is able to).⁸⁸²

The guarantee for the first 20 k€ would be chargeable to Iceland, the part between 20 and 40 k€ to the Netherlands.⁸⁸³ The last part is referred to as the topping up. (There was a lot of disagreement about the topping up. This is understandable: it is a kind of subsidy).

Icesave is discussed until p. 1585. At that point the chairman takes over. He asks questions about ING. His questions give rise to an intransparent discussion about negotiations DNB – ministry of finance. This is hard to evaluate due to lack of reliable (independent) evidence about the subjects being discussed. The discussion may be meant to evaluate Wellink and DNB. This would seem to be impossible however in the absence of reliable evidence and by an ill-prepared hearing such as this one seems to be.

On pp. 1586-7 Wellink returns to an assertion about a phone call he was supposed to have had with prime minister Balkenende (like Wellink, member of the CDA political party). It wasn't a phone call but a visit. By now Wellink remembers.

⁸⁸⁰ In the sense of the present author: in such a way that liability can be accepted.

⁸⁸¹ Hearings report 2 p. 1582.

⁸⁸² The DNB annual and stability reports, and reports of other financial supervisors, in so far as studied by the present author, nowhere defined and explained “risk management”, and described how the risk management of supervised institutions was supervised.

⁸⁸³ Hearings report 2, p. 367.

The discussion about ABN AMRO bank begins on p. 1588. Part of the cause of the wearisome nature of the negotiations was the bad personal relationship between Wellink and his Belgian colleague. (About which Wellink speaks very mysteriously, unprofessionally and un-businesslike, and makes much ado).

In this discussion too, for example on p. 1591 about EU commissioner Kroes and the European Commission, it is quite clear that Wellink tries to remain friends with everyone in a high position.

At least until this page the discussion only concerns details of Fortis-AAB. And the sum of the details does not constitute a clear story.

As in the US, the first thing that was done when a bank ran into difficulties, was to look for a bank which could take it over. In this case the ailing Fortis+AAB.

Until at least p. 1613, the inquiry commission seems to try and reconstruct a piece of history. But if this is indeed its aim, it does so in a terribly unprofessional way. The commission should have started with a thorough investigation of the documentary evidence. Especially of contemporary (annual) reports, and minutes of meetings. Hearings could be used for clarification, when necessary. After the fact, and because of all kinds of interests, they cannot be used as a primary source of information. (As confirmed in the present Wellink appendix). The hearings could be held on the basis of a draft report, or subreports. Drafts could be discussed in the hearings, and corrected and improved on the basis of the discussions, in principle only after checking.

Wellink sees no need for more evaluation of DNB.

Although the inquiry commission has not tried to identify more fundamental errors made by Wellink and DNB in the prehistory of the subprime crisis, but only looked for errors made in specific processes, the following question suggests that the inquiry commission is aware at least of operational errors of Wellink and DNB, and that lessons have to be learnt. Wellink's answer suggests that he is surprised by the question, and by the supposed need of an evaluation. His claims that evaluations have been made are false. No evaluation in the sense meant by mrs. Vermeij has been made. At least not before 2012.⁸⁸⁴ Wellink answers like a politician who wants to suggest that was done what was required, but actually shows that it was not, and that he sees no need for such an exercise. Which is in accordance with his claim that no serious errors have been made. In none of the hearings did he indicate that anything at DNB was wrong, and has to be corrected. Still, he does not say explicitly that no serious errors have been made.

«Mrs. Vermeij: Before passing on the baton to the chairman, I have a last question for you, mr. Wellink. Has a thorough evaluation been made in DNB of the operation of the bank during the various interventions?

Mr. Wellink: In any case we have had a few thorough evaluations. ABN AMRO has been studied in the Lieverse report. Of course we also looked at that report internally. We have had reports about Icesave. We will of course receive your evaluations, and have had those of the commission De Wit [the first of the two]. We did a lot during the trip. During the ride I frequently asked my people: what lessons can we learn? That is a kind of evaluation. That was done rather systematically. What lessons can we learn from what happened exactly? An example is the very concrete question what lesson you can draw as supervisor from the ABN AMRO case position. So there have been evaluations. We also had an evaluation- this was published as a book; with all those horses on the cover- about the way we saw the whole crisis originate and develop, and how we saw it. At a certain moment I personally thought that it would be extremely useful- this is a terribly complicated project however- to investigate a very concrete case position like ABN AMRO down to the most minor detail, as a lesson for the future. I don't say this in order to start a discussion with the parliamentary inquiry commission, but for the supervisor all kinds of questions have not yet been asked. Should one really, to give a few examples, allow a cash offer of this size? Should one permit hostile take overs if due diligence has been insufficient? These are all questions we have not really answered yet, and which according to me might be studied very closely.

⁸⁸⁴ Not before 2018 either.

Mrs. Vermeij: I pass the baton to the chairman. I do wonder what title you have in mind for that book: a broken bank?»⁸⁸⁵

Note that Wellink's reply shows that he does understand that Vermeij means internal and not external evaluations.

The booklet with the horses has the title "On the trail of the crisis".⁸⁸⁶ It is not an evaluation of DNB or its functioning. Page 7 even says explicitly: "This volume is concentrated on background information of a factual nature. It does not consider policy lessons to be drawn".⁸⁸⁷

The conclusion which can be drawn from Wellink's tattle is: there has not been any evaluation worth the name. Neither internal, nor with regard to the internal operation of DNB. As the report *Wellink's perjury* shows, nothing like an evaluation can even be found in the years after the crisis and the inquiries of the CDW.

After the crisis, Wellink knows, understands, & has a solution for everything.

The pages 1628-30 of the second hearings report concern the take over of AAB by Fortis, and especially the decision making process preceding the declaration of no objection (DNO). Once more, Wellink falls back on his ultimate line of defense: nobody saw it coming, everyone was surprised. Only by the crisis have we learnt what we should have known.

«The chairman: I would like to return for a moment to the declaration of no objection which you signed in September 2007, together with the minister of finance. In the hearing of the temporary commission [the first commission De Wit] you made the famous claim about the hole: if you had only found a very minor hole, you would have prevented the deal. Looking back at the subsequent developments and the declaration of no objection, I have the following question. After September 2007 one sees that already within a year, that is, before the fall of Lehmann, the financial health of the parties taking over, in two of the three cases results in considerable problems. I mean Fortis and the Royal Bank of Scotland, the criterion A in fact.⁸⁸⁸

Mr Wellink: In my opinion that question is justified, and I also asked it myself. Like Sweder van Wijnbergen did recently, I do want to distinguish between- I ask you not to react too quickly to this, because there is a whole argument behind it- the knowledge of now and the knowledge at the time.⁸⁸⁹ With the contemporary knowledge, the experience we had at the time on the basis of what we had experienced, and also the experience of the international supervisor community and the existing law, we have made a fantastic effort and done our utmost to do things as good as possible. Now the knowledge of now. I think that you have to look with that knowledge in order to ask yourself what you can learn from it. Let me begin with the question whether at the time we could have predicted- that is relevant anyway, but I want to go further- that we would enter a financial stability crisis which would amplify everything that had happened in the banking sector.

The chairman: Last time you had a clear opinion about that...

Mr. Wellink: We have to make progress. We invest a lot in that. Last time I mentioned the macroprudential tool box. I want to warn nevertheless. Last time one of your recommendations actually boiled down to managing expectations: you have to warn timely that something can go wrong with banks. In this regard we already have the first disappointment behind us. At this moment after all we have a crisis in Europe in the financial and public administration sectors which we did not foresee two years ago. This means that we have to deliver much input in order to better understand the

⁸⁸⁵ Hearings report 2 p. 1626.

⁸⁸⁶ It can be found in the dossier under 20100320.

⁸⁸⁷ Copying from the pdf file of the booklet has been disabled.

⁸⁸⁸ The words "door uzelf uitvoerige toegelicht" (elucidated extensively by yourself, in "Fortis en de door uzelf uitvoerige toegelicht Royal Bank of Scotland") have been dropped for the following combination of reasons: they produce a grammatical error, it is unclear what they mean, and they seem unnecessary.

⁸⁸⁹ The reader should know that in the last decade or decades, this has been a standard phrase of politicians to excuse misconduct and errors. In general the use of the argument is not justified however. It abuses the deficient remembrance and knowledge of recent history of the public. It suggests, as here, that knowledge which exists already for a long time is entirely new.

operation of the system.⁸⁹⁰ But there is more. With the knowledge of this moment on the basis of what you learned you can ask yourself whether you should not have known more about the other parties. The answer to this is yes. Then the question is: why didn't you know more about it? Because there still exists a split system of supervisors in which each supervisor can keep cards against his breast and exchange insufficient information. I was shocked, to be honest, when I heard after a long delay that in the week in which we negotiated about lifting out ABN AMRO, one of the three «im Bunde», RBS, required 46 billion pound ELA aid.⁸⁹¹ Shouldn't one know much more about other parties? That is one.

Then two. Should hostile offers be possible or not? In the nineties hostile offers were made in the US. This did not result in accidents. But should hostile offers be permitted in a fragile financial sector, with insufficient due diligence?⁸⁹² Because often that is the nature of hostile offers. At a given moment you stop providing information, and then everyone receives the same information. It seems to me that you should not permit this when institutions of systemic importance are concerned. Hostile offers by consortia or consortia offers in any form, if it isn't known in advance where things are going... If one thing has become clear after the fact, to me too, then it certainly is that an unbalanced distribution has taken place of costs and benefits. The funny thing is,... Strictly speaking it shouldn't be called funny, but those who thought to get more benefits got much more costs. One, Santander, left. Still another element is the question whether you should allow cash offers of this size. After all the case would have been much simpler if it would have been restricted to shares.

So for me there is a number of lessons. I think we should do more than just noting this. Some things you cannot fix in laws. Other things you need to fix in policy documents of the supervisors. You cannot devise this in a single moment, that you get something new on your own authority. This was one of our problems in the time of the case. You should actually tell the market «we simply do not do things like this and that». These are all lessons which we drew in the concrete case, and which according to me should get a follow-up. In addition there are lessons- but those belong to a wider context- which concern the question how you can reduce the risk that things go wrong. Then the buffers are under discussion. I think that the buffers in the system have to be increased a lot. We worked on that in connection with the Basel committee. We know, at least, we have calculated- whether it is entirely true I don't know- that already a few percent additional capital can halve the probability of default. So more buffers in the system is a lesson, but also a crisis resolution mechanism which, if a large financial institution gets into serious difficulties- for you don't want to exclude the possibility of bankruptcy- minimizes societal costs. One can try to do that for example with living wills. It is almost cynical that ABN AMRO had a construction which was very similar to a living will. On paper one could make big profits from sales, and use them to solve current expenditures. According to the hedge funds the current yield was actually too small because there was no synergy. So living wills, that kind of constructions, and a better quality of supervision, with a better exchange between supervisors, especially confidential information-exchange. I could continue for quite a while.

The chairman: We are back indeed in the area we also discussed in part 1, and about which the commission has made recommendations.

Mr. Wellink: That is correct.

The chairman: In that respect the lessons which you mentioned are clear. I would like to return for a moment to the question I asked you about the signing of the declaration of no objection and the criteria you had to apply. Shouldn't one conclude that something had escaped attention at that moment? I drew your attention to the position of Fortis and RBS. I can also point to the fact that ABN AMRO suffered appreciable losses in 2007, or to the fact that the financial stability in the Netherlands actually came under pressure already from the summer of 2007. Didn't these three elements make you ask yourself whether you had seen correctly?

⁸⁹⁰ With regard to the government debt crisis this is nonsense. It is obvious that structural deficits will cause problems sooner or later. That is why limits had been set. They were disregarded however. Again: the problem was not understanding, but an irresponsible objectionable attitude of the politicians.

⁸⁹¹ «Mr. Stoelinga [CFO LeasePlan Corporation]: DNB has means to help out in emergencies. We went to DNB and asked whether they could help if the crisis would last, and we got into acute trouble. It turned out that there was an ordinance called Emergency Liquidity Assistance (ELA).» Hearings report 2 p. 621.

⁸⁹² When it suits him, the sector is called "fragile"! (At other times he calls it "resilient").

Mr. Wellink: I have tried to tell you that with the newly acquired knowledge ... I said for example that you should know more about the parties. If I could «catapult» myself back to autumn of 2007, I would make a different decision. However, if I «catapult» myself back with the knowledge of that moment, I think we have punctiliously looked at so many details that according to me no other supervisor in the world has studied; that level of detail. You know that I didn't like instinctively what happened in that take over. The reason being that I like order in processes. Then all of a sudden a party enters and starts throwing money around like mad. Instinctively I had the reaction «this shouldn't happen». Without the experience we would get later, we said in fact: Let's look at all the risks in this project. Every risk we de facto ...

The chairman: You mean the step-by-step approach, gated approval.

Mr. Wellink: We tried to minimize every risk. Then there remain risks which may be connected. Perhaps we did not realize this sufficiently. Then there remains an uncertain world where remaining risks possibly are acceptable separately, even when added, but nevertheless cause such a reduction of resilience of the institution, that you shouldn't do it. For us a very important point ... At a certain moment I told the supervisors: try to draw the most important lesson from this process. Then it turned out that in the future we should take account of the lesson not to enter a process of which you know in advance that it takes too long in a world changing rapidly.⁸⁹³ When you think «I can quietly complete this process in two years», then you do something that doesn't fit the modern world. That is a lesson too, but it is also a lesson which you cannot fix in a law. This lesson could be included in something like a policy role of supervisors. «We can refuse, and you in the market should be aware of that, if in our opinion processes last too long.»»

1. In the prehistory of the subprime crisis 1998-2006 there were many reasons and opportunities for showing this kind of Wisdom (quasi-wisdom), but Wellink and DNB remained silent.
2. Once more Wellink repeats that crash and crisis were not predicted. As shown before, this is untrue. It is untrue as well that more information is necessary to understand the financial system. At least in this sense, that enough was and is known to prevent this kind of crises. The necessary understanding had already been acquired in 1998 at the latest.
3. Already in 1998 the GAO had told the supervisors in unambiguous language: “Regulators Need to Focus Greater Attention on Systemic Risk”. In boldface characters, the same report observed: “Existing Coordination Could be Improved to Enhance Regulators’ Ability to Identify Risks Across Industries and Markets”. The lack of transparency too was already noted. The ruthlessly repressed Brooksley Born initiative can be seen against this background. Some years later, CGFS reiterated the danger of intransparencies. There is no tenable ground for surprise. Wellink gives an incorrect picture of the state of affairs. He shows that he and DNB did not read what they had to read, and understood what could be understood. Wellink is misleading and commits perjury.
4. The relation between capital and safety has always been clear. There never was proof or logical ground for the assumption that the Basel requirements ensure safety. Wellink and DNB could have been critical about the requirements for years, but were silent as the grave. Elsewhere in the hearings Wellink moreover asserts that a balance has to be found between safety and a working economy, and that he had an agreement about the balance with finance minister Bos. So what exactly had been agreed about the balance, and what price did they consider adequate in terms of safety to keep the economy working? Wellink at best tells half of the relevant (possibly vital) truth, and therefore commits perjury. On this subject too he misleads.
5. There should always have been plans for crisis management, because historically crisis are a rather frequent phenomenon, and because there was no theoretical reason to assume their extinction. The suggestion of a new need is incorrect.
6. “That level of detail”, while complaining about missing information! Wellink should have noted the insufficiency of the information, and noted at least that this insufficiency means additional (unknown) risk. If he had refused to sign, the parties would surely have provided the info, or pressured the party or parties withholding it. Wellink must be lying.

⁸⁹³ The supervisor has a legal duty, and cannot refuse entering a process. He can however simply withhold the requested permission on grounds of exceptional risks. Exceptional at least due to the circumstances.

7. The last paragraph of the quote suggests that Wellink does not understand that risks should always be seen in combination with their consequences. In common parlance the word risk is ambiguous: it may or may not include consequences. So if it is not plainly untrue, then certainly for someone with a duty to protect it is irresponsible and misleading to say that you minimize every risk if the remaining risks can still cause a disaster.
8. Keep in mind that there never were sound reasons to believe that the system was safe, and that many of the proposals or recommendations, and better ones at that, could and should have been made much earlier (and actually were, though of course not by Wellink or DNB). Wellink does not show why his proposals would in any way be sufficient.
9. Note that Wellink shows not the least modesty. He speaks as if he is all knowing and all understanding, and has a solution for all problems. Most importantly: before the crisis he had exactly the same attitude of knowing and understanding everything, but said (implicitly) that no action was required. So with respect to his arrogance and self-knowledge the crisis and its prehistory have taught him nothing. He was and remains a terribly arrogant swindler.
10. The exclusive focus on the lies about supposedly missing knowledge and predictions precludes attention to the real problem: the stupidity and dogmatic, intolerant and repressive attitude of the supervisors. Supervisors, who ignored information, warnings and recommendations and gave way to pressure by politicians with a similar attitude. The attitude of Wellink in these hearings is a case in point. His smart-alecky tattle is worse than a waste of time. The real problem, that of the unacceptable and dangerous attitude of the supervisors, is neither mentioned nor addressed. It is amply demonstrated however.

Wellinks conclusion shows no modesty but self-complacency.

«Mr. Wellink: I had wanted to make supplementary remarks of the kind of some of the remarks I just made. So there is no need for that anymore. I do want to make a supplementary remark in relation to what was said by ex finance minister Wouter Bos. By now you have seen all files. I went cursorily through many files once more. Of course I came to the conclusion that in some respects things could have been done better, that sometimes there are gaps in the files. At the same time, last week I once more became aware of how much competence- with all errors, I readily add- and how much material knowledge the supervisor had, and of the unimaginable energy, sense of duty, and loyalty with which the work was done. When you note- in a certain period I counted this- the moments when meetings were held and mails were sent, and when you realize the smallness of the group which had to do this, then I do hope that this aspect will get its place in your report. As a pensioner I may say this. This can be an important motivation for people, also for the future generation which has had to draw many lessons, to continue in the future just as undauntedly and perhaps to do it even better than us, in the interest of the Dutch society.»⁸⁹⁴

1. It is a pity that the errors are not specified, given that they are not mentioned or specified elsewhere, and given the systematic denials of errors and explanations in terms of the (supposedly unavailable) knowledge at the time.
2. The self-complacency is consistent with the denial of serious errors, and is irreconcilable with admission of serious errors, such as structural passiveness, and the neglect of the reports about the risks, and the recommendations of these reports.
3. There is no indication of doubt or introspection. Which is in full agreement with the attitude manifested by the DNB annual reports 1997-2009.

The hearing of Friday 27 Januari 2012.

11u20-12u43 in the Enquêtezaal of the Logement in The Hague.

The stenographic report of this hearing covers the pp. 1825-1851 of the report of the second series of hearings of the Commission De Wit.

The subject of the hearing is «the total expenditure of the Dutch State in connection with the take over of Fortis/ABN AMRO in October 2008.»⁸⁹⁵

⁸⁹⁴ Hearings report 2 p. 1631.

⁸⁹⁵ Hearings report 2 p. 1825.

This seems to be a (quasi) technical discussion which only makes sense if one knows (much) more about the context. Possibilities to check assertions seem to be small, unless one would have access to reports (transcripts) of the relevant internal meetings, and could question more DNB employees under oath. And even then one cannot be sure. There also seem to be only very few clear conclusions. So one may doubt whether the hearing can be of much use to the inquiry commission.

The hearing shows relatively much of Wellinks relation with the rest of the DNB organization. The relation, or perhaps rather Wellinks descriptions of it, seems vague. We see no active or interested manager.

For the purposes of the present report the added value of this hearing is very limited. For that reason only a few short remarks are presented. They intend to give an impression of what this hearing is about, and what it is not about.

The nature of the answers of Wellink is the same as that in the earlier hearings. So the present session (of 27/1/12) yields no information requiring amendment of conclusions from earlier hearings. Especially Wellinks unreliability and passivity are confirmed.

On pp. 1825-6 Wellink makes the impression of being a bad manager. He follows the retrieval of AAB “by halves”. Even though he was part of the negotiation team (p. 1827, top).

Wellink’s passivity with regard to the Lazard valuations (and to the reaction of his employees on the valuations) lacks credibility and/or a sense of responsibility. (p. 1828).

On p. 1831 Wellink makes the impression of thinking that the financial system could be rescued only if agreement could be reached about the price. This is incompatible with p. 1849, below.

In Belgium he was accompanied by mrs. mr. A.J. Kellerman. He cannot remember any other contacts with DNB. Mrs. Kellerman was director Supervision pension funds and insurers. So this was a remarkable choice.

P. 1832.

Wellink seems to have heard a rumor of a much higher amount. He was therefore content with the middle of the Dutch bandwidth. This is hard to reconcile with the blind faith he earlier showed with respect to Lazard.

P. 1839. A strange and suspect story about a decision making process. Wellink has only vague memories and knows very little.

P. 1840. Wellink relied on his people, and this is how it always goes in practice. Also when he doesn’t understand.

Pp. 1841-2. Very strange that DNB seems to have withheld information. The way Wellink talks about this makes a strange impression too. See also p. 1849.

Pp. 1847-8. Examples of “miscommunication”. In fact contradictory remarks. Wellinks reaction doesn’t seem to clarify matters much: in two cases the miscommunication caused little harm, in the third it may have cost billions of euros. The underlying problem seems to have been: ambiguities in financial statements, classifications of assets etcetera. The required information seems not to have been available in an ordered fashion, and ordered according to general accepted principle. The decision making proces was hurried and improvised.

Governed by Lies

Book 3

Other cases, final analyses & corrective measures

Chapter 8. Other cases.

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8.1. General conclusions.

What follows are conclusions which can be drawn from the material presented in more than one section of this chapter. Section-specific conclusions can be found at the beginning of the sections.

In this chapter, “principal persons” are officials of public administration, unless mentioned otherwise.

1. There is no incompatibility or tension between the conclusions of this chapter and those of earlier chapters.
2. In similar cases, conclusions of earlier chapters and the present chapter agree. The random nature of the samples and the lack of any evidence contradicting the conclusions support the hypothesis that the conclusions have general validity.
3. The conclusions of this chapter overlap with those of earlier chapters, and supplement them. Probably the most important conclusion is the same as the most important conclusion from the chapter about the financial crises. To wit, that the principal (political) persons are insufficiently

competent (= have a job that is too difficult for them), and lack integrity (= do not admit incompetence, terrorize whistleblowers, and/or tolerate the terrorization). In none of the cases studied the principal persons accounted for their actions in an acceptable way. They claim to have done what they should and could do, deny wrongdoing, etcetera.

4. All principal persons are characterized by false pretensions.
5. In most of the cases studied in this chapter (very) much avoidable damage was caused. Lives were destroyed. Work, money and time were wasted. For an important part the damage is irreparable. In so far as the damage can be recovered, only a very minor part was recouped from those who caused it and/or were responsible. Nearly all costs had to be borne by innocent victims and the tax payers.
6. This can be blamed on deficient law, and therefore on the same principal persons and their peers.
7. The principal persons give priority to the policies and interests of their party and/or organization, and their personal opinions and interests. Where “necessary” at the cost of generally accepted norms and values. Such as the duty to inform timely, fully and completely, and to account for one’s performance. The principal persons do not shy away from sacrificing innocent people to indefensible interests or opinions, and to terrorize people who do their duty, and try to end misconduct.
8. The internal checks and balances of hierarchical organizations are ineffective at best. Self correction is absent. The findings of the study are consistent with the hypothesis that whistleblowing and the internal reporting of misconduct are very strongly discouraged by the terrorism exercised in the widely publicized whistleblower cases. Internal reporting- to the “management”- has very little chance of success. Negative consequences for the reporter are much more probable than correction of misconduct and its consequences.
9. External control and corrective action by supervisors, including parliament and government, is insufficient (which may mean absent).
10. The attitudes of the top managers of hierarchical organizations are very similar. Even those of the Roman Catholic Church. In other words: as regards the attitudes of its hierarchy, there is no significant difference between the Church and a typical hierarchical organization.
11. The observations support the hypothesis that much misconduct is caused or facilitated by the hierarchical organization and what it implies. Such as the almost dictatorial powers of top officers who lack the abilities and integrity necessary for their function, the lack of incentives to avoid misconduct and harm for outsiders, and insufficient possibilities for correction.
12. In almost all cases the responsible supervisors could and should have prevented almost all damage. Their indulgent attitude and negligence must be seen as a main cause of the damage.
13. The inquiry commissions installed by parliaments or governments lacked the necessary integrity and competence. Their reports provide much useful information, but are analytically inadequate.¹ In general the responsibility of politicians is mentioned only in passing. Nowhere do the commissions try to find the causes of the systematic failure of politicians to do their duty, and to explain why they did not openly and acceptably account for their actions and omissions. Due to the failure to address one of the most fundamental causes of all reported problems, their recommendations cannot be effective.
14. Both because of their a priori unsuitability and the a posteriori inadequacy of their reports, the inquiry commissions give the impression that they were not meant for real improvement, but to protect the given political system, and avoid substantial change. This goal was realized by the character of the inquiry itself, by precluding better investigations during the year or years that they were active, and by diverting attention from vulnerable aspects of the given system.
15. No measures were taken that can be expected to reduce the probability of any of the observed phenomena. None of the people responsible for active or passive causes in the studied cases has been held liable or has been prosecuted criminally.² Laws have not been provided with incentives for adequate fulfillment of responsible functions, for self correction by hierarchical organizations, and/or disincentives for failure to do one’s duty and/or penalties for misconduct.

¹ As everywhere in the present report, inadequate does not mean “completely lacking adequacy” or “entirely inadequate”, but insufficiently adequate.

² Passive causation is causation by neglecting to perform a duty properly, in particular by omission.

16. The scientific world defaults by lack of integrity and lack of interest in the real world described in this study.
17. The press defaults by failing to draw conclusions from its observations, by a failure to learn, and by collaborating with politicians in ignoring and forgetting whatever politicians want to ignore and forget.
18. The author did not encounter any case that suggested any fundamental difference with the cases actually mentioned.
19. The cases show no positive development in time.

8.2. Introduction.

Chapter 3 was meant to find out whether the phenomena shown in the policy portal project were an exception or the rule in the Dutch ministry of education. Similarly the present chapter is meant to find out whether this ministry is exceptional. Examples cannot prove that the misconduct shown in the previous chapters is the rule.³ But analysis can make it plausible, and yield hypotheses which can stand the test of comparison with all known cases.

Just like the cases studied in chapter 3, the present chapter is meant in the first place to enable checking conclusions from earlier chapters. In the second place the experience of the earlier chapters shows that one may hope to get more and better insight. Every case has its peculiarities, and may show something that other cases don't.

As regards methodology it may be useful to note that for example a successful project need not show a contradiction or even provide useful information, at least on the surface.⁴ A successful project cannot falsify the conclusions and conjectures of this report. If only because the report does not conclude that nothing goes well, or that the principal persons or their peers have no ability whatsoever.⁵ Important conclusions of the report, for example about the general nature of false pretensions, would be falsified if the principal persons would give satisfactory explanations of their apparent failure of their own accord, and if these explanations would show that they did act honorably and competently. Or if the principal persons would admit errors and a lack of necessary abilities, and forgo functions requiring more abilities than they actually have. And if they would show that they give integrity, including an open, honest and responsible attitude, a far higher priority than personal interests of themselves and their peers. Also by not shielding one another in cases of lack of integrity and competence, and by refusing to cooperate with people who seriously misbehaved. No example of such an admission and about-face was encountered in the course of the present inquiry. Neither in the literature nor in daily life.⁶

The two overlapping financial crises of 2007-2013 can be considered as “other cases” too. The most important difference between the earlier cases and the “other cases” (including the financial crises) is the visibility of the functioning of the (political) heads, and of the consequences of their functioning in the history of the financial crises. The phenomena in the ministry of education involved little more than civil servants. The political heads remained largely (though not entirely) outside the field of vision. Note however that it could have been different. Their invisibility furthermore does not reduce their responsibility. And the fact of their invisibility is information too. But in the opinion of the present author this information is insufficient to get a picture of these people that helps to explain the observed phenomena.

³ In fact, it certainly isn't the rule. If everything goes well of its own accord, without the need for more than average abilities, without temptations etcetera, there is no need for misconduct. But as will be argued, under weak conditions it very probably is.

⁴ To be able to call a project successful one needs full information. A building that looks nice may well have cost twice the originally agreed or necessary budget, and may have unbearable maintenance costs. It need not perform as required. In the cases of the present report much more is wrong than has been reported.

⁵ A successful project does say something about the population of their subordinates. For example that not all of them can be supposed to be stupid and silent. (As their superiors make us believe in case of the financial crises for example). But it says nothing about people in general.

⁶ Of course, for all of the cases studied, admissions as suggested here would come far too late.

The text about all cases, both here and in other chapters, should be seen as a guide and supplement to other documents about the case. Especially to the documents in the dossier. In this chapter it has never been tried to give a description that gives every aspect the attention it deserves from every point of view. Completeness is never aimed at. Assuming that things like complete description and equal attention can be defined unambiguously. On the other hand it has always been tried to find information that might shed new light on the observed phenomena. That is why rather different cases have been selected.

The present chapter is meant to record and describe, and to analyze “superficially”. “Superficial analysis” meaning: observationally, within the framework of the case. “Deeper” analysis meaning: establishing phenomena common to many cases, and their changeable causes. This is mainly left to chapter 9. It has been tried to describe and analyze the cases in such a way as to make reading (other) sources largely unnecessary. It has been tried to stay as close as possible to the facts, and to treat the cases as much as possible on their own merits. That is: independent from what other cases show.

The section on science is quite unlike the other sections. Its origin is explained in the section itself. The explanation is symptomatic for the sorry state of the sciences which, because of their pretended purpose, should investigate and explain the phenomena described in the present report. The section quotes an expert who implicitly confirms the impression which a vain search for relevant literature had given the present author. Although the present author has searched for decades, he was unable to find anything betraying knowledge of the reality of the internal operation of (government) organizations, and the functioning of the heads of these organizations and other politicians.⁷ There is a poignant lack of awareness of the virtual absence of empirical information. And, consequently, a just as poignant lack of efforts to do something about it, in order to be able to explain the phenomena which everyone can see with his own eyes. Probably out of fear to offend the powers that be. But whatever the explanation may be, the expert mentions no books or articles which show that the present author is wrong and overlooked something important. He only mentions some academic experiments. Nothing that would make even a small part of the present report superfluous.

These observations are consistent with the absence of any trace of understanding in the media and other literature. This phenomenon will be studied in chapter 9. It turns out to be quite understandable.

In the analysis of the subprime crisis attention was paid to economic science and the science of law. What was written there is relevant for the present chapter as well. There does not seem to be a need to waste more time and words on them.

8.3. Spijkers and the defective AP-23 mines (1983- after 2008).

Preliminary remarks.

This is probably the simplest and most instructive case.

Chapter 4 gave a concise chronicle. It shows that very many people actively collaborated with the repression of Spijkers. It shows who are co-responsible for

- Terrorizing Spijkers without the least justification;
- Gross injustice towards the victims of the mine accidents and their relatives;
- Deceiving the Dutch public.

Good reports are available, at least in Dutch. The next two are adequate and recommended:

- Sokje van Oest (= Joep van der Vliet et al.) *Rechtsstaat zonder zelfkritisch en zelfreinigend vermogen* (Constitutional state without self-critical and self-correcting abilities), Openbaar Bestuur number 3, March 2008.
- Alexander Nijeboer *Een man tegen de staat* (A man against the state), Papieren Tijger, Breda, 2006.

⁷ Of course I mean *reliable* knowledge, with a sound basis, not just hypotheses, wishful thinking or coffee-talk.

Much and useful information can be found in:

- Report 99/175 of the (Dutch) national ombudsperson concerning an investigation into the accidents with the AP-23 mine in 1983 and 1984, dated 19/4/99.⁸

The facts of the accidents with the mine, including their causes, are clear beyond any doubt. For important facts of the case the reader is referred to section 4.7 and the summary below, and for additional details to the publications just mentioned. What happened in the responsible ministry of defense is very important as well, but largely unknown. As explained below, the documentary evidence was made inaccessible intentionally.

Summary and conclusions.

1. Since 1970 it was known to the manufacturer, the army and the ministry of defense that the AP-23 mine was defective and that the defect caused the risk of lethal accidents.⁹
2. The army nevertheless kept using the mine.
3. In accidents in 1983-1984, mines of this type killed at least eight persons, and critically wounded many more.
4. In the years 1970-1984 the top of the army, the ministry, the Dutch General accounting office, and parliament were not willing (integrity) and/or able (competence) to get the mine repaired, destroyed, or expelled from service.
5. The last accident, on September 14, 1984, killed mr. Ovaa. Mr. Spijkers is ordered to tell the widow that Ovaa was the victim of his own negligence. By his behavior Spijkers shows the widow that he has doubts about the truth of this statement.
6. Subsequently Spijkers starts an investigation of the mine and its use.
7. When Spijkers does not accept falsehoods and requires a satisfactory explanation, everything related to the army, the ministry, and government turns against him. A series of all kinds of officials and agencies try to silence Spijkers, contrary to their legal duties and obligations (codes of conduct, etcetera).
8. On the other hand: nobody rises to support or defend Spijkers.¹⁰ Even though the problem with the mine was already known since 1970, and the mine had killed seven people in 1983.
9. From 1984 until at least 2008 the persons and agencies mentioned in 7 tried to make the life of Spijkers as difficult as possible.
10. The responsible secretaries of defense systematically misled parliament and public, also with lies. They have not been punished for this.
11. Much goes wrong in the army and the ministry, and integrity is obviously lacking. But neither internal nor external control- if present- is effective.
12. The media may have prevented outright murder of Spijkers.¹¹ But the publicity (or whatever) has not led parliament or government to take effective corrective action.
13. For many years parliament failed to adequately control the army and the ministry of defense. After inquiries it did not take effective action. It accepted the proposal of the responsible secretary of defense to make the relevant archives only available 50 to 70 years after the death of Spijkers, and to let the crimes that they may prove go unprosecuted and unpunished.¹² In other words: parliament made itself an extension of criminal secretaries of defense, that is: an instrument of crime. It neglected vital constitutional duties and human rights. It obstructed efforts to get justice done.

⁸ In Dutch: Rapport 99/175 van de nationale ombudsman over een onderzoek naar de gang van zaken rond de ongevallen met de AP-23 mijn in 1983 en 1984. In the dossier under 19990419.

⁹ Van Oest, Openbaar bestuur March 2008, p. 8. In the dossier under 20080331. Van Oest refers to report 175.

¹⁰ Probably excepting Ineke IJzerman and Anton Born of the BVD (National security agency). See Nijeboer, for example pp. 74 and 99. (Search for "IJzerman").

¹¹ Pamela Hemelrijk, Metro 18/10/05, in the file "Blogs van website Pim Fortuin". See also Nijeboer. Search for "Soesterberg".

¹² 20110607_Artikel Spijkers in Wikipedia.pdf.

14. Nothing is known about possible punishment of those in the army and ministry of defense who were (hierarchically) responsible for terrorizing Spijkers, and omitting to take corrective measures. Because of the terrorizing, the importance of publicizing punitive measures, if they were taken, and because secretary Knaap of defense made prosecution impossible by locking up the archive, it must be assumed that no responsible persons were punished.
15. Nothing is known about possible punishment of those in the army and/or ministry of defense who were (hierarchically) responsible for keeping the mine in use, and for the unacceptable treatment of its victims. For the same reasons as mentioned in the preceding point it must be assumed that no responsible persons were punished.
16. Due to inadequate law, abuse of power, obstruction of justice and a rather general lack of integrity, justice has not been done. Not with respect to Spijkers, and not with respect to those responsible for extreme harassment and for trying to terrorize every employee in every hierarchical organization concerned. This in the “democratic constitutional state” of the Netherlands.

In order to evaluate information about social events and phenomena correctly, and in particular to evaluate appearances, it is of great importance to realize that nothing can be concluded from the absence of signs of things going wrong. For in many cases where things go (very) wrong:

1. Almost nobody in the organizations involved will reveal misconduct to the outside world;
2. Most people accept the misconduct in their social environment as the norm, collaborate actively, and support efforts to keep the organization opaque and to prevent leakage of information to the outside world. Even if this requires infringement of a professional code or code of conduct, and everything society and the public consider self-evident or inviolable.

All cases studied in this report support these conclusions. Nothing contradicts them. This is underlined by the length and contents of the following list of persons and organizations who contributed actively in the fraud about the AP-23 mine and the destruction of the life of Spijkers:

- Eurometaal, the manufacturer of the mine: the hierarchical lines involved, including the top;¹³
- The Dutch army: the hierarchical lines involved, including the top;
- The ministry of defense: the hierarchical lines involved, including the top. Which includes the political heads of the ministry;¹⁴
- Including the manager of Spijkers and his hierarchical line;
- The military people who shot at Spijkers “by way of a joke”;
- Marid (the information service of the navy): the hierarchical lines involved, including the top;
- Lamid (the information service of the army): the hierarchical lines involved, including the top;
- The military police: the hierarchical lines involved, including the top;
- Some company doctors, and the hierarchical lines involved, including the top;
- The commission of appeal for misconduct of company doctors;¹⁵
- Those who were responsible for ending Spijkers’ benefit in 1993, at least in part because he refused to sign a declaration stating that he is unfit for employment. This meant that Spijkers had no income;
- “Judge” Vermeulen of the Central court of appeal, and the hierarchical line which keeps him on;
- Lawyer for the government G. de Groot of the firm Pels Rijcken & Drooglever Fortuijn, and those who keep him on;

¹³ Responsible persons are explicitly indicated to prevent the organization-anthropomorphism error, and to prevent the suggestion that nobody is responsible or can be held responsible, because the organization culture is responsible or similar nonsense.

¹⁴ Because of its seriousness none of the political heads should have tolerated the misconduct, or kept silent about it. Note that the misconduct is not isolated, but widespread, and dominates the ministry (and more). Those responsible actively fight opponents representing normal human values.

¹⁵ The commission seems to give top priority to the cover-principle: colleagues protect one another, especially against complaints and other forms of external interference.

- Chairperson Van Nieuwenhoven of the Second chamber of the Dutch parliament;¹⁶
 - Those who were responsible for ending payment of Spijkers' income and pension benefit as from 1/9/98;
 - The ombudspersons Oosting and Brenninkmeijer;¹⁷
 - The Dutch General accounting office: the hierarchical lines involved, including the top;
 - The Second chamber of the Dutch parliament 1970-2008 (at least);
 - All members of all governments of 1970-2008 (at least).
- (And many more).

The case Spijkers shows the impunity and lack of integrity of the whole political world.

All politicians at least tolerated gross injustice.

A “nuanced” verdict about the directly or indirectly involved politicians, suggesting that they are honorable notwithstanding their condoning the baseless harassment of Spijkers, is impossible without making a meaningful discussion about integrity impossible. As the word already indicates, integrity is an all or nothing concept. One cannot be whole and not whole at the same time. One cannot be a little honorable. Opportunistic collaboration with serious violations of integrity is incompatible with reliability and integrity. Someone claiming the opposite should give an explanation. But nobody has even tried to justify the terror, collaboration, shielding or silence.¹⁸

Experience shows that integrity or the lack thereof is not a transitory property. It is first of all a personality trait. Otherwise it would hardly be a useful concept.

Politicians accept and cover colleagues who lack integrity.

In the case Spijkers it is quite clear that all colleague members of government knew of the unacceptably unjust behavior of their colleague(s) at the ministry of defense, his incompetent management of his ministry, and his failure to act honorably and effectively. If only from the media. By their silence about the extreme injustice these people at least implicitly chose the side of their criminal colleague. None of the people listed has ever been punished for his misdeeds or misconduct. Sanctioning by means of elections obviously is no more than empty twaddle. And when these people leave politics, they tend to get an even better paid job, as if on the presumption that their pretensions agree with reality.

Politicians abuse their power to prevent adjudication of accomplices.

The following speaks volumes:

«In the fall of 1999 the Court of appeals of The Hague acknowledges that the company doctors committed forgery [in the case Spijkers]. It does not exclude further prosecution. In the end deputy secretary of defense Van der Knaap uses an agreement of 2002 to keep Spijkers from executing his plan to prosecute employees involved in the case. Van der Knaap refuses to sign the agreement unless

¹⁶ Who is also a clear example of a “representative of the Dutch people” who first of all represents the interests of her party, even if that harms the Dutch people. And even though she became representative voluntarily, and accepted her constitutional obligations by swearing an oath on the constitution. In other words: she committed perjury.

¹⁷ Who did good work as well, but in the end turned out to be unreliable, and not independent. See especially Nijeboer.

¹⁸ For the following reasons the apparent exceptions in the Second chamber of Dutch parliament don't deserve the benefit of the doubt. 1) The case Spijkers covers a period of more than two decades. This period has seen coalitions of all kinds of political parties. All coalition parties always covered the extreme misconduct. Nobody gave up his or her seat in parliament or government. 2) Those in parliament and politics who (weakly!) tried to make the government change course knew that nothing would be done unless much more heavy pressure would be exerted. Ultimately all politicians covered one another; irrespective of party.

Spijkers abandons the plan to prosecute. The former troubleshooter came down a peg or two and withdrew the charges against around ten top employees of the ministry.»¹⁹

This speaks volumes because it shows that a member of government and his top employees do not want justice be done. They clearly fear the verdict guilty, and punishment. They abuse their power to prevent this. Note that nobody else has similar power, and that this abuse violates the fundamental principle of equality before the law. Government and ministry show that they don't take integrity and ministerial codes of conduct seriously, and that such codes can only be meant to deceive you and me. What does not happen speaks volumes too:²⁰ the cabinet and parliament are silent, and nobody corrects.

For the removal of the archive of the ministry of defense concerning the AP-23 mine and Spijkers to the National archive something similar applies.

The fact that often only the most directly responsible person, in this case deputy secretary of defense Van der Knaap, is mentioned, does not mean that only he is responsible. The secretary of defense and the prime minister are responsible at least for their passive stance and for keeping him on. And what about the justice secretary? Even if these people had no direct responsibility and if decisions were decisions of an independent deputy secretary instead of cabinet decisions, they should have refused to stay in a team with what according to the definition is a terrorist.

As may be expected from the lack of measures and from the attitudes of those (directly and indirectly) responsible, no lessons were learnt. Around 2014 it turned out that defense had seriously mismanaged, and lied about, the use of carcinogenic paint and the ensuing health problems of hundreds of people. It tried to appoint someone responsible for the use of the paint as head of an “independent” inquiry commission. Etcetera etcetera.

8.4. Van Buitenen and the European Union (EU, 1998-2004).

EC= European commission, and the organization by which it is supported.

EP= European parliament.

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7. Conclusions drawn from Van Buitenen's second book: *In the trenches of Brussels* (2004).

Introduction.

Van Buitenen was a low-level employee of the EC. What the present report calls “the case Van Buitenen” concerns the following:

- The misconduct observed by Van Buitenen wherever he looked in the EC;
- His fruitless efforts to get this corrected via the EC and the EP;
- The efforts of the EC management to silence and sidetrack Van Buitenen;
- The reaction of the EU establishment to the publication of the findings and experiences of Van Buitenen;
- Critical reports of a “Committee of independent experts”, which ignore crucial aspects, and present no proposals which can eliminate the causes of the observed misconduct;

¹⁹ Nijeboer p. 322.

²⁰ As in the years 1994-2007 with respect to the financial crises.

- The reaction of the EU establishment to these reports.

The case is not only important because it shows systematic misconduct in the EU-organization, but also because it is independent of the Dutch situation and cases. It provides insight in an organization which is at most marginally dependent on the Netherlands and the USA.

Thanks to many years of courageous perseverance, Van Buitenen has given us most valuable and unique inside information about the operation of the EU. This information is indispensable for a reliable, unbiased evaluation of this organization. In addition Van Buitenen is one of the very few people who have given (reliable) inside information about the operation of an important hierarchical organization. According to the present author, Van Buitenen deserves the highest praise for this exertions.

Besides Van Buitenen, the principal parts of this case are played by the members of the European Commission. They are listed in the file Santer Commission_Wiki, and files with similar and self-evident names. The following quotes are from these files:

[«The Santer Commission was the European Commission in office between 23 January 1995 and 15 March 1999»](#)

[«The Prodi Commission was the European Commission in office between 1999 and 2004. \[...\] The commission took office on 13 September 1999 following the scandal and subsequent resignation of the Santer Commission which had damaged the reputation of the institution. It took over from the interim Marín Commission. The College consisted of 20 Commissioners which grew to 25 following the Enlargement of the European Union in 2004. It was the last commission to see two members allocated to the larger member states.»](#)

Aside: discussions about the EU.

This “aside” is inserted:

- because of the importance of its subject matter;
- because the case Van Buitenen shows that several of the assumptions of the risks mentioned are correct;
- because the subject matter does not get explicit attention elsewhere in this study.

Already for a long time there is no serious and open discussion in Europe about the regulation of the European Union. That is: about the treaties and rules which establish its institutions and operation. It is systematically avoided or refused to discuss these treaties and rules critically, in the light of the applicable knowledge, and norms and values. Quite generally, a critical attitude towards the given regulation is interpreted as anti-European. In other words: everyone who wants a peaceful and prosperous Europe should accept the present form of the EU without any reservation: uncritically. As if there is nothing in between for and against. Someone who has problems with the present regulation, is against Europe. As simple as that. This applies at least to the years 2000-2020. The possibility that the present regulation will sooner or later give rise to major problems is simply ruled out. Even though both the second financial crisis and Brexit can be seen as examples of such problems, and as a warnings.

The seemingly successful efforts to make people believe that the prolonged peace in Western Europe since World War 2 is a consequence of the EU and not of NATO²¹ can be seen as result of a continuous stream of false propaganda. Even the Nobel committee was misled or collaborated.

Ignoring weaknesses of important parts of the EU foundations creates large risks. Both in the field of economics (prosperity) and security (environment, war and peace). For an unprejudiced observer it is simple to see that the second financial crisis, the debt crisis, was caused by inadequate financial management by most EU states, and by inadequate European regulation. This crisis caused many millions of unemployed. In other words: very great loss of prosperity. While two of the people who

²¹ And the threat posed by the USSR, requiring cooperation.

were co-responsible for the financial mismanagement of their countries, Barroso and Lagarde, head two of the most important international organizations in the world, and pocket fantastic salaries.

It is very dangerous to believe that the EU is a guarantee for peace. It is dangerous because it is no more than wishful thinking, and because civil wars tend to be even more murderous than wars between states. The American civil war is a terrifying example. The more so since it was initiated by a supposedly well-intentioned president. Because of the procedures for selection and appointment of the top of the EU, the very dubious decision making processes in the EU, and last but not least the hierarchical character of the EU, it is impossible to put one's trust in the foreign policy of the EU at any time, and even more in difficult times.²² The policy with respect to the Ukraine around 2014 is an example.

Perhaps the resistance against any serious discussion about the regulation of the EU is based on the assumption that it is very difficult to improve or replace the given treaties, rules, etcetera which define the EU. Perhaps it is thought that it is this EU or nothing. In other words: that all alternatives are worse. This is one more example of "all or nothing"-thinking. (And lack of analysis).²³ But perhaps it is much simpler, and just a case of politicians not wanting to risk to lose the perspective of a lucrative job in Brussels.

Overview of the case.

Van Buitenen started his job at the EC on 1/2/90. The following quote gives the highlights of his history at the EC up to and including the time of the reports of the committee of experts in 1999. The quote is borrowed from the Dutch Wiki-page "Van Buitenen" of 4/8/13. The sequel of the history, until 2004, can be found somewhat farther on, in the subsection on Van Buitenen's second book on the EU.

«Initially Van Buitenen worked in DG 22, the directorate-general charged with the execution of programs for professional education and other programs. On January 1, 1998, and on his own request, he was transferred to DG 20, the department for financial control of the other directorates-general. As control officer and together with colleagues he collected all kinds of evidence, especially about the Leonardo da Vinci program [van DG 22] and the ECHO case, partly based on anonymous testimony. The evidence indicated direct or indirect conflicts of interest in the allocation of Da Vinci budgets to private firms which would execute parts of the program on contract basis. In addition there were demonstrable irregularities in the spending of the budgets.

Van Buitenen reported his findings to UCLAF, the anti fraud department of the EC. But in his opinion UCLAF did far too little with the report. His own department, DG 20, did however start an investigation in his former DG 22. The evaluation report confirmed Van Buitenen's suspicions. Further investigation was concentrated on only one of the dubious Da Vinci projects however; the remainder of the department was not investigated. Van Buitenen was told that he should not do any more control work, and should not question colleagues. Whereupon Van Buitenen wrote a memorandum about the course of affairs in this investigation and in the departments, cabinets and commissions concerned, and threatened to send the report to the European Parliament (EP). He sent the report to his superiors, including director Knudsen of UCLAF.

The report of the investigation by DG 20 became available on July 17, 1998. It confirmed the findings of Van Buitenen. On September 1 there was no indication of any reaction. Van Buitenen once more threatened- in writing- to send his report to the EP. On October 28 he repeated his threat. His director-general forbade submission of the report to the EP. He also forbade contacting the European Court of auditors. A few days before an anonymous letter had already been sent to all members of the EP. According to Van Buitenen without his knowledge.

On December 9, 1998, just before the EP would decide about the tender for the sequel of one of the

²² As experience shows, integrity and competence play at most a subordinate role in the appointments. In general politicians have the opinion that even dubious or erroneous decisions cannot or should not be turned back or ignored. And the hierarchical character of the organization (society) forces hundreds of millions of people to comply with the ideas of a handful of idiots for years. Remember (and study the prehistory of) the debt crisis.

²³ The measures mentioned in the next chapter can solve many of the most important EU problems.

projects, the Leonardo-BAT-program,²⁴ where Van Buitenen had found fraud, he considered it his duty to inform the members of parliament before the vote. He sent 75 copies of a bulky, well-documented report to the chairman of the Green fraction, with the request to pass it on to the budget control commission of the EP. The dossier concerned the allegedly incompetent way in which the EC managed fraud in various tender cases, and irregularities in the European Commission itself. The dossier was especially incriminating about European commissioner Edith Cresson. [...]

This step of Van Buitenen was very much resented by his superiors. His computer was disconnected from the EC network, and he was suspended, the worst possible sanction. He was accused of having harmed the regard for his office and of violating professional secrecy by publishing the report. His salary was halved. An inquiry was started into possible disciplinary law infringements.

Initially the report of the whistleblower led to no more than some commotion in the EP and the refusal of the Education committee to approve the annual accounts over 1996. The EC promised improvement of fraud management. In the beginning of December it proposed to replace UCLAF by OLAF, which should be able to work more independently.

Only after January 3, 1999, when Van Buitenen gave an interview to a newspaper about his suspension and the halving of his salary, the case was made front page news by virtually all the media.²⁵ Commissioners Cresson and Marin were dealt with harshly. Members of the EP required their resignation. They requested a vote of no-confidence. It was suggested to initiate a procedure of dismissal.

The Commission accused Van Buitenen of incompetence and spreading lies, and claimed that the cases of fraud were already being investigated, in part even criminally. On March 15, 1999 a Committee of independent experts submitted a crushing first report to the EP. It confirmed the report of Van Buitenen, and the necessity of sending it to the EP. In the evening of the same day the entire EC resigned. In essence this happened because of a clear and deadly sentence that was inserted into the report at the last moment: "It is becoming difficult to find anyone who has even the slightest sense of responsibility".²⁶ In the summer of 2008 it became known that this stumbling-block of a sentence was due to the French member of the Committee of experts Pierre Lelong.

After the annulment of his suspension, Van Buitenen was transferred from the department of financial control to the department of buildings. The disciplinary law procedure was not discontinued. In his new job he met with all kinds of restrictions».²⁷

Conclusions drawn from the first book of Van Buitenen: *Blowing the Whistle: One Man's Fight Against Fraud in the European Commission (1999)*.

The following conclusions were drawn by the present author, not by Van Buitenen. Van Buitenen's books contain no conclusions (or summary). The conclusions were formulated in November 2011, before the problems with the agreements concerning the euro and the budget deficits and government debts of Euro countries became known, and before the author began to study the financial crisis.

The main conclusion is that there is an essential lack of integrity in the EC, and that the existing systems of supervision and control are utterly insufficient. This conclusion is identical with the (or a) main conclusion from the study of the Dutch ministry of education and of the financial crises. This obviously supports the hypothesis of its general validity.

1. Wherever in the EC Van Buitenen looks, everywhere he sees irregularities and inappropriate conduct. Everywhere managers resist efforts at correction. The book shows that it is nonsense to think that "a lot goes well". It seems very doubtful whether anything goes well in every relevant sense. There certainly are no honorable and competent European commissioners.
2. Without exception, the European commissioners deny any wrongdoing.

²⁴ BAT= Bureau d'assistance technique. See *Blowing the whistle* pp. 19 and following. Please take note: page numbers for *Blowing the whistle* refer to the Dutch language edition.

²⁵ This sentence is edited using *Blowing the Whistle*, the beginning of chapter 7.

²⁶ Copied directly from the report: 9.4.25, p. 144.

²⁷ This report may be too restrained, misleadingly so. The reality shown by *Blowing the Whistle* was much worse.

3. The European commissioners cover one another without exception.
4. The European commissioners behave like rulers, abusers of power. That is, people with power, who actually use that power to serve their own interests and those of their peers, family and acquaintances, at the cost of a public which they deceive, and against people like Van Buitenen who disclose their deceit.²⁸
5. All higher officers of the EC collaborate with the corrupt top. (“Corrupt” in the sense of the dictionary: any form of rot, degradation, deterioration, lack of integrity²⁹).
6. That the European commissioners and higher officers work well is no more than a false pretension. They obstruct reliable evaluation. What is known reliably shows the opposite.
7. Remarkable is the active though covert support several colleagues (EC officers) gave Van Buitenen.³⁰ Perhaps many discontented people stay on because they need the income, and because they cannot earn more elsewhere.³¹
8. On March 15, 1999 the Committee of experts concludes: “**It is becoming difficult to find anyone who has even the slightest sense of responsibility**”. Something very similar was concluded in the parliamentary inquiries of the construction fraud (2002³²) and the financial crisis³³. The Committee obstructs improvement by failing to acknowledge and stress the responsibility of the relevant hierarchical line, and by failing to lay the responsibility elsewhere or anywhere.
9. The EP is an irresponsible and contemptible clique. It seems to be completely corrupted. It sets absurd priorities. Form is far more important than matter. It works like the Dutch parliament: it represents and defends the interests of the government and politicians, not those of the country (EU) or its population. (There may of course be minor exceptions).
10. The EP does not supervise the work of the EC and/or EU;
11. As in the case of the Dutch ministry of education it is nonsense to blame the organization culture. There clearly is not one EU culture. (Except perhaps for one “value”: maximal personal profit from the EU treasury). It is the political and management culture (of the top) which is guilty. The book shows that it is completely rotten and indefensible.

²⁸ «After the publication of the book *European idealists* of Joep Dohmen I understood better why the largest fractions in the EP didn’t like to support a whistleblower. In his book Dohmen revealed practices of favoritism and profiteering by members of the EP. Page-filling examples were: attendance money for non-attended meetings according to the SiSo system: Sign in, sod off; inadmissible use of private drivers and official cars; conflicts of interest by membership of parliamentary committees and relations with interested firms; family members back in the home country who were paid as assistants; the influence of masonic lodges; etcetera. Personally I found the story of the political appointment of a director-general who was nominated by a large fraction the most poignant. Another large fraction only wanted to accept the appointment if it could nominate a director-general too. Regrettably there was only one vacancy. No problem. A directorate-general was split in two, so that there were two vacancies.» *Blowing the whistle*, p. 195.

²⁹ In the present report more specifically: everything that is incompatible with the (public) goals of the organization, with the law, public codes or generally accepted norms and values, or anything that cannot be publicly accounted for without causing an uproar.

³⁰ In the Dutch ministry of education the present author had the idea that he was only supported morally. Although it may be relevant that by that time paper documents were no longer necessary or very useful, and dependence on them virtually non-existent. But there must be, or have been, more documents which provide essential insight in the misconduct of the top.

³¹ In the course of the years several of the discontented colleagues of the author left the Dutch ministry of education, either voluntarily, by temptation, or under pressure.

³² «The inquiry commission was amazed, and most painfully hurt, by the laconic and condoning reactions of the principal actors. Many of them knew more or less, but preferred not to really know. This applies to the top of the construction firms and that of the sector organizations, and also to some accountants, tender services, and supervisors. All of them watched, did little or nothing, and preferred to resume the order of the day. And if this becomes a long term practice, it is hardly registered any more that something really is fundamentally wrong. Because of his position everyone had a corresponding responsibility, but failed to act accordingly. This also applies to members of government». *Report of the parliamentary inquiry commission construction fraud (Rapport parlementaire enquête bouwfraude)* p. 12/8.

³³ See the previous chapter.

The EC intimidates its officers. In particular also in the period of the follow-up investigation of the committee of experts, in March-September 1999. The conduct of the European commissioners is compatible with the hypothesis that they tried to make Van Buitenen's life as much of a burden as possible; not only in revenge, but also to show potential informers what will happen to them if they talk. In other words: the EC used Van Buitenen as a means for terroristic purposes, and subordinated (human) rights- and of course codes of conduct- which the public considers indispensable, to this purpose.

The reports of the Committee of independent experts.

To the internal communications and the communications to the EP, the EC hierarchy only reacted by efforts at repression. On December 18, 1998, Van Buitenen was suspended. Perceiving no other alternative, he decided to contact the press. On Sunday morning January 3, 1999, he was interviewed by the morning paper *De Morgen* (*The Morning*). The interview was published January 4, 1999, under the heading "EC officer suspended after investigating fraud". Finally the fat was in the fire. January 14 there was a debate about Van Buitenen's accusations in the EP. The EP decided to install an inquiry committee of "independent experts". The committee was requested to report March 15, 1999 at the latest.³⁴ The report was given the title *FIRST REPORT on Allegations regarding Fraud, Mismanagement and Nepotism in the European Commission*.³⁵ It confirms the facts as reported by Van Buitenen. But the book of Van Buitenen gives a much more veracious picture. There is no reason to doubt the integrity of Van Buitenen. As the quotes will show, the committee certainly was not honorable. It is dishonest. The committee only considers selected formal aspects. It is biased in its choice of words. Criticism with respect to commissioners and high officials in general is expressed in understatements. It is disproportional. Van Buitenen gives a more complete picture, and respects proportions, as measured by generally accepted norms and values. Something the committee fails to do. Van Buitenen shows that the formal misdeeds have corrupted the whole EU organization. He shows that the management, including the EC members, collaborate in the misconduct, that they cover one another, and that nobody checks or protests the repression of Van Buitenen. In other words: the management conspires.³⁶

On January 14, 1999 the EP requested the committee «to examine the way in which the Commission detects and deals with fraud, mismanagement and nepotism including a fundamental review of commission practices in the awarding of all financial contracts».³⁷ Therefore the committee should (also) have investigated the reactions to the internal reports of Van Buitenen. It should have concluded that the EC has actively and repressively obstructed and prevented fraud finding, mismanagement and nepotism. The committee didn't. It may defend its neglect by reference to a motion adopted on January 27, 1999, by the "conference of chairpersons of the EP", stating «The first Report could seek to establish to what extent the Commission, as a body, or Commissioners individually, bear specific responsibility for the recent examples of fraud, mismanagement or nepotism raised in Parliamentary discussions, or in the allegations which have arisen in those discussions.»³⁸ Even if it is taken into account that "could" is fundamentally different from "should", and that it is unlikely that the conference had any authority, especially to override a decision of the EP, it has to be noted that this "recommendation" is quite different from the EP mandate.³⁹ Anyway, even in the follow up inquiry, the questions of the EP are not answered. This in spite of the title and subtitle of the 2nd report: *SECOND REPORT on Reform of the Commission. Analysis of current practice and proposals for tackling mismanagement, irregularities and fraud*. The question of the EP is even ridiculed:

«7.1.3. This chapter attempts no systematic analysis of the prevailing culture in the Commission. Though perhaps entertaining, it would serve little purpose to do so. For present purposes, it suffices

³⁴ That is: at a ridiculously short term.

³⁵ The 1st report is dated 15/3/99. Like the 2nd report, it can be found in the directory Van Buitenen.

³⁶ The terminology is of the present author.

³⁷ P. 9 of the first report.

³⁸ P. 9 of the first report.

³⁹ The EP mandate got a lot of publicity, the second little of none. Trickery and deceit.

that the central “cultural” area of concern has already been identified: integrity, responsibility and accountability, going hand-in-hand with transparency and openness.»⁴⁰

“This chapter” 7 of report 2 is not an investigation of the reality of the EC, but a collection of niceties about what is proper. The reactions on Van Buitenen’s efforts are not explained. There isn’t even an analysis of the non-compliance with codes of conduct and generally accepted norms and values. The theoretical and philosophical considerations of chapter 7 are the beloved refuge of everyone afraid of openness and transparency. But because they were known already centuries ago, and fully ignore the causes of non-compliance, they are entirely useless. Only a thorough analysis of reality would have been useful.⁴¹

It is a pity that the committee does not explain why a systematic analysis of the prevailing culture in the Commission would perhaps be entertaining, and why that is wrong if the EP had requested such an analysis (or rather an analysis of facts). Chapter 7 certainly isn’t entertaining. And the recommendations 74-91 corresponding to this chapter are no more than dogmatic wishful thinking.⁴² Only recommendation 87 says something about how to deal with infringements of norms. See below. As implied above, the committee nowhere analyses or answers the question why the (partly) new norms may be expected to be complied with, when the former were not.

Chapter 7 of report 2 is not the exception but the rule. Report 1 too is full of remarks in the same style. An example:

«9.3.5. In the same spirit, the Committee would stress that it is imperative for all those working in the Community Institutions to understand that no strategy of cover-up may ever be considered acceptable. No information may be withheld from other institutions, such as Parliament, or other officials- Commissioners especially- when they are called upon to play a role in the decision making process. This applies equally to information which has not yet been entirely subjected to what are often lengthy contradictory procedures (as in the case of audit reports). Such information must be shared at an early stage, of course under cover of confidentiality, with the officials, services, directorates or Commissioners who need to have full knowledge of the facts in the light of the decisions to be made or to be prepared.»⁴³

Was this unknown or insufficiently known? Isn’t this self-evident? What sense does it make to repeat this? Why is there no reflection on the reasons for infringements of these norms, and on measures, including sanctions, to make infringements unattractive?

Lack of respect for proportionality in the denunciation of misconduct is apparent from the style of the text of the reports, but also from the selection of the described phenomena. First of all the refusal to investigate the reactions to the internal reports and actions of Van Buitenen (and earlier internal reports). Such an investigation would probably make admission of unacceptable actions of commissioners and high officials, and therefore their resignation, inevitable. This would seem to be the real reason for not analyzing recent events. Regrettably, such an analysis would be the only way in which justice can be done. An example of a reprehensible text is the following:

«9.4.21. Disciplinary proceedings are rare, although the Committee has noted that they have recently been increasing in number. It encountered cases where they should have been initiated, but were not. This concerns, in particular, very senior officials to whom Article 50 of the Staff Regulations (retirement in the interests of the service) has been applied, generously and without hesitation, enabling them to depart with their reputation intact and a comfortable pension.»⁴⁴

Why this soft pedaling? Why doesn’t the committee explicitly state that this is an example of inadequate and blameworthy management? Why did the *inquiry* committee fail to find the causes of

⁴⁰ P. 110, volume 2 of the 2nd report. The 2nd report is dated 10/9/99.

⁴¹ The committee acknowledges the fact of efforts at repression: «7.6.9. The events leading up to the resignation of the former Commission demonstrated the value of officials whose conscience persuades them of the need to expose wrongdoings encountered in the course of their duties. They also showed how the reaction of superiors failed to live up to legitimate expectations. Instead of offering ethical guidance, the hierarchy put additional pressure upon one such official.»

⁴² Report 2-1 p. 23 and following.

⁴³ Pp. 140-1, report 1.

⁴⁴ P. 144, report 1.

this whitewash?⁴⁵ The choice of the word “generous” is biased. It is a positive valuation of blameworthy behavior at the cost of the tax payer: rewarding someone who should be punished. Instead of “[, generously and without hesitation](#)” the text should have read “wrongly”.

In this connection it may be noted that the committee decided not to mention names “[for reasons of confidentiality](#)”.⁴⁶ But why is confidentiality a valid reason? Why is it necessary or desirable? The committee gives no explanation. At various places it acknowledges serious misconduct. It must understand that it is now or never for preventive action. If not now, the responsible people will be able to continue their career as if nothing wrong had ever happened. Not mentioning names means protecting culprits, covering crimes, and prevention of real improvement. This is what confidentiality means. Confidentiality furthermore introduces a bias: Van Buitenen doesn’t need it, and for everyone else it means protection against exposure of wrongdoing.

Numerous remarks in report 1 show that the lack of integrity and competence of commissioners and high officers is structural. The following is an example:

«8.1.35. In conclusion, what we have here is a clear-cut case of favoritism. A person whose qualifications did not correspond to the various posts to which he was recruited was nonetheless employed. The work performed was manifestly deficient in terms of quantity, quality and relevance. The Community did not get value for money.

8.1.36. Moreover, the person recruited worked mainly as a personal staff member of the Commissioner, and there are very strong grounds for believing that he was often used in a manner which had little to do with the Commissioner’s work on behalf of Europe.

8.1.37. The competent administrative authorities signed the contracts, and Financial Control approved them beforehand. Despite the lack of a legal basis, it seems that there were no hesitations on their part.»⁴⁷

Why didn’t the committee try to find out why they did so? Why there was no resistance. Does the committee think that this and similar misconduct can be redressed without understanding its causes?

For example in the following concluding remarks of report 1 the EC is implicitly judged incompetent:

«9.4.7. The Committee of Experts found no evidence of any attempt by the Commission to assess in advance the volume of resources required when a new policy was discussed among the Community Institutions.⁴⁸

9.4.8. [...]

9.4.9. As regards organizational methods, the same picture of an inability to anticipate requirements emerges: the Commission did not try to lay down in advance how each new policy would have to be implemented and to make the necessary arrangements accordingly. It reacted as each individual problem emerged, without a guiding philosophy and with no overall view of the situation, on the one hand, by recruiting temporary or agency staff, and, on the other, by subcontracting tasks out to the TAOs.⁴⁹

9.4.10. The contracts for the provision of services were often awarded under questionable circumstances, a situation encouraged by the vagueness and the scattered nature of the texts governing the award of contracts and the weakness of the ACPC.»⁵⁰

And perhaps even more in the closing sentence of 9.2.5:

«The Commission as a whole deserves serious criticism (as in other cases under review) for launching a new, politically important and highly expensive programme without having the resources - especially staff - to do so.»⁵¹

⁴⁵ Could the top have reason to pay hush-money for collaboration? The “comfortable” is a shameful understatement. EC salaries (and “fringe benefits”!) are excessive.

⁴⁶ 9.1.3. report 1, p. 137.

⁴⁷ P. 129, report 1.

⁴⁸ Note that this is a recipe for budget shortages and the need of tax increases.

⁴⁹ TAO= Technical Assistance Office. Report 1 p. 3.

⁵⁰ P. 142, report 1. The two reports have no list of acronyms, and do not give the meaning of ACPC.

⁵¹ P. 138, report 1.

The committee did not try to find the explanation of the incompetence of the commission, and how it can be prevented in the future. The hypothesis of the committee seems to be that mentioning the deficiencies is sufficient to prevent them.⁵² If errors are no more than incidental mistakes and acknowledged by their authors, this may be possible. But *Blowing the Whistle* unambiguously shows that the commission members don't stop denying all wrongdoing.

The two reports are representative examples of official inquiries which contain much useful information, but overlook crucial parts of reality, and have so many analytical deficiencies that they do not give an adequate explanation and offer insufficient handles for effective correction or improvement. As in the other inquiries, the committee fails to critically question its own competence.

Report 1 implicitly accuses numerous officers of serious misconduct and incompetence. It reveals a corrupt culture caused and maintained by the top. But this is not established explicitly, and not posed as a problem to be analyzed and solved.

Section 9.4 of report 1, *Reforms to be considered*, embodies the insufficiency of this report. The point is that it is a list of things that went wrong. The proposals for reform are missing.⁵³ Such proposals can be found in report 2. Essential deficiency is the absence of proposals for a form of adjudication independent of the EC-hierarchy, and for expansion of the liability and punishability, in particular of the commissioners and (higher) officers. There is no or hardly any attention for intimidation and repression by commissioners and line managers, and for countervailing influences.⁵⁴ Including proportional sanctioning, proportional with salary too. The farthest reaching recommendation is:

«Recommendation 87

Any commissioner who knowingly misleads Parliament, or omits to correct at the earliest opportunity inadvertently erroneous information provided to Parliament should be expected to offer his/her resignation from the Commission. In the absence of an offer of resignation, the president of the Commission should take appropriate action.»

In other words: no liability, and no other punishment than resignation from the Commission. Since the “knowingly” and failure to use the “earliest opportunity” are hard to prove and easily denied, it is hard to believe that this will effectively prevent manipulation of information. In any case the recommendation means a double standard, and violates the principle of equal rights and proportionality.

The following quote is an example of a relatively sharp evaluative conclusion of the committee:

«9.2.4. In the TOURISM case, the Committee found that the Commission and the successive Commissioners responsible bear joint responsibility for formulating and attempting to implement a policy for which resources were not available and over which it was exceedingly difficult to exert effective control. They must also bear responsibility for failing to react over a lengthy period to clear warning signals that serious problems had arisen in the Tourism Unit. The Commissioner responsible for personnel in the previous Commission must take responsibility for failure to ensure appropriate disciplinary sanctions in respect of one of the two officials primarily concerned. Finally, the Commission as a whole is responsible for delaying a positive response to requests for the waiver of official immunity in respect of three senior officials for over two years, for an excessively lenient attitude towards the management failings and poor judgment of the Director-General of DG XXIII and for consistently failing to inform the European Parliament as to the true state of affairs over many years.»⁵⁵

But although this seems to be sharp and clear, it is not as sharp as it should be. The word “problems” is misleadingly general, and an euphemism. It does not refer to technical problems which

⁵² The same kind of magic (witchcraft: things happen by speaking the right formula) as the SG and uSG of the Dutch ministry of education seemed to believe in.

⁵³ Perhaps due to a lack of time. May be the committee intended to include recommendations, but failed to reach timely agreement about them. It may have forgotten to change the section title.

⁵⁴ Checks and balances...

⁵⁵ P. 138, report 1.

the tourism unit could not solve timely and adequately, but to systematic misconduct. And shouldn't the responsible people be sanctioned yet? Aren't (social) justice and equal rights at issue? Don't forget the treatment of Van Buitenen, about which the committee is silent.

Note that the quote presumes that the officials acted contrary to the wishes of the commissioner(s), but omits to mention this assumption explicitly. It should have investigated the presumption before accusing only the officials.

Conclusions about the inquiry committee and its reports.

1. The committee confirms a number of accusations of Van Buitenen. But it ignores for example those accusations concerning the cover up policy which would inevitably lead to accusations of specific persons.
2. The reports of the committee have no added value with respect to *Blowing the Whistle*. The main reason being that the committee does not look for causes, and refuses to call things by their proper name. It ignores the large and corrupting influence of the misconduct and wrong example of the commissioners and the top on the rest of the EC organization.
3. The committee did not do what it had been asked by the EP: it did not investigate how the commission detects and deals with fraud, mismanagement and nepotism.
4. It did not answer many questions of which the answer would not only have been entertaining, but first of all necessary for correction and improvement.
5. Its "proposals" for reform are little more than pious wishes.⁵⁶ They are nothing new, and mostly obvious. If they are not voluntarily complied with, and if the EC does not supervise compliance, nothing will change. This means that nothing will change, because the committee admits that the EC itself did not observe the code of conduct, and gives no reasons for believing that attitudes will change.
6. The committee gives no recommendations for coping with an EC characterized by structural misconduct, as the sitting EC had exhibited.
7. The committee does not conclude explicitly that Van Buitenen was right, that the obstruction by the EC and the management of his efforts at getting things investigated and corrected were wrong and excessive, that Van Buitenen's contacting the press was justified, and his suspension and salary cut were not.
8. Neither in chapter 6 about human resources policy, nor in chapter 7 about integrity, responsibility etcetera, does the committee note that it is desirable that a vindicated whistleblower keeps his job, and that those who obstructed him are for that reason declared unfit for their jobs, and discharged dishonorably.
9. In short: by refusing to investigate an essential part of reality- that of dishonorable and incompetent European commissioners -, by leaving out of its investigation and reports everything that would make sanctioning of misconductors inevitable, the recommendations of the committee do not affect the causes of the misconduct. It can continue as before.
10. Nothing is said about the monitoring of the implementation of the recommendations, and about periodic evaluation after implementation, and about progress reports.

The last concluding remark of report 1 is a variant of a remark made by almost all inquiry commissions which are mentioned in this study:

«9.4.25. The responsibility of individual Commissioners, or of the Commission as a body, cannot be a vague idea, a concept which in practice proves unrealistic. It must go hand in hand with an ongoing process designed to increase awareness of that responsibility. Each individual must feel accountable for the measures he or she manages. The studies carried out by the Committee have too often revealed a growing reluctance among the members of the hierarchy to acknowledge their responsibility. It is becoming difficult to find anyone who has even the slightest sense of responsibility. However, that sense of responsibility is essential. It must be demonstrated, first and foremost,

⁵⁶ Notwithstanding the fact that the committee is supposed to be composed of "independent experts". It includes jurists anyway. What would they say of material (criminal) law without procedural (criminal) law? Is the neglect stupidity or malicious intent?

by the Commissioners individually and the Commission as a body. The temptation to deprive the concept of responsibility of all substance is a dangerous one. That concept is the ultimate manifestation of democracy.»

Like the other commissions, the EU “committee of independent experts” gives no explanation. None of the inquiry commissions gives recommendations or suggestions for a solution of this problem.

Are there signs of improvement? Did the EC learn something?

It doesn't seem so. Under the date of 4/10/99 one can find the official reprimand of Van Buitenen by the EC. It was given in the month following the publication of the 2nd report. The dossier also contains the reaction of Van Buitenen.⁵⁷

- According to the present author the reprimand is unjust because Van Buitenen has done his duty. (That he did his duty is implicitly acknowledged by the inquiry committee);
- The reprimand can be blamed in part on the failure of the inquiry committee to give an unambiguous evaluation of the efforts of Van Buitenen to end corruption in the EC, and the active resistance against these efforts by the EC and the EC hierarchy;⁵⁸
- If Van Buitenen deserves a reprimand, wouldn't others deserve to be punished much more severely, and held liable for the waste and other damage caused by their misconduct?
- Why isn't the reprimand part of a coherent set of measures intended to make a clean sweep?

The inadequacy of the recommendations of the inquiry committee and the actions of the EC and its hierarchy are shown too by the following announcement, published 10/3/00 on NOS Teletekst.⁵⁹

«Van Buitenen leaves Brussels.

HILVERSUM. Paul van Buitenen, the financial control officer of the EU who heralded the fall of the previous European Commission, is leaving Brussels. He is going to Luxemburg, where he will again work as financial officer. According to Van Buitenen his work as member of the organization council of the EC is made impossible by the enmity of EC-officers and commissioners. According to Van Buitenen the work climate is intolerable. He wants to return to the anonymity of the officer corps. At the time, the EC fell as a consequence of Van Buitenen's information about fraud and nepotism.»

If someone who has tried with great perseverance to end (proven) corrupt practices in an organization, is not tolerated by that organization, then this organization is evidently still observing the same corrupt norms.

Conclusions drawn from Van Buitenen's second book: *In the trenches of Brussels* (2004).

This book has a dual purpose. It is intended as an explanation of Van Buitenen's candidacy for a seat in the European parliament. At the same time it is an evaluation of five years European commission under chairman Prodi. From the book the following conclusions can be drawn:

⁵⁷ According to the reaction of Van Buitenen commissioner Kinnock had called the decision to give Van Buitenen an official reprimand just and correct. This is the Kinnock who is said to have made a better or good whistleblower regulation. Even if such a regulation could be useful in principle, it is extremely improbable that the EC and Kinnock have made a good regulation. Therefore no time will be wasted on that. The more so since according to the present author the problem is not a good whistleblower regulation, but regulation making officials liable and punishable independent of the hierarchy. As shown also in the case of Van Buitenen, the problem is that the people who are really to blame can continue with impunity (even unmentioned). The unity of powers in the hierarchical organization should be ended. For more on this see the analysis of the financial crises and chapter 9 below.

⁵⁸ The reports mention “Van Buitenen” only once, namely in the factual statement 5.5.14 on p. 84 of report 1. (!)

⁵⁹ NOS Teletekst is daily news published by Dutch public radio and television.

1. The actions of Van Buitenen described above, his first book, and the reports of the committee of independent experts have not effected a change for the good. The book very convincingly shows that the organization is thoroughly corrupt, if not criminal.
2. Important cases are those of Martha Andreasen (director Administration under DG Molocksen and EC Schreyer)⁶⁰ and the thoroughly bad EC Kinnock (a liar). The last mentioned is responsible for an inadequate new whistleblower regulation.⁶¹
3. Reporting misconduct is still punished excessively. The book gives numerous examples.
4. A significant sign of the structural character of the corruption is the presentation by SG O'Sullivan about the reforms of commissioner Kinnock. The only person free to say what he wants in that meeting is the SG. He is free to lead the audience astray. The audience has to accept his statements and his answers to questions. The “communication” in the EU is one-sided, there is no open discussion.
5. In the EC, executive and judicial powers are united. It is therefore assumed that the top management and commissioners are honorable and competent. Both books of Van Buitenen and even the reports of the committee show that the top management and commissioners are not honorable and competent at all, and not by far.
6. At least three of the seven conclusions of Van Buitenen from 5 years under Prodi boil down to: the EU is opaque and uncontrollable, and the internal mechanisms for control do not work.⁶²

8.5. Bos and the construction fraud (1999- after 2010).

Conclusions.

1. The construction fraud was a form of organized crime. The criminal organization included many of the major Dutch construction corporations.
2. For each of more than ten years, the construction fraud cost the Dutch Treasury hundreds of millions of euro's. The inquiry commission estimates a percentage of 8.8% of the total amount of the contracts.
3. Many people knew of the illegal practices. But before Bos nobody did anything about them. Nobody blew the whistle.
4. Supervisors and accountants could and should have noticed the fraud. But they did nothing.
5. The government was lax in tracking down and prosecuting the crimes, to put it very kindly. It showed no trace of gladness about the discovery of very harmful deceit, as one would expect of a government giving high priority to integrity, its budget, and- of course- compliance with the law.
6. On the other hand the government displayed an untiring aggressive stance towards the whistleblower. During at least seven years it made his life and that of his family almost unbearable. It showed an extreme insensitivity to the fact, that mainly due to its harassment, Bos and his family got in very dire straits.
7. The public prosecutor was untiring in his prosecution of Bos, but left the principal criminals from the worlds of construction and government unmolested. He settled with the construction corporations for an amount that was no more than a marginal part of the gains of their fraud.
8. The responsible members of government did not do their duty.
9. The ministers Netelenbos and Jorritsma could nevertheless keep their function and continue their career unhindered. Minister Korthals of Justice had informed parliament incorrectly, and had to resign. He was nevertheless nominated for, and appointed as, chairman of his political party, the VVD (“Party for freedom and democracy”).⁶³

⁶⁰ Schreyer is dishonorable and utterly incompetent; little is said about Pierre Molocksen, but the things that are told suggest membership of a criminal organization.

⁶¹ Worse than nothing, for ineffectual and misleading.

⁶² For more see the file with notes about this book (under 20130831), and the (unique!) book itself.

⁶³ He was still chairman when the party adopted an integrity code in 2013...! The cases of Jos van Rey (a politician prominent in the province of Limburg), Edith Schippers (minister of health, misconduct in NZA affair) and many later cases prove that this code too can only be meant to mislead the public. (In 2018 the party had not yet put its integrity affairs in order. I have not heard of any action in that direction at all).

10. The parliamentary inquiry gives much useful information, but leaves essential questions unanswered. It gives insufficient explanation and recommendations. The insufficiency also applies to the (absent) monitoring of the implementation of the recommendations.
11. The case of Bos (and that of Van Buitenen) was contemporary with the last ten years of the case Spijkers.

Introduction.

“Construction fraud” is the name of a collection of criminal activities aimed at increasing the profits of a number of Dutch construction corporations. The activities took place in a period including 1990-2000. The Dutch Wikipedia summarizes the activities as follows:

«Participating contractors distributed publicly tendered projects amongst themselves. The contractor who got the order, paid the other participants at least the costs of the quotation. The arrangements were made in regular conferences.

In a number of cases civil servants were lionized or downright bribed. At one time or another 344 contractors participated in the fraud. On February 11, 2005, the construction sector agreed with the government to pay damages of 70 million euro.»⁶⁴

The agreements were recorded in “shadow accounts”.

Ad Bos was an employee of one of the participating construction corporations. In the beginning of 1999 he took the shadow accounts to the ministry of Justice, and started talks. The talks had no result.⁶⁵ Bos decided to contact the media. In November 2001 he talked about his information in a TV-program. This gave rise to a parliamentary inquiry, and for Bos, to many years of misery and harassment by authorities.

The case is important on its own merits, considered independently. But in addition there are several similarities with other cases. The construction fraud shows nothing that contradicts earlier observations and conclusions. It does show similar phenomena. It supplements and confirms. As in other cases there was a parliamentary inquiry. It was held in 2002. The inquiry commission made recommendations, also regarding accountancy. The analysis of the financial crisis shows that important recommendations for accountancy were not or hardly implemented. Misconduct has not been corrected. The essential point is that the information (judgments) provided by accountants are insufficient to evaluate the financial state of affairs of an organization. In the construction fraud (and in the run-up to the subprime crisis) accountants have shown themselves formalistic and minimalistic (passive). The inquiry commission wanted them to change their attitude. They didn't. Regrettably nobody else could take their place. Because of its relevance for the financial crisis, this evaluation of the construction fraud draws attention to the fact that parliament may write good-looking reports, but does not or hardly supervise the implementation of their recommendations. The reports are not really good, but even good reports do not automatically mean that something improves.

Chronicle of the construction fraud in a nutshell.

1948-1998.

June 9, 1948. Ad Bos is born in Velsen (North Holland, Netherlands).

1971. Graduates in road and hydraulic engineering.

Employed by J.G. Nelis in IJmuiden and P. Daalder in Alkmaar (both in North Holland, Netherlands).

1978- 1980. Employed by Interbeton, a division of the construction corporation HBG, in the Middle East. Major projects. Bos remembers a harbor project of more than a billion euro's.

⁶⁴ Wikipedia 4/8/13. (Partly) copied in a file under 20130804. The 70 million (if correct) is a trifle as compared with the total amount of the illegal enrichment of the construction sector. For a reasoned estimate please read on.

⁶⁵ Maybe Bos wanted to sell the shadow accounts. (And have had mixed motives). The sources do not provide precise information about the subject matter of the talks.

1980- 1985. Employed by road builder De Moel in Alkmaar. Meets Fred Veerman, his later opponent in the construction corporation Koop.

1985. Together with Veerman he creates the road building division of Koop: Koop Tjuchem.

1997- 1998. Works for Koop Tjuchem at the Caribbean island of St Maarten.

1999-2001.

Beginning of 1999. Leaves Koop-Tjuchem.⁶⁶

April 1999. His lawyer informs the ministry of justice about the existence of the shadow accounts.

1999- 2001. Talks with authorities. No result.

2001.

24/7/01. Informs the press.

9/11/01. Appears in the TV program Zembla.

2002.

April (or thereabouts, Koelemeijer p. 95). The police formally tells Bos that the public prosecutor has started a preliminary inquiry with him, Bos, as the or a suspect. According to Koelemeijer, Bos doesn't want to understand, doesn't fully understand, and ignores and/or suppresses this announcement.

22/8/02- 6/9/02. Hearings of the parliamentary inquiry commission.

12/12/02. Report of the parliamentary inquiry commission.⁶⁷

2004.

18/3/04. Letter of Bos to Dutch prime minister Balkenende requesting financial support. (He is almost penniless).

7/6/04. Letter of Balkenende to Bos rejecting the request. According to Balkenende, Bos has only done his duty.

29/6/04. Bos receives a fax with the announcement that he will be prosecuted.

2005.

11/2/05. Verdict in the criminal case against Bos. Bos is guilty,⁶⁸ but has revealed gross abuse. For that reason he is not punished. Bos appeals. He considers himself not guilty.

Less than a week after the verdict Bos is imprisoned for about 24 hours. No reason is given.⁶⁹

⁶⁶ On 24/7/01 this was estimated to be "two and a half years ago", Koelemeijer p. 15.

⁶⁷ In the dossier. The report does not end the harassment.

⁶⁸ For trips to Switzerland and Scotland, and a visit to an Amsterdam night club. Koelemeijer p. 127.

⁶⁹ Koelemeijer p. 130. Maybe he was incarcerated because of insulting the investigating magistrate. There may have been the suggestion of an accusation of bribing. See Koelemeijer p. 133. Note that offering and/or accepting a fancy cake, as representatives of corporations and the investigating magistrate did, is contrary to

In the night of 26-27/5/05 Bos has a heart attack.

2006.

Bos participates in the elections for the second chamber of parliament. He is not elected.

2007.

In May or June, Ad and Joke Bos have to leave their house due to financial problems. They move into a camper. The camper is parked on their own piece of land. But because of harassment and actions by a neighbor they are compelled to start wandering.

10/10/07. The TV-program ÉénVandaag tells its audience that Bos had to leave his house, and that he felt compelled to start wandering in a camper. In reaction to the broadcast offers are made for (temporary) parking places and shelter.

2008.

Bos submits an appeal to the court of The Hague. The first session is 12/6/08.

12/6/08 (the day of the first session in the appeal case). Bos gets a letter from minister Guusje ter Horst of internal affairs, with an offer of help in finding a job, application training, etcetera. Bos accepts the offer.

5/12/08 is the day of the verdict in the appeal. According to the court the prosecutor was not entitled to proceed with the case. This did not solve the financial problem of Bos. Subsequently Bos' lawyer Korvinus submitted a claim of 10.5 million euro to Ter Horst.

2009.

17/3/09 Bos is given a "cassation order". The public prosecutor appeals to the High Council against the acquittal by the court of The Hague.

18/3/09. Bos and his lawyer speak with DG Andrée van Es of the ministry of internal affairs.⁷⁰ This results in a financial agreement. Bos agrees to keep the specifics of the agreement secret.

21/4/09. The agreement is confirmed by Ter Horst. The fact of the agreement is made public.

Six weeks later Ad and Joke move into an apartment in Voorhout (South Holland, Netherlands).⁷¹

2010.

«In the past year [= 2009] the advocate-general of the High Council had sent three or four conclusions [to Bos?]⁷² in which he wrote that the High Council would confirm the acquittal. But each time the planned sessions were postponed».⁷³

unambiguous recommendations of the parliamentary inquiry commission. In other words: the irritation of Bos was justified.

⁷⁰ We already met her in chapter 4 on integrity.

⁷¹ Koelemeijer p. 219.

⁷² This is not clear from the context.

⁷³ Koelemeijer p. 218.

On May 18 the verdict of the High Council is postponed once more, to July 6.⁷⁴ On that day «Bos hears the judge say that his case has to be done all over again, and that it is referred to the court in Amsterdam.»⁷⁵

On p. 229 of her book Koelemeijer concludes that «Ad and Joke Bos were back where they began.».

Since 1999 Bos vainly looks for work.

(Because of supposedly little added value, the period until the next entry has not been investigated).

2013.

2/12/13. The court of Amsterdam releases Bos from criminal prosecution:

«Yesterday the court of Amsterdam ended a case against the 65-year old Bos that had already dragged along for years. It declared that the case of the public prosecutor does not lie. It did so at the request of the prosecutor himself. He had made the request because prosecution serves no purpose any more, and because the case had taken too long. The prosecutor furthermore acknowledged the social importance of Bos as a whistleblower. [...]»

Bos was the whistleblower in the so called construction fraud. He had a copy of the shadow account of the road construction corporation Koop Tjuchem, which he used in 2001 to demonstrate the extensive construction sector fraud. In 2005 Bos was declared guilty, but got no penalty. Whereupon the prosecutor appealed. The court of The Hague judged in 2010 that Bos had not had a fair trial, and forbade further prosecution. The prosecutor appealed to the High Council to obtain cassation. The High council referred the case to the court in Amsterdam.»⁷⁶

Conclusions from the book *Whistleblower- The life of Ad en Joke Bos of Rosa Koelemeijer (2011)* and some other documents.

At least in the decade indicated above, many construction firms have systematically violated the law. They bribed, made price agreements, and shared the spoils. They also agreed that firms which did not participate in the scheme were to be excluded from new contracts. In other words: the participating corporations formed a criminal organization. The state treasury, that is: the tax payer, was deceived for hundreds of millions of euros on a yearly basis. The inquiry commission mentions a percentage of the contracts. On p. 117 of its report it gives a substantiated estimate of 8.8%.

Newspaper articles from 2001 state that the illegal practices just mentioned were known for over 20 (twenty) years, and that the government had an implicit policy of tolerance.⁷⁷ The file with the articles gives several examples. It shows that members of the government and other politicians knew and were involved. There had been an earlier inquiry, by Van der Bunt, but nothing effective had been done with its results. The file includes an article asserting that minister Korthals could very well have challenged the settlement about the fraud concerning the Schiphol tunnel, but didn't. For no convincing reason.

In the fraud concerning the Schiphol tunnel there had been a whistleblower, John Zinhagel. He had refused to sign false invoices. An article in the NRC, one of the Netherlands' main newspapers, of 14/11/01 concludes as follows:

«For Ad Bos it is useful to reflect about the end of the case of whistleblower Zinhagel. It has been proven that he was right, but in the end he was left with nothing but his dismissal.»

At the end of the eighties even a contractor had already told Rijkswaterstaat, the Dutch road and waterworks agency, of frauds running into millions.

⁷⁴ Koelemeijer p. 226.

⁷⁵ Koelemeijer p. 228. This refers to July 6.

⁷⁶ From one of the most viewed Dutch news websites (at the time), NU.nl 2/12/13 17u12. In the dossier.

⁷⁷ See the file under 20020323.

The behavior of the authorities in the case Bos is very similar to their behavior in the cases of Spijkers and Van Buitenen and others. They are lax in the investigation and prosecution of misconduct and crimes. They are far from happy about the discovery of costly and harmful deceit, as they should have been if they had the interests of citizens at heart, and if they really desired integrity in government, and laws taken seriously. They demonstrate an outspoken hatred of whistleblowers. Who are prosecuted, harshly and persistently. The authorities demonstrate an inhuman insensitivity to the suffering of whistleblowers and their relatives. Or, what this amounts to, a great liking to terrorizing the population.

If deficient laws would be the cause of the failure to get the responsible criminals behind bars, nobody said so. There is no evidence showing that efforts have been made to improve the law in this respect.

The misconduct of the governmental representatives in the case Bos is similar to that in the other cases. Including slandering the whistleblower, and lying. Their judgment may sometimes have been influenced by ill-chosen contact persons or dubious friendships. Tineke Netelenbos and Annemarie Jorritsma seem to trust blindly in friendly heads of construction corporations, who actually were the heads of criminal organizations.⁷⁸ See for example p. 55 in the book of Koelemeijer. The husband of minister Jorritsma owns a construction firm.⁷⁹ The names of the spouses Jorritsma can be found in the second shadow account, that of the firm Boele & Van Eesteren.⁸⁰ There certainly was an undisclosed conflict of interest.

Minister Korthals of Justice had informed parliament incorrectly and had to resign for that reason.⁸¹ He was the only one to resign over this case. Subsequently he was nominated for the chairmanship of his political party, and appointed.

Once more the government shows a lack of integrity. It collaborates with, and abuses its power to protect swindlers and organized crime at the cost of the population. Conversely: if the government would be bona fide, and really wanted the best price for given products and services, it would have acted very differently.

The government did not account for its conduct. With some difficulty one can imagine that some people thought that favoring business serves the country.⁸² But this hypothesis is nowhere explained or accounted for. Until the hypothesis is proven, it has to be assumed that explanation and accounting are not given because there simply is no believable and acceptable explanation or accounting. In any case the government's conduct is incompatible with the principle of responsible government.

Control by parliament failed entirely. Not parliament but Bos discovered the fraud. Parliament was just as tolerant towards the criminals as the ministers. It approved a settlement with the construction sector which was very disadvantageous for the treasury and tax payer, and left the criminals unpunished. For a preventive effect much more money should have been returned, and much more punishment meted out. Both in the government and the construction sector. In the situation after the construction fraud, potential swindlers have little to fear: the costs of the given kind of crimes are much less than the profits.

The public prosecutor- part of the government- pretended "lack of human resources" as reason for the biased settlement. Which obviously means a very incomplete payback of stolen money, and full impunity of the crimes. In other words: gross injustice. Quite apart from questions about the truth of the claim about the lack of resources and the priorities set by the prosecutor,⁸³ it has to be admitted

⁷⁸ Jorritsma-Lebbink was minister of transport and waterworks from 22/8/94 to 3/8/98, and minister of economic affairs from 3/8/98 to 22/7/02. Netelenbos was minister of transport and waterworks from 3/8/98 to 22/7/02.

⁷⁹ Koelemeijer p. 71.

⁸⁰ See Koelemeijer p. 97.

⁸¹ "Inform incorrectly" may be an euphemism for "lied to". The problem with euphemisms is that you can only guess what they hide.

⁸² With a lot of difficulty actually. For why do we have laws prescribing otherwise? Do these laws serve the general welfare and interest less than the discovered deceit and theft? If so, why are the laws not changed?

⁸³ Or his boss, the minister of Justice...

that adequate preparation and management of a trial of the perpetrators of the construction fraud would require a lot of time from a lot of people. Quantitatively and qualitatively. This presumed problem is an important argument for the implementation of a proposal of *The Law of Logic*, which requires the convicted to pay for all the costs of the investigation, prosecution and adjudication. That would eliminate the need to explain why innocent outsiders have to pay these costs, and solve the human resources problem.

The priorities set by the public prosecutor are highly debatable. They are not publicly accounted for. The time and resources which the prosecutor spent (wasted) on the prosecution of Bos, in the same period when it claimed to be unable to prosecute the construction corporations,⁸⁴ is hard to explain except by explicit political orders, aimed at making an example of Bos, to show what happens to a whistleblower.⁸⁵ That is: to broadcast the message “whistleblowing- disclosing deceit by politicians- is the most serious crime in the world, and will be punished with destruction of the whistleblower’s life” as clearly and loudly as possible. At the same time those responsible in the corporations are spared as much as possible: cases are said to be superannuated, there is a lack of proof, and settling is the best that can be done. Those responsible in supervision, parliament and government are even spared mentioning.

For politicians nothing is beneath contempt. On 12/6/08 Bos received a letter from minister Ter Horst of internal affairs, offering help in his search of work (and income):

«What I offer you is that the government, in agreement with you, hires a commercial firm for career advice and coaching, aimed at supporting you in your search for fitting paid work. The costs of the firm will be paid by the government. I propose that the chosen firm starts with the formulation of a plan with the steps to be taken, in consultation with you. The plan might include the following elements:

- The intake, among others consisting of taking cognizance of the CV, getting an idea of the match with the most suitable adviser, and making work arrangements;
- Making tests and discussing them;
- Digest the situation of the past;
- Establishing the level of ambition on the basis of competencies, interests and market analysis;
- Training of application ability, such as making a SWOT analysis, and the training of elements of application talks.»⁸⁶

Etcetera.

The report of the inquiry commission construction sector.

The report gives a lot of information. It doesn’t do much with this information however. «The necessary changes in behavior and culture can only be realized by the sector itself», according to minister Henk Kamp of housing and regional planning. Parliament allowed the responsible ministers Netelenbos and Jorritsma to stay on. In February 2004 a Guidance Council Construction was instituted. It should bring about a cultural turnaround in the construction sector, and would be composed of independent persons. But it included many people from the construction sector. Therefore the “independence” can only have formal meaning.⁸⁷

It is not clear how the risk of repetition is going to be eliminated or reduced. The perspective of (proportional) punishment cannot act as a deterrent, since it is thrown overboard:

«The government asked the construction corporations in the beginning of 2004 to send their shadow accounts voluntarily to the Dutch competition supervisor.⁸⁸ “Make a clean sweep”, minister Laurens Jan Brinkhorst of economic affairs called the operation. In exchange the corporations could

⁸⁴ Koelemeijer p. 175.

⁸⁵ Of course, it can also be explained by stupidity or folly.

⁸⁶ Koelemeijer pp. 186-7.

⁸⁷ This adds one more example to a long list of formally “independent” commissions which due to selection cannot be expected to do their job truly independently from those who appointed them.

⁸⁸ NMa: Nederlandse mededingingsautoriteit.

apply for clemency in accordance with clemency provisions which the supervisor had created especially for this purpose.⁸⁹ Their fine would be reduced. They would not be prosecuted. And last but not least: the corporations kept access to government contracts, and would not be blacklisted and excluded from such contracts. For the construction corporations it was a golden opportunity: three hundred and fourteen corporations submitted a request for clemency.»⁹⁰

So here too, politicians withdraw suspects (among whom many certainly are guilty) from normal, non-political, adjudication. They abuse their power over the public prosecutor, and violate the principle of equal rights/ adjudication. The “exchange” is extremely disproportional. It gives very much in exchange for almost nothing.

The vacuity of its follow-up strongly suggests that the inquiry was a piece of theatre played to deceive the public. Talk about a “thorough and penetrating” inquiry suggests that nothing will be allowed to remain hidden, and that all measures which are necessary to prevent repetition will be taken. But this is not what happened. What did happen is that the report was quickly and completely forgotten. Parliament did not ask for progress reports. Neither did it monitor the implementation of the recommendations.

In the context of the present study it is important to note that the inquiry commission established that many people already knew about the fraud for years, and that nobody took any action directed at correction:

«The commission was amazed about the observation that the covert system operated for years without being detected, the more so because it was very extensive. The construction culture is closed to such an extent that internally “everyone” knows, but the outside world doesn’t notice anything. Where was the government all those years? What did supervisors and controllers, such as accountants, do?

In the opinion of the commission this is a serious situation. Serious because it concerns a culture in which illegal agreements are considered normal. This is also shown by the fact that the commission has found that a large number of the people involved believed in what they called their good intentions. Making illegal agreements about prices and the distribution of the market was considered normal. Because it hurt nobody, many people said. In the meantime shadow accounts were kept at home or in the trunk of a car. People spoke about monopoly money, but at the same time wanted to get that monopoly money converted into real money or contracts.»⁹¹

Nobody acted in accordance with his responsibility, nobody did his duty:

«The inquiry commission was astonished, and most painfully touched by the laconic and condoning reactions of the principal actors. Many knew more or less of what was happening, but preferred not to “really” know. This applies to the top of the construction firms and that of the (sub)sector organizations, but also to certain accountants, tendering agencies, and supervisors. Everyone watched, did little or nothing, and preferred to go on with the order of the day. And if this is practice for long enough, it seems that people forget that something is fundamentally wrong. Everyone had a responsibility corresponding with his specific position, but failed to act accordingly. This also holds for members of government.»⁹²

All this in spite of codes of conduct, professional codes, etcetera.

The following is found in the summary of the findings of the commission:

«Regarding the role of the accountants the commission concludes:

- Members of this group knew about the illegal practices;
- They did not act, let alone correct;

⁸⁹ Of course, one is not allowed to call this discrimination or arbitrary government.

⁹⁰ Rapport Enquêtecommissie Bouwnijverheid (2002), p. 100.

⁹¹ Rapport Enquêtecommissie Bouwnijverheid, pp. 11-2. Note that the quote contains lies: the newspaper articles mentioned tell a very different story: evidence had consciously been ignored.

⁹² Rapport Enquêtecommissie Bouwnijverheid, p. 12. This is an example of “reality is the norm”.

8. OTHER CASES

- There is hardly any indication that they were aware, let alone made their clients aware, of the need of a turnaround in doing business in the construction sector, certainly after 1992.»⁹³

The recommendations concerning the accountants are not only interesting when considered in the context of the construction fraud and accountancy, but even more when considered in the light of the subprime crisis, and the recommendations that were made- or not- by inquiry commissions of that crisis. For that reason they have been quoted and analyzed in the chapter on the financial crises. The analysis shows that the accountancy (in the Netherlands) has not changed substantially in the years following the construction fraud. Organized accountancy ignored the appeal of the inquiry commission. The hearings of the inquiry commission De Wit show an accountancy chairman with a shockingly formalistic and irresponsible attitude.

8.6. Bolkovac and trafficking by UN employees (1999).

Summary and conclusions.

1. «Kathryn Bolkovac, an American police officer who was assigned to serve as a peacekeeper with the United Nations in post-war Bosnia, 1999 [...]⁹⁴ discovered a sex trafficking ring that serviced and was fostered by other peacekeepers. Bolkovac was fired after trying to investigate the situation but later won a lawsuit for wrongful dismissal.»⁹⁵
2. «Following Kathryn Bolkovac's departure, a number of peacekeepers, including private contractors, were sent home. None faced criminal charges in their home countries.»
3. «The U.S. State Department continues to do business with private contractors like the one depicted in this film [The Whistleblower], including contracts worth billions in Iraq and Afghanistan»;
4. «Kathryn Bolkovac lives in the Netherlands with Jan [known from the film]. She has been unable to regain employment in the international community».
5. «Human trafficking is one of the fastest growing criminal industries. It is estimated nearly 2.5 million people are being trafficked around the world.»⁹⁶

In other words: one more variant of the well known story.⁹⁷

8.7. Snowden and the abolishment of the privacy of communication.

Introduction: the privacy of correspondence in 2014.

The following is a slightly abridged quotation from the Wikipedia page about the secrecy of correspondence at 4 December 2014.

«[Europe]

The secrecy of correspondence (German: Briefgeheimnis, French: secret de la correspondance) or literally translated as secrecy of letters, is a fundamental legal principle enshrined in the constitutions

⁹³ Rapport Enquête委員会 Bouwnijverheid, p. 291.

⁹⁴ The words: «While there, she reportedly» were left out. See also the files about the case Bolkovac in the dossier.

⁹⁵ Wiki-pagina *The Whistleblower* (the film). What the film shows is horrible. But the extra's say that reality was worse, but was not presented to avoid everyone shunning or disbelieving the film.

⁹⁶ The conclusions 2-5 come from the end of the film *The Whistleblower* of Larysa Kondracki, dated 2010. They were copied to the file *The Whistleblower on UN in Bosnia.doc*.

⁹⁷ The author cannot get used to the observation that it always goes like this, that it seems a law of nature, that there are no significant exceptions, with a strong and effective protest. Those who can and should stop it don't, and colleagues and peers just look on, and remain silent. Even though all of them say that human rights are to be respected. Only to get votes? The conclusion of general (not just widespread) corruption of the top, and absence of true respect for people, is inescapable.

of several European countries. It guarantees that the content of sealed letters is never revealed and letters in transit are not opened by government officials or any other third party. It is thus the main legal basis for the assumption of privacy of correspondence.

The principle has been naturally extended to other forms of communication, including telephony and electronic communications on the Internet as the constitutional guarantees are generally thought to cover also these forms of communication. However, national telecommunications privacy laws may allow lawful interception, i.e. wiretapping and monitoring of electronic communications in cases of suspicion of crime. Paper letters have in most jurisdictions remained outside the legal scope of law enforcement surveillance, even in cases of "reasonable searches and seizures".

When applied to electronic communication, the principle protects not only the content of the communication, but also the information on when and to whom any messages (if any) have been sent, and in the case of mobile communication, the location information of the mobile units. As a consequence in jurisdictions with a safeguard on secrecy of letters location data collected from mobile phone networks has a higher level of protection than data collected by vehicle telematics or transport tickets.

United States

In the United States there is no specific constitutional guarantee on the privacy of correspondence. The secrecy of letters and correspondence is derived through litigation from the Fourth Amendment to the United States Constitution. In an 1877 case the U.S. Supreme Court stated:

"No law of Congress can place in the hands of officials connected with the Postal Service any authority to invade the secrecy of letters and such sealed packages in the mail; and all regulations adopted as to mail matter of this kind must be in subordination to the great principle embodied in the fourth amendment of the Constitution."

The protection of the Fourth Amendment has been extended beyond the home in other instances. A protection similar to that of correspondence has even been argued to extend to the contents of trash cans outside one's house, although unsuccessfully. Like all rights derived through litigation, the secrecy of correspondence is subject to interpretations. By Supreme Court precedent, rights derived from the Fourth Amendment are limited by the legal test of a "reasonable expectation of privacy".⁹⁸

Edward Snowden.

«Edward Joseph "Ed" Snowden (born June 21, 1983) is an American computer professional who leaked classified information from the National Security Agency (NSA), starting in June 2013. A former system administrator for the Central Intelligence Agency (CIA) and a counterintelligence trainer at the Defense Intelligence Agency (DIA), he later worked for the private intelligence contractor Dell inside an NSA outpost in Japan. In March 2013, he joined the consulting firm Booz Allen Hamilton inside the NSA center in Hawaii. In June 2013, he came to international attention after disclosing to several media outlets thousands of classified documents that he acquired while working as an NSA contractor for Dell and Booz Allen Hamilton. Snowden's leaked documents revealed numerous global surveillance programs, many of them run by the NSA and the Five Eyes with the cooperation of telecommunication companies and European governments.⁹⁹ A subject of controversy, Snowden has been variously called a hero, a whistleblower, a dissident, a patriot, and a traitor. His disclosures have fuelled debates over mass surveillance, government secrecy, and the balance between national security and information privacy. Two court rulings since the initial leaks have split on the constitutionality of the NSA's bulk collection of telephone metadata.

On May 20, 2013, Snowden flew from Hawaii to Hong Kong, where in early June he revealed numerous classified NSA documents to journalists Glenn Greenwald and Laura Poitras, both of whom he had summoned to Hong Kong for that purpose. On June 9, four days after the press first exposed a secret NSA program based on his leaks, Snowden made his identity public. On June 14 the U.S. Department of Justice charged him with two counts of violating the Espionage Act and theft of government property, punishable by up to 30 years in prison. The U.S. Department of State revoked

⁹⁸ Wikipedia, Secrecy of correspondence, 4/12/14. For the references/ sources see the original.

⁹⁹ Five eyes= USA, UK, Australia, Canada & New Zealand.

his passport on June 22. According to Russian President Vladimir Putin, Snowden met with Russian diplomats while in Hong Kong. On June 23, Snowden—who later said he had been ticketed for onward travel via Havana, Cuba—flew to Moscow's Sheremetyevo International Airport. ABC News reported that Snowden "could not enter Russia because he did not have a Russian visa and he could not travel to safe haven opportunities in Latin America because the United States had cancelled his passport." Snowden remained in the airport transit zone for 39 days, during which time he applied for asylum in 21 countries. On August 1, 2013, Russian authorities granted him a one-year temporary asylum. A year later, Russia issued Snowden a three-year residency permit allowing him to travel freely within the country and to go abroad for no longer than three months. He lives in an undisclosed location in Russia and is seeking asylum in the European Union, although member state Germany—which rejected his application in July 2013—announced in November 2014 that Snowden had not renewed his request and was not being considered for German asylum.»¹⁰⁰

Remarks.

There is a voluminous dossier about this case. The best overview would seem to be *No place to hide- Edward Snowden, the NSA & the surveillance state*, by Glenn Greenwald. The following remarks are based on the dossier and this book.

1. The NSA and similar organizations were, and very probably are, not subject to any form of control.¹⁰¹
2. NSA representatives have shown that they cannot be trusted.
3. The same can therefore be said of those who say that NSA officers should be trusted nevertheless. Which includes a large part of governments and parliaments.
4. The security argument for the violation of the privacy of communication is even more valid as a justification of arbitrary unexpected searches of homes and other buildings. They should be searched for the presence of (illegal) arms and explosives. It is more valid because communications don't kill, but arms and explosives do.
5. Electronic surveillance and similar activities can be done without anybody noticing, and offer growth opportunities for organizations like the NSA. In other words: the primary motive need not have been national security. It may just as well have been personal advancement (by growth of one's unit), and/or growth of the organization.¹⁰²
6. A related motto is: "what can be done, must be done". The same mechanism is seen in many places, regarding all imaginable subjects and projects. This kind of abuse of power is made possible by easy money and absence of serious accountability and control.¹⁰³
7. The NSA does not only passively listen, read and store. It does not restrict itself to informing authorized state organizations about suspects. Without authorization it is actively trying to repress and eliminate people and organizations it deems undesirable.¹⁰⁴
8. The excessive reactions to Snowden show that politicians do not wish to rely on the judicial system, or the law. If the law were trusted, one could quietly let justice run its course. Instead an atmosphere is created which precludes unbiased administration of justice.
9. At the same time one sees that the law does not sufficiently protect at least certain kinds of alleged suspects, as in all whistleblower cases. Nor does it protect the public against malfunctioning government organizations, and their abuse of power.
10. The liquidation of the privacy of communication is a fact. Improved security is just a hypothesis. A government may moreover use communication data to bolster its own power position. Thereby

¹⁰⁰ Wikipedia, Edward Snowden, 4/12/14. For the references/ sources see the original. A few spelling errors have been corrected.

¹⁰¹ If you can lie with impunity about your operation towards your supervisors you cannot be said to be under control.

¹⁰² The NSA seems to have of the order of 100,000 employees, of which about 70,000 via contractors.

¹⁰³ Of course, the money is only easy for those in power, and "easy money" is just one more example of abuse of power, and lack of democratic control

¹⁰⁴ See Greenwald, chapter 4, for example p. 192.

reducing the possibilities of open discussion and timely policy correction, and increasing the risks of catastrophes. Control over governments' use of data is practically absent.

8.8. Conclusions from the whistleblower cases.

1. All cases start with a phase of denial by the responsible authorities. Clearly, authorities don't like to hear anything that requires correction. Whistleblowers are never welcome.
2. In all whistleblower cases there should have been whistleblowers years before the whistle was actually blown. There should have been very many more whistleblowers. Their absence shows the great difficulty of whistleblowing, even in those cases where whistleblowing could (and can) prevent very much harm.
3. The lack of integrity of politicians is shown by their silence, and by the hollowness of the protests of political minorities. Those who gave good reason for whistleblowing have almost never been punished.¹⁰⁵ Neither have those responsible for, or guilty of, gross harassment of the whistleblower. Measures taken in pursuance of whistleblowing in general seem to be meant only for appearances sake. The facts show that they have never been effective.
4. The harassment of whistleblowers can only be understood as organized terror, aimed at installing great fear of whistleblowing, and keeping misconduct by authorities hidden.
5. In general, whistleblowing is followed by an official inquiry of the allegations of the whistleblower. In all cases studied, the inquiries were organized by politicians. They composed and installed commissions which lacked both integrity and competence. The commissions often include (ex)politicians who were co-responsible for the reasons of whistleblowing. In general their reports give much and useful information.¹⁰⁶ But the information and analyses are insufficient as a basis for devising measures which can prevent repetition or similar phenomena. There is no or insufficient supervision of implementation of the recommendations. The inquiry commissions seem to be meant as an instrument for deception, for creating a period for cooling off, to give opportunities to play down, and to prevent investigations by really independent and competent people.
6. The prosecution of whistleblowers was and is¹⁰⁷ very much more intense and tenacious than the prosecution of whatever criminal, including the people whose misconduct required whistleblowing. In general the perpetrators of the misconduct are left unmolested.
7. The authorities have inflicted very much irreparable harm on whistleblowers. Outside the judicial system, by abusing their power, and with impunity.
8. The cases prove that the law of democratic constitutional states provides insufficient protection against authorities.
9. This obviously has a very inhibitive influence on the willingness to blow the whistle. Irrespective of the importance of the reasons to do so.
10. The cases studied concern misconduct by authorities of the Netherlands, EU and UN. The case Snowden is simple and clear enough to be able to conclude that it is essentially the same in the US.¹⁰⁸ This conclusion agrees with findings about the history of the subprime crisis. The phenomena are general.

¹⁰⁵ Only a few had to resign. There never was more punishment than compulsory resignation. The idea of holding these people liable is never even mentioned.

¹⁰⁶ It is highly probable that we have to thank only the non-political staff for this.

¹⁰⁷ The "is" refers first of all to Snowden. Notice how politicians in other countries reacted. As if Snowden is infected by the most contagious disease imaginable, instead of being defender of basic human rights. Remember at the same time that the privacy of correspondence can be found in many constitutions. Only Russia was willing to provide asylum. Furthermore the USA doesn't seem to be aware of the great economic danger it creates for itself: all political blocks will want to develop their own "vital" hardware and software. And stop buying US products and services, and replace them by their own.

¹⁰⁸ Because of its simplicity, because it is so very clear, and because of the absence of added value this case is not discussed. Some information is included in the dossier however. The reader can also be referred to the excellent book *No place to hide* by Glenn Greenwald. The book also shows that many newspapers, including the New York Times and Washington Post, actually serve the government, and give a selective and biased picture. The book is strong support for the last subsections of 9.2 on journalism below.

11. In none of the cases have responsible authorities given an acceptable account and explanation. It has to be concluded that the whistleblowers were justified in blowing the whistle, or better: served the public very well by doing so. It also follows that there was no justification for harassment.
12. The extremely disproportional reactions to whistleblowing are entirely inexplicable if the revealed misconduct is only exceptional, and does not have a structural character and cause. The hatred of politicians for whistleblowers is very well explicable however if they have much more to hide, and have a mortal fear of more revelations.
13. The other cases show that this fear has very good reasons. The misconduct is not exceptional but structural. The analyses show that the causes are structural as well.
14. The cases suggest or confirm that the law is made in such a way as to safeguard members of governments and their accomplices from normal accountability, liability, and punishability.

Dutch cases.

8.9. Death and disablement by poison gas in seacontainers.

Summary and conclusions.

1. This is one of many cases reported by the Dutch radio program Argos. In 2008-2011 the program presented interviews with a number of victims of poisonous container gases, and with experts and other people in the field of container handling.¹⁰⁹ The lives of the interviewed victims had become virtually unlivable.
2. The case of the poison gas containers is included in the present chapter because it clearly shows that among politicians, respect for people, including respect for human life and health, has no meaningful priority. The responsible politicians are characterized by denial and evasive behavior.
3. The sea containers are gassed with poisonous gases to protect the contents against vermin and decay during transport. The problem is that exposure to these gases by opening a gassed container, or entering such a container,¹¹⁰ causes irreparable and sometimes horrible health damage and/or death. There are obligatory procedures for handling the containers in order to reduce the risks for workers to a supposedly acceptable level. But compliance costs time and money, and in some of the corporations which handle containers compliance leaves too much to be desired.
4. For years the responsible politicians knew about the harm caused by non-compliance, but did no more than deny the need of (“additional”) action. Probably for economic reasons (money), and/or under pressure from bosses of corporations involved (lobbying!). Without saying or admitting that. They did (and do) not explain what they find a reasonable price for a human life, and the price for a miserable “life”. Neither did (and do) they explain why somebody may cause risks for health and life without the informed consent of potential victims.
5. The container gases are: methylbromide, phosphine, 1,2-dichloroethane, chloropicrin, benzene, toluene, xylene, chloromethane, trichloroethylene, vinyl chloride, and methylene chloride. The health risks of these gases are described in appendix 2 of RIVM Report 609021054 of 2007.¹¹¹
6. As from 2003 or before, containers arriving in the harbor of Rotterdam, and their contents, contain more toxic gases than permitted by law or regulation.¹¹² In March 2011 a report of RIVM, the relevant supervisor, asserted «that in the past years a total of 7 to 11% of the containers had gas concentrations above the applicable norms».¹¹³ This amounts to approximately 400,000 containers (for the Netherlands or only Rotterdam).

¹⁰⁹ The gassed containers figured in the programs of 20080123, 20100227 and 20110528 (and maybe other dates). Where no explicit reference is given, the reader is referred to the dossier for this section. Which includes the MP3 files and notes about the programs.

¹¹⁰ And sometimes using products such as clothing transported in them.

¹¹¹ In the dossier. The Wikipedia may give equivalent information. The RIVM is a supervisor.

¹¹² 20070420_Trendanalyse schadelijke gassen in containers_RIVM 609321001.pdf

¹¹³ 20110316_Rapport Vergelijking van meetcampagnes containers_RIVM 609021103.pdf

7. The problem does not affect only the Netherlands, but also Belgium, Germany, Sweden and probably many other countries. But the problem is not tackled in the framework of the EU or UN. The Netherlands goes it alone (like other countries).
8. The Argos programs show that in the Netherlands the container gases have caused deaths and serious disablement for life. The programs show that the victims were (largely) left to their fate.
9. Argos and newspapers show that for years the responsible ministers were indifferent to the misery caused by the poison gases.¹¹⁴ That they exerted themselves mainly to avoid having to do something about the problem. And that parliament allowed itself to be kept on a string by the government.
10. The documents of (semi) government organizations only describe the risks in general terms, such as “health effects”. They do not give empirical information, for example about the real consequences for the employees in the harbor of Rotterdam.¹¹⁵ The appendix mentioned in point 5 above does give a good description of possible consequences. But it does not relate this information with data about concentrations in the containers.
11. The acceptability of risks for innocent people is not discussed anywhere (in the context of the container gases). Liability for harm caused, including costs of medical care, isn’t discussed either. There is no explicit weighing of costs and benefits, and no discussion of the assumptions made. If the passive attitude is prompted by economic motives- and costs of harm caused are excluded in the economic calculations¹¹⁶ then this is not openly said and discussed.
12. It is clear a priori that a parliamentary motion such as that of Poppe and Boelhouwer for more control, under direction of the unreliable secretary, will hardly or not be preventive. The costs of infringement of law or regulation are hardly increased, or not at all.
13. According to the program Argos of 28/5/11 and a Zembla notice of 17/6/11, the implementation of the motion of Poppe and Boelhouwer leaves something to be desired.¹¹⁷
14. In almost ten years little improvement was realized, and certainly no fundamental improvement.
15. The answers given on 16/6/11 by secretary Atsma on questions of parliament suggest developments which reduce the health risks.¹¹⁸ The Argos program of 28/5/11, and careful reading of the answers of the secretary, show however that the picture sketched by Atsma is incomplete in important respects.¹¹⁹
16. Experience in other fields shows that it would be a miracle if the measures taken with respect to the poison gas containers are effective. Due to inadequate liability and fines,¹²⁰ use of (too much) poison gas and sloppy procedures remain profitable for the corporations involved. And supervisors rarely work as they should, and effectively.
17. Because of the motion of Poppe and Boelhouwer, in 2009 and following years gas content and concentrations was measured on 1000 containers.¹²¹ Every year another selection method was used. Therefore the measurements of successive years do not necessarily give a useful picture of

¹¹⁴ “Ministers” includes Secretaries, a kind of under or deputy minister.

¹¹⁵ As in the case of the inquiry report about the q-fever, considered below.

¹¹⁶ In other words: it is assumed that the value of human life is negligible.

¹¹⁷ The MP3 file with this Argos program can be found in the dossier under this date. The dossier also contains a file with notes about the program. For Zembla see the file 20131023_Artikelen over gifgascontainers.rtf.

¹¹⁸ See the file 20131023_Artikelen over gifgascontainers.rtf.

¹¹⁹ This can also be inferred from the things he ostensibly doesn’t know, but should know. Such as the state of affairs in neighboring countries.

¹²⁰ A fine is adequate only if the product of fine and the probability to get caught exceeds the profit made by ignoring the rule. So it would be better to speak of an adequate combination of fine and this probability.

¹²¹ See the introduction on p. 4 of the *Rapport over de uitvoering van de motie Poppe-Boelhouwer*. This report can be found in the dossier under 20090513.

8. OTHER CASES

- the development.¹²² It is nevertheless clear that no significant improvement has taken place. In about 10% of the containers a dangerous gas was found with a concentration above the norm.¹²³
18. This is confirmed by the letter of secretary Atsma to parliament February 20, 2012, with answers to 13 questions of members of parliament.¹²⁴
 19. If there happens to be a development for the better, then this is mostly due to the attention given to the subject by the media, and not to the responsible politicians or organizations. Without media attention nothing would have happened.
 20. According to the editor of the radio program Argos, the government made changes which made the situation in 2018 worse than it was around 2010.
 21. To avoid misunderstanding it is noted that there may be corporations that treat their employees and the containers according to the rules or better.

Remarks.

The answers of Atsma are misleading. An example:

«The intended shock effect has been realized through the motion Poppe and Boelhouwer by taking action with respect to the Dutch parties interested in container handling who can exert influence of exporters of containers. As expected the percentages exhaling containers in the harbor did not fall immediately, but the number of corporations degassing their containers safely has increased substantially. Since corporations can easily save these costs by taking measures in the chain, the number of containers arriving gassed or exhaling in our harbors will be reduced.»¹²⁵

If this were true, why is it happening only now, and not much earlier? Indeed, Atsma does not show that the costs of compliance are, or have become, less than the costs of unsafe amounts of gas and unsafe handling. There is no sign of sufficiently high fines (with respect to the probability of getting caught).

A very revealing remark is made in answer to the question whether Atsma considers the economic interests of the harbor more important than health and environment:

«Environment and health protection are the most important. When considering measures these are balanced with economic developments.»¹²⁶

The translation may be slightly more explicit than the original. The Dutch text speaks of weighing against economic developments, but does not specify what is actually balanced. The essential point of the answer is the weighing. The weighing means that health and life are not held inviolable. It also means that monetary value is attributed to health and human life. But what value and why is not specified and explained.¹²⁷

In January 2008 supervisor RIVM sent a report on the state of affairs in 2007 with respect to the risks of dangerous substances in seacontainers to minister Cramer of public health, regional planning and environment. It includes the following recommendations:

¹²² This very much looks like bad faith, because in a controversial matter comparability can prevent useless discussions. A single selection method is obviously necessary to get a well-defined time series that can be used to evaluate the measures. Of course not only the secretary is responsible, but parliament too. It should not have agreed. It failed to correct the secretary. The motion should have been formulated less open. That would have shown competence. But perhaps the motion was not intended to be effective?

¹²³ See the reports about the implementation of the motion Poppe-Boelhouwer in the dossier. The author could only find reports about 2008, 2009 and 2010. The letter of secretary Atsma to parliament of 20120220 suggests that the motion was meant for a term of three years (only). Regrettably the text of the motion Poppe-Boelhouwer could not be found. The motion and later reports were also searched for on the website of the ministry.

¹²⁴ The letter teems with non-substantiated statements, which one seems to have to accept on the authority of the secretary.

¹²⁵ From the answer to question 22 of 16/6/11. A file with the questions and answers is in dossier. See under 20110616.

¹²⁶ This is the beginning of the answer to question 9 of 20/2/12. A file with the questions and answers is in dossier. See under 20120220.

¹²⁷ As far as the present author knows, there is no tenable justification for causing avoidable risk of health or life for anyone who has not accepted the risk voluntarily and after full and correct information.

«When one would like to consider reduction of the risks, the RIVM sees the following options:

- An appeal to the responsibility of producers to market safe products. One can talk about good specifications of product requirements and agreements about transportation. Such an approach of the source will also reduce the risks in the work environment.
- Analysis of the trade chain to evaluate the policy instruments and the instruments for enforcing compliance with the rules, and to discover possibilities for improving the situation effectively. All interested parties should be involved in the analysis, including the market parties.
- Conferring with importers and clients about effective measures to prevent exposure upon opening of containers. One can think for example of sampling and analyzing containers preceding opening, in combination with measures if the concentrations in the container turn out to be high.»¹²⁸

The supervisor avoids using words like “liability”. The same unwillingness to hold liable, in other words: to translate “responsibility” into practical terms, is shown in the way minister Cramer reacted to these recommendations in the side letter with which she submitted the report to parliament. She mentions only the last recommendation:

«The report concludes that efforts of the importers to reduce risks offer an important possibility to reduce the concentrations of poisonous substances in the containers.»¹²⁹

She says nothing about a conference however, and offers no incentive or guarantee whatsoever. In other words: it is highly probable she will do nothing to make sure that the importers actually make these efforts.

The first two options are not even mentioned in the letter.

The radio program Argos of 25/8/18 consisted of an interview with Kees van den Bosch.¹³⁰ In the preceding ten years, Van den Bosch had been editor of the program. He was being pensioned for having reached the legally fixed age. He said that as a consequence of the Argos programs devoted to gassed containers, things had changed for the worse. The government did not want to hamper the business and development of Rotterdam harbor in any way. This was its inviolable priority. Van den Bosch gave no details. This note is just meant to record his opinion.

8.10. The real estate fraud.

Summary and conclusions.

General.

In this case politicians seem to have played at most an indirect role. They selected key officers and set (other) boundary conditions. They are responsible for law and regulation, and for the adjudication and supervision organized thereby. Because of their absence or invisibility this example differs from those of the whistleblowers, where the (extreme) misconduct of the politicians was the central subject. A short consideration of the real estate fraud is useful because it:

- concerns private instead of public affairs
- supplements the construction sector fraud
- contributes to proving the structural character of fundamental deficiencies
- shows how adjudication and science work in practice
- confirms the inadequacy or absence of correction mechanisms that is also seen in almost all other cases.

¹²⁸ RIVM Rapport 609021054/2007 *De risico's van milieugevaarlijke stoffen in importcontainers. De stand van zaken 2007* (The risks of substances in import containers which are dangerous for the environment. The state of affairs 2007) p. 10. In the dossier under 20080116.

¹²⁹ An undated version of the side letter can be found in the dossier under 20100921.

¹³⁰ His true given name is Erik. In the spirit of a local custom, sometime in his youth friends gave him the name Kees. It stuck.

For extensive descriptions of the case the reader can be referred to the following Dutch books: *The real estate fraud. Mega swindle in the top of Dutch business* and its sequel *The unravelling. The real estate fraud on trial* by Vasco van der Boon and Gerben van der Marel.¹³¹ The books are readable and clear. The *Administrative report on the real estate fraud case "Klimop"* by co-workers of the Erasmus University Rotterdam is a valuable complement.¹³²

The real estate fraud took place in the years 1998-2007.¹³³ The principal actors were Jan van Vlijmen and Nico Vijsma. They set up (criminal) organizations which influenced decision making by business partners- especially buyers and sellers- and the prices of real estate (projects). They skimmed streams of money. For example by having projects done for too high a price, and cashing the margin with bills for fake jobs. And/or inserting a party between buyer and seller with the net purpose of cashing price differences. The members of their organizations gave parties false information. With the help of intransparent (foreign) businesses the proceeds were made as invisible and untraceable as possible. The total proceeds probably exceed 100 M€. The damage caused may be a multiple. A large part of the proceeds went to Van Vlijmen. But he was not stingy, and rewarded his accomplices generously. Also or mainly with what could be called the Van Vlijmen trick: with fake jobs, after retirement, to avoid tax and other legal problems.

The case concerns many large projects, with budgets of up to hundreds of millions of euro's, and with major and minor parties.

The higher managements in the relevant hierarchies did not do their duty. They just looked on, for example when agreements were signed by unauthorized employees. They approved contracts they should not have approved. They ignored serious indications of wrongdoing. Perhaps partly due to incompetence. That is: because they could not do what they were supposed to do, and claimed to be able to do. In other words: due to false pretensions. Perhaps for another part due to bribes of one kind or another. *The real estate fraud* anyway suggests that responsible line managers and supervisors could have nipped the fraud in the bud. But the Dutch central bank and supervisor DNB, and the supervisor of the financial markets AFM too failed to do their duty.

The books *The real estate fraud* and *The unravelling*, and the EUR-research report restrict themselves to illegal activities. They don't show whether Van Vlijmen did (another) part of his projects at for example the Buildingfund¹³⁴ according to the rules, and if so, what the ratio legal/illegal projects was. Did Van Vlijmen, as director Commercial real estate at the Buildingfund, do business with many parties? Were the people he found and recruited at Philips' RetirementFund exceptions? In other words: was it difficult or easy for Van Vlijmen and right-hand Vijsma to find suitable collaborators? Did Van Vlijmen try his luck wherever he (or Vijsma) felt he saw a corruptible key-employee?

The wide extension of the corruption, combined with the fact that soft and inadequate handling of corruption was (is) the norm, except perhaps at the Rabobank, and the views of almost all interlocutors of Van der Boon and Van der Marel, suggest that it was easy to find accomplices. *The unravelling* makes it very plausible that the principal suspect of the Philips' RetirementFund had been bribed by someone else before.

Both at the Buildingfund and the Philips' RetirementFund employees at relatively low levels have warned their management. But for a long time no appropriate action was taken. The books don't tell whether in the end these employees were rewarded for doing their duty well- notwithstanding the risks-, or whether they came to no harm.

¹³¹ *De vastgoedfraude. Miljoenenzwendel aan de top van het Nederlandse bedrijfsleven* Nieuw Amsterdam Uitgevers, 2009. ISBN 978 90 468 0646 3. Indexed. 448 pages. (In Dutch).
De ontknoping. De vastgoedfraude voor de rechter. Nieuw Amsterdam Uitgevers, 2012. ISBN 978 90 468 1204 4. Indexed. 424 pages. (In Dutch).

¹³² It can be found in the dossier for this section, under 20110630. (In Dutch).

¹³³ See the verdict of Van Vlijmen, in the dossier.

¹³⁴ Bouwfonds, his employer during part of the relevant period.

Conclusions concerning the adjudication.

Preliminary observations.

1. Penalties have a qualitative dimension (monetary fines, detention), and a quantitative dimension (how much money, how long in prison).
2. The law mentions the maximum of variable penalties. (“punished with detention of at most...” etcetera). It never specifies the amount.

*Conclusions from the verdict of Van Vlijmen.*¹³⁵

3. The verdict only gives qualitative arguments. It does not explain the translation into quantities. Even though penalties always have a quantitative dimension. In other words: the size of the penalty is not substantiated.
4. The verdict does not explain why penalties have not been added. In particular section 6-8 of the verdict doesn't. (In some countries penalties are addable, or multiplied by the number of times a crime was committed).^{136, 137}
5. Nothing is said about jurisprudence or similar cases, and the penalties imposed there, possibly in appeal.
6. Nothing is said about the (preventive) effect of the verdict on the behavior of other people in the world of real estate.¹³⁸
7. The verdict shows no awareness of the problem of comparison with other cases of theft, embezzlement, swindling, forgery, etcetera. This is a problem because most of them pale beside the present one. Is a detention of four (4) years the maximum for all cases where less than 100 M€ has been stolen, and is 4 years the norm for proportionality for the penalties in all these lesser cases? Why not?
8. Instead of a clear to-the-point terminology the court adopts the euphemistic metaphors and misleading terminology (swindlers' slang) of Van Vlijmen.
9. Section 6-8, *Motivation of the sanction* (a misnomer, as explained above), presents several invalid reasonings favoring the suspect. It presents no invalid reasonings against the suspect. As a consequence the reader gets too positive an impression of the suspect. The court seems to evaluate the suspect in a way that cannot be accounted for (is irresponsible). This is not 100% certain however, since the court nowhere explains the size of the sanction (the 4 years detention).
10. The simultaneous trial of (about) 8 suspects may have had a positive effect on the text and substantiation of the verdicts. But as the above shows, essential elements are nevertheless missing in the argumentation. Some of the subreasonings are incomplete and/or inadequate. Even apart from the size of the case and the amount of stolen money, the quality of the adjudication, and therefore of the judges and the law, is insufficient. It is less than what is necessary to avoid the impression of arbitrariness or stupidity.

Conclusions about the EUR research report.¹³⁹

1. This is the report of a valuable research project.
2. The direct analysis of the observed phenomena is adequate (and instructive).
3. The analysis aimed at improvement falls short of the mark in a rather fundamental way. It ignores earlier inquiries and recommendations, for example into the construction fraud. It ignores measures already taken, and existing regulation. Let alone available knowledge and

¹³⁵ Van Vlijmen is selected as the most important and representative example. The conclusions are based on the file 20131130_Notes bij vonnissen vastgoedfraude.rtf with notes about the verdict. It can be found in the dossier.

¹³⁶ File 20131130_Notes bij vonnissen vastgoedfraude.rtf quotes art. 57 of the criminal law statute with important provisions regarding addition of penalties. It shows that detention is not really addable.

¹³⁷ In this regard questions may be asked the public prosecutor as well. Why didn't he request lifelong detention, or 20 years?

¹³⁸ Don't forget the construction fraud! There obviously is every reason for preventive action!

¹³⁹ For substantiation of the conclusions and more information see the file 20110630_Notes over EUR-rapport vastgoedfraude_JFCvV-20131203.doc

- responsibilities. There is no analysis into the causes of the failure of earlier recommendations. There is no reflection on the question whether it is plausible that implementation of the newly proposed recommendations will yield the desired result.
4. This applies in particular to accountancy. (See also recommendation 3 j, k and l on p. 67 of the report). Why would the recommendations of EUR scientists be implemented if those of a parliamentary inquiry commission are not?
 5. Nothing is said about the roles of law and adjudication, and those of parliament and government.

Remarks.

Description of the two principal criminal organizations.

The trial and the EUR report distinguish two criminal organizations. Both were organized and led by Van Vlijmen and Vijsma. The EUR report gives the following concise descriptions of the organizations and their money making operations:

«The first cooperation consisted of Van V., V., and some other suspects who occupied key positions in Buildingfund. Two directors of a project development firm were also involved. In the three projects investigated by the public prosecutor the modus operandi is similar: Buildingfund, represented by Van V., signs a contract with always the same project developer, to develop one or more buildings or to sell an option.¹⁴⁰ With the project developer a price for the project or the selling price has been agreed underhand. Officially however a price has been agreed that is much higher. The surplus money is transferred to accounts of private firms of the suspects by way of false bills and a third party account of a notary.»¹⁴¹

«The second cooperation is a sequel of the first.¹⁴² It was organised when Van V. resigned as director Commercial real estate at Buildingfund. Its nucleus consisted of some of the suspects of the first cooperation. The difference with the first cooperation is that the frauds of the new cooperation do not (only) hurt Buildingfund, but (also) Philips' RetirementFund (PRF). The new cooperation also involves some key officers of PRF. The essence of the fraud method was, that suspects in PRF induced PRF to buy or sell real estate projects to or from Buildingfund or other corporations for unrealistic prices. The “surplus profit” was channelled (indirectly) into the accounts of the private firms of the suspects. If PRF consciously sold real estate under market value, the suspects were afterwards rewarded from the proceeds of the strong appreciation.»¹⁴³

Further (analytical) remarks and conclusions.

The real estate fraud not only shows cooperating criminals, but also malfunctioning supervision. Both internally and externally. Almost all people involved are employee of a hierarchical organization. In all cases the whole hierarchical line above the criminal employee has failed completely. It was not one of the organizations involved, a prosecutor's office, the police or a supervisor who pricked the balloon, but an investigation office of the government tax department.

The observation that the fraud was discovered by accident ignores the fact that various employees of the various organizations involved in the criminal schemes have repeatedly drawn the attention of their managers to shady dealings. What was missing was not discovery but an adequate reaction to discovery. The investigation office of the government tax department was the first to investigate

¹⁴⁰ The projects include the project Coolsingel. See the books and the trial documents.

¹⁴¹ P. 9 of the *Bestuurlijke rapportage*. The report (together with related files) can be found under 20110630 in the dossier.

¹⁴² It includes Eurocenter and project 126. See the books and the trial documents.

¹⁴³ Pp. 9-10 van de *Bestuurlijke rapportage*. Slightly changed: here the abbreviation PRF is used systematically after the first mention of the name of the fund.

seriously. Of course the office had an important interest.¹⁴⁴ But so had Buildingfund and Philips' RetirementFund.¹⁴⁵

By giving selection and appointment authority to dishonorable or incompetent people, such properties can be spread and become general, and the relative frequency of harmful people increased.¹⁴⁶ Combined with absent or inadequate liability, criminal law and adjudication, and the excessively grown discrepancy between abilities and power, this can only result in disaster.

Theoretically there are control mechanisms, such as supervisory boards. But often members of such bodies lack the necessary competencies, time and independence, and sufficient incentives to act responsibly. "Good" relations with those supervised tend to get too much priority. Too often supervisors don't do what their duty requires them to do. They play-act, and keep up appearances with false pretensions (lies). Practically speaking their supervisory work is outside the law: their "responsibility" does not make them liable or punishable. If they are asked to account for their actions or omissions at all, they are given plenty of opportunities to throw dust in the eyes of their opponents (and the public). They are judged mostly by peers who have a great interest in preservation of the status quo.

The books of Van der Boon and Van der Marel show structural failure of (large) hierarchical organizations. More specifically they show fundamental deficiencies in the attitude of most if not all responsible higher managers. At most Rabobank discovered irregularities on its own.¹⁴⁷

What surprises in this case is the excellent and long lasting cooperation between the criminals. Even when they move from one employer to another, the cooperation remains intact. See in *The real estate fraud* especially the chapters 28 and 29 about respectively Vivaldi and Living City. Of course the criminals don't let anything transpire to their (new) environment.

That they form a criminal organization is beyond any doubt. Their common interest forms a very solid bond. The profits are enormous. No outsider can offer something equally or more attractive. All participants understand that the success of the organization and their own profits depend on their cooperation.¹⁴⁸ Upon discovery, punishment is relatively light, so the risk is low, and there is little reason (or need) for treason or going to the police.

Power corrupts (or corrupts further) if and when it eliminates the need to account for one's activities. This occurs especially when no accounting is requested by those who have the duty and power to demand it. Or if it is only requested for the sake of appearances, or if difficult questions are avoided, and unacceptable answers (or facts) accepted. Failure to demand acceptable accounting promotes corruption. At the same time, power need not be a cause of corruption. Power can be used responsibly. Power and responsibility are not intrinsically contradictory. Still the real estate fraud could only last for over 10 years and grow big because nobody anywhere had to account seriously for his activities. The use of power was not effectively controlled.

The real estate fraud shows that the given society, as induced and governed by the law, is unstable with respect to disturbance by a (clever) swindler.¹⁴⁹ The case shows that there are enough people who are willing and able to cooperate with a swindler, and to let a criminal business grow to a size of

¹⁴⁴ Regrettably the sources are silent about the origin of the investigation by the tax department.

¹⁴⁵ Of course, more people in these organizations may have been bribed or silenced (with money or otherwise) than has become known.

¹⁴⁶ By definition, harmful people are people who cause harm for people who have not given informed consent. Whether or not this is done legally or illegally.

¹⁴⁷ This doesn't seem certain. On 1/12/2006 Rabobank took over part of Buildingfund from ABN Amro Bank. See p. 431 of *The real estate fraud*.

¹⁴⁸ There are no fools among them.

¹⁴⁹ In a stable system, disturbances are reduced by the system, or at least do not grow. Instability means that disturbances of certain types are amplified by the system. This means that such disturbances can have consequences which are very much larger than their initial size would make one expect. In an unstable system, large consequences need not have large causes. (This note is copied from the analysis of the financial crises).

8. OTHER CASES

hundreds of millions of euros. It may be true that there are also people who note the criminal activity and try to stop it, but it is seen to be very easy to ignore or silence them. Ostensibly they are not believed, or accused of “spreading the same rumors every time”.¹⁵⁰ Managers seem to be unable to manage the situation. Maybe they dislike the need for action. Managers systematically fail to see the risks, and to take appropriate action. They trust criminals who present nice looking business proposals, and distrust and silence critics and whistleblowers. They are “optimists” disliking “pessimists”. What were meant as checks and balances doesn’t work because the people concerned cannot do what they should be able to, and/or do not act sufficiently vigorously. Trusting that they will be protected by the higher-ups.

Nobody or almost nobody of those who could and should have stopped the criminals has been held liable, was punished or excluded from similar responsible functions. Neither by a law court nor by the corporations concerned. In other words: there are no or very few incentives for acting responsibly.

In the case of the real estate fraud, politicians don’t play a prominent role. But they are not absent. Two examples. Hakstege, Van Vlijmen’s boss at Buildingfund, had been selected by the president of the supervisory council of Buildingfund, ex minister Hans Gruijters of housing and regional planning. Hakstege was at least a passive accomplice of Van Vlijmen. He gave Van Vlijmen carte blanche, at the cost of Buildingfund. In 1983 Gruijters had made an inquiry into real estate fraud in the retirement fund ABP, the largest pension fund in the Netherlands. According to Van der Boon and Van der Marel the ABP fraud shows many similarities with the fraud of Van Vlijmen & Co. By selecting Hakstege, Gruijters made an important error of judgment. An error that was combined with inadequate supervision of the operation of Buildingfund.¹⁵¹

ABP invests in real estate (among other things). In 1/5/95-30/6/13 Elco Brinkman, a failed politician, was chairman of the Dutch association of construction corporations (DACC). In 1/9/01-31/3/09 he was chairman of the board of directors of ABP. In other words: he occupied these positions in the period of the construction fraud and the real estate fraud. The periods at DACC and ABP overlap. Weren’t his functions incompatible?¹⁵²

8.11. Rabobank, LIBOR and Euribor.

Introduction.

LIBOR is the London interbank offered (interest) rate. Euribor is a similar benchmark «used as the basis for pricing 250 trillion euros (\$338 trillion) of financial contracts, ranging from Spanish mortgages to complex derivatives».¹⁵³ In other words: LIBOR and Euribor are interest rates which have a normative value in financial markets. All other rates are fixed taking account of the development of LIBOR and/or Euribor. The LIBOR and Euribor rates themselves were fixed by panels of banks.

Somewhere between April 2008 and April 2010, Barclays, one of the panel banks, notified the European commission about rigging of the benchmarks by panel banks. Whereupon the EU and an international group of supervisors started inquiries. The result was that in the last quarter of 2013 the banks were fined for a total of around 2 B€. This is only a small percentage of the losses of customers.¹⁵⁴

¹⁵⁰ P. 247 of *The real estate fraud*.

¹⁵¹ Hakstege did not do what he had to do, and did profit from the fraud. He obviously is corrupt. He was unsuitable for the function he got.

¹⁵² See the files “Elco Brinkman...”. The construction fraud alone is more than enough reason to doubt his integrity and/or competence (or both of course). For many years Brinkman served the interests of swindlers, didn’t bother to. Conversely it can be concluded that the simultaneity of his incompatible jobs at ABP and DACC is consistent with the hypothesis of lack of integrity. Finally it would be amazing if Brinkman would always have acted honorably except in just one case, that of the construction fraud.

¹⁵³ Foo Yun Chee (Reuters) 5/11/13.

¹⁵⁴ See for example the Wiki page “LIBOR scandal”, in the dossier under 20141123.

Like the real estate and construction frauds, this case is discussed because the principal actors are employees of private corporations. It differs from the real estate and construction frauds because in the present case supervisor DNB may be as much to blame as Rabobank.

The cases with the private corporations enable one to compare some aspects of private and public organizations, especially the operation of internal checks and balances and mechanisms for self correction. The documents regarding Rabobank and LIBOR show the functioning of both bank and (at least implicitly) supervisor. The picture one gets agrees with that obtained from the study of especially the subprime crisis. With respect to checks and balances and mechanisms for self correction, the organizations in the construction, real estate, and financial sectors are indistinguishable. The conclusion is, that in important cases, the checks and balances and mechanisms for self correction do not work at all.

Rabobank was just one of the panel participants guilty of rigging. Other punished banks are: Credit Agricole, Deutsche Bank, HSBC, JPMorgan, Royal Bank of Scotland (RBS), and Société Générale. So Rabobank is no more than an example, and only selected because it was the first subcase of LIBOR/ Euribor the present author heard of.

As often in this study, the section does not exactly summarize the sources. It only gives an outline of the case, and for the rest is mainly devoted to analyses and drawing conclusions. Without aiming at completeness.

Summary and more or less direct conclusions.

The US Commodity Futures Trading Commission (CFTC) gives the following summary of the case:

«The London Interbank Offered Rate ("LIBOR") and the Euro Interbank Offered Rate ("Euribor") are global interest rate benchmarks that are critical to the U.S. and international financial markets. Trillions of dollars of financial instruments are priced based on LIBOR and Euribor. For nearly six years, from at least mid-2005 through early 2011, Rabobank, through the acts of certain traders and managers located throughout the world, engaged in hundreds of manipulative acts that undermined the integrity of LIBOR and Euribor.

LIBOR and Euribor are fixed each day based on rates submitted by a select panel of banks. In determining what rates to submit, each bank is to make an honest assessment of the costs of borrowing funds in the relevant markets. An honest assessment of the costs of borrowing does not include factoring consideration of what rates would be beneficial to the derivatives and cash trading positions of the banks. Yet this is what certain Rabobank traders and managers did repeatedly across multiple currencies.¹⁵⁵

Rabobank derivatives and cash traders frequently asked Rabobank's LIBOR and Euribor submitters to submit preferential rates in attempts to manipulate U.S. Dollar and Yen LIBOR, Euribor, and on occasion, Sterling LIBOR, to benefit Rabobank traders' cash and derivatives trading positions that were tied to these benchmark interest rates. Rabobank's submitters often accommodated those requests and made false submissions reflecting the requested rates as Rabobank's contributions to the fixings of LIBOR for several currencies and Euribor. At times, Rabobank also aided and abetted other banks' attempts to manipulate Yen LIBOR and Euribor. Moreover, some of the conduct occurred even after the Commission had commenced its investigation of Rabobank's U.S. Dollar LIBOR practices in April 2010. After the Yen LIBOR submitters were told in late 2010 that it was improper to consider the rate requests of Rabobank's traders, a Rabobank trader promptly obtained the assistance of an interdealer broker ("brokers") to continue attempting to manipulate Yen LIBOR to benefit his trading positions through early 2011. At times, Rabobank was successful in manipulating Yen LIBOR.

Rabobank ignored the obvious inherent conflicts of interest created by assigning traders with cash and/or derivatives trading positions tied to U.S. Dollar, Yen and Sterling LIBOR and Euribor to serve as Rabobank's LIBOR and Euribor submitters. This fostered an environment which facilitated the traders' attempts to manipulate LIBOR and Euribor. Rabobank thus created a conflict between the submitters' responsibility to make an honest assessment of the costs of borrowing for purposes of

¹⁵⁵ For more information about LIBOR see pp. 8 and following in the FCA Final notice, see below.

determining Rabobank's daily LIBOR and Euribor submissions and the submitters' desire to maximize the profitability of their trading positions. Rabobank's LIBOR and Euribor submitters often resolved this conflict in favor of their trading positions and those of their colleagues to the detriment of the integrity of LIBOR and Euribor. The conflicts of interest were heightened because Rabobank also grouped the submitters on the same desks with other derivatives traders, which further facilitated the ease of coordinating on the submissions. In fact, one dominant derivatives trader simply shouted his requests across the desk to the submitters.¹⁵⁶ This profit-driven and manipulative submission process involved traders, managers and at least one senior manager¹⁵⁷ located in Rabobank offices in London, New York, Utrecht (Rabobank's headquarters), Tokyo, Singapore, and Hong Kong.¹⁵⁸

The manipulative conduct of Rabobank's traders and submitters occurred because Rabobank lacked internal controls, procedures and policies specifically relating to its LIBOR and Euribor submission processes during the period of 2005 through early 2011, and failed to adequately supervise its trading desks and traders.»¹⁵⁹

The following is a copy of paragraph 4.39 in a "Final notice" of the UK Financial conduct authority (FCA):¹⁶⁰

«It was not until June 2011 that Rabobank implemented processes that would enable it to audit its LIBOR submissions process effectively. It was not until August 2012—over a year later—that Rabobank formally prohibited its Submitters from trading interest rate derivatives products linked to the very LIBOR rates for which they are responsible, other than for the purposes of the bank's liquidity and liability management.»

On the day of the publication of the reports of the CFTC and FCA, the Dutch central bank and supervisor DNB reported the following. For reasons of clarity the findings have been paraphrased somewhat. Some conclusions have moreover been slightly expanded.

1. Rabobank did not make a risk analysis of the LIBOR and Euribor submission process.
2. It did not make such an analysis after it had turned out that there were risks.
3. It did not do so after having received external signals.¹⁶¹
4. There was no policy for participation in benchmark panels such as LIBOR and Euribor.
5. There was no policy for the submission process.
6. The interests of the submitters were intertwined with those of the traders.
7. The production of submissions was neither described nor accounted for.
8. After an information request of the CFTC, the senior management of Rabobank discussed the risks of participation in the panel. As a consequence something was done, but far too little. The management was unprofessional.
9. The compliance department was understaffed and did not work properly.
10. The operational risk management was insufficient.
11. The internal audit service functioned insufficiently.
12. Internal communication with the internal audit service was insufficient (injurious to the functioning of the internal audit service).
13. The management was insufficient.

¹⁵⁶ «For purposes of this Order, the term "request" means a request for a preferential LIBOR or Euribor submission for a particular tenor.» [Note in the CFTC report].

¹⁵⁷ «The term "senior manager" generally references Rabobank employees with responsibilities (either formally or informally delegated) broader than management of trading desks, although their responsibilities may have at times included managing trading desks. The term "senior manager" does not include executive managers or members of Rabobank's Executive Board or Supervisory Board.» [Note in the CFTC report].

¹⁵⁸ «Most of the individuals involved in this conduct are no longer employed at Rabobank.» [Note in the CFTC report].

¹⁵⁹ The summary can be found on pp. 2-3 of the CFTC report. The report is included in the dossier, as 20131029_CFTC Order Rabo re LIBOR.pdf.

¹⁶⁰ In the dossier under 20131029.

¹⁶¹ For specification of the signals see for example pp. 13-4 of the DNB letter. The letter is dated 20131029.

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14. Rabobank had promised «to have their internal processes for submitting rates audited as part of their firm's annual compliance procedures and provide written confirmation to the FX and MM Committee that this audit has been completed». ¹⁶² But it did not do what it had promised. When the British Bankers' Association inquired, Rabobank sent a misleading confirmation.
15. The British Financial Conduct Authority was sent a similar incorrect statement.
16. Contrary to the compensation policy of Rabobank, and contrary to the impression Rabobank had created in its press release about the LIBOR settlement, the bank did reward the employees involved in the scandal. It must be assumed with the approval of the top.

Note that several findings are of a general nature, and that it is therefore hard to believe that only the LIBOR and Euribor processes are badly managed.

A useful pointwise analysis is that of Pheijffer, dated 30/10/13, and found on accountant.nl.¹⁶³ Pheijffer also comments on the DNB letter. He notes that it is not clear what the external accountant reported to the top of Rabobank. It is remarkable, and suggestive of lack of integrity and/or competence, that the supervisors are silent about this. The reports of the external accountants are of importance too because of the recommendations made in their direction by the two parliamentary inquiry commissions into the construction fraud and the subprime crisis.

Other conclusions.

1. The participation of Rabobank in the panels dates from the nineties.¹⁶⁴ The bank has never organized its participation properly. The top of the bank may have assumed that the job was trivial, that they would be told if there was a problem. Or maybe they simply didn't understand what was asked of the bank. The top never evaluated the panel participation. It never supervised. It always remained passive. If it believed in the beeping system of Dijkstra of chapter 2, it should have realized that such a system may not work in a corrupt environment.^{165, 166}
2. All supervisors note that the integrity of LIBOR and Euribor is of great importance for the worldwide financial system. For many years Rabobank exerted influence on LIBOR and Euribor. If the top of the bank cannot be held co responsible for the adequate implementation and execution of a job like this, which it voluntarily accepted, can it be held (co)responsible for anything at all? And what is the justification of the extremely high salaries and bonuses of these people?
3. Why aren't the complete responsible hierarchical lines fired? Dishonorably, without compensation or other rewards?¹⁶⁷
4. Why isn't this hierarchical line held liable for the fine of 774 M€, and why aren't they imprisoned because they took unbearable risks, caused irreparable damage, and cannot pay the fine?
5. Section 3 of the press release of Rabobank asserts that «In total, 30 employees were involved in, aware of, or should have been aware of, the inappropriate conduct.» On p. 3 it says: «Rabobank has taken severe disciplinary measures against all of the employees who engaged in inappropriate conduct and who were still at the Bank during the investigation.» Does this include the employees¹⁶⁸ who should have been aware of the inappropriate conduct, and could and should have taken corrective action? Isn't inadequate management, that does not notice and correct (other) inappropriate conduct, inappropriate conduct as well? Of course it is. Rabobank uses a double standard, and isn't honorable.

¹⁶² DNB letter pp. 21-22.

¹⁶³ The text is included in the file 20131030_Artikelen inz LIBOR boete Rabo.rtf.

¹⁶⁴ Appendix of the DNB letter, section 4.2 p. 11.

¹⁶⁵ See the end of the chapter about the policy portal project.

¹⁶⁶ Several cases, from policy portals to real estate fraud, have shown that the system is unreliable (to put it kindly). “Beeping” evokes irritation and resistance, and may easily lead to side tracking of the beeper.

¹⁶⁷ In other words: not only the highest manager, CEO Moerland, should have been fired. What compensation (or other forms of extra pay) did he get by the way?

¹⁶⁸ As always in this study, “employees” includes managers. This need not apply to the quote however.

6. Rabobank has been judged by supervisors who cooperated for the purpose of judging LIBOR and Euribor fraud.¹⁶⁹ Internally, judgment was passed by the top (and/or their board of supervisors). However, the top itself is guilty as well (practically and by definition). The top punished itself at most by (forcing) the resignation of CEO Moerland. Although there is no openness about the amount of money he was paid or promised upon departure. For this reason it is improbable that he was really punished.
7. The selective sanctioning can be blamed on the (ab)use of power by the different actors, but may have been helped by deficient information and reasoning about causes.¹⁷⁰ Reasoning that ignores the fact that freedom of (in)action can cause risks or dangers, that this is the reason why norms have been set, and that certain people and organizations have been given/ accepted the duty to ensure compliance with the norms. And that in a case of systematic “active” infringements of norms, supervisors who remain passive infringe norms as well. In a society where liability is replaced by regulation and norms, man made disasters often need two causes: an active and a passive one. The last being the failure of a supervisor (including government) to act appropriately. As in the financial crises, passive actors could and should have prevented harm or disaster.
8. This has not been taken into account by the law and by those who are supposed to study law. Omission to do one’s duty is not or hardly punished, either by law or judges. Irrespective of the consequences of the omission.
9. Because of the proven lack of integrity and competence of the top of the Rabobank, the measures taken under pressure do not deserve belief.¹⁷¹ As confirmed by paragraph 16 of Pheijffer,¹⁷² which is inconsistent with the assertion of DNB about integrity.¹⁷³
10. Already in the year 2000 DNB could and should have noticed that the LIBOR and Euribor submission processes in Rabobank were inadequate. Earlier conclusions show that the failure of this bank with respect to LIBOR and Euribor had general, if not structural, causes. DNB could and should have seen these causes, and much earlier than it did.¹⁷⁴ At the latest upon receipt of the external signals.¹⁷⁵

¹⁶⁹ So they actually can cooperate! This is noted because they didn’t cooperate adequately in the period before the financial crisis.

¹⁷⁰ This certainly holds for the social toleration of selective punishment.

¹⁷¹ The measures are described in the press release about the LIBOR-settlement of October 29, 2013 of Rabobank.

¹⁷² «DNB furthermore concludes with a critical remark about the top of the Rabobank. It concerns the traders who were fired and got severance pay. The Rabobank remuneration policy states: *'Severance pay will never include a reward for an employee's failure and will reflect the employee's performance.'* Which can be summarized in the principle *'no reward for failure'*. DNB notes however that Rabobank made severance agreements because *'employees could not be retained and had to be suspended.'* The following observation of DNB- the concluding sentence of its report - is just as clear as it is euphemistic: *'In the opinion of DNB this judgment is incompatible with the substantiation of the compensation mentioned above. Therefore DNB could not verify that the agreed severance payments and the payments of accumulated rights satisfy the above mentioned 'no reward for failure' principle.'* What can be seen as a reproach at the address of the Rabobank top: after all, isn’t it the top which decides about severance compensation in this kind of case?» Copied from 20131030_Artikelen inz LIBOR boete Rabo.rtf.

¹⁷³ «DNB emphasizes that it does not question the personal integrity of Mr. Moerland.» P. 2 of the DNB letter of 20131029. The letter continues with positive half-truths which produce an incorrect picture. Note that this stems from a DNB which is supposed to have been substantially improved in the wake of the financial crisis.

¹⁷⁴ Little or nothing had been described and substantiated. The higher management should have convinced itself of adequate handling of the LIBOR and Euribor job. If it had inquired and been informed incorrectly, why were the misinformers not fired?! If they didn’t check anything in the case of LIBOR and Euribor, why other processes? Even simple questions would have shown DNB that the process and management did not comply with prescribed norms. In this respect too it is of interest to know what the external accountants wrote. DNB must know.

¹⁷⁵ The letter of finance minister Dijsselbloem to parliament (in the dossier, under 20131108) suggests that DNB could and should have discovered the unacceptable LIBOR and Euribor submission processes in Rabobank, and should have demanded correction, long before the external signals. But the letter is not explicit in putting blame on DNB. On the contrary, as in the financial crisis it is suggested that deficiencies in the law prevented adequate intervention. This is hard to believe, given the inquiries made and the fines meted out. But even if it were true there would still be a problem. For the minister implies that the law has to be adapted to all kinds of new

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- Similar conclusions can be drawn about banks and supervisors in other countries.

8.12. The fire in the Wir War Bar in Volendam, just after the turn of the year 2000/01.

Summary and conclusions.

- A long series of irresponsible omissions of a municipality and a café proprietor created circumstances in which a relatively small, in the long run inevitable,¹⁷⁶ mistake would cause large and irreparable damage.¹⁷⁷ To wit, 13 deaths and 263 more or less seriously wounded. Of the wounded, a number is maimed for life.
- Only the proprietor has been punished, and only marginally.
- The proprietor on the one hand, and the victims and their relatives on the other, were forced to reach a settlement about damages.
- Much of the damage caused by the fire was irreparable. The amount of money needed to compensate the consequences of the inflicted harm as good as possible exceeds 40 M€. The owner seems to have contributed approximately 2 M€, the remainder was provided by the national government (that is, the Dutch taxpayer). It is to be feared that in the end the compensation will be insufficient to justify the qualification “as good as possible”.
- Even though for many years they had been grossly negligent in the fulfillment of their duties, neither mayor nor municipality were tried. They were not held liable, and were not punished.
- For many years, municipal officers had every reason for whistleblowing. None did.
- The inadequate adjudication gives nobody, especially municipal authorities and owners, reason to act more responsibly henceforth.

Short report of the fire.

«In the café ‘t Hemeltje in Volendam [The Netherlands], in the New Year’s night of 2001, there was a short but intense fire with serious consequences. The heat of the fire, the smoke and the panic ultimately killed thirteen young people, and wounded 263 people more or less seriously.»¹⁷⁸

«Early on January 1, 2001, a short time after midnight, fire breaks out in café ‘t Hemeltje in Volendam. By lighting ‘little stars’, a minor kind of fireworks, the Christmas decoration, consisting of spruce branches, which covers almost the whole ceiling, catches fire. The café, the upper one of three, one on top of the other, is chockfull with approximately 300 guests. The number of guests is four times as large as permitted on the basis of the applicable regulation. By means of the dry spruce branches the fire very rapidly expands across the whole café. It expands and develops so fast that it is impossible to use the available small fire extinguishers to extinguish the fire in an initial stage. Burning branches fall down upon the guests, wounding many. A terrible panic arises. There is much smoke, and the lights go out. In the crush to leave the building, many people are wounded and three lose their lives. Inadequate escape routes contributed to this. After a few minutes the fire is

products, processes etcetera. If so, it will always lag behind for years, and allow unknown, and therefore potentially great, risks to grow and be realized out of reach of the law. Shouldn’t there be a legal safety net (such as liability)? Furthermore, why didn’t DNB note the inadequacy of the law, and much earlier? Can the supposed problem with the law have been invented or mentioned to exculpate DNB? After all the minister takes no action with respect to DNB. Are we to believe that it will correct itself of its own accord?

¹⁷⁶ Often it is overlooked, even by “experts”, that in the end, risks will always be realized, and that a small probability (risk) only means that it may take long(er) to be realized. But it can also happen tomorrow. (Even a large risk need not be realized soon). For example in the analysis of the financial crisis, as well as in the present case, one sees that most risk management does not enable an organization to cope with realization of larger risks independently. That is, without outside help. There is insufficient reason for making adequate provisions, mainly due to inadequate law. See also the analysis of the financial crisis.

¹⁷⁷ Municipality and proprietor dared take risks.... They created an unstable situation.

¹⁷⁸ P. 3, Summary of the report *Onderzoek cafébrand nieuwjaarsnacht 2001 (Inquiry café fire New Year’s night 2001)*.

extinguished. The spruce branches are partly burnt, and the fire did not spread to other parts of the building.

In all kinds of ways the guests leave the building. Helped by each other and by passers-by rushing to. Via the windows in the front, after forcing the lattice-work before the windows, via the normal access staircase which passes through the bar of the floor below, via the emergency exit at the side of the building, and via a storage space at the back to a flat roof. The hundreds, predominantly very young, victims flock to the dyke in front of the café. First aid, relief and care are provided by bystanders in nearby houses, café's, hotels and restaurants.»¹⁷⁹

Inquiry and evaluation.

Several reports were written about the fire. They can be found in the dossier "Volendam" of the present study. The reports are more or less independent from one another. Only to a limited extent were they placed in a coherent framework. A separate report, here called the Summary, assembles the conclusions of reports on specific aspects.¹⁸⁰ Chapter 2 of the Summary gives one kind of summary, and chapter 5 another (with recommendations). In other words: the documentary situation is rather confusing. It was probably caused by the fact that the specific aspects were investigated by different agencies, and by inadequate integration.¹⁸¹ One agency, the Healthcare Supervisor (in Dutch: IGZ), even did not allow the report to be summarized in the Summary.¹⁸²

In the run-up to the fire both the café proprietor and the local authorities made grave errors. Both acted irresponsibly, contrary to their duties. Grave errors were made in the fields of prevention and provisions to cope with calamities, and in the fields of licensing, supervision, maintenance and measures. The following quote is taken from the Report Licensing:

«Fire management in the municipality Edam-Volendam

To a large extent, the inspections of café's, hotels and restaurants made between December 1988 and March 1992 by the municipality of Edam-Volendam and the Regional Fire department Waterland lacked a legal basis. During that period, conditions for use and installation-technical provisions can only be imposed on owners of café's, hotels and restaurants by means of a licence for use. The municipality of Edam-Volendam omitted application of this instrument. The municipality of Edam-Volendam thereby acted contrary to the stipulations of the Fire safety ordinance 1986. The municipality of Edam-Volendam moreover neglected a good opportunity to begin issuing licences for use.

Since the Fire safety ordinance 1986 came into force, owners of café's and many other kinds of establishment which can accommodate more than 25 (as from 1998 50) persons are obliged to request a licence for use from the municipality. In spite of advice from the government, the regional fire department and people in their own organization, and contrary to stipulations of the Fire safety ordinance and the construction ordinance, the municipality tolerated for 14 years [until the year 2000? It would seem: until the fire]¹⁸³ that owners did business without a licence. In this period the municipality of Edam-Volendam has seriously failed its legal duty regarding fire prevention, restriction of the danger of fire, and prevention and restriction of accidents in case of a fire.»¹⁸⁴

¹⁷⁹ P. 5, Summary of the report *Onderzoek cafébrand nieuwjaarsnacht 2001*.

¹⁸⁰ In connection with the explanation of this situation the reader is referred to section 4.2, *Coherence of the different inquiries (Samenhang van de verschillende onderzoeken)*, on p. 17, and the remark under 5.2, *Medical aid (Geneeskundige hulpverlening)*, on p. 36 of the Summary report.

¹⁸¹ Giving different names to the same thing is bound to create confusion and misunderstanding, and sometimes worse. Section 5.1 of the Summary is entitled "Incident en incidentbestrijding", and gives the conclusions of the "Rapport Incident cafébrand nieuwjaarsnacht 2001". A report of which the title is rather misleading also, by the way. It isn't by far as broad as the title suggests. But although the situation is very frustrating and puzzling for a student of the fire, the reports contain much useful information and analysis.

¹⁸² According to the remark under 5.2 on p. 36 «the IGZ preferred not to integrate its report in the joint report of the [other!] supervisors».

¹⁸³ Of course this depends on the precise date of the coming into force of the ordinance.

¹⁸⁴ Report Licences (Rapport Vergunningen) p. 5.

Because of their clarity and conciseness, the remaining quotes concerning the licensing are taken from the Summary. Under point 2 one reads:

«The owner violated at least the following stipulations of the general stipulations concerning fire safety in appendix 4 of the construction ordinance:

1. the direction of rotation of doors in the escape routes;
2. the inflammability of the decoration;
3. the maximum admissible number of persons in a room given the arrangement of the room.»¹⁸⁵

The following points 4-6 demonstrate the willful negligence of the owner:

4. «While processing the request for a licence for the premises Haven 154-156 in the year 2000 the municipality of Edam-Volendam ignored the level of fire safety issued in the construction permits of July 13, 1993 and January 25, 1994. By asking the owner to choose between bringing the premises in agreement with these permits and requesting a new construction permit for the changes, the municipality would have respected the level of fire safety issued before. For as long as the actual state of the premises did not agree with the construction permit (either the old or new one), the municipality could have issued a licence for use. This licence should have included the condition that in the cellar, the ground floor and the first floor of the premises Haven 154-156 [at most] respectively 72, 81 and 72 persons may be admitted, being the maximum capacity of the available escape routes per floor. In this way the municipality of Edam-Volendam would at least have told the owner of the premises Haven 154-156 what was expected of him regarding fire safety, including the maximum number of admissible persons per floor.

This is not to say that observance of the conditions would have prevented the fire of January 1, 2001 to cause any victims.¹⁸⁶

5. (Radical) structural alterations in the premises Haven 154-156, which almost always have fire safety implications, were always realized without construction permit. When the municipality Edam-Volendam planned to legalize the alterations retrospectively, the owner showed little willingness to cooperate with the municipality within the time frame fixed by the municipality.

6. The owner of the premises Haven 154-156 has willingly and knowingly permitted the admission to the premises of more people than can be justified on the basis of fire safety. The owner should moreover have known, even without having been advised about it by the municipality, that it is irresponsible to suspend Christmas decoration in a way, and to an extent, as was done in his premises.»¹⁸⁷

The same kind of negligence is demonstrated with respect to the Christmas decoration:

«Christmas decoration.

In a letter dated November 30[, 2000, the municipality of Edam-Volendam] tells all owners of café's, hotels and restaurants in Edam-Volendam that Christmas decoration may only be used in accordance with the rules, and when impregnated. In December, compliance was checked in two establishments, including one of the largest in Edam-Volendam. The supplier of impregnant (Flame guard) was contacted by the fire prevention officer, and asked which establishments had reacted. Information was obtained which shows that a number of establishments actually realized this.¹⁸⁸ With some other owners talks have been held about the letter.»¹⁸⁹

¹⁸⁵ Summary pp. 47-8.

¹⁸⁶ Although it might have prevented the fire, its extent, and/or the speed of its expansion. Note furthermore that since its content is obvious and superfluous, the sentence reeks of having been inserted with the intention to soften the impact of the remainder.

¹⁸⁷ Summary p. 48.

¹⁸⁸ The numerous ambiguities or cryptic terms in this sentence are from the original. Note of JFCvV.

¹⁸⁹ P. 9/10, *Summary overview facts around licensing (Resumé feitenoverzicht rond vergunningverlening)*. (This is file 20010105_Kroniek vergunningaanvraag en -verlening).

The municipality failed in more duties than can and need be listed for the purposes of the description and analysis of the case and for the purposes of the present study. Only examples are mentioned. They may not be the most important.

«Conclusion: Preparation of population care insufficient.

The general conclusion about the preparation for disaster management in the framework of population care is that the municipal responsibility for adequate preparation has not been implemented.

The municipal processes in the contingency plan that was in force on January 1, 2001 in the municipality Edam-Volendam, a relatively small town, have not been worked out in terms of more specific plans and scripts. The plan does hardly or not specify the duties and responsibilities in the municipal organization. Therefore it can be concluded that this plan did not satisfy the requirements stipulated in the Law on disasters and severe accidents.

Furthermore it can be concluded that the municipal officers in Edam-Volendam who have duties in population care during a disaster were not educated, trained, or instructed.»¹⁹⁰

«In the municipality Edam-Volendam essential elements of the preparation for fighting disasters and severe accidents are lacking. The subjects “contingency plan” and “disaster management” are not alive, and hardly get attention. The contingency plan of the municipality is hardly more than a polished telephone directory. The municipal processes have not been worked out in terms of more specific (sub)plans. The plan does hardly or not ascribe the responsibilities for municipal processes. Therefore it can be concluded that the plan does not satisfy the requirements of the Law on disasters and severe accidents.»¹⁹¹

Sometimes the reports make comparisons with neighboring municipalities. They conclude that with respect to the matters under consideration the municipality of Edam-Volendam performs relatively badly.

In the Summary, the word fragment “liab” (as in liable and liability; in Dutch “aansprakelijk”) occurs only once, in the following sentence on p. 50:

«Investigations of third parties in connection with civil law liabilities are left out of consideration.»

This is not noted in the conclusions of the inquiries, but in appendix 1, titled “Plan for the coordination of the investigations by the supervisors of the fire in Volendam.”

The fire can nevertheless be seen as the inevitable consequence of the replacement of (strict) liability by debatable norms and inadequate supervision. As seen also in for example the financial system, the introduction of the euro, and the budget and debt management of states. It is very difficult to believe that the fire precautions would have been absent or sloppy,¹⁹² and the municipal letter¹⁹³ ignored (at least by some and fatally) if the owners knew that they would be held liable, and punished proportionally.

The sequel.¹⁹⁴

The following quote illustrates the attitude of the management of the café:

¹⁹⁰ P. 19, Summary, Report incident café fire New Year’s night 2001 (Rapport Incident cafébrand nieuwjaarsnacht 2001).

¹⁹¹ P. 19, Summary, Report incident café fire New Year’s night 2001.

¹⁹² See also chapter 3 of the report. Note that the misery was increased because smoke from café ’t Hemeltje (at the 1st floor) was blown into café Wir War Bar (at the ground floor) by a (dangerously) erroneous ventilation system.

¹⁹³ Which even gave the addresses of two suppliers of impregnants.

¹⁹⁴ This section is mainly based on news reports. Those of NU.nl have been collected in a single file, which can be found in the directory Volendam.

«Laura Veerman, manager of De Hemel¹⁹⁵ and daughter of owner Jan Veerman, put the instruction aside: too much ado. In her own words in an interview with [large newspaper] De Telegraaf the letter came “too late” to do what it wanted: “the decoration had already been hung up”.

Since November 30, the Christmas decoration had plenty of time to dry out. When, as rumored, a startled boy held a bundle of “little stars” against the spruce decoration, the dried needles immediately caught fire.»¹⁹⁶

«The mayor and aldermen of Edam-Volendam accepted full responsibility for the deficiencies in the licensing of café De Hemel. This was declared by mayor F. IJsselmuiden on Friday [January 2] in the beginning of an extra meeting of the municipal council.

The penitential robe does not mean that the municipality resigns. “At this moment we don’t consider that step, because especially now the municipality should be able to function completely. The municipality doesn’t want to leave the ship because that would create an administrative deadlock, unless the council thinks differently” according to the mayor.

The council, which consists of six fractions, has approved the proposal of IJsselmuiden. When the situation in the town has normalized and all inquiries are finished, the political situation will be considered anew.»¹⁹⁷

«On Friday the police and public prosecutor have announced that a criminal investigation of father and daughter Veerman has been started. They also disclosed that the boy who caused the fire has died. [...]

The municipality will not be criminally prosecuted, and therefore municipal officers neither. The reason being that none of them has done something criminal. It is up to the municipal council to decide whether the municipality has made errors. [...]

The public prosecutor furthermore concluded that it is implausible that the owner of the premises complied with the gentleman’s agreement for café’s, hotels and restaurants. This agreement stipulates that people of 16 years or less can only be admitted when accompanied by someone of 21 years or older. From the fact that one third of the victims is younger than 17 years the public prosecutor concludes that it is not plausible that in the night of the fire the café owner stood by the agreement.

The conclusion is that Veerman did not stand by his agreements with the municipality and did not develop a plan to implement the improvements in another way. Therefore a criminal investigation has been started of mr. Veerman and his daughter, to find out whether they can be charged with either fire and death through fault (at most 1 year imprisonment), or death through fault (at most 9 months imprisonment).»¹⁹⁸

«The mayor acknowledges administrative responsibility. But he thinks he cannot bear personal responsibility for something he didn’t know: that the life endangering situation in the café had been handled far too accommodatingly. According to IJsselmuiden something had been done, but not enough, to force owner Veerman to make the necessary changes.

“The errors made must be weighed by the municipal council. My duty lies in the town, I have to make sure of relief and that everything goes well”, the mayor said. [...]

About the telephonic congratulations of [commissioner] Van Kemenade after the council meeting of Friday [January 2] the mayor said: “He wanted to comfort me in hectic times. The commissioner phoned about the course of the council meeting. He spoke appreciatively of the acceptance of responsibility and congratulated me with the unanimous support of the council. He said it would be irresponsible to leave Edam-Volendam without a municipality.”»¹⁹⁹

Of course the municipality should have known about the accommodating policy towards owners like Veerman, and that it means taking avoidable risks. The mayor (and aldermen) should have made

¹⁹⁵ Hemel= Heaven. The inquiry reports speak of “‘t Hemeltje”, little heaven.

¹⁹⁶ NU.nl 5/1/01 15:02.

¹⁹⁷ NU.nl 5/1/01 20:16. The declaration of the mayor is unnecessary, an open door: it is simply a fact that the municipality is responsible for the deficient licensing.

¹⁹⁸ NU.nl “Published: 5-1-2001 18:53, Last changes: 8-1-2001 17:15”.

¹⁹⁹ NU.nl 8/1/01 20:28.

sure before the accident, and not only afterwards, that everything goes well. If the mayor and aldermen are not responsible, who is? Did they delegate any authority?²⁰⁰ To whom? If not, how can they say they are not responsible because they did not see something? Since nobody can see everything, such a defense is equivalent to saying that they can never be responsible, and that nobody is responsible. The fact that the accommodating attitude was of long standing means that it was a policy, and that they must or should have known. This fact makes them responsible, administratively and personally. If the job meant acceptance of an unbearable responsibility, they should not have accepted it, let alone aspire it.

Commissioner of the queen Van Kemenade for the province of North Holland, a career politician, gives an example of how politicians help and shield one another.

Schalken about prosecution of the municipality.

«It is very well possible to prosecute the municipality for errors made in policy. This was asserted on Sunday [January 4, 2001] by prof. T. Schalken, professor of criminal law at the Free University of Amsterdam, in [the radio or TV program] Buitenhof in a discussion about the café fire in Volendam.

According to Schalken, the second Pikmeer judgment offers an opportunity for prosecution. The conclusion of the first Pikmeer judgment was that the municipality cannot be prosecuted. Even last Friday the public prosecutor alleged at a press conference in Zaanstad that on the basis of that judgment, the municipality Edam-Volendam cannot be prosecuted. According to Schalken the High Court goes back on that in a second judgment: “unless it concerns an exclusive duty of the administration”. That means: duties which cannot be privatized. In the opinion of Schalken, the job of a fire department can be privatized quite well. If the owner of café De Hemel is prosecuted for blamable causation of death, then there is every reason to consider the municipality as accomplice, according to Schalken. [...]

Schalken is of the opinion that the punishability of the municipality should be included in the investigation, if the municipality admits having made serious errors. [...] He thinks it is rather odd that ministers and governments are always excluded from questions of guilt: “The law says that politicians can be prosecuted. But in one and a half century it has never happened”. He therefore advocates a debate about punishability of authorities. “The debate about this question isn’t closed”»²⁰¹

The criminal trial of the owner of the café and his closest employees (summer 2003).

The following is quoted from a major Dutch newspaper:

«The citizens of Volendam are divided about the verdict of the court of [the city of] Haarlem, which yesterday [July 18, 2003] sentenced owner Jan Veerman to conditional imprisonment of twelve months and 240 hours of public service. Veerman’s café manager and his daughter were acquitted of involvement in the fire. He himself is not allowed to head a café, hotel or restaurant for two years. Chairman R. Toeter of the court decided that there were sufficient grounds for imposing an unconditional sentence, but that this would deprive Veerman of the opportunity “of arranging a settlement which would be satisfactory for all those concerned.”²⁰²

Toeter stressed that no punishment can do justice to the pain and sorrow of the victims of the disaster and their relatives. The court furthermore took account of the failure of Veerman to adequately express feelings of sympathy with the victims and their relatives. On the other hand the court also took account of the fact that Veerman lost a nephew in the fire, and of the often burdensome attention of the media. [...]

²⁰⁰ Maybe they are not allowed to, by law.

²⁰¹ NU.nl 7/1/01 14:00.

²⁰² Note that this argument can be used to set every criminal free. And of course a truly satisfactory settlement is impossible since it was obvious that Veerman would never be able to pay even a minor part of whatever could be compensated, and since much irreparable damage was caused: settlement will not raise the dead nor heal the mutilated.

Two weeks ago the public prosecutor demanded sixteen months unconditional imprisonment, the maximum penalty for this kind of transgressions. For manager John Veerman (no family of the owner) the prosecutor demanded ten months, for daughter Laura of the owner three months. They were acquitted because they had only very limited authority to take independent decisions concerning the establishment.

The lawyers of the three Veermans had requested acquittal. In a reaction shortly after the verdict lawyer W. Anker said to be “reasonably content”. “Laura and John have been acquitted. For Jan Veerman it means a lot that his daughter was acquitted.”

According to the court Veerman, as operator of the establishment, had been “substantially negligent, inattentive, and thoughtless”. He should have taken care that the emergency exits and the Christmas decoration were in order, and that not too many people were admitted. The court considered the maximal work penalty fitting to redeem Veermans guilt with respect to society, and as retribution.

The court rejected the charges of the prosecutor concerning economical transgressions by Veerman. The charges concerned infringements of the local construction ordinance and the law regulating drink, café's, hotels and restaurants. Next week the prosecutor will decide whether it is going to appeal against the verdict in the cases of Jan Veerman and John Veerman.»²⁰³

The daily newspaper Trouw of 2/8/03²⁰⁴ adds:

«The publican was sentenced because of fire, death, and severe injuries through fault.»

The employees «were acquitted because they had only very limited authority to take independent decisions concerning the establishment». Does the court mean that they had no independent responsibility, even though lives were at stake? No duty to observe failings, request compliance with law and/or ordinances, to request improvements, to report to authorities or, ultimately, media? The court implicitly endorses the dictatorship principle: only the highest boss is responsible, and he or she for everything. The explanation of the court doesn't mention nearly half of the relevant truth, and fails dangerously.

The «substantially negligent, inattentive, and thoughtless» are a rather weak terms for expressing reckless and fatal negligence, of which the owner must have been very well aware, given the history described earlier. Construction and fire ordinances are not made just to waste paper.

Toeter mentions redemption and retribution as arguments or effects. Given the extent of the harm caused, it is clear that the penalty is extremely disproportional (insignificant). The owner will never be able to recover even a small part of the harm he could and should have prevented. A satisfactory settlement between Veerman and the victims is simply impossible. The presumption is simply ridiculous. It is shameful to require the victims to find and accept some compromise between themselves and Veerman. (In their and my eyes a criminal). It is just as bad that the judge does not mention and did not take account of the preventive effect of the penalty on owners, managers and employees of other café's, hotels and restaurants.

Note that the court permits someone who for over ten years was «substantially negligent, inattentive, and thoughtless» and systematically ignored the relevant ordinances, to continue his former activities already in two years:

«In the opinion of the court this measure is necessary because during the trial he [the owner] has insufficiently shown himself to be aware of his responsibilities as café owner».

In other words: even such a terrible accident did not teach him a lesson. How can one allow such a person to continue with similar activities as before?

The penalty of 240 hours of public service seems at most suitable and proportional for someone who accidentally violated a reasonably important ordinance, *and if no serious harm has been inflicted*. Conversely: how would this court penalize such a violation?

Is it possible that the penalties have been kept light because the municipality was just as fatally negligent, inattentive and thoughtless, but is not even prosecuted, let alone punished?

²⁰³ NRC 19/7/03. The verdicts of the Court of Haarlem can be found in a file dated 20030718 in the dossier Volendam.

²⁰⁴ In file 20030719_Strafzaak tegen Veerman Volendam.rtf in the dossier:

At the same date, 2/8/03, Trouw reported as follows about the appeal:

«If owner Veerman of the café reaches an agreement with the victims of the New Year fire about damages, this may also end his criminal trial. Both Veerman's lawyers and the public prosecutor are willing to discuss withdrawal of the appeal, if the victims and Veerman agree about damages.

Yesterday the public prosecutor announced that he will appeal against the verdict of the court of Haarlem in the trial of Jan Veerman. Veerman was sentenced to conditional imprisonment, and therefore remains free for the present. According to the prosecutor, the sentence fails to do justice to the seriousness of the events.

Both prosecutor and lawyers point out that the court's verdict stresses that the parties in Volendam make every effort to reach an agreement.²⁰⁵ Veerman's sentence of imprisonment was conditional for the express purpose of giving him the opportunity "of arranging a settlement which would be satisfactory for all those concerned."

The parties in the criminal trial now say that they want to talk with each other when victims of the fire and their relatives succeed in reaching agreement about damages with Jan Veerman. The prosecutor and lawyers of Veerman do not exclude that in the end they will both decide to call off the appeal as yet.»

The newspapers report more unsavory matters, such as attempts to manipulate public opinion against those who want to see Veerman punished and demand damages. The articles corroborate the impression that the court gave much greater weight to the interests of the accused than to their misconduct of years and its consequences, and to the interests of society.²⁰⁶

The aftermath.

Information on the website of the Fund for the Victims of the New Year fire Volendam (FNV) shows that a settlement was reached.²⁰⁷ A total amount of 40 M€ seems to have been made available to help the victims. Of this amount, 1.9 M€ is the proceeds of the sale of the café by Veerman. In exchange the victims have to end all 214 procedures against the municipality and Veerman. Note: not only those against Veerman, but those against the municipality as well.

The overwhelming part of the 40 M€ "has been made available by the [central] government". Which means: is paid by the tax payer.

No news report or document mentions or discusses personal liability or punishability of municipal officers.

The author has searched for a systematic overview of the developments in the years 2001-2010 (or a later end date). The search produced little more than fragmentary information. Such as the newspaper articles quoted above, and the management reports in the annual reports of the FNV. The only systematic overview that the author could find was in the periodical Som.²⁰⁸ Namely on pp. 27-30 of number 3 of 2010. It is limited to essentials. It is valuable because it considers matters in perspective. Two quotes:

«*Apart from the organization of an advice and information centre shortly after the fire, the municipality played no role in the coordination of the follow-up care. But there was real need of direction. Two citizens of Volendam therefore recruited capable persons from the population, and set up the Fund for the Victims of the New Year fire Volendam (FNV) to serve the interests of the victims of the fire and their relatives. The members of the board were chosen on the basis of specific competencies and all got a committee under them. "In the first days the municipality was too busy with the media and the matter of liability", declares Erik Tuijp, chairman of the FNV. Involvement*

²⁰⁵ Take note: the parties, so including the victims. Why would the court have any authority over them? Don't forget that already two and a half years have passed since the fire, and no agreement about damages has been reached.

²⁰⁶ In the Trouw of 18/7/03 one reads: «*The public prosecutor has requested "spicy" sentences, said court chairman R. Toeter sympathizingly to manager John Veerman during his trial*». If this is true, Toeter has lost all feeling for proportions. And is unfit for his job.

²⁰⁷ <http://www.slachtoffersnieuwaarsbrand.nl/>. Consulted 13/10/13.

²⁰⁸ The complete issue can be found in the directory Volendam, under 20100930. The article is titled "De lessen van Volendam" (The lessons of Volendam). The author is Marieke van Dogenaar.

of the municipality was a sensitive topic. A part of the population of Volendam was of the opinion that the disaster could only take place due to failure of the municipality. If compliance with the rules had been supervised better, it would not have gotten this far.

The combination of fund raising, medical, financial, fiscal, juridical and insurance-technical knowledge meanwhile turned out to be very effective. The lobby to get the government install an inquiry commission bore fruit. Upon advice from the commission Van Lidth-de Jeude the government made 30 M€ available for the victims of the fire and their relatives. Part of the money was used to set up a polyclinic and a center for follow-up psychosocial care in Volendam. The remainder of the money was meant as compensation, to help victims and relatives to reconstruct their lives. FVNV and the municipality were made responsible for the management of the government money. “Together with the 9 M€ from the fund raising, which all passed through our Fund, a substantial amount was available for the victims”, according to Erik Tuijp.²⁰⁹

That the money made available up to that moment was insufficient,²¹⁰ and that problems kept tormenting victims, is shown by a quote from p. 5 of the management report in the annual report of the FVNV over 2005:²¹¹

«That the activities of FVNV are still important is proven by recent developments in the field of medical care and re-entry into the labor market. Already before the introduction of the new care system it had become clear that the attitude of care insurers changes. At the end of 2005 problems arose for a number of victims. Where doctors indicated that an operation of a victim was necessary from a medical point of view, the insurers claimed that the purpose of the proposed operation was cosmetic. This attitude caused much unrest, and may cause financial and psychic problems. Operations considered necessary by medical experts possibly cannot be done. By now the FVNV has taken the first steps in the direction of national politics and others to ask attention for this problem, that requires a speedy solution.»

This is just one of the consequences of inadequate supervision, liability and punishability.

Note finally that the owner was not adequately insured.

8.13. Q-fever in the Netherlands (2006-2010).

Conclusions.

1. From 2006 to 2009 the number of people in the Netherlands infected by the bacterium which causes q-fever rose more or less exponentially.
2. By July 2011 about 100.000 people in the Netherlands had been infected. By 2018 74 people had died of it. It is estimated that about 250 of the chronically ill will die of it.²¹² Approximately 15% of the infected people had to be treated in a hospital.²¹³ An unknown number of people became chronically ill, and is practically incurable. These people have to live with more or less serious handicaps.²¹⁴ Most victims had nothing to do with the (causal) goats or goat farming.
3. There is no information showing that the ministries for public health and agriculture have evaluated the risk of the spreading of q-fever and the consequences of the disease for people, and translated the results in policy before 2010 and in a responsible way.
4. The ministry of agriculture seems to have seen the interests of goat farmers as an inviolable value, and to have assumed that it knew and understood these interests.²¹⁵

²⁰⁹ Pp. 28-9 of the article.

²¹⁰ Or inadequately compartmentalized, coupled to deficient conditions etcetera. In other words, there sometimes may be enough money, but it may not be available for specific problems or applications.

²¹¹ This and some other FVNV annual reports are included in the directory of this section.

²¹² Ph D thesis of Sonja van Roeden. OmroepBrabant.nl 8/9/18.

²¹³ P. 18, Report Van Dijk.

²¹⁴ The present author was unable to find reliable specifications and frequencies.

²¹⁵ In this sentence, “value” is understood as part of “norms and values”: what is considered important, *in practice* (as opposed to verbal claims). The norms play the part of boundary conditions.

5. The government policy regarding q-fever was the result of negotiations between dishonorable incompetent people, on the basis of simplistic opinions. It was not the result of responsible decision making on the basis of all relevant knowledge²¹⁶ and generally accepted norms and values.
6. That the disease could make so many victims is the consequence of blamable omissions of the two most responsible ministers.
7. It has been said that economic interests prevailed over the interests of public health.²¹⁷ This suggests something like rationality. The economic interest is only served however if illness and death create net added value, and if making innocent victims is free of cost. That is, if an increase of costs of medical care and lifelong support of victims are counted as contributing positively to economic welfare.²¹⁸ And if justice and human welfare count for nothing.
8. The two ministers nevertheless maintain that they made no important errors.
9. There is no indication whatever of control by parliament. For a long time parliament just asked questions, and took the answers for gospel. Only in December 2009 did it begin to press for clarity and effective action.²¹⁹
10. Neither the evaluation commission Van Dijk nor ombudsperson Brenninkmeijer seems to have investigated what happened inside the two most responsible ministries.
11. The reports of commission Van Dijk and ombudsperson Brenninkmeijer are useful, but insufficient to effect correction.
12. All principal persons, including the members of parliament, of the evaluation commission and the ombudsperson, lack the necessary integrity and competence.
13. The victims or their relatives have not been compensated, or only microscopically. Liability law doesn't seem to exist or work, and the government is not forthcoming.²²⁰

The report of the commission Van Dijk.

There is a report *From rejection to elevation* of an evaluation commission q-fever.²²¹ The pdf-file of the report is dated 19/11/10. The evaluation commission was installed by the ministries of agriculture and public health. On the basis of experience it must be assumed that the members of the commission were selected by the ministries. Without exception the members are professor and Ph.D. «Within the commission, the following disciplines are represented: human health, veterinary health, public management, agricultural sciences, and communication».²²² Chairman was prof. dr. ir. G. van Dijk.

About q-fever.

«The bacterium, *Coxiella burnetii* (*C. burnetii*), which causes q-fever, can infect many species of animals, but cattle, sheep and goats are seen as the most important reservoir. The germ is spread worldwide. [...] Infection percentages can run into several dozen percent. This is not accompanied by major problems of animal health. In these species the disease in general develops without external symptoms, although it may cause abortion (“rejection”), sometimes even at a large scale (“abortion storm”). In that case the animals introduce large numbers of bacteria into the environment, and create

²¹⁶ Including that about risk management.

²¹⁷ P. 57 of the Report Van Dijk, a little bit below the middle of the page. Further down it is said that the two ministers deny this. But all evidence contradicts their denial.

²¹⁸ Of course, in economics up to at least 2020, waste (and crime) contributes just as much to national income and economic growth as activities which are valued positively by the great majority of the population, and contribute to what could be called national capital. The q-fever creates a lot of work “opportunities”, including political discussions (waste).

²¹⁹ P. 57 of the Report Van Dijk, a little bit under the middle of the page.

²²⁰ In september 2018 it promised a maximum compensation of 15.000 euro (about USD 17.000) per case.

²²¹ Abbreviated “Report Van Dijk”, after its chairman. It can be found in the dossier under 20101119. The Dutch title is *Van verwerping tot verheffing*.

²²² P. 8 Report Van Dijk.

an infection risk not only for their likes, but also for people. [...] The bacterium can survive and remain infectious outside its host.»²²³

«3.2. The disease in people.

After inhaling only about ten bacteria infection of *C. burnetii* can occur in people.²²⁴ The micro-organism multiplies itself in the lungs and is spread throughout the body by the blood.

In the majority [= %?]²²⁵ of infected people the disease causes no complaints. That infection took place is only shown by the presence of specific antibodies, which can be found in blood tests. If health complaints and abnormalities occur, the phenomena of a q-fever infection are not specific, and indistinguishable from those of many other infections (of the bronchial tubes), such as influenza. In children, the disease passes more often [= %?] without complaints than in adults.»²²⁶

The last paragraph is incomplete in essential respects. The symptoms are compared with those of influenza, without specifying them. This only informs people who know the symptoms of influenza. The similarity with influenza is at most temporary. The long term effects of influenza and q-fever can be very different. Nothing is said about the (im)possibility and costs of a cure, the time needed for recovery, and the percentage of infections ending in permanent damage and invalidity. All kinds of specifications are missing.

According to p. 18 of the report, the q-fever caused 16 deaths in the years 2008-2010. In the same period it has ruined the lives of very many more.²²⁷ To get infected you only have to walk or cycle within a radius of 700 m (say half a mile) of an infected goat farm.²²⁸ Without ever knowing that you passed a goat farm. Let alone that it was infected with a very dangerous and very contagious disease.

The glossy *Gerda*, published by the ministry of agriculture, and named after its minister, is not likely to exaggerate the symptoms. It nevertheless gives a poignant example of the effects of an infection. The speaker is Jacqueline van den Bos.

«"Always painful joints. Concentration problems. And tired, tired, tired. Sometimes I simply don't know how to begin the morning." Jacqueline van den Bos was on vacation in Sevilla, in the south of Spain, when all of a sudden she fell down from fever. For five days she had a temperature of 40.1 degrees centigrade. Her husband, a general practitioner, had patients with similar symptoms in his practice in Helmond [Brabant, Netherlands]. Therefore she had her blood tested in a hospital. "When I heard the outcome, q-fever, I still thought: just some antibiotics, and I'm rid of it." Ten months later Jacqueline knows better. She has a cure for a year, without the certainty that her body will ever be free from the disease. She was psychodiagnostic co-worker, marriage officer, voluntary member of the board of a fund, student of Spanish, sporty walker, shopmother of adult daughters, you mention it. From this fizzy life the bubbles have gone. "Everything becomes less. I do what I have to do. The pleasant things have become impossible." In November, together with some other victims of the disease, she has begun setting up an association of q-fever patients. On the internet she has started a social network enabling people to share knowledge and experience. "There is so much that isn't known yet. Q-fever broke out in 2007, but initially the consequences were underestimated. Attention for the Mexican fever overshadowed the disease. Only now [2010] care and attention increase. That stings. According to me the government reacts reactively. While we can invest in research, and can learn from knowledge abroad. I hope that this development will now accelerate."»²²⁹

²²³ Selected from section 3.1 on p. 16 of Report Van Dijk.

²²⁴ The present author would say: Inhaling only about ten bacteria may cause development of the disease in people.

²²⁵ A "minority" may be any percentage between 0 and 50. In other words: it may be a lot of people. If a single person would not already be quite undesirable...

²²⁶ P. 17, section 3.2 of the Report Van Dijk, unabridged.

²²⁷ The present author could not find a reliable estimate. Probably at least partly because the government doesn't want us to know.

²²⁸ Report ombudsperson. Search for "700".

²²⁹ P. 25 of *Gerda*. Publication of the ministry of agriculture. In the dossier under 20100310.

More examples of experiences of victims can be found on pp. 25/31 and following of the report of the ombudsperson. They show that the commission Van Dijk took the disease insufficiently serious, or tried to play it down. Its description of the consequences for infected people shows remarkable similarities with that of the minister in a letter about the q-fever to parliament:

«Most infections of people develop unnoticed or as a mild fever. In more serious cases the disease begins with the sudden onset of a heavy headache and high fever. In most cases the q-fever vanishes spontaneously after one or two weeks. Sometimes it is necessary to apply an antibiotics cure. In the case of the rare chronic form a long term treatment is given.»²³⁰

Both commission and minister use the elastic terminology of “most” and “majority” in a way that seems calculated to suggest that “only a minority” of cases is really bad. But a minority may be 49%, and neither commission nor minister gives percentages (or numbers). Nothing is said in clear and understandable language about the serious cases, the difficulty of treatment, and what is left of well-being in the incurable cases. It seems that commission and minister think the truth can better remain hidden. It is hard to explain such an opinion by other reasons than self interest of members of government, and an obliging attitude of the commission (selected and appointed by the government). In other words: it can only be explained by a serious lack of integrity.

From the point of view of costs an important (methodological) error is made if the attention is only proportional to the relative numbers of affected persons. Without taking account of the degree of seriousness of the effects. A small number of seriously affected people can cause much higher costs than a much larger number of marginally affected people. Not only because of the costs of treatment, but also because seriously affected people cannot work, and produce no income. And this apart from emotional and other immaterial damage. In this regard both commission and minister show incompetence.²³¹ The error is similar to an error made in the run up to the financial crisis: risks are judged according to their probability, without taking account of the consequences of realization.

About incubation periods and the possibility of infection of human by human the report says nothing.²³² The Wiki page q-fever asserts: «On the average the incubation period is twenty days, but it can vary from 14 to 39 days.»^{233, 234}

There is little or no attention for costs and benefits.

Remarkably absent in the report is an evaluation of the misery caused for people, of the risk of new outbreaks, and of the possibilities to prevent new outbreaks and/or limit spreading and damage.

The numbers about dairy goat farming on p. 16 of the report show an increase in the number of dairy goats from 98,000 in the year 2000 to 231,000 in 2009 (in 612 instead of 838 farms). The commission seems to consider it self-evident that dairy goat farming can be continued (and grow?) indefinitely.

Not a word is spent on compensation of the victims, and who is to pay. Words with “liab” are not to be found in the report.²³⁵ Notwithstanding the availability of statistical data, the government’s policy is evaluated in the abstract, in terms of unspecified and unquantified interests of farming and public health.

On the attitude and policy of the ministries concerned.

²³⁰ Parliamentary documents (Kamerstukken) II, 2007-2008, 2852, quoted on p. 12 of the report of the ombudsperson. The report doesn’t say which minister is speaking. (Because of the strong time dependency of the reports about new cases (Report Van Dijk p. 19) it is to be regretted that the report of the ombudsperson does not give the date of the letter).

²³¹ Or (once more) a lack of integrity. As often, incompetence and lack of integrity are communicating vessels.

²³² A search for “incubatie” gave no result..

²³³ The Dutch version of Wikipedia, 13/10/13. The page is in the dossier.

²³⁴ In this period the infected person may be a source of infection for other people.

²³⁵ The word “compensation” (“schadevergoeding”) does not occur in the report. (The word “damage” (“schade”) is used only or almost only for the farms).

Although the possibility to copy or quote parts of the report has been disabled,²³⁶ some paragraphs from the conclusions should not be withheld from the reader. They are quite informative.

«A remarkable point concerns the different ways of working c.q. differences in “policy logic” of the two ministries regarding “the proof” that dairy goat farms were the most probable source of infections of people with q-fever. In the opinion of the ministry of public health it was sufficient proof that the human cases were clustered around dairy goat farms with abortion outbreaks. For this ministry the fact that goats and sheep were the most frequent source of outbreaks of q-fever in man was sufficient as a basis for the first interventions. The ministry of agriculture kept pointing to the absence of scientific proof of causality. In her perception, this was necessary with regard to the juridical testing of measures which was to be expected. That both ministries stuck to their points of view delayed the development of measures and confused outsiders, in the communication with those concerned.»²³⁷

That this is the “perception” of the ministry of agriculture is no more than a hypothesis. Another hypothesis is that they didn’t believe it at all, but only considered it a suitable argument to prevent action.

The commission does not evaluate (weigh) the “differences in policy logic”.

«In her policy the ministry of agriculture has for a long time let itself be led by the idea that *C. burnetti* can be found everywhere in the environment, and that this fact on its own was an adequate explanation for the human cases of q-fever. With respect to the consequences this hypothesis turned out to be untenable when after 2007 the number of human q-fever cases increased steadily, something this hypothesis could not explain. The epidemiological proof of dairy goat farms as source of the infections became stronger when it was found that the percentage of infected people was inversely proportional with the distance to a goat farm where an abortion storm had taken place. In addition measurements of tank milk as from the beginning of 2009 showed, that contrary to what was expected, [by whom?] most dairy goat farms were not infected by q-fever. Thereupon the ministry of agriculture adjusted its idea, and became willing, from that very same moment,[?]²³⁸ to plan interventions which were directed specifically at infected dairy goat farms.»

What a coincidence that the ministry of agriculture believed in a hypothesis which made action with respect to dairy goat farms unnecessary! And how remarkable that the evaluation commission does not note this coincidence. And what a pity that it does not explain and evaluate the basis of the original assumption of the ministry. It was incorrect, so proof cannot have existed. The commission should have asked more people in the ministry (and probably in another way).²³⁹ Shouldn’t the ministry always have understood that its idea was no more than a hypothesis, with a very soft or absent basis at that?

«In their reaction to the q-fever outbreak,²⁴⁰ both the ministry of agriculture and the ministry of public health have acted too hesitatingly. In the opinion of the commission the administrative action perspective was delayed too long by disagreement about the scientific foundation of the interventions.»²⁴¹

It is to be regretted that the commission has not explained how the disagreement between the ministries could have been resolved much earlier. On the contrary: the commission seems to be of the opinion that the assumptions of both ministries were equally legitimate, and that the ministry of agriculture was converted the very moment the proof of its error was given. This is obvious nonsense, which ignores the underlying real problem of “powerplay”. Of course this underlying problem is not limited to the q-fever, not to say that it poisons most social questions. The time lost by the

²³⁶ Even though this is a public report, paid fully 100% with tax receipts.

²³⁷ This is conclusion 3 of pp. 109-10.

²³⁸ Is this supposed to mean that the ministry of agriculture saw the light in a flash, and acted immediately? This is unbelievable, since this is simply impossible both for people and this kind of organization.

²³⁹ It would have found that not everybody (or hardly anybody) believed in the ridiculous assumption.

²⁴⁰ There actually were more outbreaks, if not a more or less gradual development.

²⁴¹ This is the beginning of conclusion 6 on pp. 110-1.

disagreement has produced many unnecessary victims. In other words: the problem of power compensating for untenable ideas was one of the most important problems in the handling of the q-fever. By ignoring this problem the commission misleads the public, and fails to contribute to its solution.

On risk management.

The commission Van Dijk gives no attention to the risk management of either ministry. Supposing the ministries had something like risk management. The commission did not ask for specification and accounting of the way risks and possible actions were weighed. Neither did it ask for the ways in which an inventory of risks and costs was made, and how risks and costs were quantified. Not in its recommendations (“lessons”) either. Lesson 4 on p. 112 of the report, about the participation of independent experts, is no solution. At least: it does not help solve the disagreement problem. Repetition can only be prevented if irrational and erroneous ideas are pointed out and accepted as such, irrespective of the power of the people defending them, without unnecessary loss of time. The commission notes that initially the danger of the q-fever was underestimated. How could that happen? Was the estimate well-founded? How does one estimate the risk and potential consequences of an (infectious) disease?²⁴²

At the top of p. 85 of its report the commission says to be of the opinion «**that at the moment of an outbreak one should first of all follow the most probable hypothesis**». This simplistic prescription is not optimal, and even very risky. It is incompatible with what is known about optimal decision making. It is exactly what bankers and supervisors did in the years before the subprime crisis, and what made that crisis possible. The prescription ignores the fact that improbable events may have much more important consequences than the probable ones. That for that reason one should take account of all hypotheses which may have irreparable or unbearable consequences. One should take into account all possibilities of which the product of probability and consequences may be significant.

With its prescription to accept the most probable hypothesis, the commission makes a grave error, which has had and can have disastrous consequences.

But even if the prescription would be accepted there is a problem. For it can only be applied if it can be determined which of a number of hypotheses is the most probable. And if this can also be determined in cases where parties disagree as to the most probable hypothesis, as in the case of the q-fever. About this question the commission is silent however.²⁴³

Remarkable is finally that the commission always speaks in terms of the ministry this or the ministry that, and never mentions any person. While it is evident that the assertions cannot be true for everyone in the ministries. The report implicitly assumes that the internal structure and internal operation of a ministry are irrelevant. It ignores the fact that the minister is the only one with real authority and responsibility.

The report “I’m sorry”- About q-fever and the human measure of the Dutch national ombudsperson.

The report is dated 19/6/12. The cover has a photo of two touring bicycles against the fence of an empty paddock of what looks like a farm.

The pages 25-38 of the report (of approximately 40 pages) are devoted to some of the horror stories of victims.

The following quote is the unabridged judgment of the ombudsperson.

«Judgment.

²⁴² Ministries have more than enough money to pay the best experts.

²⁴³ One might say that this should be determined by independent experts. But even this is easier said than done. Like this commission, the experts will be selected by the ministries... The reports of many commissions of “independent experts” show that the members are neither sufficiently independent nor expert.

The National ombudsperson is of the opinion that the government has been insufficiently open and clear by failing to actively provide citizens with information. In this way it even contributed to stress in society. In the opinion of the National ombudsperson this is not proper.

During the q-fever epidemic the government paid insufficient attention to the citizens. It did not reflect on what the citizen might need from the government during an epidemic, and also did not involve the citizen in the problem of the uncertain risk of the q-fever. The National ombudsperson is of the opinion that by not involving them actively in its dealings, the government did not act respectfully as regards its citizens. In the opinion of the National ombudsperson this is not proper.

The National ombudsperson is of the opinion that the government acted with insufficient concern, and gave insufficient priority to finding solutions, by trying too long to get certainty and irrefutable proof about the transferability of the bacterium. In this way the government failed to act energetically. In the opinion of the National ombudsperson this is not proper.

The National ombudsperson is of the opinion that the negative answer of the minister of public health- who is the spokesperson of the government for matters relating to the q-fever, and in which she asserts that the existing regulations for medical care and social security are sufficient to repair the consequences of the q-fever- of December 22, 2011 is incompatible with decency. This proposition [of the government] can only be based on the assumption that the rise and spreading of q-fever is an ordinary phenomenon like other illnesses which can afflict people. It thereby fails to appreciate the role of the government in the q-fever epidemic. It is evident that the choices made by the government in the fight against the q-fever justify the conclusion that by damage to their health, certain citizens or their relatives are or were prejudiced in such a way that reason demands compensation. By concentrating on justification of its conduct, without thinking seriously about the perspective of individual citizens and what they need to go on, the activities of the government were not adapted to the actual needs. The government has shown itself insufficiently concerned and gave insufficient priority to finding solutions. In the opinion of the National ombudsperson this is not proper.»²⁴⁴

The sentence «In the opinion of the National ombudsperson this is not proper» looks like a model formula. It may have something to do with the regulation of the ombudsperson. It is anyway remarkable that the judgment has a yes-no character, and gives no gradation. It does not distinguish between more and less proper.

The pages preceding the judgment are more open. The following is the larger first part of the section Precautionary care.²⁴⁵

«Precautionary care.

The National ombudsperson is furthermore very critical about the way in which the government dealt with the uncertain risk of q-fever. From 2006 to 2009 the minister of agriculture (and because of the relation of dependency with respect to that ministry the minister of public health as well) assumed that q-fever would disappear of its own. It was a disease of animals which apart from abortions in goats would have few consequences. According to the ministry of agriculture, the transfer of the disease from animal- goat- to man had not been proven irrefutably. For a long time the ministry claimed that it was necessary to confirm by DNA testing that the C. Burnetii bacterium of goats had migrated to people. Only in 2009, when the consequences of q-fever began to get very serious proportions- the epidemic seemed not to disappear of its own- this requirement was dropped. The very strong requirement of a causal relationship barred the way to research assuming (only) plausibility of the transfer, and prevented that other research and corresponding measures got priority. It is illustrative that the declarations of the former ministers Verburg and Klink, and those of their officers, during the investigation, stressed the fact that only when it became possible and practice to test tank milk in 2009, it could be established exactly which farms were sources of q-fever, and that only application of the new test showed that the epidemic could be tackled effectively by clearing these farms. Until that moment one had worked on the basis of initially voluntary reports of abortions by goats when the percentage of these abortions exceeded 5%. If this explanation is accepted, the

²⁴⁴ P. 20/26 Report ombudsperson. (As always) Obscurities and what may be (linguistic) errors have been kept in the translation. In other words: don't expect too much clarification from consultation of the original text.

²⁴⁵ Pp. 18-9 of the report of the ombudsperson.

question arises why no efforts had been made earlier to develop a test for tank milk of goats when such a test was already available for other dairy cattle. It would only require adaptation of an already existing test. It seems that neither ministry gave priority to collecting all information with the help of research, and instead stressed the importance of the instruments for fighting q-fever effectively. For setting priorities it was important that for a long time q-fever was not seen as a serious illness,²⁴⁶ and that, as the commission Van Dijk concludes, as a consequence of the dominant influence of the ministry of agriculture, human health was not the priority in fact finding, initiating research and the implementation of measures.

The system world of the government gives a detached answer however: the knowledge was insufficiently certain, the privacy of the goat farmers played a role, and the government could be held liable.²⁴⁷ With respect to all of these points the government made errors of judgment. Where public health is at risk, it seems quite unlikely that the judge will decide that in order to protect the privacy of goat farmers no information may be given to people living in the neighborhood. The ministers moreover did not put such questions to a juridical test, but based themselves on assumptions. The motivation regarding the certainty of the information is no good either. And how certain should one be before giving information?»

Like the commission Van Dijk the ombudsperson does not ask for specification of, and accounting about, the weighing of risks and actions. Like the report Van Dijk the report of the ombudsperson presents the case in a way that suggests that action is a matter of influence, of giving in and refusing to give in.

Note that requiring certainty is equivalent with denying the need of risk management.

The report seems very critical, but the ombudsperson is prejudiced nevertheless. At the beginning of the report, immediately behind the title page, there is a page with the following text:

«The citizen has the right to be treated properly by the government. And let us be clear: in general he really is treated properly. But the government does not succeed always. In that case it is good that someone who feels hurt or treated unjustly, can apply for protection by an independent institution. That institution is the National ombudsperson.

The National ombudsperson contributes to the reparation of confidence in the government. He does so by sharing his knowledge with government departments, initiating investigations, or helping people with unnecessary bureaucracy. An investigation of the National ombudsperson can be concluded with a report. These reports are public, and published on www.nationaleombudsman.nl»

The text explicitly assumes that a priori the government can be relied upon to serve the citizen. Given public knowledge, the terminology «in general he really is treated properly. But the government does not succeed always.» is very remarkable. It suggests that the government always tried and tries to keep the citizen informed, to eliminate avoidable risks, to compensate for the damage it caused or could and should have prevented. It would have been more neutral and objective to say: “in general he really is treated properly. But not always.” (I’m not suggesting that this is true). The case of the q-fever alone provides more than enough evidence showing that the government does not always try to treat citizens properly. The ombudsperson himself says so. But he did not rectify the incorrect propaganda on the inside front cover.

The two ministers deny any wrongdoing.

²⁴⁶ Note that politicians can easily mislead themselves by selecting down playing employees and inquiry commissions, and basing themselves on too soft evaluations. And of course, by lacking the necessary abilities and willingness to understand things by themselves.

²⁴⁷ “The system world of the government” is a misleading metaphor at best. More probably, on the basis of the present inquiry, the phrase is no more than misleading fiction, a dishonorable effort to depersonalize misconduct by those responsible. The true cause of the government’s misconduct would seem to be a arrogant and incompetent top with the characteristics listed in chapter 9 below..

The first paragraphs of the “Consideration” on pp. ii-iii, signed by ombudsperson Brenninkmeijer, are the following:

«‘I’m sorry.’

At the end of the hearing about the consequences of the conduct of the government and especially the former ministers Verburg [agriculture] and Klink [health] and their officers with respect to the q-fever, a woman who still suffers from the consequences of a q-fever infection said: “I miss three words: I’m sorry”.

In my opinion these words give a terse summary of a sentiment which was widely shared among those present in the Province House in Den Bosch. The ex-ministers Verburg and Klink both presented a smooth story about their efforts to tackle the q-fever in 2006 to 2009. But with their explanations they succeeded insufficiently to establish a connection with the feelings of the patients in the auditorium. Before the hearing I had told the patients to expect that on the basis of the opinions of the evaluation commission Van Dijk the ex-ministers would come offering their apologies. Instead they explained laboriously and sometimes coercively that apart from some points of minor importance they nor the government did anything wrong. This gave the impression that the consecutive commissioners of the queen, Maij-Weggen and Van de Donk, had no reason for repeatedly sounding the alarm. Because in the province of Brabant one began to feel that The Hague [that is: the government] did not see the required urgency. They [the ex-ministers] suggested positively that the conclusions of the commission Van Dijk were not serious, and did not require reflection on their own conduct.»²⁴⁸

This is the same song as sung by for example the commissions De Wit, FCIC and the EU Committee of independent experts.²⁴⁹ But none of the commissions analyses this any further. In their recommendations all of them ignore this irresponsible attitude.

The remainder of the consideration concerns the difficulties and pros and cons of hearing ministers and their subordinates under oath. In the opinion of Brenninkmeijer, the results of the hearings were poor. He blames this on the method of questioning, which he chose himself. Comparison with other inquiries and cases shows that it is highly improbable that the method is to blame. No method of questioning has produced reliable explanations. It seems much more probable that Brenninkmeijers aim would not have been realized in any setting. The experiences of many other commissions and other opportunities for accounting show that politicians never admit serious wrongdoing, and never admit responsibility for disastrous consequences of their errors. It is to be regretted that the “consideration” remains rather descriptive, and does not note that the attitude of the ex-ministers is entirely unacceptable. Namely because as holders of public offices they are obliged to give a full account of their actions, omissions and motives, and subordinate their personal interests to their public responsibilities.

Brenninkmeijer does not explain why a citizen should have confidence in a government that does not distance itself unambiguously from ministers who badly failed and refused to admit serious wrongdoing. In other words: a government which subordinates the interests of the population to the personal interests of two colleagues.

8.14. Outlines of some other Dutch cases.

The fight against the mafia in the Netherlands, and the cooperation between Dutch and Italian police and prosecutors.

The Argos broadcast of 16/11/13 concerned the low priority of the fight against the mafia in the Netherlands, the lack of effective cooperation with Italian police and justice, and the lack of convincing accounting. The broadcast was full of representatives of the Dutch police and public prosecutor who were clearly lying.²⁵⁰

²⁴⁸ P. ii/4 Report ombudsperson.

²⁴⁹ The equivalent judgment by the last commission is quoted in the section on Van Buitenen. Search in this chapter for “slightest sense” (of responsibility!...).

²⁵⁰ An MP3 file with the broadcast is in the dossier, under 20131116.

Three examples of irresponsible (local) government projects.

The following are examples of projects which were extremely risky since they were hardly more than wishful dreams, and since nobody understood them in any practical sense. Unpleasant “surprises” were certain. The only questions being what they would cost, and whether they would be fatal to the project. The projects are:

- The communication system C2000 for the police, fire departments and ambulance services;
- The project Blauwe stad (in the province of Groningen);
- The North-South line of the Amsterdam metro.

In all cases the original budget was exceeded by large (relative) amounts.

There is a report of the Dutch general accounting office about C2000 as a project, but no report about the completed system.²⁵¹ Completion had been planned for January 1, 2004. Even years after “completion” the system failed when most needed. It could not be relied on. Later developments, say since 2010, are unclear, possibly because too many political parties are involved, and all have an interest in keeping silent about it. In 2018 it still does not work properly.²⁵²

Evaluations of the projects Blauwe stad and North-South line can be found in the dossier.²⁵³

In general, governmental decision making about projects is inadequate, and not compatible with available knowledge. It is dominated by dogmatic thinking and political pressure. By people lacking both integrity and competence. There are no fundamental differences with the decision making about the ICT-projects in the ministry of education, as seen in the first chapters. See also the *International Handbook On Mega-Projects*, edited by Priemus and Van Wee,²⁵⁴ and the report *Expansion of highways- necessary or superfluous?*²⁵⁵

C2000 may be considered as an ICT project. By now enough money and effort may have been put into the system to make it useful for at least some purposes. This does not change the fact that the efficiency of the invested money and the system are very doubtful, and that the number of failed ICT-projects in governmental organizations is uncountable. In 2007 and 2008 the Dutch general accounting office published two very soft but still somewhat useful reports about ICT project management in the Dutch government.²⁵⁶ The ministry of education simply ignored them.

As the present inquiry has shown, it is not the ICT character that is the cause of the problem. The cause of the problem is the false pretensions of politicians and governments and the top of the government organizations. The financial crises and the failure of many other projects have exactly the same causes.

Medical care supervision.

The Medical Care Supervisor (MCS) has a long record of failure in dealing with malfunctioning physicians. It fails to adequately protect patients against such physicians. It even sidetracked and fired supervising officers who dared to give the interests of patients a higher priority than those of physicians.

The Dutch radio program Argos gave several examples, and presented them very well. Their analyses however are no better than superficial. Whatever happens is considered incidental. Even if the evidence is incompatible with “human error”. There is no deeper analysis. No structural problems are ever conjectured or looked for. None of Argos’ conclusions can end the structural dysfunctioning. Which is definitely not meant to deny that the Argos inquiries and reports are valuable. They show a lot more than 99% of the newspapers and news bulletins.

²⁵¹ The report of the accounting office is in the dossier, under 20030612.

²⁵² Zembla.bnnvara.nl 16/5/18 en 11/6/18. The government has invented a new trick: C2000 nears the end of its life, it is the new, replacement system of which some gaps remain to be filled. Rijksoverheid.nl 24/9/18.

²⁵³ Under 20090603 and 20091210 (North-South line), and 20100702 (Blauwe stad).

²⁵⁴ *International Handbook On Mega-Projects*, edited by Hugo Priemus and Bert van Wee, November 2013, 480 pp, Hardback 978 1 78100 229 2, ebook ISBN 978 1 78100 230 8.

²⁵⁵ *Uitbreiding snelwegen: nodig of overbodig?* In the dossier under 20131130.

²⁵⁶ In the PPP dossier, under 20071129 and 20080701 respectively.

In one series of programs Argos reported about a kind of whistleblower in the MCS who resisted inaction against a physician who was a danger for his patients. He was fired. He was going to fight his discharge in court. Argos did not follow the lawsuit, and did not report about the conclusion of the lawsuit or the further adventures of the whistleblower.

The case of physician Jansen Steur shows the same characteristics as other MCS cases. It shows not only dysfunctioning supervisory and judicial systems, but also dysfunctioning in the hospital where the physician worked. It shows the arrogant mendacious personality of the physician, his lack of self-knowledge. It shows self protection at all costs. And last but certainly not least it shows the lack of whistleblowers, and inadequate reactions to well-substantiated reports of victims.²⁵⁷

As in many or even all cases, the failings of the MCS could and should have been noted by parliament (or the responsible minister), and much earlier than Argos or others did. At least if it really tries to control government and its agencies, as its members frequently pretend.

Education supervision.

There are quite a few well-documented examples of its failure. In the course of time, several failures of the education supervisor resulted in scandals. They gave rise to doubts about the quality of education. To the embarrassment of the whole education sector, the education minister and parliament. But apparently least of all the supervisor. About the following examples reports can be found in the dossier:

- A fraud concerning subsidies of higher professional education, investigated in 2002-2003. Even in 2011 this fraud was still vividly remembered in the education ministry;
- Various kinds of serious lack of quality and integrity control at InHolland, a large institution for higher professional education (2011);
- Illegal use of subsidies by Stenden, another institution for higher professional education (2011).
- Financial mismanagement at Amarantis, a group of schools for secondary education, threatening its bankruptcy (2012).

In none of these cases the supervisor had given timely warning.

The supervisor never made any of the remarks discussed in the section on education or science in the Analysis part of chapter 7.

Supervision of animal care and meat production.

The Dutch ministry of agriculture is infamous for the priority it gives to financial interests of the agriculture sector, at the cost of everything else. Especially at the cost of the public health. As seen in the example of the q-fever given above. The Argos broadcast of 4/12/10 supports the hypothesis that the q-fever example is representative for a corrupt ministry, or at least a corrupt management. The programs of 13/11/10 and 4/12/10 show that the ministry successfully tries to make the food and commodity supervisor adopt the same policy.²⁵⁸ Part of the information presented in the programs stems from a whistleblower from the food and commodity supervisor. Somewhere in 2007 she had received an unpublished report on animal health and handling. The report noted all kinds of infringements of regulation, such as the marketing of meat of sick animals, deadly transportation methods, and putting pressure on vets in slaughterhouses. She had tried to get attention for the report. In her (well-founded) opinion something had to be done with it. The management told her that the time wasn't right. When she asked when the time might be right she got no answer. She didn't use the whistleblower regulation because she didn't think any of her colleagues could be relied on, and because (by then) she didn't trust the regulation and the system.²⁵⁹ She resigned 1/1/08. A month later

²⁵⁷ Basic information on the case Jansen Steur can be found in the dossier. An overview can be found in the book *De affaire Jansen Steur* by Tom Zijlstra (Aspekt, ISBN 9789461539649, 2016).

²⁵⁸ Of course the top of the supervisor is selected and appointed by the ministry. The supervisor is meant to be financed by the sector, but- as shown in the program- isn't.

²⁵⁹ Of course all on good grounds. The regulation prescribes cooperation with an integrity officer appointed by the management. The same problem existed in the ministry of education.

she gave the report to two organizations for animal rights. One of them put it on its website. This gave rise to pandemonium.

In parliament, on March 26, 2008, minister Gerda Verburg of agriculture invited whistleblowers to step forward. She said that the government should have a safe whistleblower regulation. The present whistleblower was nevertheless prosecuted. On Monday December 6, 2010 she had to appear before the criminal court of The Hague. She was charged with having leaked secrets, or information which she should have understood to be secret. However, nothing in the report suggested that it was confidential or only a draft. It was known to people outside the ministry and supervisor.

As far as the present author knows, Argos did not tell how the story of the whistleblower continued.²⁶⁰

Note that this case was contemporary with the q-fever.

High risk animal sheds.

The Argos broadcast of 16/10/10 showed that the relevant construction regulation does not protect people and animals adequately or acceptably. The reason being that an increase in costs would negatively impact the position of Dutch firms relative to international competitors. The reason is untenable because it would disappear when action is taken internationally, or by the EU. The main problem is the lack of fire protection. Animal sheds may contain hundreds or thousands of animals, even tens of thousands chicken. In general, in case of a fire, the whole shed will burn down, with all animals. There is no obligation to compartmentalize sheds or take other measures preventing a complete burn down. More generally animals are treated with a shameful lack of feeling and respect. Very regularly tens of thousands of animals are killed for one “good” reason or another. The supposed need for large scale killing campaigns does not however give rise to efforts at reduction of the probability of having to resort to them.

The Otapan.

The supervisor for environment and transport is part of the ministry for housing, regional planning and environment. Its failure with respect to gassed containers was seen earlier in the present chapter. It also failed with respect to the handling of the Otapan, a freighter for chemical waste, prior to its demolition. The ship contained about 77 tonnes of asbestos. EU regulation forbade exportation to Turkey. Dutch authorities nevertheless gave permission for exportation, so that it could be demolished in Turkey.²⁶¹

Trafigura and 100,000 victims of illegal dumping of chemical waste in Ivory Coast.

The same supervisor failed in the following case.

In August 2006 a ship of the British company Trafigura, the Probo Koala, delivered a load of chemical waste in Abidjan, the capital city of Ivory Coast. The load was dumped somewhere near Abidjan.

The following quotes are copied from the “chronology” in a report of Amnesty International and Greenpeace.²⁶²

«10 November 2006. A civil claim is filed by 30,000 Ivorians in the High Court of England and Wales against Trafigura for damages for personal injury.»

²⁶⁰ The Argos program suggests that the action of the whistleblower led to improvements. This isn't noted in the main text because of lack of evidence showing that the supposed improvements are more than words, appearance and/or temporary. In the q-fever case no fundamental or substantial improvement is noticeable in minister or ministry. And obviously, there was no safe and adequate whistleblower regulation.

²⁶¹ For more information see the report “De casus Otapan”, in the dossier under 20121120.

²⁶² Pp. 11-14 of the report. The report can be found in the dossier under 20120930. Its title is *The toxic truth. About a company called Trafigura, a ship called the Probo Koala, and the dumping of toxic waste in Côte d'Ivoire.*

«31 January 2007. Over 100,000 people are registered as having sought medical consultation between 20 August 2006 and 31 January 2007.»

«13 February 2007. Trafigura and the state of Côte d'Ivoire reach a settlement. Trafigura agrees to pay CFA 95 billion (approximately US\$ 195 million).»

At an earlier date the ship had tried to offload its cargo in Amsterdam. Police were investigating the matter, but the ship left before action was taken. The following quote is a conclusion from the report of Amnesty International and Greenpeace:

«Although Trafigura was convicted in a Dutch court of illegally exporting the waste from the Netherlands, the company was given immunity from prosecution in Côte d'Ivoire. Trafigura claims the dumping and its aftermath were not its fault.

The investigation undertaken by Amnesty International and Greenpeace concludes that Trafigura's claim lacks credibility. The investigation also establishes that many governments contributed to the tragedy by failing to uphold international human rights and environmental law and the law of the sea. They continue to fail to take adequate measures to prevent such corporate crimes in future, to redress the suffering of the victims, or to hold the perpetrators to account.

Such failures entrench impunity for corporate crimes. Although Côte d'Ivoire responded quickly to the crisis, the then government gave Trafigura sweeping legal immunity from prosecution in exchange for a financial settlement. The Netherlands— the country in the best position to act to ensure that Trafigura's waste was dealt with properly— failed to act lawfully and contributed to the violation of the right to health of the people of Abidjan. Trafigura Ltd., a company based in the UK that directed the operations on board the Probo Koala at several critical points, has never been investigated or prosecuted by the UK authorities.»²⁶³

Note that this is one more example of a disastrous failure to act by a government and one or more of its agencies.

Historical cases.

8.15. Louis XIV and the writing of history.

This section summarizes results of an inquiry which was made more than a year after completion of the first version of *Governed by lies*. The results show that and how history books help prevent the improvement and correction of the organization of society. The subject of the section, king Louis XIV of France, is accidental.

The section has the following parts:

1. Main findings of the inquiry.
2. The history of this section.
3. Saint-Simon's Memoirs and French public finance around 1700.
4. Saint-Simon's biography in a nutshell.

In this section, “Louis XIV” is abbreviated “L14”. This is meant to symbolize disrespect. It is convenient as well. The grounds for disrespect are explained below.

Main findings of the inquiry.

The inquiry shows that most histories paint a rosy picture of L14. The rosy picture is false. It is false at least if human life and welfare are taken seriously. L14 was a man of mediocre abilities. Kingship required more than he could provide. He had more than a million men killed in unnecessary wars. He caused widespread economic hardship. At his death, he left France in a very bad shape.

The rosy picture can be understood as the heritage of the royal appearance of L14 as a person, of false propaganda, as a failure to look beyond the façade, and as a failure to correct for a personal

²⁶³ P. 3 of the Amnesty-Greenpeace report.

mental preference for a positive (“optimistic”) instead of negative (“pessimistic”) picture. When making up the balance of the reign of L14, influential historians ignore most of the costs of the wars. In addition they evaluate L14 in terms of his own norms.²⁶⁴ This is a method which by definition, in other words always, yields a positive picture.

L14 did not make France great. He made France and Europe suffer. He laid the foundation for the French revolution and the military and economic supremacy of Germany with respect to France.

Truthful and balanced histories may exist, but they didn’t cross my path. If they exist, they must be the exception. They certainly are not the rule.

The relatively influential historical publications which were studied in this inquiry do not show that the grandeur of L14 is a propagandistic façade.²⁶⁵ They present it as the relevant truth. They do not show that the façade hides a ruler and underlings without any practically relevant respect for human life and welfare. They do not expose the ease and mechanisms with which this kind of ruler can find like-minded or at least subservient collaborators and, with their help, can control the population. The histories do not show that arrogant, dishonorable, and incompetent government, and the absence of effective correction mechanisms, have horrible consequences. The histories implicitly or explicitly claim that the norms and values of a given era are defined by the (mis)conduct of the rulers. They ignore the fact that fundamental norms and values like integrity and respect for human life and welfare were and are recognized by almost all common people. Throughout all ages, and by all religions. None of the history books studied comes close to mentioning the death toll of the wars of L14. In fact, it exceeds a million men.

The rosy kind of history writing is harmful because it accustoms people to think like politicians. That is: to think in terms of fantasies, and to disregard human life and welfare. It serves historical and present powers. It supports the continuation of deadly politics. Such an attitude actively helps prevent corrections which are necessary to prevent avoidable catastrophes of various kinds.

Mechanisms for the correction of false history writing, for example by Academies of Science, are found to be ineffective or entirely absent.

The time of L14 is not best characterized by the main modern historians, but by the satires and epigraphs written by Parisians upon hearing the news of his death:

A satire:

«*Cy-gist le Roi des maltôtiens,
Le protecteur des usuriers,
Le vil esclave d'une femme,
L'ennemi mortel de la paix.
Ne prions point Dieu pour son âme
Car le bon Roi n'en eut jamais*»²⁶⁶

²⁶⁴ Disregard for the suffering caused by the wars does not prevent widely distributed histories to praise the innovations in the organizations of armies and warfare (meaning more effective and more efficient killing).

²⁶⁵ This refers to the following publications:

- Voltaire, *Oeuvres historiques*, R. Pomeau (ed.), Bibliothèque de la Pléiade, Gallimard, Paris, 1957. The volume contains the *Siècle de Louis XIV*, and the *Précis du siècle de Louis XV*. It has a useful chronology. It contains several other works, but not the *Histoire du parlement de Paris*. The best available edition of that work seems to be the one in the John Adams Library in Boston USA. A scan of this book is downloadable from archive.org (the Internet Archive). The book does not mention a publisher. Later editions can be found in Wikisource and Gallica.bnf.fr. All editions have errors. I have tried to construct a corrected version of the 1775 edition. This is not yet available on the internet.
- R. R. Palmer & Joel Colton, *A History of the Modern World*, 4th edition, Knopf, New York, 1971, (I)ISBN 394-30386-3. The chapters 20 & 21, pp. 187-202 (inclusive), are about L14.
- Jean-Christian Petitfils, *Louis XIV*, Perrin, Collection Tempus, mars 2018, 895 p., ISBN 978-2-262-07504-0.
- Philippe Erlanger, the article *Louis XIV* in the Standard Edition CD-ROM of the Encyclopaedia Britannica 2002.

²⁶⁶ Y. Coirault, Mémoires de Saint-Simon, T5, pp. 618-20. “T5” means: tome (= volume) 5.

An (other) epigraph :

«On feint le roi enterré dans la caisse des emprunts.

Icy Louis quatorze emplit

Ce que si bien il désemplit.»²⁶⁷

For specification, substantiation and supplementary information the reader is referred to the publication *French public finance 1690-1725 and the writing of history*.

The history of this section.

The inclusion of this section in *Governed by Lies* (GbL) can only be understood against the background of inadequate history writing. The section reports about an inquiry which was made to obtain a reliable picture of L14.²⁶⁸ The inquiry concludes that available histories report selectively, and are biased in favor of L14.²⁶⁹ A trustworthy history could not be found. The truth could not easily be discerned.

The original goal of the inquiry was very limited. I only wanted to know whether readable stories about specific subjects could be distilled from the Memoirs of Saint-Simon. I wondered whether Saint-Simon could be made more accessible for a wider public. My acquaintance with Saint-Simon dates back to the 1990s, or 2001 at the latest. Sometime in that decade I noticed his Memoirs. I wondered what they taught about the operation of a court. I was interested in the operation of a modern ministry, and surmised that an 18th century court might have relevant similarities with a ministry.²⁷⁰ The memoirs might be helpful because publications describing the reality of organizations like a ministry are rare or nonexistent.

The memoirs are very extensive. In the Pléiade edition they cover about 1000 pages in each of 8 volumes.²⁷¹ As a consequence, and due to other activities, I had not completed reading the memoirs in 2019, although I had begun in 2001. I had stopped reading in 2005, around the time that I became involved in the policy portal project. When writing the first versions of GbL, I saw no reason to say something about Saint-Simon or his memoirs. It seems that the idea that Saint-Simon might contribute more than a text for *Related thoughts*²⁷² did not occur to me.

Completion of *Governed by lies* gave time to resume reading the memoirs. The work of the years after 2005 had taught a lot. It had answered many questions. As might be expected, it transformed the set of questions I was interested in. An important new question being: how could cases like those discussed in GbL be possible, if history education is sound? Would the cases be possible if people knew about the large gap between the necessary and actual competencies of high officials, and if they understood the many harmful and sometimes disastrous consequences of this gap? I thought not. In other words: it seemed to me that the phenomena observed in the cases are incompatible with sound history education. But I didn't understand. I had read many history books. Amazingly enough, I had no remembrance of serious shortcomings. Something must have escaped me. What?

The first thing I noticed after resumption of Saint-Simon's Memoirs, was that L14 had left a crippling debt. The debt caused long lasting economic hardship, financial chaos, and distrust of king and government. I looked up what various history books told about public finance under L14 and under the regency following his death. This led to the discovery of various kinds of inadequate history

²⁶⁷ A. de Maurepas & F. Brayard (editors), *Les Français vus par eux-mêmes- Le XVII^e siècle*, Laffont (Bouquins), Paris, 1996, ISBN 9 78221 065174, p. 1046.

²⁶⁸ A body of knowledge is called reliable if it includes all available observational knowledge, and does not contain any inconsistency. A piece of information is called reliable if it is compatible with a reliable body of knowledge.

²⁶⁹ The memoirs of Saint-Simon are not counted as a history of L14.

²⁷⁰ By now it seems to me that the similarities with a ministry are hardly significant. The operation of the court of L14 does however seem to be similar to that of the world of politicians in and around governments.

²⁷¹ The volumes also contain the “additions” by Saint-Simon to the Journal of Dangeau (another duke-courtier), and (excellent) notes by Yves Coirault. As a consequence, most volumes have more than 1500 pages.

²⁷² At the very beginning of the present report (GbL).

writing. Such as very disproportional attention to specific subjects, in combination with a complete lack of explanation of the selection method.

Because of the importance of the public debt, I thought it was necessary to give at least a minimal explanation of its origin. This led me to take a better look at the wars of L14, the major source of the public debt. The effort to get a reliable picture of the wars of L14 revealed even greater inadequacies in the history books. Their reporting about the wars is shamefully insufficient. Both in an absolute sense, given the human suffering they caused, and relatively, with respect to the information given about Versailles, Colbert and (other) supposedly great accomplishments of L14. At this point it became clear that one of the ways in which history books (can) mislead without anyone noticing is by disproportional reporting and being silent about facts which do not fit in the preconceived picture or desired conclusion.

The most shocking observation was only made after the provisional completion of *French public finance 1690-1725 and the writing of history*.²⁷³ At a given moment it struck me that I had no total number of the people killed in the wars of L14. I had not seen such a number anywhere. None of the books even gave a list of the wars, let alone with the numbers of people killed.²⁷⁴ Still, I found this to be a very reasonable question, and would be ashamed if a reader would look for it in vain.²⁷⁵ It took quite an effort to find the required numbers.²⁷⁶ Which seems to be a significant observation in itself. I only found estimates for the major wars. For one or two minor wars no number could be found at all.²⁷⁷ The lowest estimate of the total was more than a million. (The highest estimate exceeds 2 million. Both estimates exclude indirect deaths). In my opinion it is extremely significant and shameful that no important modern history book mentions this number. In my own texts, I had to replace “tens of thousands” by “hundreds of thousands”...

Saint-Simon's Memoirs and French public finance around 1700.

Due to their length and chronological order, Saint-Simon's Memoirs are rather uninviting. At the same time they are exceptionally valuable. The reason being that Saint-Simon is a very honorable person, very intelligent, and, at least as regards his writing, exceptionally insensitive to authority and to social pressure. He observes and describes many relevant persons and phenomena. He does so with less restraint and bias than almost everyone else. His observations and verbal portraits are among the best and most relevant one can find anywhere, for any era.

For some purposes the chronological order of the memoirs is very inconvenient. The chronological order makes it difficult to obtain an overview of what the memoirs say about a specific subject. The memoirs can be seen as a cord of many threads. The threads being the more or less autonomous histories of specific subjects. Each history-thread is broken off and taken up at irregular times. It is quite a bit of work to find the parts belonging to a specific subject. The question therefore arose whether a practical method can be devised to create a readable and interesting text out of the sections in the memoirs concerning a specific subject. It was found that this can be done.²⁷⁸

In order to develop a practical method, I chose public finance as the subject (“thread”). There are several reasons for this choice. The first one being its obvious importance. A second being the possibility of comparison of the state of affairs around 1700 with that of the present. This reason is the more compelling since the financial crisis of 2007-2013 is one of the main subjects of GbL. A third reason is the fact that clarity about the financial affairs is necessary for the evaluation of L14. What was the state of French public finance at the end of his reign? Had he been a good steward?

The importance of the subject does not imply that a meaningful history of the subject can be extracted from the memoirs. Indeed, it is found that a continuous financial history cannot be extracted

²⁷³ Underlining the “without anyone noticing” in the previous sentence.

²⁷⁴ Even though the book of Petitfils has more than 750 pages, or about 230,000 words.

²⁷⁵ The reader is reminded of the fact that this work is dedicated to the victims.

²⁷⁶ I had no practical access to a university library.

²⁷⁷ Of course, it may exist somewhere.

²⁷⁸ The single most important “instrument” being the digital Chéruel-Médusis edition of the text of the memoirs. It was supplemented by concordances with other editions. The numerous background studies by Boislisle of assertions in the memoirs were very helpful. According to the present author Boislisle deserves great praise (and reprinting!). His work is very gratefully acknowledged.

from the memoirs. It cannot even be done if one accepts an impressionistic picture. The reason being that Saint-Simon explicitly and consciously tries to keep his distance from the subject. Though not consistently. There may not even be enough documentary evidence anywhere to construct a more detailed (reliable) history. Still, for the purposes of the present inquiry, enough documentary evidence could be found elsewhere to obtain a sufficiently clear and unambiguous picture of the state of affairs.

The most important finding being that L14 created and left a very large debt. The debt was mainly caused by wars.²⁷⁹ The question therefore had to be answered: were these wars necessary or avoidable? Who or what was responsible? In other words: the inquiry had to be extended to the wars of L14. The result was shocking. It turned out that the wars were unnecessary. They made very many victims. After acquainting oneself with the reality of these wars, one is left confused. Because the reality of the wars and L14 is completely at odds with the picture painted by most history books of a “sun king” as creator of an “age of grandeur”. Because of the evidence, L14 can much better be called “blood king”.²⁸⁰ The grandeur was a façade. It was the product of a propaganda machine. Even in 2020, after 200 years, the main history books still ape the propaganda of L14.

Before completing this section it may be useful and respectful to tell somewhat more about Saint-Simon.

Saint-Simon's biography in a nutshell.

Saint-Simon is one of the most instructive and exceptional authors mentioned in GbL. As shown by the quote in *Related thoughts* in the beginning of the report, the objectives of his memoirs are similar to mine. Works with such objectives are rare. At the same time, as regards the era and circumstances in which he lived, Saint-Simon is one of the most “remote” authors mentioned in GbL. In particular for understanding the memoirs, it may be useful to sketch his biography. This will also indicate a few of the main differences between his and our mental world.

Saint-Simon was born in Paris, in the night 15-16/1/1675. He was the son of Claude de Rouvroy, duc de Saint-Simon et pair de France, and Charlotte de L'Aubépine. King Louis XIV and queen Marie-Thérèse were his Godparents. He was named Louis, after the king. At the time of his birth, his father was 68, and his mother about 35. He had a half-sister, and no other brothers or sisters. At his birth, his half-sister was 28 years. His father died in 1693.

Saint-Simon was largely educated at home, by his parents and by a governor and a tutor. In 1691 he attended the Académie de Mesmont et Rochefort. He was an army officer from 1692-1702. He participated in the siege of Namur (1692), the battle of Neerwinden (29/7/1693), and in campaigns in Germany (1694) and Alsace (1697).

He began writing memoirs in 1694.²⁸¹ The memoirs concern public life. They discuss aspects of private lives only when Saint-Simon considers them relevant for understanding public life.²⁸²

In August 1695 Saint-Simon married Marie-Gabrielle de Durfort de Lorge. As long as they lived they had an excellent relationship. (Gabrielle died 7/10/1725). Saint-Simon valued the counsel of his wife highly. He had an aversion to financial affairs. Therefore Gabrielle took care of the financial affairs of the family.

On 3/2/1702 the Paris parliament accepted Saint-Simon as duc et pair. Which also means that he became a member of this parliament. In the round of army promotions of the same year Saint-Simon was passed by. He felt this as a serious injustice. As a consequence, possibly in combination with an affinity or preference for history and writing, he changed the army for the court of Versailles. A step which L14 explicitly disapproved.

Except for a few interruptions, Saint-Simon stayed at court until the death of Philippe d'Orléans in 1723. Saint-Simon was eight months younger than Orléans. Notwithstanding major character

²⁷⁹ When I started the inquiry into Saint-Simon and French public finance, I was not aware of the significance of the wars of L14. I think this is at least in part a consequence of the history writing this section is about.

²⁸⁰ Even though many other kings and heads of state have just as much right to such a title.

²⁸¹ Y. Coirault, T1, Chronologie. It may be better to say that he began making notes for memoirs.

²⁸² Approximately, and my interpretation.

differences, Saint-Simon and Orléans were lifelong friends. (Neither Saint-Simon nor Orléans had closer friends, excepting their wives).²⁸³ The death of Orléans left Saint-Simon without powerful friends at court. And many enemies. Henceforth, until his death in Paris in 1755, he lived at his family chateau (a day's journey from Paris) and his house in Paris. He spent his time managing his estate, and writing and editing his memoirs and several less extensive works.²⁸⁴

8.16. The constitution and operation of the early governments of the USA.²⁸⁵

The USA has sometimes played a positive role in the history of mankind. When it did, it did so by saving people from repressive dictators. On the other hand, it also kept such dictators in power. The large scale murder of the original inhabitants of North America and the destruction of their culture, the war with England, the civil war, the late entries in the first and second world wars, the maltreatment of the League of Nations and the United Nations, and the failure to improve international organization and law (since it would endanger its supposed leadership), the many years it took to adopt the Genocide Treaty, its failure to comply with the prescriptions of this treaty, and its disproportionate contributions to the destruction of the natural environment, to give a few of the more important examples, rather make it an example of how not to do things. Even its irresponsible internal political processes show that as a state it cannot serve as an example.

It is quite clear that there never was good reason to be optimistic about the course of the political development and history of the US. This much can be concluded from the debate about the draft US constitution, as chronicled by the two volumes 62 and 63 of the Library of America. As a confirmation of the correctness of much of the criticism expressed in the debate, the history of the administrations of Jefferson and Madison (1801-1817) by Henry Adams unambiguously shows that a messy US government is not something of the 21st century.²⁸⁶ Already soon after the creation of the USA the phenomena feared in the debate on the constitution could be observed as they can be observed today. If they could not be seen at work in contemporary reality they could at least be inferred as matters of principle on the basis of common sense argumentation. Where “as matters of principle” is meant to allow for the possibility that around the year 1800 one could not reliably imagine the world of 2000, and understand that a minor difficulty around 1800 would become a major one around 2000. In practice the gap between the world of the authors of the US Constitution of around 1800 and that of around 2000 is difficult to imagine. The power of the president, caused in part by the much increased size of public administration and importance of international affairs,²⁸⁷ may have grown far beyond the proportions intended by the Founding Fathers.

This is not to say that the USA is exceptional in any sense. In connection with the war between the USA and England,²⁸⁸ Henry Adams shows that the government of England is a mess just like that of

²⁸³ This may be only approximately true. I know of no evidence or information to the contrary, at least as regards the combination of quality and duration.

²⁸⁴ Personal note. I do think that Saint-Simon is one of the very few historians deserving great respect. I do not say or think that he was perfect. But I do wonder whether one can be more honorable and competent, for the jobs one has chosen or accepted to do, than Saint-Simon. He did what he thought was his duty and could do best, in social respect, and given the circumstances. He refused to accept jobs he thought or knew he could not fulfill properly. In modern eyes he gave far too much attention to nobility and its role in the state. But this may be due more to a defect in our understanding than to an idiosyncrasy of Saint-Simon. Many texts in *Les Francais vus par eux-mêmes- Le Siècle de Louis XIV* (A. Niderst (ed.), Laffont (Bouquins), Paris, 1997, ISBN 9 782221 065167) show the importance of matters of precedence in this era. Another reason for relativity being, that it seems to be rather doubtful whether present day “democracies” are substantially better than 18th century kingship.

²⁸⁵ This section was one of the last of this work to be written.

²⁸⁶ Henry Adams, *History of the United States of America during the administrations of Thomas Jefferson (1801-1809)* and – *James Madison (1809-1817)*, Library of America volumes 31 and 32, ISBN 0-940450-35-6. The *History* was first published in 1889-1891.

²⁸⁷ Permitted by the constitution, without proportional growth of control or supervision mechanisms.

²⁸⁸ According to the front flap of the jacket of volume 2 of Henry Adams History of the USA “the most bungled war in American history”.

the USA.²⁸⁹ The war seems to be a sequence of blunders, if not by the American side then by the British or both. Of course it cost thousands of lives. Adams also shows that Napoleon was no more than a power hungry swindler.

Note that at present there is no significant discussion about the US Constitution. Weaknesses of present presidents or governments are not related to the Constitution (or to the law in general). Constitutional weaknesses are not identified or recognized, and no efforts are made to improve it. Apart from the systemic improvements (measures) discussed in chapter 9, points for improvement would seem to be: very substantial reduction of the power of the president, especially by the transfer of powers to the states, extension of liability and punishability to responsible government officers, power to the people to replace anyone they have chosen anytime, powers of initiative and amendment of laws for the people, and abolishment of the right to bear arms.

Fifty years after the governments of Jefferson and Madison, the government of Lincoln does not betray having learnt any lessons. If only to expect the unexpected.

8.17. Comparison of the case Dreyfus of around 1900 with the case Spijkers of around 2000.

Conclusions.

1. The duty of an army is to protect the state. The state primarily being defined by its constitution and laws. In the Dreyfus affair the top of the army, with an important exception, acted contrary to its duty. It violated the constitution and acted illegally. It harmed the state very badly. It put hypothetical interests of some of its members above those of the state. It abused its monopoly position as the main armed force to resist or even fight people who defended the state.
2. The Dreyfus Affair began in October 1894 with the arrest and prosecution of army captain Alfred Dreyfus. He was accused of treason, but completely innocent. The trial was illegal. It was manipulated for the purpose of convicting Dreyfus. Around the time of the trial, no efforts were made to find the truth. All efforts were directed at getting Dreyfus convicted. To prevent revision of the verdict, high military officers ordered "proofs" to be fabricated.
3. For years, the military top, and those politically responsible, systematically opposed inquiries and the administration of justice. They not only denied errors or wrongdoing, but committed crimes in order to cover errors and crimes. They were utterly dishonorable.
4. In the top of the army, mutual loyalty was an inviolable value, more important than any other duty.²⁹⁰ Lieutenant-colonel Picquart was a crucial exception. He considered integrity and justice more important than this kind of loyalty. A century later, in the Spijkers case, people like Picquart could only be found in the lower echelons.
5. In French politics around 1900, tacit interparty loyalty was not the norm. New cabinets (governments, groups of ministers) felt free to break with policies and decisions of predecessors. None of the cases of a century later shows anything similar.
6. The injustice towards Dreyfus and Picquart caused much deeper and wider indignation than similar cases a century later. The indignation was more effective too. Around 1900 influential people kept fighting for justice, and did not even give up in the face of apparently decisive setbacks. A century later there was some indignation, but it was neither strong nor effective.
7. The Dreyfus affair triggered widespread aggressive (if not terroristic) nationalistic but anti-

²⁸⁹ The same was true in the years preceding World War 2...

²⁹⁰ Undoubtedly contrary to their oath.

constitutional demonstrations, outbreaks of anti-Semitism, and manifestations of support for the conduct of the top of the army. (Which actually did not defend but undermine the nation). The affair split society in opposing camps. The case Spijkers on the other hand did not arouse strong nationalistic emotions. It did not elicit manifestations of adherence for the army. Neither did it split society. (There was no motive for anti-Semitic or other religion-related outbreaks).

8. It follows from the preceding conclusion that anti-Semitism need not have been a decisive or even important factor in the conviction of Dreyfus. Indeed, although anti-Semitism is generally said to have been the main cause of the initial “error”, and even though anti-Semitism evidently played a role, there is no positive evidence showing that it was a decisive factor. Where it should be noted that Picquart and Zola too, neither of them Jewish, were harassed systematically.
9. The affair was caused by the combination of a perceived need of political success in order to stay in power, steadfast refusal to admit errors, and the loyalty, interdependency and/or subservience of colleagues and hierarchical underlings.
10. In both the social, political and military top of around 1900 there were people who actively and effectively fought against injustice, and did everything in their power to get justice done. Nothing similar is noticeable a century later.
11. For a very long time, an overwhelming majority of the politicians in parliament and government resisted all efforts to reopen the case notwithstanding the (frequent!) emergence of new evidence raising doubts about the trial and verdict.
12. The Dreyfus affair took 12 (twelve) years, and was resolved more or less correctly at least as regards the victims and as regards truth finding. But Dreyfus got no full redress. And those responsible for the illegality of the conviction and efforts to prevent revision were not prosecuted and punished.
These 12 years can be compared with the more than 24 (twenty four) years of the case of Spijkers. Spijkers is said to have been compensated. But it is obvious that the waste of at least 24 of ones' life cannot be compensated. As in the Dreyfus affair, in the case Spijkers nobody was punished for wrongdoing. To make prosecution impossible, the relevant documents were shelved in the National Archive until at least 50 years after the death of Spijkers.
13. Very remarkable are the radical break with the past made by the Combes government, the ensuing rehabilitation of Dreyfus and Picquart, and the ministership of Picquart in the Clemenceau government. These events have no parallel in modern times.²⁹¹
14. Those guilty of failing to do their duty, or of violating the constitution or other laws, were pardoned in 1899 by an amnesty law of Waldeck-Rousseau. As far as known, no changes were made in the constitution which reduce the possibility or probability of similar misconduct in the future. The Wiki page on the affair suggests that, after many more years, the military justice system has been revised. But it does not give specifics. Revision need not mean improvement. No (other) actions seem to have been taken which may be assumed to have a preventive, deterrent effect.
15. Crucial forces in the efforts for liberation and rehabilitation of Alfred Dreyfus were his brother Mathieu and wife Lucie. Their efforts cost them very much time and money. These must have been available. It may therefore have been important for the success of the efforts for rehabilitation that Mathieu and Lucie belonged to well-to-do families. Other important supporters too were of independent means.
In the intervening century, the state has grown very much more powerful with respect to its citizens. State organizations have multiplied in number and grown in size. Taxes have increased

²⁹¹ Imagine Edward Snowden becoming Minister of Information and Communication Technology!

manifold. Also relatively, with respect to income. For an individual it has become much more difficult to defend himself equitably against authorities backed by a practically inexhaustible Treasury.

For the law to be consistent and legitimate, it should not leave room for abuse as shown in the cases of this chapter, and/or give better possibilities of appeal. It should moreover ensure that differences in power, and means of parties involved in litigation, cannot affect the outcome.²⁹²

16. The Affair occupies one of eight (8) chapters in *The proud tower* of Barbara Tuchman, and one in thirty six of *The collapse of the third republic* by William Shirer. In other words: it is considered to be an important episode, and therefore treated in some detail.²⁹³ It is difficult to imagine that similar importance will be attached to the cases described and analyzed in the present report, even though they caused many more victims and damage. The reason for the lack of attention or weight cannot be the seriousness of the wrong, for the modern cases are worse. It can only be the fact that around 2000 even terrible injustice and misconduct are considered normal, and cause relatively little indignation. Or, contrary to 1900, just solution may be considered hopeless.

Chronicle.

The following chronicle is based on the Wikipedia articles about Dreyfus and the Dreyfus affair (including pages in French), the Britannica 2002 article about Dreyfus, chapter 4 of *The proud tower* by Barbara Tuchman, chapter 3 of William Shirer's *The collapse of the third republic*, Joseph Reinach's *Histoire de l'Affaire Dreyfus*, Louis Leblois' *L'Affaire Dreyfus*, and *L'Affaire Dreyfus, « J'Accuse... !» and other texts*, assembled, and edited by Henri Mitterand.²⁹⁴ The following chronicle tries to give a concise and coherent picture of the main facts and developments, and to show especially the similarity or difference of comparable aspects of the Dreyfus and Spijkers affairs.

In 1929 a history of the Dreyfus affair by Louis Leblois was published. It can be seen as a complement to Reinach's History of the Dreyfus affair. Leblois' work consists of a concise history of about 80 pages of facts, and over 900 pages of commented texts. For the facts, the present author considers Leblois the most reliable. His "Chronologie succincte" (pp. 1003- 1034) is very useful.

Reinach is extremely important because of its descriptions of the roles of all those with responsibilities related to the Affair, governmental, political and otherwise, and without whose misconduct the Affair would not have been possible. After all, there were plenty of instruments for correction. But for a long time none of them were used or used effectively. "Anti-semitism" is too simple an explanation for this failure.

Regrettably the value and use of Reinach's History are hampered by the absence of section-headings, summaries and conclusions. Inclusion of these things would have had a positive influence on both the writing and the usefulness of the History. But the fact remains that Reinach's History shows much about the irresponsible workings of the modern western political world. Which alone make history understandable.

The collection of texts of Zola has very great value because the texts were written during and as part of the Affair. They show contemporary thinking of a main actor, and aspects not shown in the other sources mentioned. Zola communicated with all important Dreyfusists.

1859-1889.

Alfred Dreyfus was the youngest son of a wealthy Jewish textile manufacturer. He was born in Mulhouse (Alsace, France) on 19 October 1859. In 1882 he entered the École Polytechnique and decided on a military career. By 1889 he had risen to the rank of captain.

²⁹² You read correctly: cannot.

²⁹³ Its direct consequences cannot be the reason for relatively extensive treatment of the Affair. These being absent. It seems to be mainly treated as a remarkable event, and as an opportunity to show the social-political world of the times.

²⁹⁴ Referred to as "Zola-Mitterand".

1892-1893.

The French counterespionage department suspected that an employee of the German embassy, colonel Max von Schwartzkoppen, had a contact in the general staff. The counterespionage department suspected that several items of secret military information had been leaked to the Germans. Such as military maps, papers revealing the nature of new explosives, plans for mobilization, and plans for cooperation with Russia. The counterespionage department had come under increasing pressure from the top of the general staff to ferret out the traitor.

In 1893 Dreyfus was captain-trainee in the army general staff at the ministry of war.²⁹⁵ He worked in several departments of the office of the general staff, though not in its counterespionage department.²⁹⁶

1894.

General Auguste Mercier became minister of war on 30 May 1894. In the months June-August he made several significant errors of judgment. As a consequence his political position had seriously weakened. Another mistake might mean his downfall. He needed a success.

In September the counterespionage department obtains a “bordereau” addressed to the German embassy. A bordereau is an inventory of papers or documents. This particular bordereau lists secret documents about a new 120-mm gun, its performance and use, a reorganization of French artillery, and the latest firing manual for field artillery. The author of the bordereau was unknown. From its contents it is inferred that it can only have come from an officer within the general staff or from someone who had a confederate in it. Mercier orders to find the traitor.

On the basis of a superficial investigation and unreliable information, Dreyfus is accused being the author of the bordereau and of selling military secrets to the German military attaché. He is arrested on October 15. On December 22 he is convicted for treason by a military court, and sentenced to life imprisonment at the infamous penal colony of Devil's Island, off the coast of tropical French Guiana. Apart from his guards, he is the only inhabitant of the hot and humid island. He stays in a stone hut of 4 by 4 meters (13 ft × 13 ft). Haunted by the risk of escape, the commander of the prison makes Dreyfus' life hell on earth. Dreyfus becomes sick and shaken by fevers that grow worse every year.

Dreyfus is allowed to write on paper which is numbered and signed. Even his correspondence with his wife Lucie is censored. Until his return to France for the trial in Rennes, in the summer of 1899, he is not informed about the developments in France or elsewhere concerning his case.

The legal proceedings had been based on insufficient evidence. They were even illegal because of the use of material, a “secret file”, which had not been disclosed to the defense.²⁹⁷ Although Dreyfus denied guilt, and although his family consistently supported his plea of innocence, public opinion and a majority of the French press, led by a virulently anti-Semitic section, believed in the correctness of the adjudication, and welcomed the verdict and the sentence. Among other newspapers, *La Libre Parole*, edited by Édouard Drumont, used Dreyfus to symbolize the supposed disloyalty of French Jews.

The book of Leblois contains facsimiles of the bordereau and examples of the handwriting of Dreyfus and Esterhazy. According to the present author it defies explanation

²⁹⁵ It was called ministry of war indeed, not ministry of defense or something similar.

²⁹⁶ Section 1.2 of the article Dreyfus of the French Wiki.

²⁹⁷ According to Tuchman (pp. 174 and 178) and the Wiki (near the photo of Schwarzkoppen). On p. 178 Tuchman asserts that general Mercier was responsible for the use of the secret file and its withholding from the defense. This is confirmed by p. 1006 of Leblois.

1. that the bordereau was attributed to Dreyfus, and that none of the people in the War Ministry voiced doubts; and
2. that the mistake was not generally admitted the same minute examples of the handwriting of Esterhazy became available.²⁹⁸

To reach these conclusions, open minded inspection of the texts suffices. Experts- let alone quasi-experts- are not necessary.

The elder brother Mathieu of Dreyfus was convinced of his brother's innocence. He was the single most important driving force behind the rehabilitation of his brother. He spent his time, energy and fortune to assemble and strengthen a movement aimed at revision of the verdict, in spite of seemingly insurmountable difficulties. Little by little, and despite threats of arrest for complicity, machinations and entrapment by the military, he managed to convince ever more people.

Major Hubert Joseph Henry from the counterintelligence department is aware of the fragility of the case. At the request of his superiors, general Raoul de Boisdeffre, chief of the general staff, and major-general Arthur Gonse, deputy chief of the general staff and head of the intelligence department, he is charged with the task of expanding the Dreyfus file to prevent attempts to obtain a review. Unable to find evidence, he decides to fabricate some after the fact.

1895-1896.

On 1 July 1895 Marie-Georges Picquart replaces Jean Sandherr, who had fallen ill, as head of the counterintelligence department.

Picquart had been involved in the Dreyfus affair from the outset. In March 1896 he studies the original documents about the affair. He discovers evidence suggesting that Major Ferdinand Walsin Esterhazy was engaged in espionage. He saw that the bordereau which had been used to incriminate Dreyfus was in Esterhazy's handwriting.²⁹⁹ He informed his superiors of his findings. They refuse to reconsider their judgment. They assume a repressive attitude, and transfer Picquart out of the way to an infantry regiment in Tunisia, in North Africa.

On 6 September 1896, the conditions of life for Dreyfus are further worsened. On orders of minister André Lebon of the colonies, he is chained double looped. The torture forces him to stay in bed motionless, with ankles shackled. This measure was ordered after a false report, in a British newspaper, of his supposed escape. For two long months, Dreyfus is plunged into deep despair. He is convinced that his life will end on this remote island.

On 18 September, Lucie Dreyfus petitions parliament to revise the judgment of her husband. The request is rejected on 4 December.

On 6 November Bernard Lazare, an acquaintance of Mathieu Dreyfus, publishes a brochure entitled "A judicial error".

1897.

Since the machinations of the ministry of war against him did not stop, and to prepare for worse, Picquart contacts his schoolfriend Louis Leblois, who is a lawyer. Picquart informs Leblois of his experiences in connection with the Dreyfus affair.

On 13 July Leblois informs the vice-president of the senate Auguste Scheurer-Kestner about

²⁹⁸ Note in particular the writing of the upper case M, and that of the lower case d. Dreyfus often writes d, the bordereau and Esterhazy almost always write ð.

²⁹⁹ «Very moved by his discovery, Picquart diligently conducted an enquiry in secret without the consent of his superiors.» (Wiki, in the section *The discovery of the real culprit: Picquart "going to the enemy"*). Eighty eight years later, the same is true for Spijkers. The text about Picquart is misleading: Picquart did not need any consent. He had every reason to believe that he did his duty.

Picquarts experiences. Leblois shows Scheurer-Kestner the letters of Gonse to Picquart.

In the preceding years, Scheurer-Kestner had been approached and informed about the Affair by, among others, Mathieu Dreyfus and Joseph Reinach. In other words: he was well-informed. But until then he was not entirely convinced of Dreyfus innocence. Leblois' information convinced him. The next day, quatorze juillet,³⁰⁰ he told his colleagues of the senate that he was convinced of Dreyfus' innocence, and would do everything in his power to correct the error.

On 30 October Scheurer-Kestner speaks with minister of war general Jean-Baptiste Billot about the Affair. Scheurer-Kestner promises to remain silent for fifteen days if Billot orders an inquiry. As from the following day, the part of the press that rejects revision mentions the meeting, gives a false report of it, and violently attacks Scheurer-Kestner. Scheurer-Kestner complains by letter to Billot, and begs him to hold the inquiry.³⁰¹ Billot does not comply. Meetings of Scheurer-Kestner with other members of the government have little or no positive effects either.

In November, at the request of Scheurer-Kestner, Mathieu Dreyfus, in a letter to minister Billot, accuses Esterhazy of being the author of the bordereau.³⁰² As a consequence, general Gabriel de Pellieux is ordered to make a "military inquiry".³⁰³ He reports a few days later. Preparations for a military lawsuit against Esterhazy are begun.

Zola dislikes politics, and has reason to.³⁰⁴ He had kept his distance from the Dreyfus affair. In November Bernard-Lazare speaks with him about the Affair. Leblois shows him the dossier Picquart.³⁰⁵ He lunches with Scheurer-Kestner and Leblois. He concludes that he should support the campaign for review. As a consequence, in the weeks 25 November 1897- 7 January 1898 he publishes three newspaper articles and two brochures³⁰⁶ with appeals to reason, and against prejudice.

The first of the articles is concluded with: «La vérité est en marche, et rien ne l'arrêtera» (The truth is on the march, and nothing will stop it!)³⁰⁷

Around this time the development of the affair is further complicated by Esterhazy inventing "evidence" and spreading rumors. For example by letters to authorities and giving interviews to newspapers. Henry too continues to create and suppress evidence, and spreading false rumors to the press. But though Esterhazy shows a high profile, Henry prefers to work in the darkness, and remains invisible and unknown to the public.

1898.

In January Esterhazy is tried by a military court. The court hears Scheurer-Kestner, Leblois, Picquart and others. New "experts" conclude that the bordereau was not written by Esterhazy. Mathieu Dreyfus nevertheless gives reasons for believing that Esterhazy is its author. On 11 January Esterhazy is acquitted.

The army subsequently declares Esterhazy unfit for service. He benefits from special favorable treatment by the upper echelons of the army. A treatment which was inexplicable except by the general staff's desire to stifle any inclination to challenge the verdict of the court that convicted Dreyfus in 1894.

The general staff must have felt boosted by its victory. It has Picquart arrested on charges of

³⁰⁰ A French national holiday, celebrating the storming of the Bastille prison on 14/7/1789, and the beginning of the French Revolution.

³⁰¹ This letter can be found on pp. 528-9 of Leblois. (It contains: "Cherche, cherche, et tu trouveras." ("Search, search, and you will find").)

³⁰² The text of the letter can be found in note 3 on p. 709 of volume 1 of Reinachs HAD.

³⁰³ 17 November 1897. Leblois p. 1012.

³⁰⁴ Zola used his eyes, ears and brain, and had been political journalist. See his biography and/or chroniques.

³⁰⁵ Zola-Mitterand p. 43.

³⁰⁶ When the newspaper articles threatened to cost the newspaper too many subscribers, Zola published the last two articles independently, in the form of a brochure.

³⁰⁷ Zola-Mitterand p. 62.

violation of professional secrecy. Picquart had disclosed information from his investigation to his lawyer Leblois, who in his turn had informed Scheurer-Kestner. The colonel, although placed under arrest at Fort Mont-Valérien, did not give up, and involved himself further in the affair. When Mathieu Dreyfus thanked him, he replied curtly that he was “doing his duty”.

The acquittal of Esterhazy precipitates an event that strongly energizes the movement for revision of Dreyfus' trial. On January 13, 1898, novelist Émile Zola publishes an open letter to the president of the republic, Félix Faure, on the front page of the newspaper *L'Aurore*. Under the headline “J'ACCUSE...!” it covers the full front page.³⁰⁸ By evening, 200,000 copies of the paper have been sold. The article accuses specific members of the army of covering up its mistaken conviction of Dreyfus and of engineering the acquittal of Esterhazy.

The earlier five articles had been “soft”. The Esterhazy verdict showed that this strategy did not work. Therefore Zola chose the direct attack.

By the time of *J'ACCUSE*, the Dreyfus case had attracted widespread public attention and split France into two opposing camps of very unequal size. The issues were regarded as far exceeding the personal interests of Dreyfus and his family. The great majority of anti-Dreyfusards (those against review), nationalist and authoritarian, viewed the controversy as an attempt by the nation's enemies to discredit the army. They presented it as a case of national security against international socialism and Jewry, of France against Germany. The Dreyfusards (those seeking revision of the verdict) saw the issue as the subordination of the principle of justice to the interests of the army, and subordination of the republican civilian authority to a military authority that puts the personal interests of its top-officers above the interests of the state.

With the help of uproar in the Chambre and anti-Semitic riots in the provinces, the government is pressed by the nationalists to bring Zola to justice. At the same time a petition demanding revision of the Dreyfus trial was signed by some 3,000 persons, including Anatole France, Marcel Proust, and a host of intellectuals. The trial of Zola begins on February 7, 1898 and lasts sixteen days.³⁰⁹ Zola is found guilty of libel, and sentenced to a year's imprisonment and a fine of 3,000 francs.

The Zola trial is a victory for the Dreyfusards nevertheless. In the trial, the contradictions of the affair have been clearly presented and widely discussed. Reasons for doubt about Dreyfus' conviction are increased. Also by the often dubious management of the trial. The impression that the military have something to hide is confirmed.

Even more than the Affair had done hitherto, the Zola affair causes a division of people into two opposing camps.

Zola appeals. Via quite a few juridical stations, the definitive verdict will be changed into one month of prison.³¹⁰

Before and after “J'ACCUSE...!”, Zola wrote several articles and letters about the Affair. They were published in newspapers.³¹¹ The open letter quoted in “Related thoughts” at the beginning of this report was published 16 July 1898. The 18th, to avoid imprisonment, Zola left France to go into exile in England before a new and harsher verdict could be formally read to him, and thereby enter into force. He returns to France in June 1899.

After the elections of 8 May a new government takes office. Its minister of war is Godefroy Cavaignac, a civilian. He was said to be a man of rigid republican righteousness. He had a very high regard of himself. As minister of war for a six months' tenure in 1895, he had accepted the integrity of the secret file. He firmly believed Dreyfus guilty. The outgoing prime minister, Meline, had attempted to deal with the case by denying that after the rendering of the verdict any case remained.

But Cavaignac chooses to reinvestigate the documents. He convinces himself that although

³⁰⁸ Zola-Mitterand p. 30 and pp. 121 and following, or the file the dossier, under 18980113.

³⁰⁹ Tuchman p. 198.

³¹⁰ See Leblois.

³¹¹ See Zola-Mitterand.

Esterhazy was somehow involved, the Dreyfus verdict had been just.³¹² This is the gist of what he tells the Chambre on 7 July. He thought he could thereby bury Revision for good. Grim and commanding, he tells the representatives that Esterhazy has been wrongfully acquitted (!) and will be dealt with as an accomplice. But at the same time “I am completely certain of Dreyfus' guilt.” He goes back over the entire history of the case, reconstructs the argument which the Dreyfusards had bit by bit proved false, and in final proof cites Dreyfus' supposed confession and the so-called Panizzardi letter which Méline, who was sitting in the audience, knew was a forgery.³¹³ The members of the Chambre give him an ovation and vote to display copies of the speech and the three incriminating documents in the 36,000 communes of France.³¹⁴ The anti-Dreyfusards seem to have triumphed. But Cavaignac had implicitly recognized that in 1894, Dreyfus' defense had not had access to all the evidence. This made the appeal for annulment of the verdict by Lucie Dreyfus admissible (justiciable). She had already requested annulment on 3 July. Her request had been rejected however by minister Jean Sarrien of Justice because of lack of proof.³¹⁵

The day after the speech of Cavaignac, Picquart declares in *Le Temps* to the president of the council of ministers: “I am in a position to establish before a court of competent jurisdiction that the two documents bearing the date of 1894 cannot be attributed to Dreyfus and that the one that bears the date of 1896 has all the characteristics of a fake”. In the week following his speech in parliament, Cavaignac orders legal proceedings against Esterhazy, Picquart and Leblois.³¹⁶ Picquart will be detained for eleven months.³¹⁷

In the evening of 13 August, Louis Cuignet, officer of the general staff, studies various documents of the secret file. Under lamplight he discovers that the letter of Panizzardi and another document are false. The originals had been taken apart. Fragments had been pasted to forge new documents. Cuignet is able to identify Henry as the falsifier. He reports his findings to his superior officer, general Gaudérique Roget. Together they inform minister Cavaignac. Cavaignac decides to interrogate Henry personally. He does so on 30 August, in the presence of Boisdeffre and Gonse. Henry is unprepared. He fails to give an acceptable explanation, and confesses. He is imprisoned immediately following the interview. The next day, Henry commits suicide in his prison cell. Whereupon Esterhazy flees to London, and Boisdeffre resigns.³¹⁸

The confession of Henry is an important landmark. The confession of forgeries suggests the absence of real proofs. As a consequence, the government of Henri Brisson approves the request for appeal to the cassation court.³¹⁹ Cavaignac disagrees, and resigns on 3 September.³²⁰ He is succeeded by general Émile Zurlinden. Zurlinden is the sixth minister of war since Dreyfus' arrest.³²¹ Within two weeks he too resigns.

On September 26 the government votes to revert to the cassation court. On October 29 the Court announces that it accepts the case and will begin its inquiry. *L'Aurore* proclaims VICTOIRE! in the same type as J'ACCUSE! Revisionists hail the decision as re-establishing civil power over the military. For the next seven months the cassation court is the focus of the battle.

From this point on, the anti-Dreyfusards are on the defensive. The affair enters its period of greatest

³¹² Showing his incompetence.

³¹³ Alessandro Panizzardi was military attaché of the Italian embassy in Paris. Méline remained silent on the forgery.

³¹⁴ The three “proofs” were: the letter by Schwartzkoppen to Panizzardi of September 1896, the letter “Canaille de D...”, and the letter by Panizzardi. (Reinach, HAD, volume 2 p. 16; and search in the digital version of the Table for for example “lettre de Paniz”).

³¹⁵ Leblois p. 1020. Leblois gives Jean as Christian name, Reinach in the index mentions Ferdinand.

³¹⁶ Leblois p. 1021.

³¹⁷ Leblois p. 52. Leblois adds: «*Protégé sans doute par sa qualité d'avocat, M^e Leblois resta libre*».

³¹⁸ Leblois p. 1022.

³¹⁹ This court only checks procedural correctness of preceding litigation. If it finds fault, the case is (re)submitted to a normal court.

³²⁰ Leblois p. 1022.

³²¹ The succeeding governments and the most relevant ministers are listed in Leblois, pp. 78-80.

frenzy. The court is excoriated by the nationalist press as the “sanctuary of treason”, a “branch of the synagogue”, the “lair of Judas”, a “combination of Bourse and brothel”. The judges are variously called “hirelings of Germany”, “valets of the synagogue”, and “rogues in ermine”. Pressures of all kinds are exerted. Both sides are accused of corrupting the judges.

In the criminal chamber of the cassation court, Cavaignac makes a statement two days long, but fails to prove the guilt of Dreyfus. Rather the contrary. He unwittingly exonerates him by a demonstration of the date of the bordereau (August 1894). Picquart then explains the various errors, and the conspiracy to get Dreyfus convicted and to block revision. A decision of 8 December, by the criminal chamber of the cassation court in response to his divestiture announcement, protects Picquart from the military court. The secret file is formally submitted by the ministry of war to the criminal chamber on 27 December.³²² The criminal chamber requests the foreign ministry to disclose the relevant diplomatic records. The request is granted.

1899.

On 27 January, president Mazeau of the cassation court advises the minister of justice, that the criminal chamber, due to all kinds of pressure, can no longer be expected to function as judges should.³²³

On 9 February 1899, president Loew of the criminal chamber submits the inquiry report. The report establishes two important facts:

1. Esterhazy used the same paper as that of the bordereau, and
2. as regards Dreyfus, the secret file is completely meaningless.

These two conclusions eliminate all grounds for proceedings against Dreyfus.

Like the proceedings of the criminal chamber, the report seems to foreshadow annulment of the conviction of Dreyfus. This is not to the liking of some of the ministers and majorities of representatives and senators. They furthermore assumed that transfer to the united chambers of the cassation court would reduce the odds for annulment. “In the interest of appeasement” the government therefore submits a law of divestiture of the criminal chamber, and transferal of the case to the united chambers. The law is passed in both Chambre and Senate.³²⁴

On 6 March the new president of the civil chamber of the cassation court, Alexis Ballot-Beaupré is appointed reporter for the case. Additional witnesses are heard, and the secret file is studied anew. Ballot-Beaupré presents his report to the joint chambers on 29 and 30 May. He proposes revision and retrial by another military court.

On 3 June 1899, the joint chambers annul the judgment of 1894 in solemn audience. The case is referred to the military court of Rennes. By its judgment the court imposes itself as an authority capable of standing up to the military and political powers.³²⁵ Many Dreyfusards see the ruling as a prelude to acquittal. They forgot to realize however what it meant that it was the army which would judge. In canceling the judgment and transferring the case to a military court, the cassation court assumed the independence of the military court. It did not take account of the subservience of the court members to the military hierarchy.

On 9 June Dreyfus is taken from Devil's Island, and brought back to France. He arrives June 30. The following day he is locked up in a cabin of the military prison of Rennes as if guilty, even though he no longer is.

He gets two lawyers, with different strategies. The experienced Edgar Demange wanted a defensive strategy and just get acquittal. Fernand Labori, a younger lawyer, wanted an offensive strategy, and, apart from acquittal, demonstrate the misconduct of the top of the army. Mathieu Dreyfus imagined that the two lawyers would complement one another. The course of the trial shows that this was a

³²² Leblois p. 1026.

³²³ For explanation and background of this shameful denunciation see Reinach, HAD volume 5.

³²⁴ See especially the documents in Leblois, pp. 834 and following.

³²⁵ It simply had this authority. So it is at most remarkable that it dared use it irrespective of wishes and pressures of interested parties.

mistake. Disagreements between the lawyers are exploited by the prosecution.

The trial opens on 7 August in an atmosphere of extreme tension. Rennes is in a state of siege. Dreyfus' physical appearance disturbs his supporters and even some of his opponents. But in spite of his deteriorated physical condition he has acquired a thorough mastery of the dossier. Everyone of the general staff testifies against him, without however providing any proof. The military stubbornly ignore the confessions of Henry and Esterhazy. The trial could easily cause a judicial and political crisis, because the military court ignored both the instruction and the decisions of the cassation court. Misled by people whom they apparently trust and/or see as their superiors, the military court reconsiders questions which had already been answered by the cassation court (the highest in the country). This made the proceedings illegitimate if not illegal. Only fear for the consequences can have prevented formal objections to be made.

On 14 August 1899 Mr. Labori is the victim of an attack while on his way to court. He is shot in the back by somebody who escaped and was never apprehended. The lawyer is missing from the court sessions for over a week, including the sessions for the examination of witnesses. On 22 August his condition has sufficiently improved to enable him to continue his participation. Incidents between the two lawyers for Dreyfus multiply. Labori reproaches Demange about his excessive caution.³²⁶

The management of the proceedings by the president of the military court was biased in favor of the military. Witnesses from the military were systematically given much more leeway than civil witnesses.³²⁷

So there were good reasons to fear a fall back on the old positions of the military. The question arose whether the government should and could interfere. The government had two ways to influence the development of the trial: call for testimony from Germany, or abandon the charge. However, the negotiations in the background remained fruitless. The trial was left to develop on its own.

On 9 September the court renders its verdict: Dreyfus is convicted of treason but "with extenuating circumstances", by 5 votes against 2. He was sentenced to ten years' imprisonment and degradation.³²⁸ Contrary to appearances this verdict was on the verge of acquittal by one vote. The code of military justice had adopted the principle of a minority vote of three against four to be an acquittal.

Anti-French demonstrations take place in twenty foreign capitals. The press is outraged. The report of the Lord Chief Justice of England, Lord Russell of Killowen, on 16 September 1899, is representative of the global impact of the Affair. The English judge, who went to Rennes as an observer, criticizes the weaknesses of the military court: «[The explanation of the erroneous judgment, as I conceive it to be, at which they \[= the judges\] arrived I take to be this : they were unversed in law, unused to legal proceedings, with no experience or aptitude to enable them to weigh the probative effect of testimony; they were steeped in prejudice and concerned for what they regarded as the honor of the army; and thus, impressed or overawed by the heads of their profession, they gave undue weight to the flimsy rags of evidence which alone were presented against the accused man.](#)» He concluded: «[It must be remembered also that recent proceedings cast no slur on the administration of justice in the civil Courts of the land; for surely it might have been predicated with certainty, that, if the revision trial had taken place before the Cour de Cassation \(which is the highest Court in the land\), Dreyfus would now be a free man.](#)»³²⁹ In Germany and Italy, the two countries widely challenged by lawsuits against Dreyfus, there is relief.

The day after the verdict, Dreyfus, after much hesitation, files an appeal for retrial. This brings the government in a difficult position. It wants to lay the case at rest. In the interest of the health and life of his brother, Mathieu Dreyfus decides to try and get a pardon. Waldeck-Rousseau, prime minister

³²⁶ Given the situation, it seems far from obvious that one of the two strategies is the best. It is also far from obvious that the two strategies are incompatible. There would not seem to be a logical necessity for conflict.

³²⁷ See Reinach, HAD, Volume 2, the book or part titled Rennes, chapter 4, Rennes. Leblois, the introductory section of the chapter *Le procès. La condamnation. La grâce* on pp. 61 and following.

³²⁸ The degradation is implied by the grace decree, reprinted on p. 894 of Leblois.

³²⁹ The quotes are from chapter 16, "The Dreyfus case", of *The Life Of Lord Russell Of Killowen* by R. Barry O'Brien (1901). The text was found in archive.org.

since June 22, and the other ministers concerned, accept the proposal. The pardon is to be conditional however: Dreyfus had to retract his appeal. Since his honor and that of his children is his most important value, the condition is extremely hard to accept. But he is exhausted, and after years of isolation very much longs for a normal life with his family. He therefore accepts. The pardon is signed by president Émile Loubet on 19 September. Dreyfus is released two days later, on the 21th.

On 17 November Waldeck-Rousseau presents an amnesty law covering “all criminal acts or misdemeanours related to the Dreyfus affair or that have been included in a prosecution for one of these acts” excluding only Dreyfus himself. Dreyfus is to remain allowed to seek acquittal. Many Dreyfusards protest because this indemnifies not only Zola and Picquart against (further) punishment but also protects those responsible for Dreyfus’ prosecution and conviction, and for obstruction of revision, and their collaborators. Despite the massive protests the bill is passed. In other words: none of the military having contributed to the false judgment or having actively obstructed revision will ever be punished. Military culture is not corrected. The guilty officers can continue their careers, and influence or dominate appointments and promotions unhampered.

Dreyfus’ acceptance of the pardon seriously hurt the relationship between the Dreyfus family and a branch of “ultra Dreyfusists”.³³⁰ Labori, Jean Jaurès, and Clemenceau, with the consent of Picquart, openly accuse Dreyfus of accepting the pardon and only gently protesting the amnesty law.

1900-1906.

Dreyfus’ rehabilitation will only be completed after six more years, without sparkle or passion. Many books on the Affair are published in the intervening period. Dreyfus himself publishes *Cinq années de ma vie* (= 1894-1899),³³¹ Jaurès *The Proofs*, Reinach the first five volumes of a comprehensive *History of the Dreyfus Affair* (of the years 1894-1899) of six volumes, and Zola *The truth on the way*.³³²

In the night of 29 September 1902 Zola dies of CO poisoning. A chimneysweeper had abused a reparation at the roof of a neighbor to obstruct the chimney of the sleeping room of the Zola’s.³³³

Jean Jaurès was a leader of the socialists, and an exceptionally gifted speaker. Initially he believed the military court, the military top and the government. But he changed his mind as a consequence of the conviction of Scheurer-Kestner, the steady stream of revelations in the course of time, and the systematic misconduct at the succeeding trials. Misconduct that was obviously meant to hide the truth. Scheurer-Kestner was generally seen as someone with the highest standards of integrity.

The elections of 1902 return Jaurès to the Chambre. By this time, the Dreyfus affair has lost quite a bit, though not all, of its capacity to set minds on fire. The new parliament is far from revisionist however. Witness the fact that neither Scheurer-Kestner nor Jaurès kept their vice-presidency.³³⁴ (Of Senate and Chambre respectively). Jaurès nevertheless decides to give revision one more try, probably hoping that his oratory powers will prevail. On 6 and 7 April 1903, in a speech to the Chambre, he resuscitates the Affair. He evokes the long list of falsehoods peppering the Dreyfus case. He places particular emphasis on two points:

- The letter of resignation of general Pellieux, who had investigated Esterhazy and defended the general staff. Legally, the letter formed an admission of the collusion of the General Staff:

³³⁰ The ultra is from the source, the French Wiki-page “Affaire Dreyfus”. The terminology is kept as information about the mental climate. Where people only defend fundamental rights and resist obstruction of justice the present author would use a terminology less suggestive of extremes or excesses.

³³¹ Already in 1898 he had published *Letters of an innocent*. These were the letters written from Devil’s Island.

³³² Zola wrote “La vérité”. “The truth” and not “Truth” to stress the unique character of the truth, and to preclude any suggestion of more, and incompatible, truths. For Zola as for the present author, any suggestion of more, and incompatible, truths is false and misleading.

³³³ Zola-Mitterand p. 390.

³³⁴ Leblois p. 68.

“Victim of people without honor, unable to keep the confidence of my subordinates, without which command is impossible, and having lost from my side the confidence in those of my chiefs who made me work on falsified documents, I have the honor to ask you to be so kind as to let me retire because of long service.”³³⁵

- The [hypothetical] note allegedly annotated (by Kaiser Wilhelm II), which General Mercier had alluded to at the Rennes trial, and which the press said to have influenced the judges of the Military Court.

Jaurès proposes an administrative inquiry into the intelligence department. André, the minister of war, accepts this proposal in the name of the government.

The inquiry is capably conducted by captain Targe, aide to the minister. During searches in the ministry he uncovers numerous hitherto unknown documents, many of them fabricated. They provide the “new facts” which are needed to justify a new revision process. On 19 October André submits the report of the inquiry to prime minister Combe, who transfers it to the minister of justice, Vallé. An advisory committee tells Vallé there are grounds for revision. Whereupon Vallé orders attorney general Manuel Baudouin to ask the Cour de Cassation to review the Rennes verdict (24 December 1903). On 5 March 1904 the Criminal Chamber of the Cour de Cassation agrees.³³⁶ It begins its work with a very thorough investigation. It wants to see all possibly relevant documents, including those of the ministry of war, and really tries to get at the bottom of everything that is not entirely clear.

Due to the inquiry, but also to avoid interference with elections, it takes the Court almost three years to reach its conclusions about the facts, and to reach a verdict. On 12 July 1906 it unanimously cancels the judgment of the military trial at Rennes in 1899. It allows no transfer of the case, and pronounces the rehabilitation of captain Dreyfus:

“Since in the final analysis nothing of the accusation against Dreyfus remains standing; and since annulment of the judgment of the military court leaves nothing that can be considered as a crime or misdemeanor; therefore, by applying the final section of Article 445, the case cannot be submitted to any other court.”

By a law of 13 July 1906, Dreyfus is partially reinstated in the army with the rank of cavalry major. But his five years of imprisonment are not taken into account for the reconstruction of his career, and he cannot not claim the rank of a general officer. This decision annihilates every hope of a career worthy of his successes before his arrest in 1894. He resigns in June 1907.³³⁷ He never claimed damages. He only wanted recognition of his innocence.

As a reserve officer, Dreyfus participated in the First World War of 1914–1918 at a fortified camp near Paris, as head of an artillery depot. He was posted to the Chemin des Dames and to Verdun. He was promoted to the rank of officer of the Legion of Honor in 1919. He ended his military career as a colonel. He died 12 July 1935.

Picquart was rehabilitated more completely. He was reintegrated into the army with the rank of brigadier general. He was minister of war from 1906 to 1909 in the first Clemenceau government.

The verdict of the cassation court is not only the final text on the affair in a formal sense. Its solid foundation in an open minded and thorough inquiry, its no nonsense reasoning, and its conciseness and clarity make it the primary reference for most of the disputed and mysterious elements of the affair. The openness and thoroughness of the inquiry and the no nonsense reasoning set it apart from the earlier lawsuits in the affair. The text of the verdict can be found in both Leblois and Reinach.³³⁸

³³⁵ This is a translation by the present author of the text on p. 818 of Leblois and p. 117 of volume 2 of Reinach’s HAD. The text read by Jaurès in the Chambre was actually slightly incorrect. See Reinach volume 2 p. 789.

³³⁶ Leblois p. 1033.

³³⁷ In section 7.2.2 of the French Wikipedia article on the Affaire Dreyfus one reads: «*Cette décision brise tout espoir d'une carrière digne de ses réussites antérieures à son arrestation de 1894. Il est donc contraint à une douloureuse démission en juin 1907. Les magistrats ne pouvaient rien contre cette ultime injustice volontairement commise.*» It would seem that the words “contraint” (forced to) and “ne pouvaient rien” (were unable to do anything) do not express the facts in a correct manner. For some elucidation see p. LXXXIX of the introduction to Reinach’s HAD by Hervé Duchêne, and the *Carnets* of Alfred Dreyfus.

³³⁸ Leblois p. 981, Reinach volume 2 p. 971.

Apart from Picquart and Freystaetter none of the military involved in the affair admitted errors. In the hearings of the cassation court the military gave ambiguous or evasive answers. Mercier remained arrogant and offensive. He never delivered on his oft repeated promise to provide conclusive proof.

8.18. The Gulag Archipelago.

This section is meant as a reminder of the fact that Stalin was a representative of the class of persons with the characteristics listed at the beginning of chapter 9. The section notes that he could find more than enough supporters (misbelievers) willing to people the hierarchical organizations which turned and kept the Soviet Union in a state of terror; and finally that he sent a substantial part of the population to forced labor camps. Where circumstances were such as to allow only a minority to survive.

Together with the section on the Chinese famine, the section is meant to keep in mind that with a mixture of doctrine, lies and terror, and pampering of selected visitors, governments can make almost everyone, both their own population and outsiders, believe in a completely false picture of the state of the country.

With minor changes, the following is quoted from the Encyclopedia Britannica 2002.

«Gulag is the abbreviation of the Russian for Chief Administration of Corrective Labor Camps. The Gulag was the system of Soviet labor camps and accompanying detention and transit camps and prisons that from the 1920s to the mid-1950s housed the political prisoners and criminals of the Soviet Union. At its height the Gulag imprisoned millions of people. The name Gulag had been largely unknown in the West until the publication of Aleksandr Solzhenitsyn's *The Gulag Archipelago, 1918–1956* (1973), whose title likens the labor camps scattered through the Soviet Union to an island chain.

A system of forced-labor camps was first inaugurated by a Soviet decree of April 15, 1919, and underwent a series of administrative and organizational changes in the 1920s, ending with the founding of Gulag in 1930 under the control of the secret police, OGPU (later, the NKVD and the KGB). The Gulag had a total inmate population of about 100,000 in the late 1920s, when it underwent an enormous expansion coinciding with the Soviet leader Joseph Stalin's collectivization of agriculture. By 1936 the Gulag held a total of 5,000,000 prisoners, a number that was probably equaled or exceeded every subsequent year until Stalin died in 1953. Besides rich or resistant peasants arrested during collectivization, persons sent to the Gulag included purged Communist Party members and military officers, German and other Axis prisoners of war (during World War II), members of ethnic groups suspected of disloyalty, Soviet soldiers and other citizens who had been taken prisoner or used as slave laborers by the Germans during the war, suspected saboteurs and traitors, dissident intellectuals, ordinary criminals, and many utterly innocent people who were hapless victims of Stalin's purges.

Inmates filled the Gulag in three major waves: in 1929–32, the years of the collectivization of Soviet agriculture; in 1936–38, at the height of Stalin's purges; and in the years immediately following World War II. Solzhenitsyn claimed that between 1928 and 1953 "some forty to fifty million people served long sentences in the Archipelago." Figures supposedly compiled by the Gulag administration itself (and released by Soviet historians in 1989) show that a total of 10 million people were sent to the camps in the period from 1934 to 1947. The true figures remain unknown.

At its height the Gulag consisted of many hundreds of camps, with the average camp holding 2,000–10,000 prisoners. Most of these camps were "corrective labor colonies" in which prisoners felled timber, labored on general construction projects (such as the building of canals and railroads), or worked in mines. Most prisoners labored under the threat of starvation or execution if they refused. It is estimated that the combination of very long working hours, harsh climatic and other working conditions, inadequate food, and summary executions killed off at least 10 percent of the Gulag's total prisoner population each year. Western scholarly estimates of the total number of deaths in the Gulag in the period from 1918 to 1956 range from 15 to 30 million.

The Gulag started to shrink soon after Stalin's death; hundreds of thousands of prisoners were amnestied from 1953 to 1957, by which time the camp system had returned to its proportions of the early 1920s. Indeed, the Gulag was officially disbanded; its activities were absorbed by various

economic ministries, and the remaining camps were grouped in 1955 under a new body, GUITK, the Chief Administration of Corrective Labor Colonies”».

As for example Solzhenitsyn shows, it is incorrect to say that the Gulag housed “political prisoners and criminals”. Most people were not sent to camps because they had undesirable political ideas or done something punishable, but because the quota for a town- and the camps- had to be filled. As the EB text indicates at the end of the next paragraph, people often did not and could not understand why they had been arrested. They were forced to confess to invented crimes. Really serious political crimes led either to immediate execution or to deportation to the worst camps- this too meaning a death sentence. Saying that the camps were filled with political prisoners and criminals suggest a kind of rationality that was entirely absent.

The 15 to 30 million deaths are clearly incompatible with the total number of inmates of 10 million of the Gulag administration, and support Solzenitsyn’s estimate.

Before the publications of Solzenitsyn, prominent speakers in the West relativized both the accomplishments of the West and the underperformance of the “socialist” states. After the extent of the Stalinist repression had become known, such voices were hardly heard any more.

Still, the illusion of reason even in the Soviet Union of Stalin is very persistent. The illusion is harmful, because it means underestimation of risks, and consequently leads to erroneous risk management and policy decisions. A remark in a short notice “Goodbye Stalin” in the first 2015 issue of the periodical “Wordt Vervolg” (“Prosecuted”) of Amnesty International (!), asserts that under Stalin people were persecuted for their convictions.^{339, 340} Of course, people were persecuted for convictions. But undesirable convictions were not necessary at all for deportation and hard labor. No valid reason was necessary at all. Towns were given numbers or percentages of people to be prosecuted, and reasons were simply constructed. The quota had to be fulfilled, no matter what. It is misleading to suggest that only people who had given reason were transferred to the Gulag, or that innocent people existed or were spared. Absolutely nobody could sleep free from care; absolutely everybody had reason to fear the knock on the door in the early morning.

For a rather comprehensive description of the Gulag the reader is referred to *The Gulag Archipelago* of Solzhenitsyn mentioned in the quote.

8.19. The governments of many states could and should have prevented world war 2.³⁴¹

The second world war and the financial crisis of 2008 have an important trait in common. In both cases governments which could and should have prevented the disaster failed to do so. In neither case, the culprits afterwards designated by governments should have been allowed to wreak havoc. The main difference between WW2 and the financial crisis being that Germany, Italy and Japan had governments which violated international agreements and law, while the banks seem to have operated within the limits of the law.

For the prehistory of the second world war see for example Shirer’s *Collapse of the Third Republic* and *The Rise and Fall of the Third Reich*. Most but not all of the missed opportunities concern German violations of the Versailles Treaty, which was expressly meant to prevent a second world war. Essential failures are:

- The attitude of the USA with respect to the League of Nations. The USA undermined the authority and effectiveness of the League. (It could have tried to make it better).
- The attitude of the USA with respect to reparations and repayment of loans. See Shirer’s *Collapse*, pp. 130-1. To understand the significance of this attitude, one should realize that the first world war was fought on Belgian and French soil, not on German soil. This was a consequence of the fact that Germany started the war by invading Belgium and France. Almost all destruction in the first world war was wrought in Belgium and France, by the Germans. The

³³⁹ In the dossier under 20150131.

³⁴⁰ The notice reports that an inquiry of the *Moscow Times* had shown that almost half of the Russian population fears a return to the repression of the Stalin era in his or her lifetime.

³⁴¹ This section was one of the last of this work to be written.

destruction was unimaginable. The USA required full repayment of its war-loans, but allowed Germany to pay only a very small part of the reparation prescribed by the Versailles Treaty.³⁴²,
³⁴³,³⁴⁴

- The allies of WW1 allowed Germany to rearm.
- The allies, especially France, allowed Germany to occupy the Rhineland. France could and should have prevented this.
- The allies permitted the take over of Austria ("Anschluss", 13 March 1938).
- They permitted the dismantling of Czechoslovakia. The UK and France felt free to give Hitler part of Czechoslovakia, in violation of the Versailles Treaty. The Munich Agreement of 30 September 1938 was followed by the German occupation of the parts designated in the Agreement, and a few months later, 10-16 March 1939, by the occupation of the rest of Czechoslovakia. (Given what had preceded the Munich Agreement, it was pure folly to count on German peacefulness or reliability).

WW1 caused France and Belgium to be weakened substantially with respect to Germany. In May 1940 the military situation of France and Belgium with respect to Germany was far worse than it was in August 1914.

The situation after WW2 differed greatly from the situation after WW1. In WW2 Germany, Italy and Japan suffered badly. And as for the development of the post-war world, the appearance of the atomic (and later hydrogen) bomb drastically changed the thinking about conflict and warfare.

8.20. The Great Chinese Famine 1958-1962.

Summary and conclusions.

- The Great Leap Forward was a set of radical agricultural, economic and social measures, many of which were simply crazy and bound to cause disaster. They were not based on experience, experiments, or any reliable theory. They contradicted common sense. They were possible only because China was a state of terror controlled by the power-jealous mentally sick Mao Zedong. Disaster struck in the form of China-wide famine. Due to the rotten state of public administration and the fear of Mao, it took years before corrective measures were taken and the famine ended. As a consequence, the famine lasted four or five years, 1958-1962.
- Mao remained the dominant power in China well into the so-called Cultural Revolution. Which began in 1966, and ended in 1976. Mao never admitted errors or failure. He maintained a state of terror and fear. As a consequence, reliable reports about the famine took more than a decade to reach the outside world.

³⁴² There are two big and fundamental problems concerning destruction caused by armies and war. The first is that it is relatively easy to destroy very much more than one can ever repair. The second is that in general wars are caused and entered by governments without the consent of the people, but that the costs have to be borne by the people. Including the costs of reparation. (Note by the way that the lives of soldiers are taken, not given). So the supposed harshness of the Versailles Treaty is no more than a consequence of the (mostly barbarian, often willful) destruction wrought by the German army, and the fact that the war was entered and continued without regard to the opinion of the German people. The problem could possibly have been solved with long-term loans (to Germany). Shirer's *Collapse* shows that France suffered many years, if not the whole interwar period, from the financial consequences of the first world war. Modern historical literature tends to agree with these remarks, and to deny the harshness of the Treaty.

³⁴³ The French had to pay back the US loan, but the Bolshevik government of Russia refused to pay back the (even larger) French loan to the tsarist government. Shirer, *Collapse*, p. 130.

³⁴⁴ In connection with the Versailles Treaty it should be remembered that after the Franco-German war of 1870-1 the French not only had to cede Alsace and half of Lorraine (the north-east corner of France), but also had to pay a large indemnity and the costs of an occupation army. Even though German territory suffered no harm. In other words: if the reparation payments were not rather mild, they at least had a precedent. Sources: Encyclopaedia Britannica 2002 (CD edition), and p. 434 of Pierre Milza *L'Année terrible- La guerre franco-prussienne septembre 1870-mars 1871*, Perrin, 2009, ISBN 978-2-262-02498-7.

- Mao may be dead, and China may no longer seem to be a state of terror and fear, but the Chinese government keeps honoring Mao. If only on its paper money, and by manipulating the writing of the history of the Great Famine. It systematically tries to diminish the role of human misconduct in the causation of the Great Famine.
- In addition to many other examples, the Great Famine and Cultural Revolution show the extremely large risk of allowing large hierarchies. The higher the pyramid, the greater the gap between competence present and competence needed, the more need of violence to keep power, the easier to find an entourage willing and able to support the Leader (Führer), and the more victims.
- In many people, including academics and journalists, there is a dominating tendency to positively interpret a situation upheld by the powers that be, and to distort or suppress anything that is incompatible with a positive image. This may produce false reports, even for decades. During the Great Famine and Great Proletarian Cultural Revolution and concerning the Great Leader it did.
- Visiting foreigners were deceived professionally. When touring China they actually visited the performance of a play on a set stage. See especially Chang and Leys for the “How”.³⁴⁵
- In 1976 the “historian” Hsu did not hesitate to write the history of 1958-1962, even though he had hardly any reliable evidence, and notwithstanding internally conflicting evidence and opinions. He presents colored judgments in favor of Mao, and gives an incorrect picture of situations and developments.
- The Wikipedia and UNESCO History are affected by the Chinese government to such an extent that the text sometimes gives an entirely erroneous picture. In other words: the editors of the Wikipedia and UNESCO History have not managed to make them independent and reliable. International cooperation need not be for the better. Cooperation may make the “better” submit to the bad in order to save the peace (temporarily!) and retain a workable situation. (Allowing the bad the time to make things worse).

Introduction. Aims of this section.

This section is about the so-called Great Chinese Famine: the worst famine in the history of mankind of the last 100 years or more. The adjective “Great” is conventional. It is rather cynical, because it makes the name fit nicely in the “Great” communist Chinese history: Great Leap Forward, Great Chinese Famine, and Great Proletarian Revolution. All of them decreed by the Great Helmsman. The section is based on, and discusses, if only briefly, the following publications:³⁴⁶

- Jung Chang *Wild Swans* 1991 Simon & Schuster/ Harper Collins
- Frank Dikötter *Mao’s Great Famine* 2010 Bloomsbury
- Encyclopedia Britannica 2002 (CD-edition)
- *History of Humanity, Scientific and Cultural Development. Volume VII, The Twentieth Century* 2008 UNESCO
- Immanuel C. Y. Hsu *The Rise of Modern China* 2nd edition, 1975 Oxford University Press
- Yang Jisheng *Tombstone* 2008 Allen Lane/ Penguin
- Simon Leys *Essais sur la Chine* 1971-1991 Laffont
- Wikipedia *Great Chinese Famine*, Internet 7/4/18.

The book of Chang is the only one to provide a view from the inside. It is especially valuable for its description of the social atmosphere: the climate of terror and its far reaching effects. It serves as a supplement to, and consistency check on, the other publications.

³⁴⁵ The visitors had no freedom of movement.

³⁴⁶ In alphabetical order of (author’s) name.

According to Dikötter,³⁴⁷ the famine lasted for almost five years, from early 1958 to late 1962. The number of deaths from the famine can only be estimated. Yang's estimate is 36 million, Dikötter's 45 million, and Leys mentions a reliable source having 50 million.³⁴⁸

The present section is included in the first place out of respect for the victims of the man-made famine. They were victims of the false pretensions of their principal "leaders". In the first place Mao Zedong.³⁴⁹ It would be shameful for the present work to pass over this terrible episode in mankind's history in silence. The episode is also studied as a consistency test. To see whether it shows things which are at variance with the remainder of the present report. It does not. It supports the findings of the other cases. Especially the findings about the arrogance of governments, the properties of "great leaders" (they don't mind the suffering of their people, and (implicitly) claim never to make errors), and about the state of the science of writing history. It shows the unreliability of history writing. It is a warning. Important history authors are seen to be unable to take account of the limitations of available evidence, and unable to eliminate the influence of state- or social pressure. They don't know themselves sufficiently well. They are not modest but arrogant. They are not open about their methods. They present an incorrect historical picture as a result. A picture that serves those in power, facilitates the continuation of harmful if not disastrous misconduct, and prevents correction.

Long time very little was heard outside China about the inexpressible horrors of the famine (and the "cultural revolution"). Even now, some 60 years after the facts, much remains badly known. The situation can only be understood as a consequence of the terror exercised by the Chinese Communist Party (CCP).

The chronology in a nutshell (The main or explanatory facts).

Mao Zedong proclaimed the Peoples Republic of China in 1949.

Events in the years 1949-1957 show the dominance of chairman Mao of the Chinese Communist Party. They show decreasing room for differences of opinion in the top of the Party, and a worsening climate of terror. Voicing dissent increasingly means putting one's life at risk. Mao's acts can be characterized as being based on untested ideas and theories. They lack common sense and regard for the consequences, including human suffering, irrespective of the scale. If policies don't bring what Mao wants, he blames revisionists, rightist elements, etcetera. He does not look for errors in his own thinking or policies, or their implementation. He is impatient, and wants to accelerate the economic development of China (or says so).

In 1955, in accordance with Mao's wishes, economic policy was aimed at a "rash advance". It was marked by high production targets, to be realized at high speed. It involved more wishful thinking than deliberation and common sense, and created Great Risks for the national economy. When in the following year high grain-procurement demands caused starvation in the countryside, Zhou Enlai, Chen Yun, and other top officials tried to rein in the ruinous policies. Only to suffer Mao's wrath.³⁵⁰ Still, some corrections seem to have been made, even if half-heartedly and not very effectively.

Around this time, the Soviet Union made much ado about its efforts to rival the United States. Mao did not want to be left behind. So China should rival the United Kingdom, in at most 15 years.³⁵¹ To realize this goal, Mao in 1957 initiates the Great Leap Forward. The Great Leap consists of a number of radical social transformations and large programs in various areas. Such as agriculture, water management, and steel production. Important social transformations were the formation of large collectives, organized hierarchically and "led" by party officials, communal instead of private kitchens, free meals, and the abolishment of private property. A substantial part of the population was displaced and removed from agricultural work to making steel or building dams.

³⁴⁷ Cited on the Wiki page *Mao's Great Famine*, about Dikötter's book. *Mao's Great Famine* is its title.

³⁴⁸ Leys *Essais* p. 487. The author is Père Ladany, editor of the *China News Analysis*, published at Hong Kong. Information about Père Ladany can be found in the essay *The art of interpreting non existent inscriptions written with invisible ink on a white page* on p. 785 and following of the *Essais*.

³⁴⁹ In 2018 Mao's portrait is still adorning Chinese paper money.

³⁵⁰ Yang, *Tombstone*, p. 18.

³⁵¹ The Politbureau meeting of January 1960 in Shanghai revised this into 5 years.

In 1958 Mao Zedong and Liu Shaoqi visit various provinces. They praise (foolish) projects, and talk as if believing the supposedly greatly enhanced productivity.³⁵² But already in previous years serious problems had turned up. Also in the form of harshly suppressed insurrections. Party conferences in the last months of 1958 criticized wild exaggeration and called for developing practical and realistic work styles.³⁵³ The calls for temporization or correction had little effect however.³⁵⁴ What were meant to be investments mostly turned out to be waste of manpower and means. Production decreased instead of increased. Due to (Great) losses of manpower and tools, crazy ideas of the Great Helmsman, and very bad management, this applies especially to agricultural production.

The combination of the party monopoly of power, lack of control, a climate of terror, competition with neighboring counties and provinces, and the desire to curry favor with higher ups gave rise to the (mis)reporting of exaggerated production numbers.³⁵⁵ Since central imposition (taxation) was based on these numbers, exaggeration meant that the farmers lost a relatively large part of their produce and sustenance. In other words: the locally available amount of food was reduced by at least three factors: loss of manpower and tools, relatively high taxation due to exaggerated production numbers, and waste in communal kitchens.

On April 27, 1959, Liu Shaoqi succeeds Mao as President of the People's Republic of China. Mao remains Chairman of the CCP. According to the Encyclopedia Britannica 2002, it was «Partly as a result of the failures of the Great Leap, [that] Mao relinquished his position as chairman of the People's Republic of China, though he remained party chairman, and Liu assumed the chairmanship in April 1959».³⁵⁶

An important opportunity for correction was lost. In July 1959 a party conference was held in Lushan. Prior to the conference, high ranking party member Peng Dehuai had made an inspection tour of the country, and seen what the Great Leap meant in practice. At the conference he gave Mao a letter describing some of his observations, and requesting review and correction. Even though Peng explicitly noted that the letter was not meant to discover personal responsibilities, Mao acted as if the letter was meant to attack his person. He used it as an instrument to silence the remaining opposition.³⁵⁷ He distributed the letter among the conference participants. By misrepresenting the letter and historical events concerning Peng and himself, he used the letter to concentrate everyone's attention on the vilification of Peng and other "right-deviating opportunists", instead of the harmful effects of the Great Leap and their correction. As soon as Mao had demonstrated his rejection of Peng's remarks and requests, the large majority of conference participants aped Mao or tried to scold even louder, and kept silent about the misery caused in the country by the Great Leap. (Which many knew about). As a consequence, the letter and the conference caused not a correction of the Great Leap, but a purge of everyone everywhere in China who dared note errors, and dared request reconsideration like Peng. The follies of the Great Leap continued unabated, and the famine was aggravated. It may have been worst in 1960.³⁵⁸

Reports of famine and insurrections seem to have become more frequent or unstoppable in the course of time. The CCP hierarchy (minus Mao) needed much time however to dare discuss these reports, and develop a climate in which the truth could be said. A climate in which it could be admitted that not saboteurs but the "general line" itself, and misleadership, were responsible for the terrible state of the country. The communal kitchens were formally abolished in June 1961. But official admission, summarized by Liu Shaoqi, of the catastrophes and errors which were reported by

³⁵² Mao: "What will you do with so much extra food?". Yang chronology, August 4, 1958.

³⁵³ Yang chronology, p. XX.

³⁵⁴ Not being supported by Mao? The consulted sources do not describe this period in any detail, and even the communication of conference results top down is not clear.

³⁵⁵ Even in perfect western democracies red warning lights tend to become green on their way up in the hierarchy!

³⁵⁶ It cannot have been a consequence of the (later) Lushan conference. But the event meant demotion of Mao, and Mao may have resented it. It may help explain his misconduct at the Lushan conference.

³⁵⁷ The descriptions in for example Yang show that one needed a lot of courage to openly say something critical of Mao or his thoughts.

³⁵⁸ Peng himself was divested of all his official functions. As minister of defense he was succeeded by staunch Mao supporter Lin Biao.

Peng already in 1959, had to wait until January 1962. Of course it took many months more before the necessary corrections had been realized in practice, and had taken effect. The famine, killings, and other disastrous consequences of the Great Leap cost the lives of approximately 40 million people.

The following evaluates publications which do or should discuss the famine. The publications are evaluated in the order of publication.

1971-1991.³⁵⁹

Simon Leys.

In the West, Leys was one of the first and few to show the false pretensions of chairman Mao. He showed that his “new clothes” were entirely imaginary, and that he was a power-lusty repressive and incompetent dictator, without any respect for human well-being or life.

Leys’ publications are not only important because of their subject matter, but also because they show what was known at the time of their publication. The publications show that most Western self proclaimed “experts” lied about the events in China. At worst the experts pictured China as utopia come true. At best they were utterly one-sided. While- as Leys proves- they could know the horrible truth. The “experts” ignored the terror, the suffering and the many millions of famine victims in China. They betrayed both the Chinese people and their Western audience. Without conscience and reflection they aped the propaganda of the Chinese communist party.

The new clothes was Leys’ first book on contemporary China. It dates from 1971, and is a chronicle of the so-called Cultural Revolution, the effort of Mao to regain the power he had lost after the failure of his beloved Great Leap Forward. Appendices of the book present the following essential documents relating to Peng Dehuai:

- Letter by Peng Dehuai to Mao Zedong, dated 14/7/59, at the Lushan Conference.³⁶⁰
- Letter by Peng Dehuai to Mao Zedong, including Pengs apologies after his fall (less metaphorically: his demotion), dated 9/9/59.
- Fragments of the declaration of Peng Dehuai during his trial in the Great Proletarian Revolution (28/12/66-5/1/67).
- Fragments of a declaration of Pengs wife Pu Anxiu during Peng’s trial (undated).

The appendices are important because they show that in the summer of 1959 everyone responsible knew or could know that the Great Leap was causing suffering and problems on an unprecedented scale.³⁶¹

The appendices show that Peng had made inspection tours in several parts of China prior to the Lushan conference (July-August 1959). According to his declaration at his trial, in Hunan he found that not only had production not increased, but had actually diminished.³⁶² He «immediately wrote a poem:

“The corn has been sown, the leaves of the sweet potatoes are already withering;
All the young people and strong men have gone to melt steel;
For the harvest only women and children remain.
So what will people have to eat next year?
In the interest of the people let us toll the alarm bell!”

³⁵⁹ *Les habits neufs du president Mao*, Éditions Champ Libre, Paris 1971, and some other books and essays in *Essais sur la Chine*, Robert Laffont (Collection Bouquins), Paris, 2015. The set is highly recommended as a report on the functioning of scientists and universities.

³⁶⁰ Leys calls the letter “open”. In chapter 10 of *Tombstone*, Yang casts doubt on this qualification. Yang has consulted several apparently reliable sources, and as regards this matter, gives a rather detailed account of the related events at the Lushan conference. Given Mao’s character, it seems very probable that Mao (gratefully) distributed the letter in order to eliminate Peng. For these reasons the present work does not assume that Peng meant the letter to be open.

³⁶¹ Leys source is given on p. 227 of *Essais*. It is dated 1969.

³⁶² Hunan was the province where Peng was born. Encyclopedia Britannica 2002, “Peng Dehuai”.

I [Peng] could no longer remain silent. I decided to do as Hai Zjwéi.»³⁶³

That is: inform the emperor.

The appendices prove that the Lushan conference, and its chairman Mao, were well informed about the agricultural and economic state of China, and about its causes.

Essais sur la Chine shows that a dominating majority of academics and media can be thoroughly mistaken and misleading. What they said about China had hardly any overlap with reality. As regards the policies of a powerful state, they were strongly biased in favor of positive interpretations, and against serious reflection (“critical thinking”) and questioning. They created and upheld a fundamentally and practically important completely erroneous image of “communism”, and of a government and a country. Their nonsense supported one of the most criminal governments and persons in history.

The phenomenon can be seen as a consequence of rather general human deficiencies.³⁶⁴ It need not surprise therefore that it can be observed in other times and fields as well. Before world war 2, many people in western countries sympathized with the German nazi-regime. And the Soviet Union was treated like communist China. In 2018, Western Europe paid hardly any attention to the aggressive policies of China with respect to Taiwan, Tibet, the South China Sea (a misnomer!³⁶⁵), and Xinjiang. The “experts” may have worried about the visa for their next visit to China. But Western governments sacrifice the best values and future well-being of their nations to the Supreme God of Economics and an aggressive state. Until this becomes untenable, when it probably is too late to avoid much greater harm.

The *Essais sur la Chine* contain publications from the years 1971-1991. The mention of 50 million famine victims is made in a publication of 1976, and not in an earlier one. This probably means that Leys did not know about the extent of the famine earlier.

1975.

Hsu. The Rise of modern China. Second Edition, Oxford U.P.

The following is quoted from the Wiki page Immanuel C. Y. Hsu.³⁶⁶

«Biography

Born in Shanghai in 1923, he studied at Yenching University in Beijing, and at the University of Minnesota. [...] After receiving his doctorate from Harvard, he spent the years 1955–1958 as a Research Fellow at Harvard's East Asian Research Center. He taught modern Chinese history at the University of California at Santa Barbara from 1959 until his retirement in 1991, serving as Chair of the History department from 1970 to 1972. He was a Guggenheim Fellow in 1962–1963, as well as a Fulbright Fellow. His most widely read book is *The Rise of Modern China*, a survey of Chinese history from 1600 to the present, and a standard textbook. [...]

Tribute

According to Jonathan Spence in the Preface to the Chinese translation of his *The Search for Modern China*, the “two most prominent previous (to *The Search for Modern China*) English-language surveys” (of modern Chinese history) were those “by John King Fairbank in the 1960s and by Immanuel Hsu in the 1970s”.»

My copy of the book is cloth bound, jade colored, and embossed with the picture of a classical Chinese horse statue. Only gold edging could have made the book look even more prestigious.

³⁶³ Leys, Essays, p. 207.

³⁶⁴ Supposedly general, though in varying degrees. Leys obviously was an exception.

³⁶⁵ It could better be called South East Asian Sea (SEAS (!)).

³⁶⁶ Wikipedia 26/8/16.

The book is characterized by a paucity of sources or references for many of its assertions. Comparison with other (better) books shows that Hsu's book does not suffer on the side of carefulness. It systematically gives in to the temptation to tell more than available knowledge allows. Regrettably without telling the reader what is documented fact and what is interpolated or interpretation or sheer fantasy.

Hsu says very little about the Great Famine. In the index on pp. 959-1002 (inclusive), with a length of 44 pages, no mention is made of "famine" or "Great famine". (The Great Leap is mentioned). In particular, there is no section about the famine. The reason probably is that not much was known of the famine at the time of the writing of the book. The famine and "problems" are mentioned, but only qualitatively, without specification.

The following is quoted from the section "The dismissal of Peng Dehuai" in the chapter "The great proletarian cultural revolution":

«A far blunter critic of the leadership was Defense Minister Peng Tehuai, an old comrade-in-arms of Mao's and a prominent soldier. He had recently returned from a three-week goodwill trip to Eastern Europe, during which time he met Nikita Khrushchev in Tirana, Albania. The two of them discussed the deterioration of Sino-Soviet relations, and Peng, in an attempt to dissuade Khrushchev from withdrawing his pledge of nuclear aid to China, indiscreetly divulged the confusing conditions in China and the shortcomings of the Great Leap. Khrushchev encouraged him to oppose Mao, and a week after his return home the Soviets announced the termination of the nuclear agreement with China signed two years earlier, perhaps hoping to strengthen Peng's position against Mao. At Lushan, the foolhardy minister circulated a "Letter of Opinion" characterizing the Maoist approach to Socialist transformation as "hasty and excessive", pointing to the confusion and chaos resulting from the introduction of the Communes and the vast waste of two billion dollars (*yuan*) because of the "backyard furnace". Sarcastically he remarked:

Bewitched by the achievements of the Great Leap Forward and the passion of the mass movement, some leftist tendencies emerged, since we had always wanted to enter communism in a single step... In the view of some comrades, putting politics in command could be a substitute for everything... But putting politics in command is no substitute for economic principles, much less for economic measures.

He equated the Great Leap with "petty bourgeois fanaticism" and called it "a rush of blood to the brain... a high fever" of unrealism- an unmistakable allusion to the condition of Mao's health. Peng oppugned the idea of surpassing the British industrial output in fifteen years and deprecated China's economic "blunder after blunder". He attacked party control of the army and asked for the creation of a modern professional army with up-to-date equipment. By inference he favored a closer relationship with the Soviet Union to effect the supply of modern weapons, questioned Mao's views on the efficaciousness of the "people's war", and decried the constant diversion of soldiers to political duties. Vitriolic as his criticisms were, Peng did not urge the removal of Mao but only a revision of his policy.

Ch'en Yiin considered such an impetuous attack on Mao to be counterproductive; a more effective way to influence him would be to present facts and figures showing the poor results of his policies and allow him to make his own decision.³⁶⁷ In this way Mao, unchallenged, would probably terminate or temper the Great Leap on his own.»

The supposedly treacherous trip to the Soviet Union is mentioned (without sources for the contents of the talks of Khrushchev and Peng), but fact finding missions crisscross China are not.

The requirement of facts and figures is misleading, if not deceit. Peng had complained about exaggerated (= incorrect) production numbers. Later research has shown him to be right. Hsu should have noted that at least in 1959 reliable numbers were hard to come by, or not available at all.

³⁶⁷ This proposal lacks credibility since it falsely assumes Mao to have empathy and common sense, and since the problems were already known for at least a year.

According to the translation of Leys, Peng spoke of petty bourgeois exaltation instead of fanaticism. In Leys' translation, Peng did not equate the Great Leap with petty bourgeois fanaticism (or exaltation). Peng's letter actually seems to have been formulated rather carefully.

Obviously, Hsu is trying to present Peng in an unfavorable light by using rhetorical (highly unscientific) tricks: subjective qualifications ("far blunter", "foolhardy", "sarcastically", "vitriolic", "impetuous attack on Mao"), selective quotes, and dubious or false translations. He fails to note that politics was indeed put in command, and that it is simply true that this "is no substitute for economic principles, much less for economic measures". (He could have said truthfully that the Great Leap politics contradicted all common sense).

So even without better knowledge of the food situation, Peng's letter should have been presented much more positively, as a possibly earnest effort at redress. The validity of its arguments should have been evaluated seriously, without prejudice. Knowing how very, very bad the situation really was, makes Hsu's prejudiced and inconsistent treatment (see below) a lasting shame.³⁶⁸ If he was unaware of his lack of sufficient information, and the risks he was taking with his biased guesses, he was an utterly unprofessional historian.

Contrary to Hsu's assertion, Yang at least suggests that not Peng but Mao distributed Peng's letter at the Lushan conference. Yang gives references, Hsu does not.

Hsu concludes the section about the dismissal of Peng as follows:

«Mao proclaimed that the dizzy pace of the Great Leap was over and that there would be "no more pompous exaggeration". He now acquiesced- at least temporarily- to a policy of moderation.»

This is followed by a section:

«RETIREMENT AND LIBERALIZATION

The Lushan Conference was followed by three years of retrenchment and pragmatism necessitated by poor harvest, bad weather, drop in agricultural and industrial production, and the withdrawal of Soviet technicians. The country was facing serious economic dislocation. During an inspection trip to Hunan in the spring of 1961, Liu Shao-ch'i, although hardened by a lifetime of struggle, was deeply touched by the destitution of the people.»³⁶⁹

As shown by Yang and Dikötter (and of course many others) the end of exaggeration, and the moderation, retrenchment and pragmatism are plain nonsense. What followed Lushan was ruthless repression (with quantitative goals, as for Stalin's Gulag). Lushan was not followed by moderation but by hardening. The mention of the trip of Liu Shao-ch'i is remarkable because the much more important trips (plural) of Peng of 1959 were left unmentioned, even though they were already known at the time of writing of *The Rise of Modern China*.³⁷⁰ In 1959 Liu clearly was not moved by the destitution of the people (as reported by Peng).

Even what follows in Hsu is incompatible with "moderation, retrenchment and pragmatism", or anything reasonable.

The conclusion is that Hsu seems to have written the history of the Great Leap and the Cultural Revolution on the basis of insufficient or false evidence, and prejudiced guesses. He did not use what was available, such as *The new clothes* and its sources. He failed to analyze and present what he had in a reliable way. He is inconsistent, and shamefully biased.

A prestigious book by a prestigious author may present a false picture of history.

1991.

Jung Chang: Wild Swans. Three daughters of China.

This is the very eventful history of the mother and grandmother of the author, and of the author herself. In other words, it is the history of these three daughters of China, and of their closest relations.

³⁶⁸ It also puts to shame the often praised "referee system" for quality control in science.

³⁶⁹ No sources for the first sentence, with the bad weather, are given.

³⁷⁰ See Leys' *New clothes of chairman Mao*.

Changs grandmother was born in 1909, and the story ends with the author's departure for the UK in 1978. The history is either an eyewitness account, or the account of close, well-known relations. It is highly recommended supplementary reading. It gives an invaluable look from the inside, and provides just as invaluable context. It gives an impression of the human suffering, and of its extent. In the present work it is mainly used as a check and supplement. A supplement especially as regards the emotions and reactions to events of the members of a specific family. The book shows how events affected or determined their lives. The book is not the history of an ordinary or median family by the way, but of a highly talented and for a time rather successful family. For a time, the parents of the author held high positions in the Party. As a consequence the author went to the best available schools, and was very well shielded against the famine.³⁷¹

The book suggests the following:

- The Hundred Flower project acted as a strong warning signal. Everyone already knew that one had to be careful about what one said or did. But in the Hundred Flower project people were initially misled into thinking that they could freely express their opinions about what was wrong or could be improved. To discover somewhat later that this might be paid with years of hard labor in a camp in a remote area.
- Before the Great Leap and the famine, Mao's fame was unblemished. The failure of the Great Leap and the famine were ascribed to Mao however. These, and the repression of Peng and other "rightists" who had given warnings, made people doubt. Many people seem to have lost their formerly unwavering belief in the Party and what it stood for.
- For this reason Mao could no longer count on the adult population.³⁷² This is why he (ab)used the youth to make the Cultural Revolution to try to regain power.

As regards natural disasters as (contributing) cause of the famine Chang says the following:

«Many thought then, and still think today, that the famine was caused by natural disasters. I have no full picture, but of all the people I have talked to from different parts of China, few knew of natural calamities in their regions. They only have stories to tell about deaths from starvation.»³⁷³

«Then their conversation turned to a particular famine. They described having to eat sweet potato leaves and digging into the ridges between the fields in the hope of finding some roots. They mentioned the many deaths in the village. Their stories reduced me to tears. After saying how they hated the Kuomintang and how they loved Chairman Mao, the peasants referred to this famine as taking place at "the time of forming the communes". Suddenly it struck me that the famine they were talking about was under the Communists. They had confused the two regimes. I asked: "Were there unprecedented natural calamities in this period? Wasn't that the cause of the problem?" "Oh no", they said. "The weather could not have been better and there was plenty of grain in the fields. But that man"- they pointed to a cringing forty-year-old- "ordered the men away to make steel, and half the harvest was lost in the fields. But he told us: no matter, we were in the paradise of Communism now and did not have to worry about food. Before, we had always had to control our stomachs, but then we ate our fill in the commune canteen; we threw away the leftovers; we even fed the pigs with precious rice. Then the canteen had no more food, but he placed guards outside the store. The rest of the grain was to be shipped to Peking and Shanghai- there were foreigners there."»³⁷⁴

Chang not only mentions the campaign directed at the complete eradication of sparrows in China, but also a campaign to eradicate grass. The large scale killing of sparrows resulted in large scale increase of vermin. This is mentioned only as a reminder of the craziness of what happened in the Great Leap and Cultural Revolution.

³⁷¹ The book shows how the system pampers its servants. Differentially. There is no equality!

³⁷² Witness Mao's difficulty in getting his inflammatory 1965 paper, calling for a Great Proletarian Cultural Revolution, published.

³⁷³ Jung Chang, *Wild Swans*, 25th anniversary edition, Williams Collins Paperback, London, 2016, p. 285.

³⁷⁴ Chang, *Wild Swans*, p. 530.

The following is meant as a marginal, conjectural note. In principle it should be supplemented by systematically collected evidence, and further analysis.

Chang tells us that for a long time, as a child and teenager, she unquestioningly believed in Mao. Her belief remained unshaken until well into the Cultural Revolution. It took time to become aware of the fact that Mao's supposed Greatness was not based on facts but on indoctrination and the repression of every suggestion to the contrary. Only under the pressure of ever more evidence contradicting Party principles and theories, including the repeated arbitrary and cruel persecution of her obviously honest and reliable parents, did the belief in Mao's Godlike Greatness begin to waver, and could she consciously start asking questions about him. Even though only secretly and silently, in her mind.

The phenomenon strongly reminds the present author of a similar almost religious belief in Hitler in Germany 1934-1945, possibly especially in the younger part of the population. In China the belief in Mao may have been crucial in enabling and/or continuing the Cultural Revolution. In Germany it must have lengthened the war. The phenomenon may have been stronger in China, where a whole generation was brought up in the communist religion, with Mao as its prophet or god. As regards world war 2, belief in the holiness or god-like nature of the emperor may have played a similar role in Japan.

Chang's book is also very valuable because it does not describe the history of only a few years or a single period, such as the Great Famine, but the history of a lifetime. Namely that of the author's grandmother. It does so very well, showing the coherence and continuity of the main developments in 1909-1978. None of the other sources does something even remotely similar.

The book furthermore clearly shows the difference in character between on the one hand histories written by someone claiming to serve science, concentrating on superficial events at government or party level, and purportedly trying to be objective and distanced, and on the other hand someone describing the effects of the policies on peoples lives, bodies and minds. In other words: the various forms of suffering the policies caused, and their destructive effects on people's bodily and mental health, on families, and on their social environment. Let alone the difference between Chang's book and the nausea evoking half truths and lies of authors trying to comply with their political Master's wishes. Or those of his successors, see below. Chang's book shows that "objective" histories lack elements of vital importance for a truthful portrayal of human history.³⁷⁵

2002.

The Encyclopedia Britannica 2002 (EB, CD-edition).

The following is quoted from the article Mao Zedong, from the section Retreat and counterattack.³⁷⁶

«As for class struggle in China itself, Mao's fear that revisionism might appear there was also heightened by the policies pursued in the early 1960s to deal with the economic consequences of the Great Leap Forward. The disorganization and waste created by the Great Leap, compounded by natural disasters and by the termination of Soviet economic aid, led to widespread famine in which, according to much later official Chinese accounts, millions of people died. The response to this situation by Liu Shaoqi (who had succeeded Mao as chairman of the People's Republic in 1959), Deng Xiaoping (Teng Hsiao-p'ing), and the economic planners was to make use of material incentives and to strengthen the role of individual households in agricultural production. At first Mao agreed reluctantly that such steps were necessary, but during the first half of 1962 he came increasingly to perceive the methods used to promote recovery as implying the repudiation of the whole thrust of the Great Leap strategy. It was as a direct response to this challenge that at the 10th Plenary Session of the Central Committee in September 1962 he issued the call, "Never forget the class struggle!"»

³⁷⁵ To avoid misunderstanding: Hsu's book is not objective at all, but biased in favor of Mao. It is unreliable. Given Hsu's methods and lack of accountability, one cannot trust his descriptions of earlier times either.

³⁷⁶ EB 2002 does not have an article on the famine.

The premise of “Mao’s fear” lacks evidence. Mao may have play-acted, and said things he wanted people to believe, while not believing them himself. Historians should not present hypotheses as facts. They cannot look inside people’s heads.

The “disorganization and waste” is a shameful understatement. Its suggestion of something normal (“things happen”) is misleading.

I have not seen any specified evidence of natural disasters or its contribution to the famine. Soviet aid was indeed terminated, but again I have seen no evidence about its contribution or even relevance to the famine. Don’t forget that the famine lasted for at least four years. Everywhere else in the world the effects of natural disasters in one region in a given year are compensated by surpluses in other regions and/or surpluses of recent years. In normal circumstances this must have been possible within China too. China is a large country. But the facts as told by Yang and Dikötter clearly show that the follies of the Great Leap and the party leadership made mutual help (within China) impossible. Furthermore it is quite clear that the follies alone are more than enough explanation of the famine. There is no need of additional causes. But for the follies, natural disasters need not have caused any famine. If natural disasters were the most important cause, China could have applied for outside help. It didn’t. Even during the famine it kept exporting grain, fruit and meat (see the second quote of Chang!). The Chinese party top kept bragging about the successes of the Great Leap. Especially the books of Leys suggest that the outside world didn’t even know about the famine or its gravity.³⁷⁷

The text of the EB and that of the UNESCO History, see below, do not mention the food exports at the time of the famine. (See Dikötter chapter 15, and Yang. Yang gives the gross numbers in his chronology, at the beginning of each of the years 1959-1961). Obviously, food exports at a time of adverse weather conditions and famine are impossible to explain if one assumes a CCP or government caring for its population.

The text of the EB doesn’t mention years. As a consequence the reader might think that Liu and Deng acted as soon as they heard about the famine. They didn’t. For years they knew, but not only did nothing to end the famine, but participated in the repression of everything supposedly obstructing continuation of the Leap. They feared the wrath of Mao much more than they cared for the other 600 million Chinese. Only in 1962 did they voice dissent with Mao, and began repeating what Peng had said in 1959, in vain.

2008.

UNESCO’s History of Humanity, Scientific and Cultural Development. Volume VII, The Twentieth Century.³⁷⁸

The table of contents shows that this history is not only about scientific and cultural development in a strict sense. It treats these subjects against the background of social and political developments. For most subjects, such as science, sociology, economics, ethics, legal science, political science, literature, education and many others, this is obviously necessary. A defective picture of the background may easily cause defects in the treatment of the main topics. Defective political science co-explains defective politics & public administration, and a repressive regime cannot coexist with activities which satisfy the criteria of science.

“Great famine” is not found in this book, “Great leap” four times.³⁷⁹

Some quotes:

«Subsequently, the development of Chinese society began to follow the tenets of Maoism. In 1958 and 1959, Mao Zedong undertook the ‘Great Leap Forward’ that resulted in the establishment of rural communes and in large-scale industrialization (Plate 39)³⁸⁰. The country strove to achieve self-reliance

³⁷⁷ In the last part of *Wild Swans* one can see how this came about.

³⁷⁸ *History of Humanity, Scientific and Cultural Development*, Volume VII, *The Twentieth Century*. Edited by Sarvepalli Gopal and Sergei L. Tikhvinsky, co-edited by I. A. Abu-Lughod, G. Weinberg, I. D. Thiam and W. Tao. UNESCO 2008.

³⁷⁹ This refers to searches in the pdf-file.

³⁸⁰ Plate 39 shows «Propaganda poster showing [a smiling, hand waving] Mao Zedong, Shanghai, 1967. Architect of the People’s Republic of China, he came to power in 1949 and launched the Cultural Revolution in

and the level of highly developed capitalist countries. From 1966 to 1976, the ‘Great Proletarian Cultural Revolution’ against ‘old ideas, old culture, old habits and old customs’ was launched. However, after Mao’s death (1976) and Deng Xiaoping’s return to power [...]»³⁸¹

It is definitely misleading, or downright incorrect, to characterize the Cultural Revolution as a movement directed against old ideas, old culture, old habits and old customs. This characterization entirely misses the ruthless and arbitrary prosecution, torture and killing of uncountable innocent people, and the destruction of much of China’s material cultural heritage.

«China was quite successful in its economic recovery and implementation of the first five-year plan from 1953 to 1957. Mao Zedong, however, was not satisfied with the Soviet model of development and tried to develop faster. He launched a movement called the ‘great leap forward’ and organized peoples’ communes in the rural area. The experiment was a total failure and the country’s economy was seriously hurt. This, combined with natural disasters, led to widespread famine across the country during the early 1960s, especially in rural areas.

Although China and the Soviet Union became allies in the early 1950s, [...]

In 1976, Zhou Enlai, Zhu De and Mao Zedong passed away, one after the other. The party secretary Hua Guofeng, with support of the veterans, was able to suppress the so-called Gang of Four and the Cultural Revolution, which lasted for ten years and brought catastrophe to the country. A number of veterans, who were overthrown during the Cultural Revolution, were now rehabilitated, including Deng Xiaoping. With his profound strategic vision and courage, Deng Xiaoping launched reform and openness at the end of the 1970s, and normalized diplomatic relations with the United States. It was not a coincidence that the two great events took place at the same time. It meant a change of China’s national goal. [...]»³⁸²

In Lushan, the same Deng took sides with Mao against Peng and revision of the Great Leap.

Note what this history does and does not tell, and the number of words it spends on different aspects, events and whatever. The supposedly “profound strategic vision and courage” of what first of all is an irresponsible, ambitious coward, giving his personal career priority over the lives of millions, is a case in point.

The other texts presented in this section show that the Unesco *History of humanity* gives an excellent example of falsification of Chinese history by selection. Whatever is inconvenient is left unmentioned. Terrible consequences of governmental misconduct are phrased in soothing language (“the economy was seriously hurt” sounds immeasurably less shocking than “caused millions of deaths”), and subordinate (or imaginary or hypothetical) events are given a disproportionate number of words.

By the way, that rural areas were hurt most by the famine should strike the reader as amazing, since it is exactly the rural areas which produce the food for the nation. It seems to be true nevertheless. Chang, Yang and Dikötter think so. The explanation is rather simple. The central government (the top of the CCP) requisitioned a lethal part of agricultural production, and gave the city population priority in the redistribution. Possibly because villages are easier to keep under control than cities. Possibly the author of the text doesn’t understand that he implies something like this.

2008.

Yang Jisheng: Tombstone- The Untold Story of Mao's Great Famine.

«I originally intended to title this book *The Road to Paradise*, but even eventually changed it to *Tombstone*. I had four reasons for choosing this title: the first is to erect a tombstone for my father,

1966, during which revolutionary attitudes were encouraged, officials dismissed, and all aspects of culture destroyed.». P. 943 of the pdf file of the book. This is an misleading picture of reality. For more truthful descriptions see Chang or Leys.

³⁸¹ P. 59/91 left column. In the section *Different Models of Socialism*.

³⁸² P. 769/798, in the section *Introduction* of the chapter East Asia.

who died of starvation in 1959; the second is to erect a tombstone for the thirty-six million Chinese who died of starvation; and the third is to erect a tombstone for the system that brought about the Great Famine. The fourth came to me while I was halfway through writing this book, when a temporary health scare spurred me to complete the book as a tombstone for myself. Although my health concerns were subsequently put to rest, the risk involved in undertaking this project might yet justify its serving as my own tombstone. But, of course, my main intentions are the first three. [...] I erect this tombstone so that people will remember and henceforth renounce manmade calamity, darkness, and evil.»^{383, 384}

Apart from an introduction, translator's note, notes, bibliography and index, the book has the following table of contents:

- «A Chronology of the Great Famine An Everlasting Tombstone
 - 1. The Epicenter of the Disaster
 - 2. The Three Red Banners: Source of the Famine
 - 3. Hard Times in Gansu
 - 4. The People's Commune: Foundation of the Totalitarian System
 - 5. The Communal Kitchens
 - 6. Hungry Ghosts in Heaven's Pantry
 - 7. The Ravages of the Five Winds
 - 8. Anxious in Anhui
 - 9. The Food Crisis
 - 10. Turnaround in Lushan
 - 11. China's Population Loss in the Great Leap Forward
 - 12. The Official Response to the Crisis
 - 13. Social Stability During the Great Famine
 - 14. The Systemic Causes of the Great Famine
 - 15. The Great Famine's Impact on Chinese Politics»

The book clearly shows that various crazy elements of the Great Leap Forward, the absence of correction mechanisms, and the exaggeration called forth by fear and competition, inevitably led to a general famine. The book does not compromise. It does not waste time on Mao's supposed positive accomplishments.

The book greatly contributes to the writing of history, but is not by itself a history of the famine. It describes many explanatory phenomena and some important events, but these are not integrated in a coherent understandable whole.

In his conclusion Yang puts too much store in democracy as it functions in Europe and the USA. He doesn't really know and understand the west. Nothing is said about constitutional boundary conditions, about basic guarantees, and about true versus apparent differences between political parties. Without which democracy and dictatorship need not differ much. From the fact that the Chinese communist system is extremely bad it does not follow that another system is good. In some respects the western political system is definitely better. But this is not to say that it is good, or even sufficiently good to enable mankind to survive.

2010.

Frank Dikötter: Mao's Great Famine- The History Of China's Most Devastating Catastrophe, 1958-1962.

³⁸³ Yang, *Tombstone*, p. 3.

³⁸⁴ The "Paradise" refers to communist paradise. Chang shows how this is to be understood: «I had always been told, and had believed, that I was living in a paradise on earth, socialist China, whereas the capitalist world was hell». *Wild Swans* p. 461.

This book fully supports Yang's *Tombstone*. It has a much more transparent structure than *Tombstone*, even though the titles of the chapters hardly summarize their contents. It is less extensive than *Tombstone*. It adds little. It claims to be better researched: less arbitrarily, more systematically.³⁸⁵ For most readers this is probably far outweighed by in particular Yang's valuable description of the Lushan conference and its principal actors.³⁸⁶ Like Yang's, Dikötter's book is not really a history. It gives impressions of events and phenomena in the years 1958-1962. More than half of the chapters are devoted to specific topics, such as agriculture, industry, corruption, children, and women. In chapters like these there is hardly any chronological order or development. Although the first and last sets of chapters concern the beginning and end of the famine period, there is hardly any chronological order in the chapters in between. Developments, either politically or with respect to practical circumstances in the countryside and towns, are not discernable. It is not explained how the end of the famine came about.

As to the cause or origin of the Great Leap and its implementation, Dikötter gives great weight to Mao's desire to do better than the Soviet Union and to overtake the United Kingdom economically. Substantiation of this hypothesis leaves quite a lot to be desired. Mao's supposed desire does not explain the complete lack of common sense and the neglect of experience and reliable knowledge and know how in the implementation. The operation of the party top or government is not described. The party/ government hierarchy, from Peking down to the villages, is touched upon, but not studied systematically or in any detail.

As regards some crucial explanations, Chang's *Wild Swans*, is more useful than either Yang or Dikötter (and the other consulted publications). For example the state of terror created by the Hundred Flower project and other processes goes a long way to explain the lack of normal evaluative discussion. As the Lushan conference would show, Mao is very quick to interpret criticism as an attack on his person and position, and knows only one way to cope with criticism: elimination.

It follows from the above that a true history of the Great Famine remains to be written. In order to be somewhat self explanatory, *Wild Swans* suggests that it would be best to embed it in a history of the Mao-period, or the period 1949-1962, 1/10/1949 being the date the People's republic was established. Perhaps it should also incorporate the Great Proletarian Cultural Revolution. Because of its profound impact on the Chinese people, and because the facts of that "revolution" strongly support the hypothesis of Mao's idiocy and his complete lack of respect for other human beings and what they find important. The Cultural Revolution can also serve to show the mental state of the population. Because of its abnormality, understanding this mentality definitely requires a lot of empirical evidence.³⁸⁷

2018.

"Great famine" in the Wikipedia.

The Wiki-article does make some useful remarks. But these are more than compensated by too many sickening ones. The article seems to try to undermine and relativize the famine and the responsibility of the leadership of the CCP. The article can be rejected on the basis of rather simple inconsistencies with undisputed facts, maybe even on the basis of internal inconsistencies.

In order to enable the reader to evaluate the relative weight the article gives to topics like the name of the famine, it is noted that the text of the article has about 3200 words.

The article begins with the following:

«The Great Chinese Famine [...] was a period in the People's Republic of China between the years 1959 and 1961 characterized by widespread famine. Drought, poor weather, and the policies of ruler Mao Zedong contributed to the famine, although the relative weights of the contributions are disputed. Estimates of deaths due to starvation range in the tens of millions. [...]»

³⁸⁵ Dikötter, *Mao's Great Famine*, p. 347.

³⁸⁶ Yang, *Tombstone*, chapter 10.

³⁸⁷ As we have already seen, and the sources for this section confirm, there is not just one mental state or mentality. Different people react very differently. Chang's implicit examples are invaluable in this respect too. The present text is a simplification.

The famine in China has been known by multiple names, inside China, and out. In China, it is known as the “Three Years of Great Chinese Famine”. The government of the People's Republic of China called it “Three Years of Natural Disasters” before the 1980s, and later renamed it the “Three Years of Difficulty” or “Great Leap Forward Famine”.»

This clearly shows the attitude of the Chinese government, and its influence on the article.

The article continues:

«Origins.

The great Chinese famine was caused by a combination of adverse weather conditions, social pressure, economic mismanagement, and radical changes in agriculture imposed by government regulations.»

The article takes the “natural disaster” hypothesis seriously:

«These radically harmful changes in farming organization coincided with adverse weather patterns, including droughts and floods. In July 1959, the Yellow River flooded in East China. According to the Disaster Center, the flood directly killed, either through starvation from crop failure or drowning, an estimated 2 million people, while other areas were affected in other ways as well. Frank Dikötter argues that most floods were not due to unusual weather, but to massive, poorly planned and poorly executed irrigation works which were part of the Great Leap Forward. In 1960, an estimated 60% of agricultural land in northern China received no rain at all. The Encyclopædia Britannica yearbooks from 1958 to 1962 also reported abnormal weather, followed by droughts and floods based on Chinese government sources. This included 760 millimeters (30 inch) of rain in Hong Kong across five days in June 1959, part of a pattern that hit all of Southern China.»

The article which is referred to as the source for the assertion about the absence of rain in 1960 has the title “Part 2: The Great Leap Forward not all bad”. It seems quite significant that no better source is mentioned. On the basis of the sources mentioned in the present work, it must be concluded that a paper with such a title deserves skepticism. Given the number of victims, the title demonstrates a horrible lack of sense for proportions (between the good and the bad in the Leap). It also shows a terrible lack of respect for the victims, and a misplaced and misleading respect for Mao c.s.

The Britannica Yearbooks were not to be found, and “Chinese government sources” obviously cannot be trusted. So the foundation of the natural disaster hypothesis is very weak at best, and may just as well be absent. Furthermore, as noted earlier:

1. adverse weather conditions need not have caused widespread famine if the government had (re)acted adequately;
2. it is obvious that the innumerable and far reaching follies of the Great Leap must have caused disasters on an unprecedented scale, with or without cooperation of the weather;
3. the occurrence of natural disasters makes exportation of foodstuffs by the government all the more criminal.

The article suggests that there was a real “illusion of superabundance”:

«This series of events resulted in the illusion of superabundance, in which the Party believed that they had an excess amount of grain they could access; but, the Party was also unaware that crop yields were in fact lower than average.»

No proof is given. Given the prehistory (such as the Lushan conference) and the revolutionary changes realized in the Leap, it is impossible to believe that nobody in the leadership doubted the numbers. In fact, Yang, Dikötter and others positively show that they did know, and persevered anyway. Chang for one shows that letters about the actual situation remained to be sent to Beijing.

It is not explained how the Party could believe in superabundance if the country was ravaged by natural disasters.

If the Wiki does not simply lie, then at best it tells only half of the truth. It is remarkable that it tells the half that suits the CCP best. The point is that Peng Dehuai had already noted the exaggerations at the Lushan conference in the summer of 1959. The reports of the conference show that he was not the only one to have noted the exaggerations. Because of this conference, attended by thousands, everyone higher up must have known. Even if exaggerating production numbers would have been forbidden by the conference, compliance should henceforth be checked. After Lushan, nobody was permitted to believe production numbers at face value. There was a very good reason to doubt them. If the numbers

indicated superabundance, this should have given rise to an investigation, not to rejoicing and exportation.

It need not surprise that the Wiki article does not mention the Lushan conference, or Peng's efforts at correction. A report of Peng's intervention would falsify the essence of the article.

Another example of the juxtaposition of harsh judgments and supposedly attenuating or undermining remarks:

«Amartya Sen puts this famine in a global context, arguing that lack of democracy is the major culprit: "Indeed, no substantial famine has ever occurred in a democratic country- no matter how poor". He adds that it is "hard to imagine that anything like this could have happened in a country that goes to the polls regularly and that has an independent press. During that terrible calamity the government faced no pressure from newspapers, which were controlled, and none from opposition parties, which were absent". On the other hand, Sen points out that in India the numbers of "excess mortality" regularly surpass those of China during 1958-1961.»³⁸⁸

The Wikipedia article looks like a compromise, or a truce, between more or less independent historians and persons representing the Chinese government. Regrettably, a compromise between the truth and a lie is a lie.

8.21. The book *A Problem from Hell* by Samantha Power, and the characteristics of US presidents and government officials.

This book gives extensive descriptions of the genocides of the twentieth century, and of the efforts of the USA to stop them and bring the perpetrators to justice, as required by the Genocide Treaty. The genocides and the passivity of "democratic" governments are far worse than you probably think. The reason being that governments in general have been trying hard to suppress all information requiring their active involvement.³⁸⁹ Because the media let themselves be led (informed) to a large extent by governments, this means biased information of the public.

The book shows a terrible reluctance of US governments to accept the facts, and to act upon them as required by the Treaty. In fact it is far too kind to say that they are reluctant to accept the facts. They do accept them, but don't like them. Possibly among other things because the facts require action which might cost them votes. To defend their passive attitude they do everything in their power to show why information is unreliable and/or does not require their involvement. And similar trickery. The book shows that presidents and their higher collaborators are extremely insensitive to human suffering even if it takes place on a very large scale. The book shows very little, or no, traces of troubled consciences of the higher ups. It does show that people lower in the governmental hierarchy and in the field suffer from the inaction of those responsible.

For example in chapter 12 about Kosovo, the book shows efforts at manipulation and other examples of a lack of integrity by the US Armed Forces. In conjunction with a lack of common sense and ability, or willingness, of responsible politicians to assess the advice of the military. When the military oppose (more) involvement, they claim the need of many more soldiers than acceptable to the politicians.

The book is amazing in that it shows an author who tacitly finds a leading role of the USA self-evident. It does not discuss the question why the USA would have a special responsibility, why it should not try to cooperate much more with the UN and other states. It does not discuss why the USA should not try to improve the possibilities for the UN to play a leading role, or, if the UN is for some reason unsuitable, to try and improve it, or to devise a better alternative. It is amazing that the book does not seem to be aware of its premises, and their dangers.

³⁸⁸ Of course, we know by now that the article cannot be trusted. Therefore these assertions should be verified before assuming them to be true.

³⁸⁹ As you can also see today, for example with respect to the Kurds, Tibet, and the conquest of the South East Asian Sea by the Chinese. Governments are silent because they don't want to wager their supposed economic interests (tax income) in Turkey and China.

8.22. The reaction of the hierarchy of the Roman Catholic Church to sexual abuse by its officers (1945-2010).

Summary and main conclusion.

In at least the years 1945-1981 clerical child sexual abuse was a structural phenomenon. The length of the period shows that the Church hierarchy took insufficient action. It was even worse: victims were left to their fate, and the abuse was covered up. As if the Church and its officers had nothing to do with Christian norms and values. Even after the scale of the abuse had become widely known, the attitude of the Church was not forthcoming. It had to be forced to apologize and compensate for damage caused.

The main conclusion is that in important respects, the Church is indistinguishable from any other hierarchical organization. It considers its public image much more important than any other norms and values.

Outline of the case.

Sexual abuse is a frequent phenomenon. It is not restricted to religious organizations. Some organizations may however create circumstances which increase its probability, and make it relatively easy to keep it secret. For example by claiming to be a champion of integrity, and by claiming that supervision of observance of norms can or should be left to the organization. In the case of the Church, the claim of self rule could be supported by the custom of over a century, to apply rules for relations between states to relations between organizations. An important example of such a rule is that of non intervention in internal affairs (or indeed, self rule). Which can even be seen as part of the implementation of the principle of separation of Church and State.

The problem is that officers of the Roman Catholic Church sexually abused people from outside the Church. It was not an internal affair. The state(s!) nevertheless took decades to take action. An Irish inquiry commission came to the following conclusion:

«Conclusion

1.113 The Commission has no doubt that clerical child sexual abuse was covered up by the Archdiocese of Dublin and other Church authorities over much of the period covered by the Commission's remit. The structures and rules of the Catholic Church facilitated that cover-up. The State authorities facilitated the cover up by not fulfilling their responsibilities to ensure that the law was applied equally to all and allowing the Church institutions to be beyond the reach of the normal law enforcement processes. The welfare of children, which should have been the first priority, was not even a factor to be considered in the early stages. Instead the focus was on the avoidance of scandal and the preservation of the good name, status and assets of the institution and of what the institution regarded as its most important members – the priests. In the mid 1990s, a light began to be shone on the scandal and the cover up. Gradually, the story has unfolded. It is the responsibility of the State to ensure that no similar institutional immunity is ever allowed to occur again. This can be ensured only if all institutions are open to scrutiny and not accorded an exempted status by any organs of the State.»³⁹⁰

For decades both Church and State ignored or even denied the abuse and its scale. A scale which investigations found to defy imagination. The following quote from the summary of a Dutch inquiry report gives an impression of the scale of the abuse:

«The number of victims that grew up as Roman Catholic, spent part of their youth in a Roman Catholic institution and reported being sexually abused by an offender working in the Roman Catholic Church before the age of 18 during the period between 1945 and 1981 is approximately 10,000 to 20,000. Their experiences ranged from very mild to severe.»³⁹¹

And the Netherlands is a relatively small country, with a predominantly non-catholic population.

³⁹⁰ P. 28 of the Murphy report. In the dossier.

³⁹¹ P. 10, Deetman_Report_English_Summary.pdf. In the dossier for this section.

The most remarkable in this case would seem to be, that the Roman Catholic Church, an organization professing to be the embodiment of Christian norms and values, behaved itself just like an “ordinary” hierarchical organization. That it behaved contrary to its own norms and values, and persisted in denial of wrongdoing. That it maintained that adequate measures had been taken, and that things had improved greatly etcetera. The well-known story. In other words: the Church does not act in accordance with what it says to believe. How is this possible, how is this to be explained?

The most probable explanatory hypothesis seems to be, that all hierarchical organizations have the same mechanisms for selecting their managers. Mechanisms which exclusively select a certain type of people. Namely people who give an overriding priority to what they see as the interest of the organization (as an organization),³⁹² and imagine that they are very well able to lead a (large, international) hierarchical organization. And lead it better than anyone else. In other words: people who don’t know themselves, and have questionable and/or contradictory norms and values. Contradictions of which they are aware: they try to give the outside world a different picture of themselves and their organization: a picture that is consistent with generally accepted norms and values. Cost what it may, including violation of published norms and values or their organization, they try to maintain that they and their organization functioned and functions properly, made no errors and did no wrong. As they fought to get their position, they fight to keep it, and therefore deny wrongdoing and lack of competence.³⁹³

An additional hypothesis is, that even a religious hierarchical organization is first of all a hierarchical organization, and that the religious norms and values come only in the second place. That they are a means, not an end. Which means that the interests of the organization as an organization are priority number one, and that everything else is subordinated to that priority. This implies that the picture which the outside world has of the organization is sacrosanct. Where necessary, the religious norms and values of the organization, its purported reason for existence, are sacrificed.

The sources, and comparison with other cases, show that the way the hierarchy of the Church reacted on accusations of sexual abuse is indistinguishable from the way any hierarchical organization reacts on accusations of wrongdoing. With denial. Including denial of liability, and of the obligation to recover harm inflicted. The Christian norms and values, the code of conduct of every Christian, played a subordinate role at best. There was no openness and honesty. Charity was reserved for the guilty officers. Who had violated religious and legal norms seriously and systematically. The many victims were left to their fate. The Church never explained why it kept the misconduct hidden, why it denied wrongdoing and its scale, and why it did not help the victims in accordance with Christian norms and values. The Church had to be forced to pay damages.

In selecting the higher functionaries, the hierarchy of the Roman Catholic Church must have given priority to people who find the interests of the Church more important than the Christian norms and values, and who perceive these interests in an debatable, unchristian manner. People who find appearance more important than substance.

Another important conformity of the Church with other hierarchical organizations is the absence of whistleblowers. Even though there can be no misunderstanding about the norms and values of the Church, and therefore about the wrong of sexual abuse, and the obligation to help victims. It would seem that all officers know that appearances and the interest of the Church are not to be endangered in any way and under no condition.

In 1867 Francis Parkman described the Roman Catholic Church as follows:

«Holy Mother Church, linked in sordid wedlock to governments and thrones, numbered among her servants a host of the worldly and proud, whose service to God was but the service of themselves,- and many, too, who, in the sophistry of the human heart, thought themselves true soldiers of Heaven, while earthly pride, interest, and passion were the life-springs of their zeal. This mighty Church of Rome, in her imposing march along the high road of history, heralded as infallible and divine, astounds the

³⁹² To be distinguished from the goals of the organization.

³⁹³ Perhaps “managers” are (implicitly?) selected on debating and justification abilities, instead of the abilities to listen, judge objectively, and reason logically. Perhaps because it reflects assertiveness, or the will and ability to win (irrespective of its justification and consequences).

gazing world with prodigies of contradiction: now the protector of the oppressed, now the right arm of tyrants; now breathing charity and love, now dark with the passions of Hell; now beaming with celestial truth, now masked in hypocrisy and lies; now a virgin, now a harlot; an imperial queen, and a tinselled actress. Clearly, she is of earth, not of heaven; and her transcendently dramatic life is a type of the good and ill, the baseness and nobleness, the foulness and purity, the love and hate, the pride, passion, truth, falsehood, fierceness, and tenderness, that battle in the restless heart of man.»³⁹⁴

One and a half centuries later there is no reason to change his summary.³⁹⁵

8.23. Outlines of some more cases.

Srebrenica.

«The town of Srebrenica came to international prominence as a result of events during the Bosnian War (1992–1995). The strategic objectives proclaimed by the secessionist Bosnian Serb presidency included the creation of a border separating the Serb people from Bosnia's other ethnic communities and the abolition of the border along the river Drina separating Serbia and the Bosnian Serbs' Republika Srpska. The Bosnian Muslim/Bosniak majority population of the Drina Valley posed a major obstacle to the achievement of these objectives. In the early days of the campaign of forcible transfer (ethnic cleansing) that followed the outbreak of war in April 1992 the town of Srebrenica was occupied by Serb/Serbian forces. It was subsequently retaken by Bosniak resistance groups. Refugees expelled from towns and villages across the central Drina valley sought shelter in Srebrenica, swelling the town's population.

The town and its surrounding area was surrounded and besieged by Serb forces. On 16 April 1993, the United Nations declared the Bosnian Muslim/Bosniak enclave a UN safe area, to be “free from any armed attack or any other hostile act”, and guarded by a small unit operating under the mandate of United Nations Protection Force (UNPROFOR).

Srebrenica and the other UN safe areas of Žepa and Goražde were isolated pockets of Bosnian government-held territory in eastern Bosnia. In July 1995, despite the town's UN-protected status, it was attacked and captured by the Army of Republika Srpska. Following the town's capture, all men of fighting age who fell into Bosnian Serb hands were massacred in a systematically organized series of summary executions. The women of the town and men below 16 years of age and above 55 were transferred by bus to Tuzla.

The Srebrenica massacre is considered the worst massacre in post-World War II European history to this day.

In 2001, the Srebrenica massacre was determined by judgment of the International Criminal Tribunal for the former Yugoslavia (ICTY) to have been a crime of genocide (confirmed on appeal in 2004). This finding was upheld in 2007 by the International Court of Justice. The decision of the ICTY was followed by an admission to and an apology for the massacre by the Republika Srpska government.

Under the 1995 Dayton Agreement which ended the Bosnian War, Srebrenica was included in the territory assigned to Bosnian Serb control as the Republika Srpska entity of Bosnia and Herzegovina. Although guaranteed under the provisions of the Dayton Agreement, the return of survivors was repeatedly obstructed. In 2007, verbal and physical attacks on returning refugees continued to be reported in the region around Srebrenica.»³⁹⁶

³⁹⁴ The quote is the beginning of chapter 8 of *The Jesuits in North America [in the 17th century]*. This is book 2 of *France and England in North America*. The quote can be found on p. 458 of volume 1 of the edition of The Library of America. In the sequel of the quoted text, Parkman calls the Jesuits in North America “her nobler and purer part”. The remainder of the (recommended) book shows why.

³⁹⁵ But note that in the last sentence, Parkman assumes quite a bit of relevant similarity between all men. One of the main conclusions of the present study will be, that this is an untenable mistake. Whatever the similarities, the practical importance of the differences is immeasurable. For elucidation see the following chapter.

³⁹⁶ Wikipedia, Srebrenica, 4/12/14.

Note that even a Wikipedia page of 2014 omits to mention the number of men killed. The French newspaper *Le Monde* of 29/11/01 mentions 7000 to 8000 men.³⁹⁷

The massacre of Srebrenica is a clear example of false pretensions with terrible consequences.³⁹⁸ The promise (by politicians) of protection was false. In addition the case provides examples of obstruction of investigation, accounting, and of the administration of justice by, among other things, intentional destruction of evidence by governments. Some reports can be found in the dossier. See also the book *A problem from hell* by Samantha Power. Its chapter 11 is devoted to Srebrenica.

Shell and its code of conduct.

For many years the conduct of the oil company Shell has been incompatible with its own code of conduct. For example in Nigeria and in the Dutch province of Groningen, through its participation in the NAM, the company extracting gas from the soil of that province. The gas extraction causes earthquakes, and damage to houses. For many years the safety interests of the population were ignored. Damages were at best paid only after great efforts by outsiders, and mostly only in part.

Lance Armstrong.

Lance Armstrong was a professional cyclist. He is an example of an extremely stubborn liar who for many years successfully created and manipulated a social environment supportive of his illegal performance enhancing practices, and in keeping up appearances. Among other things, the case shows the following:

1. That swindlers like Lance Armstrong exist, get plenty of loyal help, and may operate successfully for over a decade;
2. That many people in his support network knew about the use of dope and other illegal performance enhancing practices. Nevertheless for many years none of them blew the whistle. In other words: the case also gives an example of a group of people whose status, if not existence, was based on improper conduct and lies, and who kept shielding one another. The case proves that this is possible and exists;
3. The history of the case shows that efforts to expose and end misconduct may meet serious opposition and other difficulties. The film *The Armstrong lie* and the Wikipedia articles on Armstrong and the UCI strongly suggest a harmful (and potentially dangerous) bias against exposing misconduct of the rich and mighty. Praise needs no proof at all, accusations need very strong proof. Someone exposing misconduct runs a serious risk of lawsuits. With the given (biased) law such a risk is no problem for the very rich (the organization paying for its top officers), but a great problem for everyone else;
4. This is illustrated by the history of the book L.A. Confidential of Pierre Ballester and David Walsh, published in 2004 (four). It was published only in French: «It had become evident early on that English publishing houses weren't going to risk their lives in a scrum for the publishing

³⁹⁷ The article is in the dossier.

³⁹⁸ In the opinion of the present author, given what had recently happened in the given area, the worst was to be expected. For that reason the conduct of the responsible politicians and military is blamable and extremely reprehensible. Because these people voluntarily accepted their jobs and because of their promises to the population, one can again speak of causation by omission. Evidently the responsible people could not foresee exactly what they would meet in their jobs. But they knew at least what kind of situations they might be confronted with. They could and should have known that they depended on colleagues/ politicians who cannot be trusted. From an emotional point of view the author finds a more or less objective investigation of the case difficult because of the extremely repulsive behavior of several of the responsible politicians and military. As if nothing at all has been learnt from the horrors of history. From a rational point of view investigation of the case is not very well possible, and is probably unnecessary. It is hard to see what essential new insights it can produce. (Though admittedly one never knows). It is not (at present) very well possible because of a lack of information about especially the UN and US. In fact, this lack of information and openness can be considered as a separate case.

rights, so it would be a French book>.³⁹⁹ Armstrong asked a French judge to have a denial inserted in the book. In vain. When the English newspaper *The Sunday Times* published an article referring to the book, it was sued for libel. In 2006 this and another suit were stopped by an out-of-court agreement. *The Sunday Times* published an apology, and paid Armstrong “a large sum of money”.⁴⁰⁰

5. The case gives an additional example of an inadequate and biased, if not false, “independent inquiry” ordered by the UCI:

«In October 2005, in response to calls from the International Olympic Committee and the World Anti-Doping Agency (WADA) for an independent investigation, the UCI⁴⁰¹ appointed Dutch lawyer Emile Vrijman to investigate the handling of urine tests by the French national anti-doping laboratory, LNDD. Vrijman was head of the Dutch anti-doping agency for ten years; since then he has worked as a defense attorney defending high-profile athletes against doping charges.

Vrijman's report cleared Armstrong because of improper handling and testing. The report said tests on urine samples were conducted improperly and fell so short of scientific standards that it was “completely irresponsible” to suggest they “constitute evidence of anything”.»⁴⁰²

The following is an example of Armstrong's lying:

«On August 23, 2005, L'Équipe, a major French daily sports newspaper, reported on its front page under the headline “le mensonge Armstrong” (“The Armstrong Lie”) that 6 urine samples taken from the cyclist during the prologue and five stages of the 1999 Tour de France, frozen and stored since at "Laboratoire national de dépistage du dopage de Châtenay-Malabry" (LNDD), had tested positive for erythropoietin (EPO) in recent retesting conducted as part of a research project into EPO testing methods.

Armstrong immediately replied on his website, saying, “Unfortunately, the witch hunt continues and tomorrow's article is nothing short of tabloid journalism. The paper even admits in its own article that the science in question here is faulty and that I have no way to defend myself. They state: 'There will therefore be no counter-exam nor regulatory prosecutions, in a strict sense, since defendant's rights cannot be respected.' I will simply restate what I have said many times: I have never taken performance enhancing drugs”.»⁴⁰³

The film shows that he lied, and very convincingly. Without blushing, changes of expression or any other bodily indication of internal conflict. His behavior in the “confession session” with Oprah Winfrey was exactly the same. In other words: he is utterly unreliable.⁴⁰⁴ It seems very doubtful whether he really was not aware of wrongdoing,⁴⁰⁵ and finally saw the light.

In this connection it should be noted that his “openness” too is very doubtful. It may very well have been no more than politics and self interest. He did admit some (well-known) things, but not all. Not even all of his important misdeeds. Such as systematically denying declarations of witnesses who had heard him list a number of the illegal drugs he had used to boost his performance. Denials which had a very damaging effect on the lives of the witnesses.

³⁹⁹ P. 240 of David Walsh, *Seven deadly sins- my pursuit of Lance Armstrong*, Atria Paperback, Simon & Schuster, New York, 2012, ISBN 978-1-4767-3711-9.

⁴⁰⁰ English Wikipedia, the article “L.A. Confidentiel”, 20200518.

⁴⁰¹ «The Union Cycliste Internationale (UCI; [...] “International Cycling Union”) is the world governing body for sports cycling and oversees international competitive cycling events. The UCI is based in Aigle, Switzerland. The UCI issues racing licenses to riders and enforces disciplinary rules, such as in matters of doping. The UCI also manages the classification of races and the points ranking system in various cycling disciplines including mountain biking, road and track cycling, for both men and women, amateur and professional. It also oversees the World Championships.» From the Wikipedia page UCI.

⁴⁰² Wikipage Lance Armstrong 26/1/15. For more information on this “investigation” see also the film *The Armstrong lie*. The film is of 2013.

⁴⁰³ Wikipage Lance Armstrong 26/1/15.

⁴⁰⁴ The film could have been titled: *The Lie Armstrong*.

⁴⁰⁵ The allegation that everyone did the same is heard often, but I've seen no proof or even serious substantiation. Even “many people” need not mean everyone. And first of all: not physicians or producers of pharmaceuticals are to be ranked, but cyclists.

The following illustrates his downfall:

«In February, 2011, Armstrong announced his retirement from competitive cycling, facing a US federal investigation into doping allegations. In June 2012, USADA [= United States Anti-Doping Agency] charged Armstrong with having used illicit performance-enhancing drugs. In August 2012, USADA announced that Armstrong had been issued a lifetime ban from competition, applicable to all sports which follow the World Anti-Doping Agency code. USADA also stripped Armstrong of his seven Tour de France titles. The USADA report concluded that Armstrong engaged in “the most sophisticated, professionalized and successful doping program that sport has ever seen”. On October 22, 2012, the UCI upheld USADA’s decision. It also decided that his stripped wins would not be allocated to other riders. Armstrong chose not to appeal the decision to the Court of Arbitration for Sport.

Despite having denied drug use throughout his career, in January 2013, Armstrong admitted to doping in a television interview conducted by Oprah Winfrey. In September 2013, he was asked by UCI’s new president, Brian Cookson, to testify completely about his doping. Armstrong refused to testify until and unless he got a complete amnesty, which Cookson said is most unlikely to happen.»⁴⁰⁶

Blatter, Platini and FIFA: corruption galore.

This is another example of clever, perfect, parasitic liars, expert play-actors and lack of any meaningful conscience. The case confirms that such people exist. Even if rare, they are clearly not exceptional. As the Wiki-page FIFA and related pages show,⁴⁰⁷ Blatter and Platini were not the only ones. Corruption in the FIFA top was the rule, not the exception. The case once more shows that no significance can be attached to codes of conduct. In this case too they seem to be meant only to deceive the public. The case is furthermore interesting because of the hesitant reactions of FIFA members to the discoveries of corruption and fraud. They should have discovered and corrected the wrongdoing themselves, and long ago. For many years they failed in their supervision of the executive directors. The case underlines the need of far better mechanisms of personnel selection and control.

8.24. Academic experiments and scientific literature.

Conclusions.

1. The results of the academic experiments are compatible with the findings of this report.
2. Although the experiments show differences between people, they also seem to assume that people are “essentially equal”, and differ only in subordinate respects. Maybe in some sense there is some truth in this. It doesn’t matter much. For even if there were some truth in it, it would have little practical significance, except for suggesting a misleading picture of man.⁴⁰⁸ Even small differences may have major consequences, and in people they often do. (Assuming the differences are called small). Small differences may have major consequences for example when they translate into different outcomes of all or nothing choices, as when people decide whether or not to step into, or accept, situations with a large probability of “having to” structurally violate generally accepted norms and values. With major consequences. With only a few successive choices, human beings can transform minor initial differences into major and consequential differences.
3. Some experiments concern prisoners and their guards. In certain circumstances prisoners and guards do unacceptable things. But not everybody wants to be prisoner or guard. Not everybody wants to join the army, or go into politics. Some people avoid circumstances which they fear to bring along unknown risks, or risks of unwanted kinds; if only intuitively. So even if everybody can theoretically be put in a situation where he or she will show certain types of behavior, this does not mean that everybody is just as likely to land in such a situation. People are not that equal.

⁴⁰⁶ Wikipage Lance Armstrong 26/1/15.

⁴⁰⁷ Some can be found in the dossier.

⁴⁰⁸ A picture that hinders explanation of social reality.

4. The relation between the experiments and reality is unclear. The experiments concern only a few of the many aspects of real work situations. It is therefore unclear what they say about reality. Of hierarchical organizations for example.
5. The experiments show phenomena (in given circumstances), but provide no explanation.
6. The experiments show phenomena which are also seen in the cases. In the cases the effects seem more pervasive however. One might conjecture that organizations select very effectively, and that the pressure perceived by employees of hierarchical organizations is more effective than that perceived by participants in the experiments. Where one should reflect that opinions about correctness, admissibility, etcetera of dubious actions may play an important role, and are influenced by pressure and information or deception.⁴⁰⁹
7. The phenomena shown in the experiments can be construed as arguments against hierarchical organization.
8. Why experiments and speculation? Why so very few (if any) studies of real phenomena, reality?⁴¹⁰
9. The social-scientific literature shows little or no interest in the phenomena described in this report, or in any real phenomena for that matter. There is no scientific literature explaining the phenomena discussed in this report in a coherent explanatory framework. Science defaults almost completely.

Three experiments.

In September 2011 I contacted an expert with the request for a discussion about:

- Empirical research in social sciences, and the juridical aspects of publishing about them (because the possibility of identification of persons mentioned in reports about real events is inevitable);
- Integrity in politics and government.

The expert reacted as follows:

«I would advise you to study in the area of philosophy and in particular in the theory of rule-guided conduct- I am thinking of Winch and Wittgenstein, but also of somebody like Schauer. Besides one can think of social-psychological work, like that of Zimbardo and his Stanford Prison Experiment. I think this can be very useful for you».

He could better have recommended Reinach's *Histoire de l'affaire Dreyfus*. This history shows much more than all philosophical writings and academic experiments combined. Nothing as relevant has been published since then. I don't understand the advice to study philosophical writings. A discussion has not taken place, the expert having no time. The work of Zimbardo and related experiments have been studied. The following brief descriptions give an impression. They have been included for easy checking. Skipping them will not cause a significant gap in knowledge or understanding. The reader may as well continue with the section about the scientific literature.

The Asch conformity experiments (1950s).

«This experiment was conducted using 123 male participants. Each participant was put into a group with 5 to 7 “confederates” (people who knew the true aims of the experiment, but were introduced as participants to the naive “real” participant). The participants were shown a card with a line on it, followed by another card with 3 lines on it labeled a, b, and c. The participants were then asked to say which line matched the line on the first card in length. Each line question was called a “trial”. The “real” participant answered last or penultimately. For the first two trials, the subject would feel at ease

⁴⁰⁹ This agrees with the observations of the author in the Dutch ministry of education. The “deception” refers for example to the supposed political control by parliament (to whitewash everything that happens in a ministry). Hitler was chosen democratically (more or less, but this applies more often than not), but that does not mean that he was good and should be obeyed blindly.

⁴¹⁰ Because one is afraid of the results, of political reactions?

in the experiment, as he and the other “participants” gave the obvious, correct answer. On the third trial, the confederates would start all giving the same wrong answer. There were 18 trials in total and the confederates answered incorrectly for 12 of them, these 12 were known as the “critical trials”. The aim was to see whether the real participant would change his answer and respond in the same way as the confederates, despite it being the wrong answer.

Solomon Asch thought that the majority of people would not conform to something obviously wrong, but the results showed that 25% of the participants did not conform on any trial. 75% conformed at least once, and 5% conformed every time (37% conformity over subjects averaged across the critical trials).

In the basic Asch paradigm, the participants- the real subjects and the confederates- were all seated in a classroom. They were asked a variety of questions about the lines such as how long is A, compare the length of A to an everyday object, which line was longer than the other, which lines were the same length, etc. The group was told to announce their answers to each question out loud. The confederates always provided their answers before the study participant, and always gave the same answer as each other. They answered a few questions correctly but eventually began providing incorrect responses.

In a control group, with no pressure to conform to an erroneous view, only one subject out of 35 ever gave an incorrect answer. Solomon Asch hypothesized that the majority of people would not conform to something obviously wrong; however, when surrounded by individuals all voicing an incorrect answer, participants provided incorrect responses on a high proportion of the questions (32%). Seventy-five percent of the participants gave an incorrect answer to at least one question.»⁴¹¹

Het Milgram-experiment: learning with electric shocks (1961).

«The experimenter orders the teacher, the subject of the experiment, to give what the latter believes are painful electric shocks to a learner, who is actually an actor and confederate. The subject [=the teacher] believes that for each wrong answer, the learner was receiving actual electric shocks, though in reality there were no such punishments. Being separated from the subject, the confederate [=the learner] set up a tape recorder integrated with the electro-shock generator, which played pre-recorded sounds for each shock level.

The Milgram experiment on obedience to authority figures was a series of notable experiments in social psychology experiments conducted by Yale University psychologist Stanley Milgram, which measured the willingness of study participants to obey an authority figure who instructed them to perform acts that conflicted with their personal conscience. [...]»⁴¹²

The experiments began in July 1961. Milgram devised his psychological study to answer the question: “Was it that Eichmann and his accomplices in the Holocaust had mutual intent, in at least with regard to the goals of the Holocaust?” In other words, “Was there a mutual sense of morality among those involved?” Milgram’s testing suggested that it could have been that the millions of accomplices were merely following orders, despite violating their deepest moral beliefs. The experiments have been repeated many times, with consistent results within societies, but different percentages across the globe. The experiments were also controversial, and considered by some scientists to be unethical or psychologically abusive, motivating more thorough review boards for the use of human subjects.»⁴¹³

The prison experiment of Zimbardo (1971).

«The Stanford prison experiment was a study of the psychological effects of becoming a prisoner or prison guard. [...] Twenty-four students were selected⁴¹⁴ out of 75 to play the prisoners [or guards]

⁴¹¹ Wikipedia 29/9/11. (The apparent repetition is in the original. Since something may escape me, I left the text unchanged).

⁴¹² The following was skipped: «Milgram first described his research in 1963 in an article published in the *Journal of Abnormal and Social Psychology*, and later discussed his findings in greater depth in his 1974 book, *Obedience to Authority: An Experimental View*.»

⁴¹³ Wikipedia 29/9/11.

⁴¹⁴ «Zimbardo and his team selected the 24 males whom they deemed to be the most psychologically stable and healthy.»

and live in a mock prison in the basement of the Stanford psychology building. Roles were assigned randomly. The participants adapted to their roles well beyond what even Zimbardo himself expected, leading the “officers” to display authoritarian measures and ultimately to subject some of the prisoners to torture. In turn, many of the prisoners developed passive attitudes and accepted physical abuse, and, at the request of the guards, readily inflicted punishment on other prisoners who attempted to stop it. The experiment even affected Zimbardo himself, who, in his capacity as "Prison Superintendent", lost sight of his role as psychologist and permitted the abuse to continue as though it were a real prison. Five of the prisoners were upset enough by the process to quit the experiment early, and the entire experiment was abruptly stopped after only six days. The experimental process and the results remain controversial.»⁴¹⁵

The scientific literature.

The scientific literature says practically nothing about the less well-known phenomena described and analyzed in this report. The author has sought in vain for case studies and empirically based theoretical studies.^{416, 417} The “empirically based” excludes studies which assume a de facto theoretical, in general rose-colored, world, without checking internal consistency or compatibility with reality.⁴¹⁸ An empirically based study starts from the reality as shown by historical events and a sequence of news items.

In scientific disciplines which do not have the phenomena of this report as their primary subject, but study subjects which are closely related to these phenomena or vice versa, such as law or economics, one hardly finds any trace of (reliable) knowledge or understanding of them. For elucidation the reader is referred to the analysis of the financial crises.⁴¹⁹ It would seem that most people, including scientists, think they understand, and don't understand that they don't understand at all. And cannot understand without much better information. Especially of the internal operation of

⁴¹⁵ Wikipedia 29/9/11.

⁴¹⁶ To be distinguished from for example (quasi) philosophical “studies”. An important exception is the paper by Sokje van Oest about the case Spijkers mentioned earlier in this chapter. An excellent paper, but regrettably an exception. Analytically it is nonetheless insufficient. It does not show that the events described are impossible if not much more is wrong. It does not show that- for logical reasons- the case Spijkers cannot be an exception.

⁴¹⁷ A search in psychology, sociology and management was in vain too. Examples of books that should give serious attention to the phenomena, but are completely silent about them, are:

R. Hague, M. Harrop en S. Breslin, *Comparative Government and Politics, an Introduction*, 3rd ed., Macmillan, London, 1992, pb, xxii+504 pages, ISBN 0 333 55820 0.

Philippe Braud *Sociologie politique*, 9e édition 2008, L.G.D.J. lextenso éditions, series manuels, 824 pages, ISBN 978.2.275.03278.8,

and all (other) books and papers mentioned in *Het recht van de logica* (The law of logic).

The book of Hague et al confirms the assertion in our text in a rather tragicomical way: «A British television series [...] provided [...] insight into how bureaucracies can stress objectives other than their supposed purpose. [...] The minister is concerned with furthering his own career prospects, while the administrators act to preserve their influence, and to promote the ministry's interests against other departments. These interests frequently conflict, and only rarely coincide with those of the government as a whole.» (pp. 347-8). Not reality is the basis for analysis, but a TV-series. And even that would be better than what is actually done. For the “joke” is no more than an aside. The phenomena mentioned are not taken seriously, and not studied at all.

⁴¹⁸ There are more assumptions that preclude relevant insight: “fatal assumptions”. Such as the assumption that crises and wars are inevitable, irrespective of what people want or do, and that politicians try to be informed and advised as good and competently as possible, and act on the best possible information and recommendations. This is incompatible with reality and logic, nonsense in fact, and prevents obtaining explanatory understanding. Most scientists moreover make the same errors as journalists which are discussed later in this study.

⁴¹⁹ There are several possible explanations. Interests undoubtedly play a role. Including fear of discontinuation of subsidies by politically governed organizations and exclusion from the scientific world as a consequence of displeasing or irritating important politicians. But also the illusion that one knows how it works a priori, without any further study of reality. Even the quoted, seemingly trivial, mail exchange shows that the expert thinks that the theoretical work and experiments are “very useful”. If there had been something better, wouldn't he have said so?! Last but not least an investigation of the reality of politics, government and hierarchical organizations may seem to be very difficult. The analysis of the financial crises shows that, to a large extent, this is no more than appearance.

(semi) governmental organizations. Reality cannot always be imagined by logical reasoning.⁴²⁰ Reality may be unimaginable. And of course, lack of understanding may be due to lack of open eyes or serious efforts. The worst of modern science may well be the unscientific lack of interest in the internal operation of (semi) governmental organizations. The lack of interest in the internal operation that is revealed by Van Buitenen and in the first chapters of this report, and implicitly shown by the analysis of the financial crisis.⁴²¹

As regards progress in human understanding it seems rather significant that of the references given in the present report, only Tuchman's *Proud tower* and Shirer's *Collapse of the third republic* mention Reinach's *Histoire de l'affaire Dreyfus*. Even though Reinach's book would seem to be the best and most relevant in connection with the general lack of integrity and competence of politicians, and the explanation of the phenomena surrounding whistleblowing. Much more is known about many more actors in the Dreyfus case than in any later case. The Dreyfus case has many (too many!) similarities with especially the Spijkers case. In both cases a key role was played by the ministry of war/ defense. (A comparison was made and conclusions were drawn in section 8.17 of this chapter).

⁴²⁰ Logical reasoning requires a basis, information about facts (example: physics) and/or assumptions (example: mathematics).

⁴²¹ And supported by the Irish inquiry reports about the financial crisis in Ireland.

Chapter 9.

Final analyses, conclusions and corrective measures.

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- 9.6. Fatal explanatory facts and their principal consequences.
- 9.7. Measures.
- 9.8. Conclusion.

9.1. Characteristics of politicians and top officials.

Conclusions.¹

From the preceding chapters it can be concluded that politicians and other top officials:

1. Seem to be able speakers;²
2. Tell stories³ which they should know they cannot vouch for;
3. Seem to be intelligent. On the surface, their stories, and their answers to questions, seem reasonable, and possibly even expert. But often they are not, even when prepared by people who are supposed to be real experts. Appearances are helped by prior agreement about the questions to be asked in an interview, and by the vital interest of the interviewer to avoid embarrassing the person being interviewed. For people in high positions, appearances say next to nothing.⁴
4. Tend not to discuss but to defend. They never discuss openly and responsibly, in order to develop a sensible law, plan, policy, or report which can withstand criticism. They defend moreover as if they are infallible;
5. Hardly if ever show doubt about what they say;
6. Pretend much more than they can prove. They do so to a far greater extent than other people;
7. Never admit this;
8. Are born play-actors. Their words are not meant for (two sided) communication, but to realize (personal) goals;
9. Seem to think that their play-acting, including lying, is admissible and necessary;⁵
10. Play-act and lie even when under oath;
11. Therefore, talking with these people makes sense only for specific purposes and under suitable conditions;
12. Consider their personal position and power as their first and inviolable priority;
13. Consider the position and power of friendly peers as their next highest priority. In this sense, and only in this sense, they are social;

¹ The conclusions are not independent of one another, and the order may not be the best from all points of view.

² “Seem” if one lets oneself be misled by appearances, and does not sufficiently reflect on the contents. The following appearances may mislead: self assurance of the speaker, smooth flow of words and sentences, the appearance of being able to answer every question, the suggestion of reasonableness, and the suggestion that there is no reason for doubt.

³ Often a terminology like “idle talk” is more appropriate to the quality of the contents, and to the way it should be treated. This can be shown by analysis, and afterwards by (independent) evaluation. The present study gives many examples, even if explicit prior claims have only rarely been quoted.

⁴ In fact, what they say can almost never withstand serious criticism. There are many important questions the speaker would not be able or willing to answer. Which is not noticed, because such questions are not asked. The hearings on the financial crises abound with examples.

⁵ It is remarkable that there is not the least indication of the opposite.

14. Subordinate all other norms and values to self interest and peer loyalty;
15. Including human rights and national interest;
16. Including their obligation to account for their acts and omissions, and for those of the organizations they are responsible for. Public and parliaments are seen as potential opponents to be misled or deceived when “necessary”;
17. Have regulated their legal duty to account in such a way that they can only be judged by their peers, will only be punished for misconduct in highly exceptional cases, and cannot be held liable. Contrary to the principle of equal rights for everyone;
18. Behave as if they will never have to account seriously for their behavior, and behave as if liability and criminal laws don’t exist. The cases show that their assumption is correct. None of the principal persons has been held to account,⁶ held liable, or punished;
19. Their misconduct is unthinkable if they would have had good reason to fear accountability, liability or punishment. If there had been good reason to fear accountability, liability or punishment, they probably would not even have accepted their job; knowing that their competence is far too limited;
20. Have a tendency to meddle with everything and everybody. Claim to know what is best for everyone, and to have the right to prescribe the law, whatever people think or want;
21. Have no real respect for other people;⁷
22. Have confidence in people they cannot judge, or only as regards subservience and loyalty;
23. Depend on people who perceive obedience or loyalty as highest and inviolable norm;
24. Do not work in an accountable way, in accordance with available knowledge and know-how. For example with respect to the organizations of which they are the head or for which they are responsible;
25. Do not take adequate measures to prevent repetition of gross failure;
26. Rely on their power (and that of their peers) to cover up and make forget;
27. Are able, after the discovery of misconduct and/or failures, to make a large part of the population believe that these were mere incidents, which will be corrected, and do not detract from their integrity and competence;
28. Are able, as a group, to make people believe that the need to resign is a terrible punishment, in spite of excellent severance pay, and the help from powerful friends in finding a cozy well paid other job;
29. Are being treated as honorable and competent managers, leaders, experts or whatever, by especially the media, even after causing immeasurable avoidable harm for very many people;⁸
30. Hold diplomas which say nothing about their abilities to act as a member of government, or as head of a large (government) organization.

Note that most or all of these conclusions are actually summaries of observations. That is, they are not the result of long, complicated and questionable reasonings.

It is furthermore important to note that many of the listed characteristics are really as pronounced as suggested, and that there are no exceptions. None of the many cases of gross misconduct mentioned in this study has been accounted for in a way that can stand even weak criticism.⁹

⁶ In a sense which is normal for common people.

⁷ As opposed to verbal respect. “Real respect” means respecting the safeguarding principle, and accepting liability. See *The law of logic* or *Communication and norms*. See lawoflogic.net.

⁸ The cases of the preceding chapters give many examples. The most important and obvious probably being the financial crisis. Long time president Wellink of the Dutch DNB and undersecretary of the US treasury Summers being notorious examples.

⁹ One might think that the cases of the study have been selected expressly for the purpose of proving assertions like this. Obviously the education ministry was not selected. It was a random sample. There is no reason to assume it to be a relatively bad example. Other cases suggest rather the contrary, that it was a relatively good organization (N.B. Only relatively!). Especially the whistleblower cases and the financial crises show the general nature of the lack of integrity. And none of the cases would have been possible if the system of which they are part had effective correction mechanisms.

The above conclusions can be drawn from many of the cases separately. They are compatible with all of them. In addition, the cases and the events surrounding them become unintelligible if even one of the conclusions would be incorrect.

The conclusions imply that differences between people are far greater and far more important than commonly thought. The principal persons in particular do not truly respect outsiders, without exception. This is not exactly in agreement with what these people try to make us believe. It may therefore be useful 1) to look for causes of the underestimation of differences between people, 2) to review some of the observational evidence, 3) to discuss possible causes of the underestimation, and 4) to discuss possible justifications for these causes. This then is the program of the next section.

Lack of respect for others may be caused by overestimation of oneself. And by failure to realize that superiority- real or imagined- gives no special rights. It is obvious that all principal persons consider themselves superior to other people. At least, they claim suitability for the most responsible or influential jobs in the world, and show no trace of modesty, or doubts about themselves. They accept functions which exceed human capabilities. Functions which entail responsibilities nobody can bear. Where it should be noted that responsibility is only a meaningful concept when coupled with bearable liability, or if everyone who is affected accepts the (self) justification. Which obviously is not the case.

The underestimation of differences between people, and its causes.

Not everyone feels free to meddle in other people's affairs.

The behavior seen in the various cases could easily make the reader forget that a large majority of the people feels no inclination to meddle with other people's affairs, or to form an opinion about what a government should do or not.¹⁰ A majority of people don't seem to feel any urge to meddle with other people. A majority seems to be apolitical in the best sense of the word. The self image of a majority seems not to exceed the reality of their abilities. They have jobs they can do properly, and don't need to lie about their work. Not even when they make mistakes. Because their mistakes are not only human, but, more important, rarely have irreparable consequences.

Politicians do not only meddle with everyone and everything, but also pretend to have the right to bindingly impose their opinions on everybody. Even on people who disagree with them for (good) reasons.¹¹ This is a very essential difference between people, for it is a major source of conflict and suffering.

This difference between people is visible in everyone's personal environment, and in the literature. It is quite remarkable that in the literature, a large majority of characters in novels displays not the least interest in "political questions". They are fully occupied with their own affairs, and with their personal social environment. It is remarkable that this does not make these characters or novels unrealistic or incredible. It is furthermore clear that in this respect there may be a large difference between men and women: many more women than men dislike politics, or discussing political subjects. While men and women differ quite a lot within their sex group.

Exceptional and something of the past?

In the media and sciences there is very little reflection on differences between people and the consequences of differences.¹² Too little reflection actually, at least if large and harmful consequences and risks are assumed to justify the use of "too". Far too often people reason from premises like

¹⁰ Note that this is an indirect way of meddling in other people's affairs, since government actions affect everybody. Think of law making, taxation, and redistribution. Asking a government to do something implies requiring everybody to contribute financially.

¹¹ If a reason would be necessary.

¹² In this report, "science" is meant in the wide sense, all fields of reliable knowledge and know how. It therefore also includes law, mathematics, and technology.

“fundamental” equality, being more or less intelligent, having more or less abilities, etcetera. As if the ranking in a the hierarchy of an organization corresponds with knowledge and abilities. Perhaps the general acceptance of such ideas is a consequence of their simplicity, suitability (for some), or wishful thinking. But they do not agree with reality. In fact, they make reality inexplicable.

What could give rise to doubts about the simple picture is the question whether ordinary criminals and people like Alexander “the Great”, Amin, Genghis Khan, Eichmann, Hitler, Mao, Mladic, Napoleon, Pol Pot, Stalin, Tamerlane, Wilhelm II, and their principal supporters, form a distinct group, which may be considered exceptional. In other words: that these people are phenomena which do not belong to the normal world. And which need not be taken into account when trying to understand what is happening in the world of today. As if such people only exist or manifest themselves in faraway primitive countries or times. Even though already this tiny sample clearly shows that this kind of people very regularly has a dominant and devastating influence on the lives of innumerable people, if not mankind as a whole.

But what should cause even more doubt about the exception hypothesis is the exceptionality of the hypothesis. That is: the assumption of two widely different classes of people in a world where in general there is not only black and white, but every possible shade of gray. As if there are only normal people on the one hand, and these very different exceptional people on the other. As if the various aspects of idiocy and criminality cannot be ranged on a gradual scale, but lie on opposite sides of a wide empty space. For several reasons this is highly improbable. From a theoretical point of view it is improbable because all or almost all human characteristics can be ordered on a continuous scale. Which means that all values are possible and actually occur. In general, intermediate values are most frequent, and extreme values the least. Apart from the distinction man-woman, no clearly distinguishable classes of human beings are known. Both from empirical and theoretical point of view the most probable hypothesis is that the people of the shortlist are simply the worst, or those of the bad end of the scale who managed to reach the top.¹³ That they are the top of an iceberg. The principal persons of the cases may not be so bad as those of the list.¹⁴ But they can be understood much more easily if one assumes a gradual scale, and if one assumes them to occupy positions far away from the average, and quite close to the monsters of the list. With whom they would undoubtedly be glad to cooperate.

Simplistic misconceptions about equality of people.

There is widespread skepsis about politicians. Their behavior is often hard to explain in a positive way. The skepsis is vague and unspecified. People don't know what to do with it, mentally nor practically. Nevertheless, at least a significant part of the population continues to participate in elections.

To a certain extent, the situation may be explained by the fact that whatever happens, politicians, and in their wake the media, continue to do as if nothing happened. Or as if only others are to blame, or nobody. The media accept “reality”. Even though much of it is created by themselves, and even though they could act and react differently. Politicians and many other top officials dislike looking back. They want to put a dot behind the past. As soon as possible; in general far too soon. They want to focus on the future. They want to give the impression that they always do their best, and are always willing to discuss all relevant topics, especially in parliament. Someone looking superficially at the political system may indeed get the impression of a properly operating system. He will be at a loss when asked to tell how it could be improved. His impression will be supported by -misleading- folk wisdom. Such as “to err is human”, “That's how people are”, and: “it has always been like this, and will always remain so”. Such “wisdoms” promote defeatism, and hinder improvement and correction. They are utterly superficial. Even a little reflection shows they are untrue and misleading. They assume an overly simplistic model of man, and ignore the changeability of laws and institutions. The

¹³ Someone is called bad if he violates other people's right to be safeguarded. This is a logical principle, independent of laws. See *The law of logic* or *Communication and norms*. Someone who violates human rights may be called bad as well, but 1) the human rights of the year 2000 have some overlap, but are not equivalent, with the right to be safeguarded, and 2) these human rights are a political compromise, and not logical.

¹⁴ But beware! Circumstances and opportunities play a role too.

first two “wisdoms” seem to assume that people are equal. Or at least that the characteristics people have in common are much more important than the differences. This idea may be a consequence of deficient or erroneous information about (other) people. It cannot be based on reliable empirical research, and it is incompatible with the cases. It furthermore assumes that the monsters of the shortlist can be left out of consideration when making a model of man.¹⁵ As the cases show however, the differences between people are large and of vital importance. The hypothesis of approximately equal people is not only incompatible with the cases, but makes them inexplicable. The cases show large differences between people, especially as regards the relation between their pretensions and their true abilities and deeds. The differences, and the lack of knowledge about them, have great explanatory power.

The first two “wisdoms” furthermore ignore that many politicians are supported by a (often large) hierarchical organization, of which they are the head.

In a certain sense the proposition “That’s how people are” is a truism. But its premise that people are equal is not what the facts (“That”) show. In fact, as noted, the premise is incompatible with the cases. Like the first “wisdom”, the second ignores that human beings differ widely. Indeed, if one assumes people to be equal or similar, in other words: to have similar consciences, norms and values, it is easily understood why people are mystified by the facts, and do not understand them. The facts can only be understood if it is understood and accepted that people differ substantially, and if it is understood what the differences (can) lead to. To understand the world and the history of man, it is imperative to understand that only people with despicable characters enter the top of public administration, and that once in the top they have plenty of opportunities for the greatest possible mischief. It is imperative to understand that these people have norms and values which differ greatly from those which they profess in public. They know very well what the public expects of them. It is of great importance to understand that these people cannot do, and do not do, what they claim. And that they do not mind saddling people and society with the damage caused by their arrogance and deceit.

A basic difficulty.

A fundamental difficulty in getting to know and realize the differences between people is the fact that we only have direct knowledge about our own thoughts and thinking. As long as we lack direct knowledge of others, we have few alternatives other than assuming that others think like ourselves. To assume that all human beings think alike. We may try to infer their thinking from their words and deeds. But this is both difficult and unreliable. If only because we know only little about the deeds, and because words are only words. Experiences may warn us. The more so since experiences have to be interpreted with the help of uncertain assumptions. The easiest assumption is that people speak the (full relevant) truth. But one cannot know, so this is risky. Some people intentionally give an incorrect picture of themselves. This is known for a fact too.

With respect to the differences between people the author feels uneasy and ignorant. Neither in his environment nor the scientific literature did he find anything really useful. Neither in the fictional literature. (Though an exception is quoted below). On the contrary: most of the literature seems to assume a great uniformity in thinking (reasoning), and even a lot of uniformity in basic norms and values. (Those with other norms and values, say “criminals” or “bandits”, are treated as abnormal). Even if this semblance may be partly caused by selection effects. Some kinds of people being unable to write coherent tenable articles or books.¹⁶ In any case, the uniformity cannot be correct. If the fictional literature would mirror the diversity in thinking of the population or mankind, the reader would undoubtedly often be amazed and irritated. With such a paucity of reliable and explanatory information, it is inevitable that our picture of others is little more than a mirror image of ourselves. The reports show that this picture of others may be misleading and dangerous. At the same time the descriptions of the cases may help with the explanation of the given situation. For two reasons. In the first place because they show a badly known part of the world; a part which in many respects is incompatible with conventional wisdom. In the second place it seems obvious that it is virtually impossible to write a pleasant, salable book about people with high functions in public administration

¹⁵ Just as banks, rating agencies and supervisors left (leave?) crises out of consideration when estimating risks.

¹⁶ And chaotic books with inconsistent or really criminal characters are hard and unpleasant to write and read.

who are characterized by extremely harmful false pretensions, and systematically act inexcusably. Supposing one could find an author who could reproduce the “thinking” of such a person.

Note by the way that thinking in terms of exceptions and incidents can be understood as wishful thinking. Acceptance of the structural character of widespread significant differences makes thinking and living much more difficult.

Tolstoy concluded similarly.

As far as known to the present author, Tolstoy is one of the very few authors to understand that there are great and important differences between people. He is one of the few to understand that there is a connection between these differences and social phenomena. The following quotes serve to illustrate this. The first is from *Anna Karenina* (1877), the second and third are from *Resurrection* (1899).

«Vronsky's life was particularly happy in that he had a code of principles, which defined with unfailing certitude what he ought and what he ought not to do. This code of principles covered only a very small circle of contingencies, but then the principles were never doubtful, and Vronsky, as he never went outside that circle, had never had a moment's hesitation about doing what he ought to do. These principles laid down as invariable rules: that one must pay a cardsharp, but need not pay a tailor; that one must never tell a lie to a man, but one may to a woman; that one must never cheat anyone, but one may a husband; that one must never pardon an insult, but one may give one and so on. These principles were possibly not reasonable and not good, but they were of unfailing certainty, and so long as he adhered to them, Vronsky felt that his heart was at peace and he could hold his head up.»¹⁷

«It is usually imagined that a thief, a murderer, a spy, a prostitute, acknowledging his or her profession as evil, is ashamed of it. But the contrary is true. People whom fate and their mistakes have placed in a certain position, however false that position may be, fabricate a view of life in general which makes their position seem good and respectable. In order to keep up their view of life, these people instinctively stick to the kind of people who share their views of life and their own place in it. This surprises us, where the persons concerned are thieves, bragging about their dexterity, prostitutes vaunting their depravity, or murderers boasting of their cruelty. This surprises us only because the circle, the atmosphere in which these people live, is limited, and we are outside it. But don't we observe the same phenomenon when the rich boast of their wealth, i.e., robbery; the commanders in the army pride themselves on victories, i.e., murder; and those in high places vaunt their power, i.e., violence? We only don't see the perversion in the views of life held by these people because the circle of this kind of people is limited, and especially because we ourselves are on the outside.»¹⁸

«When they left the Senate, Nekhludoff and the advocate walked on together, the advocate having given the driver of his carriage orders to follow them. The advocate told Nekhludoff the story of the chief of a Government department, about whom the Senators had been talking: how the thing was found out, and how the man, who according to law should have been sent to the mines, had been appointed Governor of a town in Siberia. Then he related with particular pleasure how several high-placed persons stole a lot of money collected for the erection of the still unfinished monument which they had passed that morning; also, how the mistress of So-and-so had earned a lot of money by speculation at the Stock Exchange, and how So-and-so agreed with So-and-so to take over his wife. The advocate began another story about a swindle, and all sorts of crimes committed by persons in high places, who, instead of being in prison, sat on presidential chairs in all sorts of Government institutions. These tales, of which the advocate seemed to have an unending supply, gave him much

¹⁷ This is the beginning of chapter 20 of part 3 of *Anna Karenina*, as published by LiteratureClassics.com.

¹⁸ From chapter 44 of *Resurrection*. Translated by Louise Maude as published in the project Gutenberg. Her translation has been amended for reasons of comprehensibility by the present author with the help of a Dutch translation by Hans Leerink, published in the Russian Library of Van Oorschot.

pleasure, showing with perfect clearness, that his means of getting money were quite just and innocent compared to the means which the highest officials in Petersburg made use of.»¹⁹

Absence of respect and -consequently- absence of (adequate) accounting.

Willingness to make innocent and truly social people suffer.

One of the most important characteristics of the principal persons is their lack of respect for other people. This lack of respect is most directly demonstrated in cases like those of Dreyfus, Spijkers, and Van Buitenen, those of the (potential) victims of poison gas in containers, of the sexual abuse by church officers, and of the q-fever. In another way it is demonstrated by keeping on practically everyone responsible for these cases, and by the structural covering up of governmental and parliamentary failure by the use of “independent inquiries”. In none of the cases members of governments and parliaments or (high) employees of various government organizations showed any scruples about consciously causing great suffering for innocent (and even exceptionally social and courageous!) people. They accepted colleagues who terrorized innocent people, refused to admit errors, and accepted that obvious misconduct was continued without justification and adequate accounting. In the whistleblower cases, they knew that the victims of the state terror were the only ones who really fulfilled their social duty. That only the whistleblowers acted in accordance with the norms and values the responsible politicians say to respect highly, but actually trample when it suits them. None of the politicians rose to protest against the illegal and utterly unjust harassment of whistleblowers by abject colleagues.

Acceptance of impossible functions.

The lack of respect is indirectly demonstrated by the acceptance of socially important functions which exceed one’s competence. It is demonstrated by inadequate fulfillment of duties, and by inadequate accounting. In general the CV of these people gives no reason to assume competence for a job in the top of public administration. Inadequate fulfillment of duties is a logical consequence of incompetence.²⁰ A socially important function is a function for which adequate fulfillment is important for the welfare of many people. This applies for example to all government organizations (including agencies and supervisors), organizations for (health) care, and education institutions. Acceptance of a socially important function which exceeds one’s abilities is a mark of lack of respect. Acceptance shows that the official is indifferent to the harmful effects which his deficiencies may have on the welfare of the people whom the function is intended to serve, and who finance the function. The official can know in advance that he or she will not be able to cope with even probable events. That he or she will not be able to repair the consequences of errors, and will not be able to give an acceptable explanation of failure, excepting “human error”. Incompetence guarantees “human errors”.²¹

Loyalty.

The principal people seem to be loyal with respect to one another. “Seem to be”, since their behavior may also be interpreted as mere toleration, and as an indirect means of self-support and self-preservation. This kind of loyalty is merely a condition for cooperation. It need not have anything to do with respect. Let alone respect for outsiders.

For the principal persons as a group, loyalty is crucial. Without loyalty the group would not be able to retain its power. Peers are shielded because they in their turn have to remain silent about what they know of each other. On the basis of reciprocity. All members of the group have to feel obliged towards the other members. In the upper as in the underworld. Dutch finance ministers Bos and Zalm, and

¹⁹ From chapter 24 of part 2 of Resurrection. Translated by Louise Maude, amended for reasons of comprehensibility by the present author with the help of a Dutch translation by Hans Leerink, published in the Russian Library of Van Oorschot.

²⁰ Incompetence is supposed to include the desire to realize an untested dogma or theory.

²¹ Of course, by definition, all errors made by human beings are human.

DNB president Wellink are perfect examples. In this respect too they play-act. They deceive the public.

That the loyalty towards peers does not mean respect of people in general is unambiguously manifested in the practice of rolling off costs of avoidable failure on innocent people. None of those responsible ever personally paid even a minor part of the damages he caused, let alone as large a part of the damage as he could. The structural nature of this injustice is confirmed by acceptance of laws which enshrine the inequality, and by the absence of requests for fundamental change.

Refusal to account properly.

Lack of respect is finally shown by unwillingness to account unconditionally and openly for one's conduct, to publish the relevant archives, and to allow truly independent and expert commissions to make open and thorough inquiries. All of which is indispensable for the legitimacy of a democracy. In reality, politicians rarely account properly for their conduct, and especially when the consequences of their failure are large, and cause great harm for many people. And when it is of the greatest importance to find out what can be done to prevent repetition or similar failures.

The lack of openness and willingness to account for one's conduct on the one hand, and the willingness to mislead and lie on the other, are most clearly demonstrated in the cases of Dreyfus and Spijkers, and in the hearings about the financial crisis.²² It is seen in the way members of government hide behind the formal accounting given to parliament, and parliamentary acceptance of their stories. Acceptance by parliament meaning: acceptance by the government coalition. Acceptance in spite of incomplete, incorrect and misleading information. See the many annual reports referred to, and the descriptions and analyses of the cases. In all cases, from policy portal project to financial crises, there was plenty opportunity to explain one's conduct. The histories show however, that in none of the cases satisfactory explanations were given. The accounting never was credible, let alone honest. It has never been explained why for so long no attention was paid to the dossier of Bos. Why this man had to be tormented and harassed for years. And even less why Spijkers had to be tormented even longer, and opposed by all means short of murder.

None of the principal persons admitted that his job was too difficult. That when accepting the job he had thought to be better than others, or that fulfillment "as good as possible" would be good enough. Nobody admitted failure or having acted dishonorably.

The euro had to be introduced without adequate supervision of the agreements about budgetary deficits and public debts, and without the least information about the risks. The introduction can only be explained by blind and dogmatic belief in "Europe", wishful thinking incompatible with experience, absence of liability and punishability of the decision makers, and the knowledge that the bill for failure will not go to the responsible decision makers, but to the population.²³

Something similar applies to the expansion of the EU.

Words and deeds.

Someone who considers deeds more important than words should bear this very well in mind when judging people. One should not mistake words for deeds, or assume words to be reliable. In a time where press releases and interviews very often replace direct observation, this is far from easy. People strongly depend on indirect verbal information. That is: on what other people say (or show). In the reports about cases, words were or can frequently be compared with deeds (or other facts). Often the comparison shows gaps and incompatibilities between words and deeds; and therefore that the principal persons have little or no (meaningful) respect for the people to whom they are accountable. They may say that they do, but their deeds and the quasi-justification they give for them are unacceptable.²⁴ They do not say what is required of them as responsible officers in a democracy.

²² Wellink in the hearings of the inquiry commission De Wit may be simplest example. As seen and shown in chapter 7, the FCIC used more advanced trickery. Such as half truths and irrelevant truths, and unclear or conflicting conclusions.

²³ Not to mention plain corruption: the promise of a job in the EU or something equivalent.

²⁴ Many of the principal persons refused to be interviewed for the film *Inside Job*. See the film.

Instead they say what suits them best, irrespective of their duty and the interests of the public. They obviously feel no obligation to be open and honest. In other words: they do not feel responsible, even if they say they do.

It is important to remark that their words almost always assume generally accepted norms and values. This is important because it shows that they acknowledge the existence of such norms and values. The difference between words and deeds furthermore suggests that the deeds cannot be accounted for in terms of these norms and values. If they could be accounted for, why don't they do so?

Similar things can be said about members of parliament. Whose primary goal seems to be to keep up the appearance of a critical attitude, while actually believing that everything goes well of its own accord, and condoning all kinds of dysfunctioning. The terminology of "government and opposition parties" already shows where the primary loyalty of the coalition parties lies. With the government. In other words: the population comes last (if it is not forgotten).

The lack of respect for people makes much avoidable misery much more understandable. Including wars.

Conclusion.

The conclusion can only be that for most cases there is no justification. The reason that they are not acceptably accounted is that an acceptable account does not exist. In most cases, parliaments accept unacceptable accounting. Without adequate explanation. Both the cases themselves and the unacceptable accounting are manifestations of the lack of politician's respect for people. Politicians collaborate tacitly in the protection of a corrupt system by keeping up appearances at the cost of the population.

The mental constitution of the principal persons.

On the one hand the present author feels sure that the analyses of the cases lead to the conclusions listed at the beginning of this chapter. On the other hand he cannot envision the thinking of these persons. There may be logical reasons for the difficulty of imagining the thinking of someone else. However this may be, the author cannot help feeling uneasy about it. It would be nice if these people wrote open and honest autobiographies. But such a wish may very well be a contradiction in terms. For these people, openness and honesty are not norms, but means to be used when suitable, at appropriate moments. Means which in general endanger their real priorities: power and other forms of self interest. And if their conduct is determined by unacceptable norms and values (goals), then the reasonings starting from them cannot be acceptable either. With a reliable autobiography they would accuse themselves. When one looks around, it is easy to see that most misconduct is never explained acceptably. That is: in terms of generally accepted norms and values. Perhaps the absence of open and truthful analytical (auto)biographies is an important cause of the lack of knowledge and understanding of the true character and thinking of these people. As it is for other criminals.

All conclusions in the list follow directly from the observations in the preceding chapters. They are little else than a summary of the observations. The inability of the principal persons to fulfill their duties properly, and the pretensions and lack of modesty they display for example in hearings, show that they fancy themselves far too much. But they didn't only overestimate themselves. They don't even understand that they overestimate themselves. Or perhaps they do, and just don't want to admit it. Quite generally they maintain stubbornly that they did everything needed and possible, even if keeping up this fiction requires lying and terrorizing people like Spijkers and Van Buitenen.^{25,26} Even after overly obvious failure, they pretend to be perfectly suitable for top functions. The right people for these functions.²⁷ They seem to be unaware of, or don't mind, the injustice which this implies. Which of course is consistent with overestimation and incompetence. If they are aware of it, they apparently are indifferent for this injustice, and for the implied lack of respect for (other) people. Perhaps it is on

²⁵ The film *The Armstrong Lie* shows that Lance Armstrong did similarly.

²⁶ Of course, their terror can also be a form of revenge.

²⁷ Geithner and Wellink are notorious examples.

the basis of a far too positive self-image, and a far too negative image of others, that they think they can forgo accounting for their conduct towards the (supposedly stupid) population, and that it suffices to perform what may be seen as rituals. Even under oath they do not seem to feel the need to speak the (full relevant) truth. Perhaps they consider oaths as a ritual too, as part of “the game”, just another necessary lie.²⁸ But questions and puzzles remain. Do they think one should not lie, and look for excuses when needed, or do they simply lack norms like honesty, and do they see their statements as a justified means to realize justified goals?

To avoid misunderstanding: for common people and society the reason is of secondary importance. These people are unfit for public functions, both because of incompetence and lack of integrity. They think they have no real obligation towards those for whom they should work, except tattle.

An important related question is whether these people can (and do) adequately judge the integrity and abilities of other people. Whether they can select suitable employees in spite of their own unsuitability. This seems highly improbable. At any rate there are no facts or documents supporting the hypothesis that they can. On the other hand there is plenty evidence for their inability (or lack of willingness) to select honorable and competent people.²⁹ Evidence does exist for their ability to select and appoint dishonorable incompetent people. Perhaps they trust the advice of internal and/or external people of well known loyalty. Perhaps they recognize something like family traits, including the ability to play-act, mislead, repress, and remain loyal under all circumstances. Dirty hands are a recommendation, because they create dependency and make loyalty compulsory. Perhaps integrity is the most weighty contra-indication, except when it is coupled with a religious belief that all authority derives from God, or something similar. And the combination of integrity and competence is even worse, because sure to endanger the position of every dishonorable and incompetent employee in the neighborhood.

The fact that application talks play an important role in the selection of employees may favor people with better verbal abilities, and people who think more highly of themselves. People who are less modest. Who are ambitious, and dare to take risks. In the modern world these traits are valued positively, and the people having them are favored. It is far easier to judge the appearance of ambition and daring, than to judge the ability to cut one's coat according to one's cloth. Fashionability of traits and overvaluation of appearances may explain that the owners rise high, and are able to stay on top. Together with blind faith, insufficient and inadequate questioning, and insufficient comparison of words and deeds by the selection committee.³⁰ Only those people are proof against deception, who look at the deeds, the actual performance; and compare them with the words, and require them to agree. That is serious work, and not always easy (though often possible). But it seems improbable that reliance on words fully explains the characteristics of the management and top. It seems just as probable that collaboration in, and loyalty in spite of, activities that have to remain hidden from the public eye, in other words: mental kinship, is a condition sine qua non for all higher management jobs. The willingness to make dirty hands, to keep silent or lie about them, and to remain unconditionally loyal to peers.

Politicians and administrators have no scruples suggesting or pretending that the opinion of their organization, board, party, or majority is their personal opinion. They hardly distinguish the two. They do as if they embody the group for whom they speak. Which can also be seen as a manifestation of their ability to play-act.

This is noted in the first place as a general practice. In the second place the practice is questioned. That people give the opinion of the group they represent is no problem. That they do as if it is their

²⁸ In one correction cycle I passed this point in the report during the Ford-Kavanaugh hearings in the US Senate on 27/9/18, held in the course of the confirmation of president Trump's nominee Kavanaugh for the US Supreme court.

²⁹ The Dutch education ministry is the best example, because both the facts and the organization are well known. In the history of the financial crisis it is shown more by the facts- the consequences of their decisions- than by knowledge of the organizations.

³⁰ Or judges, as in the Dreyfus case of 1894. See J. Reinach, *Histoire de l' Affaire Dreyfus*, part 1, chapter 10, *Le Procès*.

personal opinion is something else, and rather amazing. Namely because differences of opinion within a group is the most normal thing in the world. A spokesperson need almost never be ashamed of having a personal opinion which differs from that of the (majority of the) represented.

Perhaps some people think that it is self-evident or necessary that a spokesperson play-acts, if only for convenience. But such a practice is not only misleading but dangerous. Awareness and acknowledgement of legitimate differences of opinion and thinking facilitate an open discussion and changes of opinion and thinking. A spokesperson may suggest that he is the group (organization). But the fact remains that he is only a single member of the group. There is a risk that he thinks that everyone in the organization thinks like himself, and that his opinion is the only one that counts. In case of trouble he may expect, or require, everyone to accept his opinion. He is the spokesperson, and wants to avoid loss of face.

The present author has often represented his section, directorate and organization. When useful, he explicitly distinguished the position of the organization (unit) he represented, and his personal opinion. Which is not really difficult, because both have simple reasons and explanations. Nobody ever showed difficulties with this. In other words: it is possible to make this distinction, not only in theory, but in practice too.

The hypothesis that the environment is the cause of the misconduct of the top.

There is an infinity of incorrect explanations of the phenomena described in this study. It is therefore impossible to enumerate them, and even less to discuss them. Many explanations tacitly assume similarity of people. That people are approximately equal. They try to answer the question: if I was in that position, what would make me act as the actual top managers do? The hypothesis of external causes is an example. It is mentioned as a warning against efforts to use it to keep persons in positions where they are a (great) danger for other people, and to warn against its use to prevent effective measures.

In the present context, the “environment” of the top indicates the human environment inside the organization.

The hypothesis that the environment is the cause of the misconduct of the top is untenable due to the combination of the following reasons:

- The hierarchical position of the top gives its members almost dictatorial power. This observation agrees with the facts: in practice, top officers are seen and accepted as dictator, even though the word “dictator” is taboo. They depend very much less on their environment than everyone else;
- It is true that the top has difficulties with the norms and values of its environment. The reason is, that its own norms and values are incompatible with the norms and values of the environment. Those of the environment agree with the code of conduct. In other words: the top finds it difficult (or impossible) to work in accordance with its own code of conduct;
- It is possible that the top lost the confidence of the rank and file due to its lack of integrity and competence. This obviously doesn’t make an organization operate better;
- In none of the cases top officers mentioned the environment as an explanation of errors. Neither did they show that it is plausible that the errors were caused by environmental factors, instead of their own incompetence.³¹

These reasons can be inferred from the reports of the cases in the Dutch education ministry, and the description and analysis of the financial crises. They are at least compatible with all other cases.

The hypothesis which is obtained by replacing “environment” by “organization culture” is untenable for the same reasons. The cases furthermore show that the actions of the top define the effective culture of an organization. The culture of the non-managers on the other hand does not really affect the conduct of the top (and does not define a meaningful concept of organization culture). All cases show that the top practically ignores the codes or opinions of non-managing employees.

³¹ This reason is almost empty, because in general errors were denied.

The kindest explanation of the hypothesis about the influence of the environment is the complete lack of knowledge about the reality of large hierarchical organizations. It can also be explained by malicious intent: it exculpates the top, and blames people who cannot talk back.

Very different is the hypothesis that top managers become more dishonorable and sloppy³² as a consequence of the power of their position, and even more, of the absence of a need to account for their conduct and performance in a serious way (as if towards a critical superior manager). For people with the given characteristics this hypothesis seems quite possible. But the cases or other information show no personal development of top managers in this respect. They betray no remnants of a different past or character. The development of attitudes that did not exist before may therefore be doubted.

The factor “power” is independent of the factor “environment”. Therefore the hypothesis which sees power as a causal factor is independent of the hypothesis about the influence of the environment.

The evidence studied does not exclude the possibility that more or less normal persons are corrupted on their way to the top. But the material seems to show quite a lot of phenomena which seem to be incompatible with this hypothesis (and its premises?).³³ It shows nothing that supports it (“positively”). The cases do show that the top lacks integrity, and cannot be honorable, because it pretends to have abilities which it cannot have and has shown not to have. False pretensions with respect to one’s job are not normal. Both the manager and the cashier of my supermarket do work they can do adequately. They don’t have false pretensions.

For the explanation of the observed abnormal characteristics of the top of public administration, selection seems to be much more important than personal development. The selection of top officials for impossible functions is simply equivalent with acceptance of false pretensions and a dishonorable and insufficiently competent top. Which is compatible with the observation that none of the cases has shown anybody who has been able to successfully withstand the corrupting influence of power or whatever. The selection was systematically inadequate.³⁴ And it is evident anyway that there are great differences between people; that we are still a very long way from being able to describe them adequately from the point of view of what to expect of them; and from understanding their relation to observable social phenomena.

9.2. Origin and stability of a dishonorable incompetent top.

This section should be seen in combination with the next section. A faulty interpretative framework is an important contribution to the stability of an inadequate top.

Conclusions.

1. In the given legal framework, a top officer of a large hierarchical organization cannot be honorable and competent;
2. False pretensions are a necessary condition for a job in the top;
3. Passive selection is one of the causes of the given situation. Honorable people avoid functions requiring abilities which they don’t have. They also try to avoid obviously corrupt work environments;
4. The top functions in society are political functions. The selection process for such functions requires a lack of integrity, and does not require the abilities necessary for an adequate fulfillment of the function;
5. The top has reason to fear integrity and competence. It therefore only tolerates kindred people in its neighborhood;
6. Politicians do not only appoint the top officers of all government organizations and dependent organizations (agencies), but strongly influence many other appointments;

³² “More sloppy”= taking less account of professional know how and norms.

³³ Among them also the irreversibility of the supposed personal development: none of the principal persons has remembered his old self, and ever re-adopted his “normal” attitudes.

³⁴ Note that none of the appointing politicians has admitted having appointed or proposed an unsuitable person. While many of the cases gave plenty of reason to do so.

7. Politicians have practically elevated themselves above the law;
8. Control and supervision by similar people causes a vicious circle;
9. The population of journalists is the result of selection processes which detract from the publicly professed norms and values of journalism;
10. Journalists forget, and stimulate forgetting. They are de facto accomplices of corrupt politicians;
11. Without notice, journalistic norms and values are subordinated to requirements of superiors and persons to be interviewed.³⁵
12. The press is free (to some extent), journalists are not;
13. Important media wish to have a cooperative relation with the government, and allow this to affect the content of their publications.³⁶

The purpose of this section.

This section tries to answer the following questions: how did the given situation arise, what enables unsuitable people to reach the top, why is the top practically void of honorable and competent people, how can the situation be stable, and how can it remain essentially unchanged whatever happens?

Lack of integrity and competence are caused and stimulated by hierarchical pyramids which are too high.

A hierarchy is called “too high” if the functions in the higher part of the organization cannot be fulfilled properly, and if accountability for these functions is not really possible. It is called “too high”, if the size and character of the organization makes a culture of saying sorry inevitable.³⁷ Often in such circumstances the top managers can do little else but believe what their subordinates tell them.³⁸ They simply are insufficiently competent to understand and check what they are told and are asked to sign, and even to judge the personal qualities of subordinates. The top assumes, and/or play-acts, that its subordinates and organization are competent. Sometimes however it claims to know better, and imposes its opinion upon the organization (or the units concerned), or requires the organization to provide substantiation for an actually untenable standpoint. Arbitrariness and inconsistency need not be the rule, but they are not exceptional either.³⁹

This means that the people in the top are happy with having to believe, with the inability to judge, and with having to hope for the best. Though perhaps this is only a detached objective assessment. Perhaps these people really believe that they can judge perfectly well what they have to judge. Even if hindsight shows this to be a disastrous mistake. Perhaps they only play-act. At any rate: none of the cases shows any high officer admitting to have bitten off more than he could possibly chew. Neither does any officer or inquiry commission conclude that another principal person or investigator lacked integrity or competence. Without exception they keep up appearances. They seem to believe, or to try to make believe, that a person is competent if he or she can keep up appearances in an environment of people who collaborate in keeping up appearances.

Selection: honorable people dislike politics and stay away from it.

Decent and wise people see or intuitively feel that many top functions cannot be fulfilled in an accountable way. In addition, they don't like the dishonorable social environment engendered by false pretensions.

Joining or not joining a political party is the first important selection moment. That this must filter out honorable people is perhaps most clearly shown by the continuation of the repression of, and terror

³⁵ See Glenn Greenwald, *No Place to Hide*, Penguin Books, 2014, ISBN 978-0-241-96898-7, and Seymour M Hersh, *Reporter*, Knopf, New York, 2018, ISBN 9780307263957.

³⁶ See the books of Greenwald and Hersh mentioned earlier.

³⁷ As shown in many of the cases.

³⁸ They may see this as the price to be paid for power.

³⁹ It would seem that arbitrariness and inconsistency cannot be the rule for purely logical reasons.

against, whistleblowers by the Dutch political party “Christian” Democratic Appeal (CDA).⁴⁰ At a time when two of the worst whistleblower cases in recent Dutch history were at best only partially closed, it devoted a major convention to an 18 year old immigrant called Mauro. Mauro was “threatened” with removal to his home country Angola. His request for a residence permit had been rejected.⁴¹ Someone who joins a political party like the CDA either lacks understanding, is inconsistent, and/or dishonorable.⁴² Someone who wants to become or remain a member of a political party which on the one hand effectively approves the terrorization of a whistleblower and retains the responsible minister, (thereby terrorizing the rest of the public), and on the other hand organizes a national convention about the residence permit of a specific immigrant, displays a rather extreme lack of integrity. Such a person shows to prefer loyalty with misconduct to integrity, and to have a disregard for the (Christian) norms and values he professes to represent and defend. Presumably only to mislead potential voters.

Of course this does not apply only to the CDA. Every political party may have distinctive characteristics. But for all of them this kind of examples can be given. Honorable people keep their distance from political parties.

The more false pretensions, the better one’s chances for a high function.

Many people seem to have a natural, unconscious inclination to believe that other people are what they appear to be. Or to think that other people are like themselves, approximately, of fundamentally. Maybe without being aware of this inclination. This inclination is not surprising. Without further information, people have no logical alternative. Only additional, correcting information may give a reason and possibility to correct the advertised picture. Often this information comes at a price. A price which is especially high when swindlers abuse trust.

The inclination to trust people hampers prevention of harm due to deceit and other forms of lack of integrity. It gives people who disregard generally accepted norms and values an advantage with respect to people who respect these norms and values. The same applies to people with false pretensions. Irrespective of the question whether the false pretensions are conscious deceit, or due to a lack of self knowledge and other understanding. By definition however, false pretensions are coupled with intolerance for criticism. Otherwise the self knowledge would be far less deficient. False pretensions are also coupled with the willingness to take great risks.⁴³ To wit, the risk to fail in an important function, and the risk that the falseness of the pretensions becomes known. The higher the function, the more pretensions are needed, and the less worry about the harmful consequences of default. And therefore less respect for the people who suffer the harmful consequences. The need of their continued support creates a need for further deceit and misleading.⁴⁴ Ministerships are extreme examples. Nowhere does one find a greater disproportion between the necessary and true knowledge and know how.

Inadequate evaluation and selection of candidates.

It is obvious that dishonorable and incompetent people wouldn’t stand the smallest chance if they would be evaluated properly. They would not be appointed if (honorable and competent) selection committees were permitted to conclude that there is no suitable candidate. The facts clearly show that in government and associated organizations, and in many corporations, an open evaluation never takes

⁴⁰ “Christian” between quotation marks, because it is not christian at all. The “christian” can only be meant to attract voters.

⁴¹ See the file dated 20111029.

⁴² This is not an opinion but a fact, whatever dictionary definitions of the used terms one chooses.

⁴³ Of course taking great (unbearable) risks can be the consequence of plain stupidity. Indeed, stupidity can be seen as a form or element of false pretensions.

⁴⁴ The financial crises are excellent examples. But the countries which were to be victimized by the aggressive dictators of the 1930s are good examples too. In the pre war period, their governments did next to nothing to avoid a war. As nowadays.

place, and that selection committees have to nominate at least one candidate. If not truly suitable, than the least unsuitable (the “best”: relatively).

Even when efforts are made to evaluate candidates or top officers as good as possible, there remains a fundamental difficulty. Namely the difficulty that the higher functions in large hierarchical organizations cannot be fulfilled properly. That this is an impossibility. There simply are no people who have the knowledge and abilities to do adequately what such functions require. To accept responsibility for the organization. The head and other top officers of such organizations don’t need only 5 legs. They need at least 10. Such people don’t exist. As a consequence, a selection committee has to define what it considers acceptable and best. It follows that the most positive outcome of a selection procedure is the selection of the candidate who will produce the best or least negative results. Which is sure to cause risks. The best need not be good or even sufficient.

Anyway: if adequate selection is understood to mean: selection of a candidate who can do the job properly, then all candidates for top functions can be rejected out of hand. If they are not, the selection procedure is fundamentally inadequate.

Recommendations and references need not be reliable. They may be. For example if the person giving them is honorable and competent in judging people.⁴⁵ Perhaps they are also reliable when only a specific characteristic has to be assessed, such as loyalty. Or when a judgment is based on unambiguous experience. As when integrity and competence have been put to the test in circumstances similar to those of the job applied for.

Perhaps a distinction can and should be made between commercial organizations, where profit is the decisive criterion (assuming bearable risk and full liability), and organizations whose heads are directly or indirectly appointed by politicians whose position depends (only) on success in elections. The history of the subprime crisis gives empirical reasons to assume or even conclude that the difference is not essential or large. The assumption is supported by the evidence about consultancy firms presented in the chapters 2-5. In the case of Spijkers, the firm Eurometal can be considered as an example too. There is moreover no reason to expect a positive effect of competition. Often the simplest way to cut costs is to ignore all kinds of norms. And one can also survive competition by doing just as bad as, or worse than the competition. (As in politics).

After having been appointed, selected persons play an important role in the selection of others.

The cases and dossiers do contain indications of awareness of the problems caused by the unfulfillability of top functions. The awareness may be inferred from the refusal of parliaments to discharge heads of government organizations which have made grave errors. On the one hand the head is (formally) responsible. On the other hand it is assumed that he cannot know and control everything in the organization. The problem with this reasoning is that nobody else is held responsible (or liable and/or punishable), or can be held responsible. Neither legally nor practically. Parliaments nor anybody else concludes that the job cannot really be fulfilled in practice as assumed in theory and formally. They ignore the fact that this inevitably causes irresponsible conduct, and the risk of great harm.

A deficient foundation: the highest functions have the worst selection procedure.

«Elections, my dear Sir, Elections to Offices which are great objects of Ambition, I look at with terror.- Experiments of this kind have been so often tryed, and so universally found productive of Horrors, that there is great Reason to dread them.»⁴⁶

⁴⁵ The CV’s of the principal culprits of the subprime crisis give plenty examples of erroneous assessments. An important class of errors is: judging people only as regards academic abilities, knowing nothing about their functioning as manager, and in a socially responsible function.

⁴⁶ Quote from the letter of John Adams to Thomas Jefferson of 6 December 1787. The letter is included in Part 1 of *The Debate on the Constitution*, B. Bailyn editor, Library of America, volume 62. The quote can be found on p. 473.

In the present democracies the most important officers are selected by the worst procedure. Namely by elections which take place on the basis of manipulated and fabricated information, and on the basis of non binding promises. The date of the elections may be determined by the constitution or by those in power. In both cases those in power can plan their activities and policies with an eye on the election day. They can optimize activities and policies for their own reelection and/or the election of friends. Using taxpayer's money. Elections decide who is to occupy the most important functions in society. All important social developments, and many of the most important appointments, depend on these persons and elections. For these reasons this selection procedure is without any doubt one of the greatest deficiencies of supposedly democratic states. Few other deficiencies cause greater harm and risk. The procedure ensures that the most important and powerful people are in many respects the least suitable and most dangerous. The most dangerous because these are the people who suffer most from self overestimation, and have the least scruples with misleading and deceiving the population.

That people lacking integrity and competence can submit their candidacy without running any risk, is one of the consequences of 1) the fact that their failures and misconduct in the elected function will not be judged in the normal judicial system, and by an independent judge, but by their peers and friends, and 2) the practical absence of liability and punishability. That their party proposes or approves their candidacy, and supports this kind of people, says a lot about political parties. Though it need not surprise: the party top has been elected in a similar way.

Due to the absence of liability, punishability, and other regulation that could protect innocent people against deception by, and failure of, politicians, selection committees are free to determine the weight they attach to questionable qualities of candidates. They may select the candidate who believes what the selection committee wants a candidate to believe, trusts what and whom he is required to trust, can make believe, has a good speech writer, and knows how to talk himself out of all kind of difficulties. Sometimes the looks and other PR-aspects of a candidate, or the salability of the selection, seem to be more important than the qualities that matter for the job. Often not a person is chosen, but a facade, an artificially created image. An image of someone who doesn't really exist. It doesn't seem to matter. What counts is eligibility, and success in elections. On the basis appearances. But the actor will get real power all the same.

From the point of view of society this kind of selection is extremely risky. If the above is correct as regards the main points, the most important positions in society are occupied by insufficiently honorable and competent people, making it impossible to expect good laws and good government. This conclusion is supported by the evidence of all the cases studied, and by history. One could hope for happy mistakes, but such mistakes seem to be made only in the early stages of a persons way to the top, mostly out of sight of the public. Anyway, in none of the cases any exception was encountered.

The top depends on co-optation of its likes. Honorable, competent intruders are unwanted, and "together we are strong".

Honorable and competent people who "know too much" cause problems for the top. Integrity demands that structural misconduct is exposed and that incompetent colleagues are removed. This is a threat for the top. It wants to keep up appearances. It wants to avoid exposure at all costs. It will therefore try to keep honorable people as far as possible from positions where they can see how it works. In its neighborhood it only tolerates people who don't worry about incompetence, play-acting (= lying) and other misconduct. People who collaborate and do not endanger their position. For the top, loyalty through thick and thin, including collaboration in the cover up of misconduct and failure, is an inviolable boundary condition. Demonstrable loyalty. To ensure this, "admission" is given only to people who depend on the support of their peers, and cannot keep their position by integrity and competence "only". So as to ensure themselves of the mutuality of loyalty. For the top, lack of integrity is inevitable as a consequence of the impossibility of the job. It is necessary for survival. The top has a vital interest in keeping itself homogeneous as regards lack of integrity.

There are very many government organizations, agencies, etcetera. The hierarchical organization of the state gives the government control over all top appointments.

The number of press releases and other publications of government organizations and their subsidiary organizations is roughly proportional to their number and size.⁴⁷ Since their aggregate relative size is enormous, and since the media consider them important, they determine a large part of the daily information stream to the public.

As a rule, the heads of these organizations are appointed directly or indirectly by politicians. For their budget, they depend at least strongly on government (tax) money. So even if the heads have not been selected for political sensitivity, they have an interest in giving their publications a bias in favor of the government and government organizations.

In the course of time this phenomenon and its consequences have grown in importance. An ever greater part of the gross national product is spent by politicians, through governments and their agencies.⁴⁸ Because of the increasing involvement of politics with ever more activities, situations and whatever in society, all kinds of government agencies have been created, and more and more activities are subsidized. More and more people depend ever more strongly on government policy for their income and other personal circumstances. It should be kept in mind that society was not always organized as it is now.

Governments have practically put themselves above the law and liability. Parliamentary control is a show: effective control is almost absent.

Politicians and only politicians make the law. They have arranged the judicial system formally and informally in such a way as to ensure that they are judged only by their peers and friends, and can only with great difficulty- or not- be punished or held liable for damage caused by dysfunctioning. They made laws giving them authority to appoint the heads of innumerable organizations, the members of councils, commissions etcetera, giving their peers and themselves the perspective of splendid jobs, and enabling them to cover up and make forget individual and collective misconduct. Also by making people believe that transfer from one job to another is a kind of degradation or punishment; even if such a transfer is coupled with a higher salary.

Politicians pretend that parliaments control governments, and that parliaments make governments account for their conduct. But this account is actually rendered to the majority coalition. That is: to members of the same political parties. While all members of parliament depend on the government and the political system for their career. As a consequence, more often than not the accounting is inadequate. Really informative questions are not asked. Or answered inadequately, and accepted all the same. Governments and parliaments enact a ritual. They have a vital common interest in preserving public belief in the integrity, competence and accountability of their system. Neither the opposition nor the government coalition has an interest in unmasking the other. It would mean collective suicide.

The cases show that control, in the sense of evaluation, is almost absent. Government accounting offices can only investigate a small sample of organizations. They have no authority regarding the organizations investigated, and cannot order improvements. In general, the reports of the accounting offices lack clarity and openness, and are phrased too diplomatically. More often than not, the reports are ignored by both parliaments and the organizations directly concerned. Even the implementation of recommendations of parliamentary inquiry commissions is not monitored. (Which is consistent with the hypothesis that they are mainly meant as cover-up, for the show). Nothing significant is done with annual reports of supervisors. Parts 1 and 2 of the present report are full of examples. The phenomenon is systematic: there are no significant examples. (There cannot be: an exception would make the system come down like a house of cards).

⁴⁷ This can be checked with annual and budget reports, and statistical yearbooks. As regards the statistical yearbooks one might consult the "historical" or long time series editions.

⁴⁸ See for example the OECD annual publication *Government at a glance*. In for example the 2015 edition, p. 71.

These observations are supported by the daily news. It shows that politicians and parliaments spend a disproportionately large amount of time on policy, new laws and changes in laws, and a minimal amount of time on the effective and efficient operation of the organizations (agencies) performing public duties.⁴⁹ It is as if it is assumed that laws are implemented, maintained, etcetera, of their own accord. As if the government only has to speak, like God in Genesis: “God said, Let there be ..., and it was so”.⁵⁰ Of course, the assumption is contrary to experience.

In addition, it may be assumed that misconduct and failures that get publicized accidentally, can be talked straight, ascribed to human error or unhappy incidents, or made to forget by time consuming processes such as an inquiry. The cases show that the government coalition, and even the opposition, collaborates with the government in covering up misconduct. Often parliament, and former coalitions, is or are just as responsible as the sitting government. Formally of course it always is. But it is even more responsible when it fails its critical and representative duties, sets common sense aside, and simply believes the government (for reasons of party loyalty), and makes itself a government employee. At the cost of the public. Modern parliaments often represent not the voters, but the government.⁵¹

The ideas of the “opposition” may differ from those of the public policy of the government coalition. But as regards their opinions about the political system, and the duties and activities of “representatives” in parliament, there is no difference at all. The politicians of the opposition are the same kind of people as those of the coalition. They are selected by exactly the same processes. Moreover, the opposition is by definition a minority. So even if it would like to control, it cannot. But it is rather unlikely that it wants to, for fear of a similar treatment when the roles of government and opposition are reversed. Therefore the opposition will choose for “live and let live”. Govern and let govern.

Obviously the absence of control has nothing to do with a lack of human resources, and everything with a lack of integrity and competence. There is simply not the least effort at systematic control.

Note that the focus on the news, that is: disproportionate attention to the latest press releases, at the expense of independent information gathering, and at the expense of integrated, explanatory knowledge, is a problem in itself.

Journalists forget and promote forgetfulness. Which makes them de facto accomplices.

Journalists are interested in what's new(s). They are interested in the news of the day. And in press releases instead of independently collected and evaluated information. They don't make a distinction between what happened and what should or could have happened.⁵² There is no integration of new with existing knowledge, and no learning process. No conclusions are drawn from what the news shows in the light of what was already known. As far as journalists are concerned, top officers can make a new start every day, as if the past does not exist.⁵³ At least for as long as the officers retain a formal position. Whatever they did or omitted yesterday or the days before. On top of this there are relations and dependencies between politicians and the top of media corporations, and laws which require proof of allegations, but not for praise or (mis)information in general.

Journalists write about topics which were turned into news by other people. They accept the process by which other people define what is news. They do not independently try to identify and track relevant developments, and make reports when something interesting can be told. Irrespective of significance or importance. Such as developments concerning international organization or anarchy,

⁴⁹ For a table of such organizations see for example p. 481 of George C. Edwards, Martin P. Wattenberg, Robert L. Lineberry, *Government in America*, 2012 edition, Pearson, 2014, ISBN 978-0-205-86561-1 (pbk).

⁵⁰ Genesis continues: “And God saw that it was good”. Politicians are better than God. It is self-evident that everything they do is good. They don't have to look.

⁵¹ This may be true also for earlier parliaments, but the present author doesn't know.

⁵² We're talking about the great majority of news reports, and about the “sum total” impression made by news web pages or newspapers; not about the rare exceptions.

⁵³ An excellent example is Nout Wellink, former president of DNB, see chapter 6. In 2018 he was still considered a reliable expert, and given space on (Dutch) radio and newspapers. I heard him being interviewed as an expert on Radio 1 on 30/10/18.

the environment and climate, and armaments (of citizens and states). While the supposed nuclear program of Iran is (was) almost daily news, the nuclear arsenal of Israel is hardly ever even mentioned; let alone questioned. If governments keep silent, so do the media. Disproportionate if not exclusive attention is paid to top officers. To their words that is. In other words: the news is defined to a very large extent by governments, and biased correspondingly. Journalists pass on. They rarely analyze, let alone critically, in the light of relevant knowledge. As a rule, news is systematically and proportionally positioned only in closely related current developments, say in Syria. The selective nature of press releases and communications of spokespersons is rarely pointed out. Let alone corrected. Nobody shows or tells that the fundamental causes of the financial crises are at work in other areas as well, and cause risks which pale the financial crises.⁵⁴

Journalists moreover regularly and unthinkingly copy and adopt propagandistic, misleading government terminology. Terminology invented by governments to make people accept policies which they would never accept if they were presented openly, using the most appropriate words. The problem is not only that governments mislead, but that journalists make themselves uncritical extension of government. They don't use the freedom they (claim to) have to use the words which are most fitting. Something similar applies to the uncritical adoption of press releases of government and other organizations.

Obviously all these phenomena have explanations. Some of them are indicated in the next subsection. But not all explanations can stand the light of day, and even a good explanation is not an excuse. And whatever the explanation, the net result of the phenomena is to support the government and political system, and to obstruct serious reflection and correction or improvement.

Of course, there would not be any problem if governments were open and honorable. But when they are not, media which assume what they are supposed to prove, are worse than useless. They help support the illusion of a properly operating system, while this system is actually steadily deteriorating and creating ever greater risks for the population.

The integrity of journalists and media. Interviews.

Media and journalists should know what they write about, and be able to weigh information and opinions about developments in their field of specialization. And they should be able to write about them. Press releases should be distinguished from summaries by independent experts. Often, press releases are meant less to inform than to promote: as misleading propaganda for a decision, policy or whatever. They are selective and biased.⁵⁵ Without reliable evaluation they can better be ignored. It is almost impossible to correct for unknown deformation and gaps. For people who have to evaluate ("control") governments, political parties, policies, or laws, and therefore for voters, it is of the utmost importance that those who publish press releases know that press releases will not be taken at face value, but checked expertly, and that misleading representation of the facts will have unpleasant consequences for their authors.

Pretending to be critical while blindly copying sources, pretending to have expertise and to be open, while actually keeping silent about unpleasant findings, is dishonorable.

The media often use interviews. As a rule, the suggestion that these interviews are independent and open is incorrect. As a rule, the interviewer is not free to ask questions. Interviews are "given" (not always!⁵⁶), but not unconditionally. Often interviews are preceded by negotiations about the topics to be discussed and the questions to be asked. Sometimes interviewers moreover accept answers which actually are unacceptable. Integrity would require publication of the interview-contract, i.e. the agreements made beforehand, together with the interview. Even though selection of an interviewer can have exactly the same effect as such a contract. Though disclosure would not solve the problem. The

⁵⁴ Examples are given below.

⁵⁵ See for example Shafritz et al, p. 189, lessons on power, by Machiavelli: «Princes ought to leave affairs of reproach to the management of others, and keep those of grace in their own hands. [The good news a leader delivers with a maximum of publicity; the bad news is quietly announced by a low-level assistant.]». Jay M. Shafritz, E.W. Russell, Christopher P. Borick, and Albert C. Hyde, *Introducing public administration*, 9th edition, Routledge, 2017, ISBN 978-1-138-66634-4 (pbk).

⁵⁶ See the documentary film *Inside Job* for many examples of people refusing to be interviewed.

interview-contract would still not enable the reader to correct the interview. Interviews (and hearings) should be held without prior agreements. By knowledgeable and critical interviewers. Either that, or no interview.

It is to be expected that many top officers do not permit open interviews. They want to impose conditions, and don't want them to be publicly known. Therefore (unconscious) self-censorship and a social selection process resulting in a population of "understanding" interviewers is their ideal. The consequence is, that journalists and media who collaborate in keeping up the desired appearances will be favored. Honorable journalists and news corporations will have to look for other jobs.

Conversely, if journalists and media would stick to their professional or other integrity codes, far less interviews would be held. If journalists and media would stick to the codes, interviews would be far too troublesome and risky for most politicians and top officers. Which shows that these people are not willing at all to inform openly. They only want to show and tell us what suits them. They do not respect the interviewer and his readers or listeners. They want to use them for their own purposes.

"Information" from fabricated interviews is misinformation which undermines the proper functioning of a democratic society. Political choices can only be made in an accountable way on the basis of full and correct, and therefore non-selective, information.

The result of these mechanisms is a selection process which creates and maintains a society which lets itself be informed in a systematically biased way, and runs the risk of completely overlooking all those matters which the establishment does not, will not, or cannot see or tackle.

The above is supported by the refusal of almost all principal persons to be interviewed for the documentary film *Inside Job* about the subprime crisis.⁵⁷ Refusals which also support the allegation of rigging of interviews in general.

The press may be free, but journalists are not.

Charity begins at home. Journalists are free lance, or employee of a hierarchical organization. For work and income they depend on superiors or people who might be willing to buy their articles for publication. They depend on the willingness of interesting persons to be interviewed. They are not free at all. The journalists who are writing what is being published at present are the survivors of repressive selection processes. The journalists may simply believe that the system is good as it is, think that it could be worse, may have concluded a compromise between the interests of the political establishment and what is prescribed by their professional norms and values, or something else to the same effect.

The following quote gives an example from practice. It concerns the case Spijkers:

«When a month later the monthly New Review and the TV news programme Nova inform the public about the death threat by undersecretary Van Hoof, the column of Rijkers in the Catholic Newspaper is silent as the grave. [For years Henk Rijkers had systematically commented on the case]. Neither does Rijkers write about the events in the following months, when the National Ombudsperson announces his mediation, and when it turns out that the mediation has failed. His superiors have forbidden him to continue writing about the case. "You'd better not do that whistleblower any more", Rijkers was told by Foundation director Lambriex. [...] It is common practice that journalists are managed this way.»⁵⁸

The idea that the press is free is worse than an illusion. It is self-delusion against one's better judgment. It closes one's eyes to systematic and dangerous biases in one's information. Rupert and James Murdoch and other media-tycoons may be free, at least to a much larger extent than their employees. But journalists are subordinates in hierarchical organizations, or otherwise dependent on publishers or other media people. They do what their superiors ask (a euphemism for require or order) them to do, in the desired way. Respecting conditions and norms which experience with this

⁵⁷ *The Armstrong Lie* says something about the selection of interviewers by Lance Armstrong. The interview with Oprah Winfrey is an example of an interview which is known to have been preceded by negotiations and agreements.

⁵⁸ Nijeboer, *Een man tegen de staat (A Man Against the State)*, p. 271. The Foundation is the publisher. In note 14 on p. 276 Lambriex is even quoted as having said that no more attention should be given to whistleblower stories in general.

organization has taught them. They have learnt what is allowed and what is not, and what their superiors want. There are good reasons to reject the illusion that people like Murdoch leave their subordinates free as long as they make a profit. One only has to think of the relations of Murdoch senior with the Australian political top.⁵⁹ And of course, the profit motive can easily have consequences for the contents. People don't want to hear everything, and politicians even less. And what they want to hear or should hear is subjective and can be manipulated.

Politicians can help journalists, magazines, etcetera with scoops, interviews, journeys, and other benefits. They don't do that just to help them, for love of a free press. Tit for tat. Nothing is simpler than not inviting certain journalists or papers, and to refuse or postpone an interview.

Just like everyone, journalists are educated inadequately. Their basic knowledge too is deficient, even though their job and important social role may require better knowledge and understanding than other people.

As noted before, journalists pass selection processes. They have to be appointed, and should not have too many problems with the practices of their workplace, and the requests of their superiors. That is: with the compromises they have to accept in order to keep their job, and to be able to remain working in journalism.

Textbooks about the political system as partial explanation for absence of correction.

In this section, “the political system” indicates the coherent system consisting of politics, government and public administration (PA).

The cases, the immense harm they caused, and the structural misconduct and failure of politicians exposed by analysis of the cases, in combination with the absence of efforts to improve the political system, seemed incompatible with good education and good textbooks. In particular (text)books on history and politics and related subjects. It would seem that people who knew and understood history and the political system, would act and write differently than they actually do. Good education would probably have prevented the cases. They would at least have been analyzed much better in the media. Good education would preclude the telling of fairy tales by politicians.

For this reason a study was made of history books, and later of textbooks about the political system. Such studies were necessary because initially the present author had no idea what could be wrong with these (text)books.

The nature of history (text)books is discussed in section 8.15, Louis XIV and the writing of history. History books are found to be biased in favor of governments and their heads. The bias is created by underexposing their misconduct, especially warmongering; and by underexposing the suffering and other costs caused by the wars.

As regards textbooks in the field of politics, government, and public administration an evaluation was made of 16 (sixteen) textbooks found at the internet and in the personal library of the present author.⁶⁰ Of about half of the books the full text was available, of the other books at least the table of contents and pages giving an indication of the character of the book.

⁵⁹ See the relevant documents in the dossier. Search for “Murdoch” in the filename.

⁶⁰ The following textbooks were studied:

1. *Algemene begrippen staatsrecht* (*General concepts constitutional law*, in Dutch), Holterman T. (ed.), W.E.J. Tjeenk Willink, Zwolle, 3e druk, 1991, xiv+330 pp. ISBN 90 271 3365 4.
2. *American Government*, 2nd edition, Glen Krutz and others, Openstax (Rice University (Houston)). 2019. 781pp. PDF ISBN 978-1-947172-66-1.
3. *Basics of American Government*, Carl D. Cavalli (editor). Updated August 2013. University Press of North Georgia, Dahlonega (GA). 386 pp. ISBN: 978-0-9792324-6-6.
4. *Cases in comparative government and politics*. John McCormick, Macmillan Intnl & Red Globe Press, ISBN 978-1-352-00735-0 (pbk). Ca. 340 pp. (Pp. 50-340 are chapters per country. The cover and internal layout make the book look like a pendant of Hague et al.)
5. *Comparative Government and Politics, an Introduction*. R. Hague, M. Harrop and S. Breslin, 3rd ed., Macmillan, London, 1992. xxii+504 pp. ISBN 0 333 55820 0 pb.

Armed with the knowledge and understanding acquired by analysis of the cases, it soon became clear that the textbooks have fatal deficiencies. Even though at first view nothing seemed amiss. Appearances deceive: reflection and a second view quickly explain the general impotence manifested by the cases. The books leave the student completely unprepared for reality. The following is a combination of a summary and conclusions.

1. None of the textbooks informs sufficiently to understand and interpret political events, and to participate in political society in accordance with generally accepted norms and values, and for the reader's own and society's benefit. On a scale of -5 to +5, the textbooks would get -3 on average, with an estimated spread of 1.
2. The textbooks are neither reliable nor scientific. While suggesting reliability, the books study reality only marginally and arbitrarily, and do not expose structural deficiencies and dangers of the system(s). The books are misleading. They harm the interest of the student and society.
3. Most textbooks do give examples of misconduct and failure of the people and organizations having positions of responsibility and power in government and PA. The examples are almost never analyzed properly however. Deficiencies of the constitution, laws, people, or organizations are rarely indicated. Deficiencies are never said to require correction.
4. The majority of the textbooks is organized in accordance with the formal system. Facilitating the neglect of phenomena, events and other parts or aspects of the real world.
5. The textbooks are mainly theoretical. Their reflections have no purpose; they are just interesting. They are too superficial and incoherent to be instructive or useful for the student.
6. Reality is given cursory attention only. It is not studied in a systematic way.
7. Case studies play a subordinate role. Their analysis is superficial at best. No conclusions are drawn.
8. Contact with reality, for example by discussion of (budget) laws, annual, inquiry or statistical reports, or policy documents, is practically absent. (GbL/FC can serve as an example of how to integrate contemporary documents in descriptions and analyses).
9. None of the books pays serious attention to supervision. (An error that can cause a crisis, as proven).
10. None of the books pays attention to the competences required for public office or top jobs in government and PA.
11. Several books betray absence of necessary knowledge of the subject matter being discussed. Even publicly available documentation has not been checked sufficiently. At least two books inform

6. *Comparative government and politics*. Rod Hague, Martin Harrop & John McCormick. 11th edition, Red Globe Press, 2019. C. 380 pp. ISBN 978-1-352-00505-9 (pbk).
7. *Droit constitutionnel et politique*. O. Duhamel Éditions du Seuil, Paris, 1993. A little more than 900 pages. ISBN 2-02-022842-4.
8. *Government in America. People, politics, and policy*. George C. Edwards III, Martin P. Wattenberg, Robert L. Lineberry. MyPoliSciLab, 2012 edition, Pearson. 738 p. ISBN: 978-0-205-86561-1 (paperbound).
9. *Introducing Comparative Politics- The Essentials* Stephen Orvis & Carol Ann Drogos, Sage & CQpress. Ca. 450 pp. ISBN 9781506385693 (pbk).
10. *Introducing Public Administration* 9th ed, Jay M. Shafritz, E.W. Russell, Christopher P. Borick, and Albert C. Hyde. Routledge, 2017, Ca. 600 pp (pdf 633 pp.). ISBN 978-1-138-66634-4 (pbk).
11. *Magruder's American Government*. Prentice Hall Student Edition 2009. 864 pp. ISBN 978-0133656312.
12. *Oxford Handbook of Comparative Politics* Carles Boix & Susan C Stokes (eds.) Oxford UP, 2009. Almost 1000 pp. ISBN 978-0-19-956602-0 (pbk).
13. *Political science- A global perspective*. Leonardo Morlino, Dirk Berg-Schlosser, and Bertrand Badie. Sage 2017. Ca. 290 pp. ISBN 978-1-4129-6214-8 (pbk).
14. *Principles of comparative politics*, 3rd ed., by William Roberts Clark, Matt Golder & Sona Nadenichek Golder, Sage (London) & CQpress (Thousand Oaks (CA)), 2018. Ca 840 blz. ISBN 9781506318127 (pbk).
15. *Public Administration and Public Affairs*. Nicholas Henry. Routledge (Taylor & Francis), 2018. C. 520 pp. ISBN: 978-1-138-69352-4 (pbk).
16. *Understanding the political world. A comparative introduction to political science*. 12th ed. James Danziger & Charles Anthony Smith. Pearson, 2016. Ca. 500 pp. ISBN 978-0-133-94147-0 (student edition).

9. FINAL ANALYSIS, CONCLUSIONS & MEASURES

- incorrectly about the duties of the Federal Reserve. (Of great importance for understanding the subprime crisis).
12. None of the textbooks mentions or discusses points for improvement of the political system.⁶¹ None of the textbooks concludes that any constitution could or should be improved or corrected, if only as a matter of risk management, in order to avoid catastrophe.
 13. No effort is made to learn from history or historical events.
 14. As a consequence of the above properties, the textbooks on the politics, government, and public administration of a single country are de facto nationalistic. In this sense, that they implicitly declare the national system to be beyond serious reproach. Their deceptive attitude violates the norms and values the nation is supposed to stand for. They contribute to the conservation of the system as it is. They serve the people who have a vested interest in keeping correction at bay at the expense of everyone else.
 15. The textbooks help explain why political systems do not change.
 16. The above characterization of the collection of textbooks studied, can be explained as the result of selection by either university administrators, publishers, authors, or combinations of them.⁶² Open eyes, a reflecting attitude, and “too much” attention to deficiencies, may well be considered a guarantee for negative reviews, and deadly for sales and success. (Even if a majority of reviews would be positive). Colleges and universities appear to be unable and/or unwilling to defend the truth and scientific values, and to abhor controversial textbooks.
 17. The deficiencies may be partly caused or amplified by a textbook author’s efforts to respect contradictory norms and values. Especially the norms concerning reliability, and the norm that all opinions have equal value, and should be treated similarly. The main error being that most opinions in question are not (“pure”) opinions, but based on, or mixed up with, incorrect assumptions. They may reflect inconsistent values. Both the run up of the financial crises and the “climate debate” are characterized by such contradictions. Obviously, a reliable or scientific book should at least be clear about these matters. At present, the “neutral” treatment of a textbook supports the legitimacy of opinions which are actually indefensible. Indefensible at least without denying the value of human life and welfare, and the relevance or existence of reliable knowledge (either logical or scientific, not necessarily “certain”). Risk management being knowledge too.

If optimism about the future were justified, and if all went well on planet earth, then some of the textbooks might be somewhat acceptable. However, given the state of the mankind, the existing risks, and the absence of risk management, the textbooks are simply indefensible and harmful. They suggest that there is no problem, while there are several problems each of which puts the future of mankind at risk, and while there are hardly any instruments for timely correction.⁶³

This section gave part of the explanation of the passivity of the world outside politics. The next section gives another part.

9.3. Causes of an incorrect interpretative framework.

Causes of the stability of the political system.

Principal causes must be, that most people don’t understand politicians and the political-legal system, and can do little more than vote for a variant of the same. Obviously understanding isn’t enough. It must be possible to do something constructive with what you know and understand. There is even a difference between knowing how it works, and knowing that there are better alternatives. And if there are better alternatives, how they can be realized starting from the given situation. Questions about alternatives will be discussed in the sections with general conclusions and measures.

⁶¹ Except marginally and ad hoc, as in the last chapter of Henry. It proposes wage increase for people working in public administration.

⁶² Reasons for assuming otherwise being absent, the collection is assumed to be representative.

⁶³ Assuming that the existence of such instruments does not create inconsistency (is impossible).

The present section is restricted to the thinking about the political system. The causes of the lack of understanding can be summarized as follows:

- The knowledge acquired in education (including higher education) is insufficient and misleading;
- The play-acting and misleading information by politicians and top managers;
- The news, and the dominance of news in the stream of information to the public, is dominated by politicians and top managers;
- The de facto collaboration by most journalists and media;
- The opaqueness of hierarchical organizations;
- Self interests with the same effects as (self)censorship;
- Laws that provide insufficient mechanisms for prevention and correction, and support those in power.

Information which is important or even useful for the understanding of the conduct of members of government, and of phenomena like crises, forms only a tiny fraction of all the information going to the public. Such information may moreover be difficult to recognize. It may take weeks or months to be understood as being important.

The following list is an inventory of causes of an incorrect and misleading framework for the interpretation of the operation of politics and government:

1. As far as subjects related to this report are concerned, education is predominantly theoretical-idealistic. Education teaches how it should be or is imagined to be, without telling how it is. It does not prepare people for functioning socially in society, as an employee in a hierarchical organization and as a citizen (voter) in a state. People acquire only inadequate knowledge and understanding of the world they enter after education. They are unprepared to cope with a reality which differs greatly from the theory and ideals painted in the textbooks;
2. The incorrect idea that “democracy” and “democratic constitutional state” can only be implemented in the given way, and that the actual implementation is the best possible;
3. The large majority of novels, films, TV-series, etcetera describe and discuss phenomena which have no recognizable overlap with any of the phenomena considered in this study. They show almost nothing of a part of reality that is conditional for what they do show. They don’t contribute the least to the understanding of, and the coping with, political reality (and history). They don’t say anything about the way political reality determines social (societal) development;
4. In media like radio, TV, newspapers and magazines, news has a dominant position. Actuality is hardly seen as the last installment and result of developments in the past. Every hour, radio, TV and news websites broadcast the latest news. Analytical websites are virtually absent. Integration of information does not take place. The media rarely give more than separate, selective and biased snapshots of reality. Journalists live by the day. (Indeed, the French word “jour” means “day”);
5. Journalists and news services allow politicians and top managers to start with a clean sheet every day. They are always treated in the same way: as a full-fledged official and respectable person. Irrespective of what they did yesterday or the days before. In ordinary life one would never speak again with persons having misbehaved so badly, but journalists seem to think that the world is created afresh every night. In doing so, they actively contribute to forgetting and to failing to learn, and to keeping unsuitable and dangerous people in power;
6. Analysis and integration of news information are dangerously deficient. In science as well as the news media. Conclusions are not drawn, and learning is absent. (Making the lives of the few who do learn much more difficult);
7. Doing as if nothing has happened can be partly explained by the fact that the responsible officials kept their job. They are (still) minister or whatever. And even after losing their job due to gross failure, the desire of copy may be more important than proven incompetence and deception. Former president Wellink of the Dutch Central Bank, and head of BIS in crucial years before the crises, is an excellent example. The explanation is no excuse however. The decision to retain the official may have been wrong. In that case journalism contributes to preserving a system which reacts inadequately to dysfunctioning;

8. Many professional writers wrote from childhood, or at least since their school-days.⁶⁴ This limits their knowledge of many important social phenomena. They have no reliable personal experience with working in large hierarchical organizations. The “reliable” has been added because for example an internship of a year in such an environment has at most little value. It can even mislead. Often the intern will not understand his colleagues, since there is a large gap between what he knows and has learnt on the one hand, and reality on the other. Colleagues don’t know the intern, and will only trust him to a minor extent. The intern is a risk. As noted earlier, literature, including the scientific literature, tells next to nothing about the internal reality of large hierarchical (government) organizations;
9. In the media, the words of politicians, top managers and others, get very much more attention than their deeds (or the effects of their words and deeds in their organization), let alone their omissions. In general, the words are swallowed uncritically. And even though experience shows that interviews and press releases give an incomplete and biased view, they rarely get an independent check before they are broadcast to the millions;
10. Journalists (and many others) depend on news originators for their job and future. Which means: especially on politicians and top managers. Politicians and top managers can give them all kinds of favors, from scoops to hotel arrangements. A truly critical press is unthinkable, meaning suicide (or almost);
11. There is a peculiar difference between what is taught in education, and the information stream one is exposed to after leaving school, college or university. The information provided by the media, and by films and novels, is kind of prehistoric. The methodological lessons learnt in education seem to be completely forgotten. The present report does little more than apply what has been taught;
12. Biographies of politicians and top managers conceal by selection, and are defensive. Note that biographies of politicians and top managers are rarely written by the subjects themselves;⁶⁵
13. Someone who writes must be, or seem to be, consistent. Not because one has to be consistent, but because communication only makes sense if it is consistent. Otherwise nobody can or will take it seriously. Without consistency there is no meaningful communication, only strings of words (as already noted by John Locke (1632-1704));
14. At most sporadically something is published in the scientific literature that is related to the reality described in this report. None of the spores seems to have penetrated the textbooks. Systematic research into the reality of government organizations is not done. Scientists seem unaware of the absence of essential empirical information, and the textbooks certainly are. They do not note a shortage of empirical information, or uncertainty about the picture given. Perhaps scientists presume to know how it works, or that it is simple or obvious. Without saying so in textbooks or other publications;
15. Almost nobody analyses the phenomena described in this report more than superficially. Almost nobody seems to be aware of the fact that none of the members of government and parliament who keep silent about the case Spijkers, and therefore condone gross misconduct, can be honorable. They don’t draw the conclusion that this silence betrays a fundamental and structural problem. In the research for this report the seemingly obvious question as to what happened in the ministry of defense in relation to the case Spijkers was only asked in the book of Nijeboer. Not by the Dutch parliament for example. To protect criminal friends? Because everyone fears the unacceptable but probable answer that no corrective action was taken at all?
16. The misconception that major events must have major causes. In other words: insufficient awareness and understanding of the possibility that minor causes may have major consequences. Examples are the instabilities in the financial-economic system described in chapter 7, and voting.⁶⁶ It is hard to conceive events where the proportion between causes and consequences are

⁶⁴ There are important exceptions, such as Tolstoy and Solzhenitsyn. It would seem to the present writer that this is no coincidence, and that these authors were not only able writers, but had much real life experience, and something to say.

⁶⁵ Painting a positive picture is helped by authors who do not know politics and organizations from the inside.

⁶⁶ Infections are an important example in an entirely different field of knowledge. (This was written before COVID-19).

as big as in parliamentary elections.⁶⁷ The danger of underestimating this fact is that “minor” events or phenomena are given far less attention than necessary to understand and improve social reality.

Ignorance and lack of understanding can make journalists accomplices of governments and politicians without being aware of it. Although the last seems rather improbable, and is no excuse anyway. An example is that of calling a specific person or group responsible for the failure of a government proposal to get a majority in parliament. Examples are the tea-party in the USA which was supposed to block a budget agreement, and Dutch parliamentarian Duivestein who is supposed to have prevented acceptance of a government proposal for the solution of a budget problem until just before Christmas 2013. Such representations are misleading because pointing to specific persons or groups within a minority or majority is completely arbitrary. Until the person or group has changed his opinion, a majority is against. As simple as that. A majority always consists of several persons and often of several groups (parties). As long as every representative is free to make a choice, blaming a specific person or group is arbitrary. Everyone in the majority is equally responsible. Blaming only a specific person or subgroup is a political choice, and a rhetorical trick. Use of words like “obstruction” in reports about this kind of phenomenon favors governments. It deflects attention from the fact that actually a majority is against. It suggests that only a few people pose a problem instead of a majority. By adapting an obstruction terminology the pressure on specific individuals or groups is increased, and government helped. It is obvious that a (dishonorable) government tries to isolate persons or groups which it assumes to be liable to turn around under pressure. But the government’s framing of the situation should not be adopted by independent journalists.

Some incorrect and misleading ideas and concepts.

(An incorrect idea or concept can but need not be misleading. The moon is not a cheese, but thinking that the moon is a cheese need not harm anyone).

This subsection shows that the following ideas or concepts are incorrect, misleading and/or harmful:

- “The culture of a nation or country”;
- “Governments are representative of the population”;
- “People have the government they deserve”;
- “human”, “we” (in the sense of: people, human beings).

Both the error itself and what the error shows will be discussed.

“The culture of a nation or country”.

In this report a culture is understood to be a set of norms and values shared by the members of a group of people. The norms and values determine the behavior of the people in the group. Norms and values are defined by what people do and do not. A culture is not determined by the norms and values people profess in words, or by what they say they believe. Norms are conditions to be satisfied by behavior; values are what a person considers important. In general, the set of values includes norms. One can speak of a culture if the important norms and values are shared. Where what is important is defined by the culture.

If people have norms and values which according to some of these norms and values differ in important respects, then by definition they do not belong to the same culture.

The idea of a single culture in each of the participating countries makes many wars incomprehensible and unexplainable. The great majority of people seems to be peace-loving and to abhor war.

⁶⁷ And choosing the parties to form a majority coalition. Often, the same election results allow for very different coalitions. It is up to the politicians to choose, the voters can only look on.

(With good reason of course).⁶⁸ It is true that people do not only want peace, but pleasant lives and many other things as well. That is: they may have contradictory values. But on the basis of knowledge of people as you know them from experience and from serious literature, it is plain nonsense to assert that they would contribute to developments or factors which increase the risk of armed conflicts, if they were aware of such an effect, and if they had a choice. It is nonsense to assert that they consider things like cheap coffee or tea worth a war with uncountable deaths and disabled. One cannot blame 95% of the people with a warlike attitude. One can however blame them with thoughtlessness and docility. Especially with respect to politicians and top managers with false pretensions. Although in this respect too they often have little choice.

The phenomena and events studied in this report can only be understood and explained on the basis of a main conclusion of this study, to wit, that politicians and top managers lack the integrity and competence necessary for adequate and responsible fulfillment of their duties. That they only pretend to be honorable and competent, and consider keeping up appearances more important than the welfare of the people whom they are supposed to serve and to whom they are accountable. The norms and values of these people are very different from those of the vast majority of the population. It follows that in most countries there are at least two distinct cultures: a peaceful one of the vast majority, and an arrogant, respectless, and power-greedy culture of the top.

In the course of history, this seems never to have been different.

With their words politicians and top managers pay lip service to the norms and values of the majority. If they want to get or keep popular support they have little choice. Their own norms and values moreover are inconsistent, and cannot serve as a basis for a logically adequate reasoning. Their words furthermore are not consistent with their deeds. The seemingly natural inclination to think that people speak the truth (mostly), that they mean what they say, and that words and deeds agree, can be seen as important causes of the continued existence of illusions about politicians, and of much incomprehension. Far too much attention goes to their words, far too little to reflection on the state of affairs. The factual basis of this report shows that many words of politicians and top managers do not reflect what they think or do. Their words are meant to influence the audience and get support, a majority. In their verbal reasoning they adopt the norms and values of the audience, in order to show that what they did or propose is good or desirable in terms of the norms and values of the majority of the audience.⁶⁹

The present report shows, that the characteristics of the members of the “leadership” are far more different from those of the general population than usually assumed. All cases show that they act on the basis of norms and values which are incompatible with what is expected and considered desirable by the public. Such as respect for people and the truth, and for the interests, opinion and wishes of others.

This conclusion requires revision of the interpretation of, and thinking about, social and/or group phenomena. When trying to explain events, one should take much better account of deception, incompetence, abuse of power and other forms of misconduct as probable causes. One should not blindly assume that governments and parliaments honorably and competently try to do what is best for the population, and that whatever goes wrong is only caused by differences of opinion about legitimate political choices or by incidental errors. The investigation underlying this report has falsified these assumptions beyond the least possible doubt. The report also shows that a large majority of the people are docile, and believe and obey their superiors. It shows too, that even in cases of very harmful misconduct, only very few people dare to oppose their superiors, and go public if they don't take corrective action.

These observations explain the large contrast between the images of society created by literature, music, other art forms, and for example religion on the one hand, and the image created by collective failure and misconduct as organized by the political “leadership” on the other. With wars and the

⁶⁸ “Leaders” often don’t share these reasons, since they are better protected and will probably be able to go to a safe place whatever happens in their country.

⁶⁹ Compare the adaptation of speeches of American presidential candidates to the local audience.

accompanying barbaric cruelties as the almost common extreme.⁷⁰ Note that according to the norms and values of politicians as they have emerged from the present inquiry, wars are far less objectionable than they are according to the norms and values of the general public. The lack of attention for prevention of wars and other catastrophes is consistent with the lack of respect for others which is shown in almost all cases. It is incompatible with the hypothesis of respect and the idea that governments serve the (interests of the) people.

Because to a large extent behavior of society is controlled and determined by a non-representative top, it is not correct to interpret societal behavior as a manifestation of something like a collective or shared will or sentiment. In the present states, societal behavior should be seen as the result of a legal system which gives an overwhelming majority of the population hardly any control over a small minority which has the power to impose its will on everyone, and which does not protect the majority by liability or punishability. There is no guarantee that governments take account of peoples' wishes, interests, and opinions, or abide by fundamental norms and values.

Seen in the light of historical developments, quasi representative majority decision making is only the latest trick to make a population accept what a small group of rulers wants. The "representation" is called quasi, because the representation is actually no more than a claim. It is a claim of people who have a vital interest in having people believe that they are represented. Representation, and only that, legitimizes their power. But the people who are supposed to be represented have no possibility to make these representatives defend and realize their points of view. While those in power have every means to appoint reliable or docile persons in important positions, and to reward the desired behavior. Contrary to everywhere else in society, those who are supposed to be represented have no possibility to depose their representatives when they want to. How do you think employers would react to the proposal that everyone representing his organization has to account, and can be replaced, only after four years?

This means that there is no good reason to see especially wars and crises as expressions of a public will or a culture.

"Governments are representative of the population".

The incorrectness of this opinion/ hypothesis follows from the previous paragraphs. There is no reason to consider members of government as being representative of the population, and there is every reason to consider them to be very different from the vast majority of the population. Especially as regards norms and values. Their being elected neither means that they are representative nor that they represent. In general moreover, people cannot choose a honorable competent person, but only the least bad.

There is in fact not a trace of proof for the hypothesis. It need not even be true in a democratic constitutional state that works as it is supposed to be intended. Because even then governments rest on a minimal and arbitrary⁷¹ majority coalition. The assertion that such a government or coalition represents the whole population is no more than empty talk. And of course the case descriptions and analyses show that the democratic constitutional state does not work at all as taught at school.

So for at least two independent reasons governments are not representative of the population.

"People have the government they deserve".

The incorrectness of this opinion/ hypothesis follows from the previous paragraphs.

One might object that the assertion follows from the fact that a government is formed on the basis of election results. This inference ignores however that the voters have a minimal choice, and incomplete and partially incorrect information. It ignores the fact that election results allow for very different, sometimes virtually opposed, majority coalitions, and of course the choice of many very different ministers etcetera. In other words: "formed on the basis of" includes very little logic, and

⁷⁰ *The collapse of the third republic* by W. L. Shirer is a good example.

⁷¹ It is logically incorrect to speak of "the majority" and "the minority". In general there are several possible majorities and several possible minorities.

much arbitrariness. Or rather: manipulation. Although a given government may have a majority in parliament, it cannot in general be said to be a (logical) consequence of the election results.

The incompleteness and incorrectness of the information of the voters may have a considerable or even decisive influence on their choice and the election results. “Incorrectness” may be too weak a characterization, or simply incorrect. As a rule voters are “only” misled, preferably without lying. Well selected one-sided information can be just as misleading as lies. To many people, the corrupt character of the candidates, and their lack of integrity and competence, is unknown and cannot be known. Many people will have difficulty imagining such people, or getting used to the idea that there is a wide gap between reality on the one hand, and appearance and pretensions on the other. The author can hardly blame them. Until 2010 he had no inkling of the fact that the political top of modern societies has the characteristics listed in the first section of this chapter. That all principal persons have these characteristics. The list is a conclusion of the present report. The underlying inquiry was not meant to prove the list or any hypothesis whatever. The list didn’t even exist until the inquiry was far underway. The inquiry was meant to generate insight and understanding of what we know about recent history and the actual world. Initially it wasn’t even clear whether it would bring any insight and understanding at all. There was little more than hope. Of course some things were already known before the inquiry. But hardly more than a collection of largely incomprehensible and apparently incoherent facts and phenomena. Even a little reflection on whistleblower cases can make one suspect the worst. But whistleblower cases explain very little. They show very little of the state of affairs inside ministries. Like most other organizations, ministries are completely opaque. It is especially the analysis of the history of the subprime crisis which shows that false pretensions and lack of respect for people are a general phenomenon. Not only widespread, but general, without significant exceptions. At the same time it should be noted that the present report is based on a limited amount of cases and evidence. It cannot be excluded that more is the matter.

A cynic might remark that the above analysis actually proves the hypothesis it tries to disprove. That the voters get what they deserve. Namely because they are naïve and stupid. They don’t think properly about what they see, and for that reason don’t deserve any better. To a certain extent this point of view is defensible. But only to a certain extent. The argument fails if punishment is to be proportional to the size of the error, and to the extent to which it is blamable. In the present case the consequences are clearly disproportional. It is true that in general it is simply wrong (illogical) to assume that consequences are proportional to causes. There is no law saying that causes and consequences are proportional. People should be much better aware of this, and take it into account.⁷² So if, and only if, one thinks that voters should know that small causes may have large effects, and if one thinks that one may use the term “deserve” if effects are disproportional, one may conclude that voters get their just deserts.

The same argumentation implies that all principal persons deserve imprisonment for life and forfeiture of their fortune. The heaviest possible penalty. The more so since they voluntarily accepted their function, and therefore should be aware of the possible disproportionality of causes and consequences.

The use of words like “human” and “we”.

Terms like “human error” and “we as a nation”⁷³ presume and suggest an essential similarity of people, and the relative unimportance of differences. If the differences are important, the terminology is misleading. In arguments, the terminology may lead to incorrect conclusions and harmful decisions. It hampers explanation of important social phenomena and events, and solution of political and social problems.

The present report has proven that the hypothesis of similarity is wrong and dangerous. People differ in socially important respects. The principal politicians and top officials have norms and values which differ fundamentally from those of the largest part of the population. The norms and values of

⁷² Which they didn’t in the financial crisis for example.

⁷³ FCIC report p. xxiii/23 and xxvii/27. On p. 23 the FCIC is relatively careful: «Collectively, but certainly not unanimously, we acquiesced to or embraced a system, a set of policies and actions, that gave rise to our present predicament»

the top make them unsuitable for their positions. They are a threat to the welfare and future of mankind.

One might assume that people are equal in principle, in essence, or in disposition. Perhaps such things can be defined objectively, and measured. Perhaps there is some truth in it, perhaps there isn't. But whatever the answer may be, the report has shown that whatever the precise nature of the hypothetical "equality" or similarity, it can only be of theoretical importance. As regards social phenomena, assertions about supposed equality hide much more than they reveal. Even theoretically not only the disposition is of importance, but the development and result just as well. They obviously differ greatly. Even if the dispositions were equal, which known genetic differences make highly improbable, experience shows that practical differences are large and very relevant for all kinds of social phenomena. There is every practical reason to consider the differences far more essential and important than the supposed equality. Whatever the cause.

Underestimation of the differences is bound to cause erroneous reasoning and inadequate solutions.

9.4. Miscellaneous remarks.

Additional observations regarding the writing and explanation of history.⁷⁴

If explanation of a set of assertions means: logical deduction of the assertions from accepted knowledge, then explanation requires consistency of both this knowledge and of the set of assertions to be explained. The assertions should be consistent with one another, and with the accepted knowledge. Where consistency means the absence of logical contradictions. From inconsistent assertions one can derive whatever one likes, and from consistent assertions one cannot derive contrary assertions.

This is logical, and therefore also applies to the explanation of human behavior and history. A problem is that in human behavior and history, consistency need not be present. Decision-making, and the ensuing activities, are governed by the abilities of the decision maker.⁷⁵ Where "abilities" also refer to the ability to use information properly. Which includes: consistently. Decision-making is further affected by factors such as errors, and lack of timely, complete and correct information.⁷⁶ Deficiencies may make explanation in the normal (logical) sense not just difficult, but impossible. Deficiencies may make decision-making similar to throwing dice. Errors can be made due to fatigue, insufficient competence, lack of full and correct information, and other factors. But like throwing dice, "fatigue" has no explanatory power, since it can "explain" almost anything. Including incompatible outcomes.

Often, optimal consistent decision making is difficult.⁷⁷ Intuition and common sense rarely suffice to make a good decision. People nevertheless rarely know anything about the science of decision making.⁷⁸ And although colleagues in organizations might theoretically correct deficiencies of colleagues, in practice they rarely do. The preceding chapters show that hierarchical organization often makes matters worse by repression of everything the incompetent top does not like or understand.

People need not even be consistent or logical in their decision making if all of physics, chemistry and biology were understood. The reason being that understanding in terms of the natural sciences need not imply logical deductibility and predictability in the sense of the present context. In practice moreover, not everyone tries to be consistent in his norms and values or behavior, or is even aware of

⁷⁴ In preceding chapters, observations were made regarding the selection of what is described, about the choice of causes, and about the role of summaries and conclusions.

⁷⁵ Here "decision-making" is considered synonymous with "making a choice", or "choosing between alternatives".

⁷⁶ Not all forms of lack of integrity or competence, and not all deficiencies in information result in other or sub-optimal decisions. It depends. The cases suggest that deficiencies in information are relatively unimportant, and that everything that went seriously wrong can be ascribed to fatally unsuitable people in the top.

⁷⁷ In the abstract the method is quite clear, but not easy to implement in relatively complicated circumstances. See part 2 of *Het recht van de logica* and the references cited therein. Note furthermore that optimal or good decision making requires a consistent set of priorities and boundary conditions. Otherwise qualifications like "best", "good", "optimal" or "perfect" are not (or not unambiguously) defined.

⁷⁸ Reminder: in this report, the science first of all stands for reliable knowledge.

the indefensibility of inconsistency. For this and maybe other reasons, not everyone tries to avoid contrary priorities or activities, or is able to. The author once met an apparently intelligent person who explicitly told him that he knew he had incompatible ideas (and gave examples). But he liked that, and wanted to keep it that way. This may seem funny, as stupidity sometimes does. But the potential consequences are not funny at all. Inconsistency means that yes can mean no, and that help can mean harm. It can make communication meaningless. In practice inconsistency can cause all possible forms of paralysis, inefficiency, risk, and damage (up to and including catastrophe). That people don't understand this is part of the problems of mankind.

Integrity and competence are well defined and relatively unambiguous. Lack of integrity and competence on the other hand come in innumerable forms, and may furthermore change from one minute to the next. This is important since integrity and competence are necessary for good decision making, and because good decision making is necessary to protect people and mankind against numerous dangers. So although in general only few of the possible outcomes of decision making can be called good, there is an infinity of outcomes leading to a large variety of unwanted or risky situations and courses of events. As noted by Tolstoy in the first sentence of Anna Karenina: «[Happy families are all alike; every unhappy family is unhappy in its own way](#)». To keep one's family happy, one has to take sensitivities and more into account, and accept restriction of one's freedom. An infinite variety of taking liberties will soon end the state of happiness. A state of happiness is unstable; that of unhappiness is stable.

This report has shown that the characteristics of the members of the “leadership” differ from those of the general population, and much more than is usually assumed. All cases show that government officials act on the basis of norms and values which are incompatible with what is expected and considered desirable by the public. Such as respect for people and truth, and for the interests, opinion and wishes of others.

The above observations require revision of the interpretation of, and thinking about, social or group phenomena, including history. When trying to explain events, one should seriously consider the possible roles of deception, incompetence, abuse of power and other forms of misconduct. One should not blindly assume that governments and parliaments honorably and competently try to do what is best for the population, and that whatever goes wrong is only caused by legitimate differences of opinion about political choices or “human” mistakes and the like. The present report has falsified such assumptions beyond any possible doubt. The report also shows that a large majority of the people are docile, and believe and obey their superiors. It shows too, that even in cases of very harmful misconduct, only very few people dare to oppose their superiors, and go public if they don't take corrective action.

From the above it follows that descriptive history need not be logical. Therefore it is not superfluous. Many specific historical events cannot be predicted or logically deduced from previous history or any premises whatever. One can only observe and describe. In fact, some vital and fatal (erroneous) decisions cannot even be imagined by what the present author formerly would have called reasonable and responsible people.

Factors like incompetence, inconsistent norms and values, deficient information, and errors, make the outcome of decisions, and therefore behavior and courses of events, unpredictable and inexplicable. Where it should be kept in mind that errors or mistakes cannot in general explain specific (erroneous) decisions.⁷⁹ Anyway, the fact that to a certain extent decisions are unpredictable and inexplicable does not mean that nothing at all can be said about the resulting course of events. Prediction is rarely a matter of all or nothing. In the terminology of Tolstoy: one may be able to predict unhappiness without being able to predict the specific form or intensity of the unhappiness. In other words: knowing that top managers are incompetent, and must be expected to make unpredictable errors when making decisions, does not preclude the possibility of saying something useful and reliable about future developments. It is safe to conclude for example that wars, financial crises and other kinds of disaster are bound to recur, and that innumerable more or less costly projects will fail. Even when it is impossible to give details. That is: without being able to say exactly what will go wrong and where and when.

⁷⁹ Of course, a specific error or mistake may.

Since important decisions affect or determine the sequence of all following events, this implies that history is predictable in a global sense, but unpredictable and inexplicable as regards the specifications of failures and disasters. It is certain that as long as authoritarian nitwits with false pretensions are allowed to govern states with millions of inhabitants and immense technological possibilities, to spend about half of the national income, and to force their inhabitants to support and take part in armed activities, things will go wrong terribly. This much is predictable. It is predictable not only on the basis of historical experience (“there have always been wars, and therefore will always be wars”), but first of all on the basis of analyses which explain the historical recurrence of wars, and which show that the present governments are simply insufficiently willing and competent to plan and steer a safe course. And of analyses which show that the present legal and political systems virtually guarantee irresponsible government, and thereby disaster. On the other hand, the analyses suggest- if not prove- that with good governments, competently serving the interests of their population, there could and would be peace and real progress, without the risk of man-made disaster. If governments had worked as they should have, the 20th century would not have seen two world wars, and at least the last two financial crises would not have occurred.⁸⁰ Both the wars and financial crises were the consequence of erroneous decisions that could and should have been made differently.⁸¹ Note that according to the norms and values of politicians as they have emerged from this report, wars are far less objectionable than they are according to the norms and values of the population. On the other hand the lack of attention to the prevention of wars and other catastrophes is consistent with the lack of respect for others which is shown in almost all cases.

To conclude and return to the beginning of the (sub)section. Explanatory history should start with the observation that a human population contains people with a wide variety of characters and (limited) abilities. Important dimensions being docility, intelligence, abilities, self-knowledge, arrogance, respect for other people, and the ability and perceived freedom, need, and willingness to impose opinions on others. (This characterization certainly can be improved). The result being that a large majority of people follows people who make them believe that they are good and able leaders, or otherwise know how to keep the overwhelming majority quiet and powerless. Or just succeeded in once grabbing power, say by violence or trickery. Quite generally, there is no reason at all for assuming “leaders”, i.e. people who managed to get to the top, to be able to deliver on their promises, and to ensure durable security and well-being. On the other hand, there is every reason to expect arrogant, dishonorable, and incompetent people to cause (not only fail to prevent) wars, crises and all other kinds of disasters and wrongs such as described in the present work.

The present chapter shows what mechanisms cause what leadership characteristics, and what causes their stability. The characteristics of the leadership explain its frequent and unlimited failures. At the same time explaining that due to lack of both integrity and competence their policies and actions are at most predictable in a rough sense. The most important reliable prediction being that fatal risks are only growing, and will certainly be realized, if the law and political system are not radically corrected.

Active and passive selection of employees.

This report has frequently drawn attention to selection effects and their consequences. It is useful to distinguish active and passive selection:

Active selection:

⁸⁰ It requires some reflection, but the book *The collapse of the third republic* by W. L. Shirer is sufficient to show that governments of many countries could have prevented the second world war. Individually. Not only those of Germany, Italy and Japan, but also those of (at least) France, the UK, the USA, Poland and Russia. For several years, cooperation would not have been needed. All of these states acted incompetently, irresponsibly, and without any form of risk management. It is of course obvious that with good governments, the organized mass murder campaigns in China, Germany, Rwanda, and the Soviet Union (to name but a few of the largest) would not have taken place.

⁸¹ Note that the examples suggest that integrity is more important than competence.

- Selection and appointment by an organization (= its representatives);
- Transfer by an organization;
- Discharge (or a variant).

Passive selection:

- The choice to apply for a certain function in a specific organization;
- Internal transfer at the request of the employee;
- Voluntary departure.

To understand the described and similar phenomena it is of great importance to realize that these forms of selection occur, and that they define the characteristics of the flows of employees to and from an organization. And that these flows determine the characteristics of the population of the organization employees. In the long run, unwanted characteristics are practically eliminated, with the exception of mistakes with respect to the inflow. It follows that one cannot expect an organization population to be representative of the population at large.

The same applies to the “management” and the top of organizations.

Inside an organization, selection determines what kind of people work where. Separate organization units may have their own profile, at least to a certain extent. Of course this is true for an optimal organization as well. Still, the top is free to use its possibilities to transfer critical and outspoken employees to positions where they cannot cause serious difficulties.

The study shows that the top prefers the following characteristics:

- Docility;
- Acceptance of the values, terminology and way of thinking of the top;
- Refraining from criticism that requires real changes;
- Blind loyalty to superiors and the top. That is: when necessary, to subordinate all other norms and values to the interests of superiors and the top;
- The ambition to climb in the hierarchy, and the willingness to compromise and make sacrifices to reach a higher position.

Especially the cases regarding the Dutch education ministry and the subprime crisis explicitly show that these characteristics are much more important than competence. Making even serious errors is permitted, but the image of the organization (= the top) is inviolable.

The intolerance for criticism and the absence of willingness to discuss are obvious from all cases from the Dutch education ministry. There simply was no willingness at all. Many of the other cases indicate exactly the same. A tell-all example at a higher level is that of chairperson Brooksley Born of the US CFTC in 1999.⁸² Ten years later she became a member of the American Financial Crisis Inquiry Commission, which was to discover the causes of the financial crisis. The following is from the biography of the members of the Commission:

«From 1996 to 1999 she was chair of the US Commodity Futures Trading Commission (CFTC), the federal government agency that oversees the futures and commodity option markets and futures professionals. [...]»

Ms. Born is a 2009 recipient of the John F. Kennedy Library Foundation's Profile in Courage Award “presented annually to public servants who have made courageous decisions of conscience without regard for the personal or professional consequences.” She received the award in recognition of her efforts as chair of the CFTC to urge that the over-the-counter derivatives market should be subject to federal oversight and regulation. The failure to regulate that market is now seen to be a major cause of the recent financial crisis.»

The example is very important because it indisputably proves the lack of integrity of the conspirators Greenspan (chairman of the Fed), Levitt (chairman of the SEC), Rubin (secretary of the Treasury) and Summers (undersecretary of the Treasury). That is: of the top of the financial world of

⁸² FCIC-report p. 48/76.

the USA. It also shows the inadequate operation of the US constitutional system: decisions are not made on the basis of material merits, and criticism is not refuted with arguments but shoved aside by abuse of power. If present, the checks and balances don't work. The system fails to correct itself. Note by the way the choice of a vague objectified formulation "The failure to regulate..." for what was actually intolerant and irresponsible behavior of the principal persons.

For another example see the report of the hearing of employees of Moody's by the FCIC on 2/6/10. It gives a close-up of a management abusing its power to silence discussion and criticism.

Character and size of parliaments and other organizations with control duties.

Introduction.

The following paragraph from an article by "Brutus" of 29 November 1787 may serve as an introduction:

«In order for the people safely to repose themselves on their rulers, they should not only be of their own choice. But it is requisite they should be acquainted with their abilities to manage public concerns with wisdom. They should be satisfied that those who represent them are men of integrity, who will pursue the good of the community with fidelity; and will not be turned aside from their duty by private interest, or corrupted by undue influence; and that they will have such a zeal for the good of those whom they represent, as to excite them to be diligent in their service; but it is impossible the people of the United States should have sufficient knowledge of their representatives, when the numbers are so few, to acquire any rational satisfaction on either of these points. The people of this state [the article was published in the New York Journal] will have very little acquaintance with those who may be chosen to represent them; a great part of them will, probably, not know the characters of their own members, much less that of a majority of those who will compose the federal assembly; they will consist of men, whose names they have never heard, and whose talents and regard for the public good, they are total strangers to; and they will have no persons so immediately of their choice so near them, of their neighbours and of their own rank in life, that they can feel themselves secure in trusting their interests in their hands.»⁸³

Parliament as representative of the people.

It is unclear whether the link between members of parliament and the people has ever been stronger than that between members of parliament and the government. Many political (constitutional) systems may very well have been designed for the purpose of making government easy. Because a majority is the least and simplest possibility that is somewhat defensible. Whether the link between represented and representatives is stronger or weaker in systems with a district and two-party system is not known to the present author. What is clear however is that the link must have weakened appreciably in the course of time. Namely because of the relative growth of the population, the increase of government expenditure, and the correspondingly much increased relative power of government. Including its authority to appoint the top of an increasing number of influential organizations. It is conceivable that two centuries ago, the future of members of parliament depended on reelection for their personal welfare. In the beginning of the 21st century this is a ridiculous idea. A bright career perspective first of all requires toeing the party line. Not the represented but the party bosses have to be satisfied. Even or especially by those who sometime want to move to the private sector. A private sector which strongly depends on government contracts and regulation.

Political parties try to appear transparent. But actually they are just as opaque as any other hierarchical organization. Although it may appear that much debating is going on in political parties, it is often unclear how decisions are made and party positions arrived at. Political parties certainly do not decide with unanimity. The claim that parties represent their own members is open to doubt. That they

⁸³ Brutus IV in the New York Journal of 29 November 1787. Included in Part 1 of *The Debate on the Constitution*, B. Bailyn editor, Library of America, volume 62, pp. 426-7.

represent other people beside their members lacks every theoretical and empirical basis. It is no more than a claim, or an illusion.

Although it is often said that politicians take account of public opinion, it is entirely unclear how they do this. It is just as unclear whether they do this as a matter of principle, and systematically. Regrettably these questions testify to illusions against better judgment. If only because public opinion depends on what the public knows, while all cases show that politicians misinform the public. Where else in society do the represented tolerate such behavior of their representatives? Nowhere of course.

Summarizing it can be concluded that there is no empirical basis for the assertion that parliaments (or parts thereof) represent the people. It is a fiction. On the other hand the cases provide plenty empirical evidence showing that in important matters politicians ignore the opinions and interests of the people they have a duty to represent. They collaborate in serving the higher ups in the party hierarchy and the government by abusing their position to mislead the represented.

Some remarks about the size of supervisory bodies.

- The size of representative bodies is less important than the quality of their work and the consequences which they connect to findings of inadequate functioning. Still, it is obvious that adequate control (supervision) of a very extended system of large organizations is only possible with a sufficient number of people;
- The problem of the size can be partially obviated by substantial sanctions for dysfunctioning. Making harmful errors should be unattractive. That is the heart of the matter. As in all systems of punishment, the product of the fine and the chance of being caught should be sufficiently preventive. As long as the sanctions are kept relatively insignificant, the size and quality of the controlling body should be relatively large;⁸⁴
- Effective control requires the effective cooperation of the different parts of the system for control. The sizes of the parts of the system for control should be considered as parts of a whole, and not as being independent. Overlapping duties should be avoided, but together the parts should cover everything that needs to be supervised;⁸⁵
- The required size of the system depends strongly on the effectiveness of internal control of the organizations being supervised. The cases show, that at present, internal control leaves everything to be desired. Since external control can never be as efficient as internal control, improvement of internal control is one of the main goals of measures to be mentioned later on;
- Of course, the cases show that at present there is no effective control at all. The principal problem being the quality.

In 2012, prominent Dutch politicians proposed reduction of the size of parliament.

This is mentioned as an example of talking without thinking, by leading politicians.

Consider the following question:

If in 1815 the Second Chamber of Dutch parliament had 68 members, how many members should it have around 1995 in order to make every member of parliament represent just as many labour-fte?

A simple calculation yields the answer: 862.⁸⁶

According to the same yardstick, a country like the USA with more than 200 instead of 16 million inhabitants, should have a representative body with more than 9000 members. And according to the norm of 1 per 30,000 from the time of the adoption of the US Constitution, the number of representatives should be 6667.⁸⁷

Of course an assembly of more than 6000 members is unfit for discussion. Which only goes to show that the present implementation of “democracy” is completely out of tune with the growth of the past centuries. Calculations such as given here should be reason to look for better ways to implement people’s participation in public decision making. Modern technology offers more than enough

⁸⁴ What is large and small can be determined on the basis of experience, of the effects.

⁸⁵ This was not the case in the USA before the subprime crisis, for example.

⁸⁶ For the calculation, see the document 20110531_Analyse relatieve omvang TK.doc (in Dutch).

⁸⁷ $(2.10^{**8})/(3.10^{**4}) = 6667$.

opportunities. But this is a subject that is far removed from the subjects of this study. A line has to be drawn somewhere. And as will be shown below, improvements in this field do not seem to be necessary to realize fundamental correction of government. For these reasons further analysis of this question is forgone.

In 2012, the government of Dutch prime minister Rutte saw things very differently. It proposed reduction of the size of both Chambers of parliament. The Second Chamber should be reduced from 150 to 100 members. The reason given was that the government had become smaller. The proposal is therefore only logical. As if the size of “the government” should or could be a standard for the size of the representative or supervisory body, and as if taxes had been reduced by 30%!⁸⁸ In fact, the size of the aggregate of the government organizations has grown tremendously, and government expenditure even more. And of course, ultimately it is the expenditure that has to be supervised. (Although law making may have grown just as much, and should be evaluated much more critically than in the past century).

The proposal of the Rutte government says a lot about the competence and attitude of politicians and their historical consciousness. Including a lack of attention for the arguments and lack of respect for their predecessors. And of course lack of understanding of the inadequacy of the control exerted by the given parliament. The ideas that things go well by themselves, and/or can do with less control are contrary to experience, and theoretically risky and irresponsible.

Beside size, government by a majority coalition is a serious problem for adequate control of government. In addition to the effects of obedience to the party top, and of the much greater loyalty to party members than to those who are to be represented. A loyalty strongly supported by the fact that the government has decisive influence on appointments to innumerable lucrative administrative functions in public administration, and even beyond.

Etzioni on norms and values of politicians.

The following remarks could have been included in “Related thoughts”. Because of ambiguities this has not been done. As a sign of respect, as a reminder, and since they are clearly related to the subject matter of this study, they are quoted to conclude this section:

«The assumption that political power is crucial and potentially repressive in its own right has led [writers] to the further assumption that democracy is worth promoting because it serves as the most effective known restraint on such power. In this context, it is a widely shared assumption that elections and the consequent threat of replacement as well as the codes of ethics or “rules of the game” which elites in a democracy must be seen to adhere to in order to gain and maintain power [...] are crucial in restraining power and power struggles. [...] It has less frequently been pointed out, however, that the democratic rules are fragile, that they are easily circumvented when interests are at stake, and that they are not always clear-cut and definitive. And when the rules are hazy, inconsistent or controversial, the restraint they put on elite power and power struggles becomes even more fragile than it usually is; power is thus enhanced and power struggles are exacerbated. Under such circumstances power struggles may become especially disruptive and pose a threat to democracy.»⁸⁹

9.5. General conclusions.

The following conclusions can be distinguished from conclusions which refer to only one or a few specific cases. They are general in this sense too, that they are compatible with all cases (and with everything else the present author knows).

1. All cases, including the financial crises, show arrogant but incompetent top officers. Excepting only very few persons, none of them is honorable. The top officers mislead the public. They nevertheless maintain that they are both honorable and competent;

⁸⁸ Taxes had not decreased but increased.

⁸⁹ P. 226, *Bureaucracy and democracy. A political dilemma*. Eva Etzioni-Halevy. First published 1983. Revised edition (year unknown). Routledge & Kegan Paul, London. In the dossier under 20111022.

2. Towards the outside world, top officers of organizations systematically pretend that their organization and they themselves function excellently. Criticism meets denial and repression;
3. Most if not all cases would not have been cases if the politicians and top officers who were directly or indirectly involved had been honorable and competent, or if they had done their duty properly. In all cases their responsible functioning would have prevented all or most of the suffering and damage. Neither of the financial crises would have occurred, for example;
4. The principal persons accepted jobs they could not properly fulfill. This and their systematic dysfunctioning show that they thought that they need not fear negative consequences of misconduct and failure. Their undisturbed and successful careers show that in this respect they were right. None of them has been punished or held liable;
5. All cases show structural misconduct of almost all higher officers;
6. Even when fully justified, disclosures by whistleblowers rarely lead to correction. Even partial redress is very hard to obtain. In no or only very few modern cases was the effort at redress as successful as in the Dreyfus affair of around 1900. And in that case too those guilty of gross misconduct have not been punished or held liable;
7. In none of the cases responsible officers acknowledge misconduct, errors or the like. They suggest that they can (and have to) refute all relevant allegations. Whatever happens, the appearance of infallibility is kept up at whatever cost to integrity;
8. In none of the cases responsible officers show signs of real and structural improvement. Internal reporting, inquiries, recommendations, promises of better behavior, etcetera: it is only a display of empty words. Nothing is learnt (at least nothing positive);
9. For none of the cases responsible officers have given an acceptable explanation;
10. Top officers ignore existing (reliable) knowledge and know-how, even if it is of vital importance for lives and welfare. They wrongly pretend to know better;
11. Top officers don't let themselves be restrained by lack of knowledge and know-how. If it suits them, they ignore unbearable risks, or claim that it is necessary to take them whatever the consequences;
12. It is untrue that governments have done and do what they could and can to prevent or reduce (immense) harm and suffering. The wars and crises since 1900 at the latest were caused by avoidable actions or omissions of governments lacking both integrity and competence. These and most other unnatural catastrophes were avoidable;
13. The observation about avoidability applies to all cases mentioned in this report, including both financial crises;
14. Roughly speaking, wars can be understood as being caused by actions of one country or group of countries, and by omissions of other countries, both being necessary for making war feasible;
15. In many situations, governments have replaced at least part of liability by the combination of norms and supervision. In such situations, not only actions, but omissions can be understood as cause of harm. For example omissions in supervision and the definition of norms.⁹⁰ Omissions should especially be called cause when the omitted action, in other words: adequate norms and supervision, would have prevented innocent victims. As in the prehistory of the financial crises;
16. The appointment of top officers lacking integrity and competence is due to similar officers. They appoint people of their own kind. They exclude honorable and competent people;
17. They are responsible for laws that safeguard themselves and their kind, allow them to act at the risk and cost of outsiders, and for laws that keep the political administrative system working as it does;
18. By making selectively permissive laws, lawmakers enabled and promoted developments which caused wide gaps to grow between required and available competences, and between risks actually taken and risks bearable by those who make the decisions. In the course of time numerous functions ("duties") were created which cannot be fulfilled in a responsible way. As a consequence, top officers of large organizations cannot check, but have to believe, what

⁹⁰ "For example", since not learning from experience, not correcting the law, and failure to properly regulate and supervise supervisors can be seen as omissions as well. Again, this small list of examples need not be exhaustive.

- subordinates tell them. They cannot properly account for failures. In this way (too), society has been made much more dangerous and risky than necessary;
19. Governments and (other) large organizations are the most important examples of this. No human being has and can have the competences which the top of such organizations should have in order to be able to bear responsibility for the adequate operation of these organizations in a meaningful way. The pretensions of their top officers are false. The gap between the required and available competences shows that they cannot be honorable. This is a logical conclusion that is amply borne out by the cases. Hierarchical organization causes a top which cannot be honorable;
 20. The law enables “to privatize profit and socialize losses”;
 21. Although many employees of involved organizations must have known about serious misconducts or omissions which are contrary to applicable norms and duties, and which cause harm and waste-, and many should have done something about it or blown the whistle, only the actions of an extremely small fraction have been visible;
 22. In the Dutch education ministry, employees of lower rank were probably kept in check by fear for personal consequences. The fear was caused by deterrent examples, distrust in the top, and lack of self-confidence. As regards the EU, Van Buitenen is explicit about the fear of employees of lower rank, and the repressive attitude and actions of European commissioners and higher managers. No essential difference between the ministry and the EU can be observed;
 23. Structural misconduct of the top would be impossible without the subservience and silence of all other employees. Without silent subservient organizations, top officers cannot afford to be dishonorable and incompetent, to operate irresponsibly, and to keep up appearances;
 24. Codes of conduct and professional codes are found to be violated repeatedly. Whistleblower regulations played no positive role. (If they had, most of the cases would not have existed). From these observations, the absence of adequate provisions to ensure compliance with the codes, and the intrinsic inadequacy of whistleblower regulations, it can be concluded that these codes and regulations are not intended to ensure integrity, but to mislead the public into believing in the integrity of the organizations concerned;
 25. The reactions of top officers to whistleblowing are extremely disproportional and terroristic. What is known about people and organizations, what whistleblowers have brought to light, and the facts of the cases, clearly show that in most government organizations important things go wrong, and that outside the organizations not even the tip of the iceberg is visible;
 26. All observations are compatible with the hypothesis that the non-specific phenomena shown in the cases are representative. The analyses support the generalization. In other words: it is improbable that there is a significant number of honorable and competent top officers. Fact is that no top officer has exposed false pretensions of any other top officer, and thereby broken the closed front against the general population;
 27. The failure of codes, and the absence of (self)correction, is made comprehensible by the combination of inadequate liability and criminal law, dishonorable top management, and the unity of powers (= the absence of separation of powers) in hierarchical organizations.⁹¹ There is no compelling reason for improvement, and improvement would threaten the position of the sitting top;
 28. In the past century, the size and power of (central) governments has increased more than tenfold. This has greatly changed the relation between parliaments and governments. Already for decades, members of parliaments have a much greater interest in supporting their government than in critical control. And where governments reflect majority coalitions, critical control cannot be expected in the first place;
 29. In most cases control and/or supervision are relevant.⁹² Often they are crucial. In all cases where they are relevant, control and supervision were insufficient or absent. Including parliamentary

⁹¹ The powers are: law making, judiciary, and executive.

⁹² As everywhere in this report, “control” means checking proper operation, proper fulfillment of duties.

- control and supervision.⁹³ In all of these cases, adequate control and supervision would have prevented most or all of the harm;
30. Members of parliaments assert that they control government. This assertion is untrue. All cases show an almost complete lack of control. As regards control or supervision, parliaments are passive. They behave as if all goes well of its own accord. And when failure or misconduct is brought to their attention, at best they only take superficial measures, without tackling causes;
 31. For control and supervision to be effective, they must have a sufficiently strong deterrent effect. For control and supervision to remain effective if reduced in intensity, it is necessary that sanctions for misconduct are increased at least proportionally. In actual practice there often are hardly any consequences at all. Moreover, if sanctions are small, no effect is to be expected. Even doubling or tripling a penalty may be insufficient;
 32. To call members of parliaments “representatives” is misleading. They do not truly represent the population. They represent the government, politicians as a group, their party, interests, theories or just their personal opinions and interests. They do not respect generally accepted norms and values. They refuse to put their pretensions regarding representation to the test of referenda, or by giving voters the right to replace them at will;
 33. The justification of “representation” and power on the basis of expertise is untenable. The cases show a fatal (if not complete) lack of expertise of politicians;
 34. Nowhere else in society do representatives have a carte blanche for years. Nowhere else is this considered reasonable, let alone necessary;
 35. If the principal persons, including members of parliaments and governments, would have known that they would have to account in a serious way for their actions and omissions, many of the cases seem extremely unlikely to have happened;
 36. The principal persons have nothing to fear from misconduct. They are not held liable or punished for misconduct or its consequences. On the contrary: in the cases studied, many of the people co-responsible for causing irreparable or unbearable damage were rewarded with large severance payments and/or jobs with a salary the general population can only dream of;⁹⁴
 37. In this respect too the law is deficient. It is inconsistent with the equality principle. Especially as regards liability and punishment. As it is, it cannot be expected to work preventively;
 38. The overwhelming majority of the very large number of victims of the dysfunctioning of governmental organizations was not adequately indemnified;
 39. None of the official inquiries which were made in connection with the cases can pass muster. Even when claimed to have been made by “independent” experts. The commission members are neither honorable nor competent. The inquiry reports fail to expose and analyze the (structural) dysfunctioning of politicians in a proportional way. They do not try to find the causes of their dysfunctioning, and do not try to make recommendations which could eliminate these causes;
 40. There are several mechanisms which preclude the inclusion of some of the most important causes of failure in inquiry reports. “Most important” if one wants to prevent repetition. Examples of such mechanisms are: the selection of inquiry commission members, such as peers instead of outsiders, dependency on the people who commissioned the inquiry, and coaching committees;
 41. The inquiry commissions can only be meant to gain time, keep up appearances and prevent real investigation. This explanation is supported by the fact that implementation of the- often seriously weakened- recommendations isn’t monitored;
 42. The (hypothetical) mechanisms for (self)correction are seen not to work;
 43. Since all of the cases can be understood as consequences of lack of integrity and competence of top officers, it follows that the dangers of lack of integrity and competence are grossly underestimated;
 44. The hypothesis that in Western or other states there is agreement about the most important norms and values is incorrect. The top and the general population have fundamentally different sets of norms and values. The set of norms and values of the top subordinates the interests and opinions

⁹³ Doing virtually nothing cannot really be called by these names. Don’t forget by the way that parliaments also have to check adequate supervision by government of all kinds of agencies and other subsidized organizations, and whatever has been stipulated by innumerable laws.

⁹⁴ As if not their incompetence but competence had been proven.

- of society to those of itself. To serve its self-interest, the top pretends to share the norms and values of the general population. But its behavior shows that it does not truly respect other people. The cases show that the hypothesis that it serves the interest of the whole is untenable;
- 45. The lack of integrity and competence of the top of society, and the mechanisms which support and stabilize this phenomenon, are the main, and in a sense only, threat to mankind and life on earth;
 - 46. In the present circumstances of mankind, underestimation of the incompetence and lack of integrity of the political “leadership” is a deadly danger. This report shows that society’s top is unwilling and unable to do its duty, and that it is not open and honest about what it does or fails to do. The cases show that very great risks are taken, and that risk management is practically absent. Many subjects of life and death do not even get a fraction of the attention they need. If things go wrong, power positions are used to mislead the population, and to make it believe that the leadership could not do better, and therefore can stay;
 - 47. Education has important deficiencies. It does not prepare adequately for the real world. It does not give a reliable picture of reality, especially of large hierarchical organizations and government. It does not teach well-informed constructive and critical thinking about social questions. It does not teach how to comply with generally accepted norms and values without harming oneself in a corrupt environment;
 - 48. Neither education nor science provide insight in the relation between the law and social phenomena and developments. They do not show what could be changed by changing laws, and what not. The suggestion by education and media that political parties offer all relevant choices is incorrect. In fact, none of them proposes any of the fundamental changes mentioned in this study;
 - 49. Politicians and journalists are products of the same education system;
 - 50. The media may be free, but journalists are not. The media abuse their freedom for the (implicit, de facto) support of authorities, and for letting people who were proven to be dishonorable and incompetent keep their position. They do so by interviewing and writing about such people as if nothing had happened, and by doing as if somebody who lied and failed yesterday must still be considered honorable and competent, and suitable for top functions in public administration;
 - 51. The combination of inadequate education, play-acting by high officials, and de facto collaboration of the media and sciences with top officers, creates a thought-environment dominated by the incorrect and fatal idea that we live in the best of the possible worlds, which cannot and need not be corrected fundamentally;
 - 52. Due to a combination of laws which allow governments to misbehave and fail with impunity, and misunderstanding by the general populace, even those who interpret their observations correctly can do very little to correct the situation;
 - 53. Employees and citizens have very insufficient or no means to take effective action against responsible top officers or organizations which fail to do their duty (which includes adequate risk management);
 - 54. As a consequence there is hardly any (self)control and (self)correction of organizations and society.

Someone who does not want to be surprised by unbearable or unacceptable consequences of his actions or omissions, should make his decisions in such a way as not to depend strongly on the completeness and correctness of his information, and on the correctness of his ideas and reasoning. He should take account of the fact that information and theories are incomplete and uncertain, and that to err is human.⁹⁵ Such ideas should be part of his risk management. Appropriate implementation of these ideas would have prevented not only the subprime crisis, but the world wars of the 20th century as well.⁹⁶

9.6. Fatal explanatory facts and their principal consequences.

A set of facts is called fatal if it is bound to lead to disaster.

⁹⁵ Note that this is almost the opposite of wishful thinking.

⁹⁶ The second financial crisis, i.e. that of the government debts, was even simpler to prevent. Just don’t spend more than you have, at least not systematically.

The list in the preceding section is intended to enumerate all important conclusions of the inquiry. The following list enumerates facts which explain the main characteristics of all cases. Most of them are adapted from the above list, some are direct observations. The list is given to aid understanding, and to facilitate referencing. The list should not only explain the cases, but also explain why nothing changes much. It should explain why the causes are not eliminated. The list implies that fundamental improvement is possible. It shows the main issues to be tackled. It suggests that the causes of all cases and disasters mentioned or indicated in the present report can be eliminated.

1. There are “intelligent” people lacking integrity and respect for people, who nevertheless claim to be competent to do jobs they cannot and do not adequately fulfill;
2. The law is made by people of this kind;
3. The law allows (hierarchical) social organization with top jobs which cannot be properly fulfilled by real people. The law exempts top officers from personal liability, and allows much of their misconduct to go unpunished. Top officers have little or nothing to fear from accepting a job which they cannot properly fulfill;
4. Most people have a tendency to follow whom they see as leaders;
5. A large majority of people greatly underestimates the differences between people. They accept people of the kind mentioned in point 1 in positions of authority. If they see the failings of top officers at all, they rarely see these failings as symptoms of structural inadequacy, but rather as incidental and inevitable “human” errors;
6. In other words: as a consequence of the wide variety of characteristics of people, societies have become stratified in such a way that the top (the so-called “leadership”) consists of people of group 1. Given the hierarchical organization of society and the claims of the top, it cannot be otherwise. With the given law, integrity and proper fulfillment of a top job are incompatible;
7. Modern governments have excessive power;
8. Most people terribly underestimate the consequences of the misconduct of the “leadership”;⁹⁷
9. The “leadership” includes parliaments. Parliaments try to make people believe that they represent them, and that they supervise governments. But they do not. They represent their peers, and are part of a systematic effort to keep and increase their power;
10. Official inquiry commissions are silent about the lack of integrity and competence of politicians. They never mention this lack as major cause of failure or disaster. They therefore never make recommendations which tackle the fundamental problem of irresponsible and misleading government;
11. Governments terrorize whistleblowers who reveal their lack of integrity and competence;
12. The laws regarding hierarchical organizations enable opaqueness of these organizations. In general, “hierarchical organization” is a euphemism for dictatorship. Excepting the top, employees have no means to try and prevent an organization from harming its environment;
13. Together, the use of power by the public administration, the hierarchical organization of the media, and the legal bias with respect to reporting about people, result in a heavily biased, far too favorable, picture of public administration and its top officers;
14. The same basic facts cause forgetfulness. They prevent serious analysis and the drawing of practically relevant conclusions from events;
15. The sciences do not provide reliable knowledge and understanding of the organizations of public administration, including governments. Presumably out of fear of losing subsidies;
16. The media apply various forms of (self)censorship. They do not give a reliable picture of facts and developments of importance for people’s well-being, and which citizens in a democratic society need to know to enable them to make well-informed choices in elections and referenda;
17. Education does not prepare people for the real world. It gives a misleading picture of reality, especially of people, large hierarchical organizations, and government. It does not teach how to comply with generally accepted norms and values without harming oneself in a corrupt environment;
18. Neither education nor science provide insight in the relation between the law and social phenomena. Education and science do not show what could be improved or corrected by changing

⁹⁷ “Terribly” because it endangers the welfare and lives of themselves and their nearest and dearest.

- laws. The suggestion by politicians, education and media, that political parties offer all relevant choices, is incorrect. As a matter of fact, none of the parties proposes any of the fundamental changes mentioned in this study;
19. The combination of inadequate education, play-acting by top officers, and the de facto collaboration of the media and sciences with authorities, creates a thought-environment dominated by the incorrect and fatal idea that we live in the best of the possible worlds.

The fundamental facts 1 and 4 probably cannot be changed. But law and understanding can be, and this would seem to be sufficient to bring about a much more respectful and safer world. To realize this, the law has to be changed in such a way as to ensure that the harmful consequences of unchangeable facts are reduced to a minimum. As all cases amply demonstrate, the present law allows members of governments to misbehave, fail and harm with impunity. This enabled unsuitable people to hierarchize society, occupy the top functions, make laws that protect their kind, and by their unavoidable failings cause all kinds of disaster, including wars.

9.7. Measures.

The measures can be grouped under the following headings:

1. Consequent liability and criminal law;
2. Education that prepares for participation in society as it is;
3. Honorable science that gives the durable well-being of the population a higher priority than avoidance of anything resembling criticism of the operation of the political system;
4. Reorganization of jobs and/or duties. All jobs and/or duties should be fulfillable by real people;
5. Abolishment of (dictatorial) hierarchical organization. (This can be seen as consequence of the preceding);
6. Parliament and representation.

The measures should not be discussed or negotiated with the sitting establishment. This is not only meaningless, but deadly. The measures are not just possible improvements, but necessary corrections. They are necessary as presented. It may be necessary to supplement or strengthen them, but they certainly cannot be weakened without losing effectiveness. Negotiations with persons responsible for the cases, or loyal to such people at the cost of integrity, can only lead to deadly compromises between the status quo and what is needed. One should take account of the ability of people to create and find holes in regulatory nets, and of their eagerness to exploit them to the full. Therefore it is imperative to avoid such holes, and to have a safety net. The sitting establishment, and the selection system by which it was created, have to be replaced anyway; fully, and not by similar people. The unsuitability of the sitting establishment has been proven. Its members should have no say or power at all. If we had a good judicial system, all principal persons and their collaborators would be in prison.

Consequential liability and criminal law.

Section 7B.4.3 of the analysis of the financial crises discussed those aspects of liability and punishability which are more or less directly relevant for the behavior of the principal persons and organizations in connection with the financial crises. The present subsection considers more fundamental and general aspects. It is followed by a subsection which discusses objections against more consequent and strict liability.

The cases and their analyses have shown:

- that the principal persons wrongly pretend to be honorable and competent;
- that they must have had the idea that they had nothing to fear from false pretensions;
- that their dysfunctioning caused immeasurable suffering and damage;
- that they did not acknowledge any serious wrongdoing; and

- that they have not been held liable, and have not been punished. That they were sometimes rewarded instead.

For those readers who know something about the law, this will not come as a surprise. In practice, liability and criminal law are not applied to members of governments and their employees.⁹⁸ Due to the hierarchical organization of society and ministries, only the members of government are formally (legally) responsible for the activities and omissions of government organizations, agencies, etcetera. But these people are not judged in the normal judicial system, but by colleagues or party friends. Who often are co-responsible for their appointment, and for their performance.

The annual reports of financial supervisors like the Dutch DNB and US Fed are submitted to, and (theoretically) evaluated by, the treasury secretary (minister of finance) and parliament (Congress). In practice they are approved with little or no discussion. Every citizen may fill newspapers and websites with proofs of the deficiency of policies and performance of supervisors. In exceptional cases the criticism may elicit defensive tattle from the supervisor or responsible minister, but that is all. There is no positive effect at all. One cannot submit proof of misconduct to a truly independent judge. Something similar applies to the dysfunctioning of the (finance) ministers and members of parliament. They pretend to be competent and to control. But they actually believe blindly or against better judgment in supervisors, and do not control in the least. Nobody elsewhere in society can do anything about this.

As long as principal persons are allowed to get away with tattle that sounds erudite but is arbitrary at best, they have nothing to fear. The principal persons are loyal to one another, and keep up the appearance of integrity and competence. Beside parliament, there is no person or organization which has the (legal) means to prosecute them. They are not held liable. Their tattle always concludes that they did what was necessary and possible. In the rare cases that the tattle is not accepted by their colleagues, they are allowed to wait outside the limelight for the storm to pass over, or ask friends to help them find a similar (or better) job. They do as if resignation is a terrible (and unjustified) punishment. Even though for common people moving to another job is a regular affair, and for high officials the move from public administration to private business means going from a high salary to an even higher one.

The problem is that the principal persons simply have no good reason to refrain from jobs which they cannot fulfill properly. To make government reliable, they should be given good reasons to accept only jobs they are suitable for, and to do their duty, and properly. False pretension should be risky for themselves personally. They should be given good reasons for responsible decision making and risk management. For thinking twice. The most logical measure that can realize these goals is the extension to members of government of personal liability for causing avoidable damage. And to make them punishable if the damage cannot, or only partially, be recovered. For people outside government this has been a rule for thousands of years. The rule is considered normal everywhere. Which is understandable since voluntary and trustworthy communication, the basis of any society, presupposes mutual respect. Safeguarding and liability are logical consequences (or translation) of mutual respect. The essence of liability is the safeguarding of innocent victims. The extension is moreover logical because it reduces legal inequality, and makes liability and criminal law more consequent. Consequency requires that causation of similar effects is treated similarly. It is a form of equality.

The measure eliminates an exception which has grown in importance due to the tremendous growth of government and other organizations. The de facto exclusion of members of governments and parliaments, and of heads of organizations, from personal liability and punishability, can be seen as a remnant of an era with different rights for different social classes. Abolishment of the exclusion means that the costs of unfounded pretensions and personal misconduct can no longer be transferred to innocent victims, the tax payer, or the organization.

Cases are to be judged by an independent judge, not by politicians. In other words: parliaments no longer judge cases of misconduct by members of government.⁹⁹

The measure is consistent with the dictatorial nature of the hierarchical organization. It assumes the responsibility of the head of the organization. Which may be unrealistic if no human being can truly

⁹⁸ Except of course to an employee who blows the whistle.

⁹⁹ This may require changes in constitutions.

accept responsibility (and liability) for the risks caused by the activities of a large number of employees. As an institution, the hierarchical organization is based on false pretensions. With the cases as consequences. However, the management could know, and has accepted the risk. The unrealistic nature of the responsibility is no excuse. It is rather a confession of deceit and guilt. The measure hampers continuation of the hierarchical organization and its unbearable concentration of responsibility (liability). It complements other measures directed against the given regulation of the hierarchical organization, to be mentioned below.

The key elements of the measure are:

- Generalization of personal liability and punishability;
- Elimination of the “no one is responsible/ liable” de facto rule;
- Personal liability and punishability for consequences of failure to do ones duty;
- A general right to submit claims for damages due to avoidable activities, including activities of government employees (including the members of government);
- Mutatis mutandis where no action was taken while there was a duty to act;
- Adjudication by independent judges. (Non-political, and not appointed by politicians).

The generalized justiciability is meant to reduce the dependence on politicians and supervisors, and to reduce the dominance of government in society. Criminalization of dysfunctioning of responsible public administrators (in cases where they cannot pay damages) is meant to prevent false pretensions and dysfunctioning, and the disasters which follow in their wake. For the activities under consideration liability is logical, just, and necessary, but often unbearable, inadequate, or practically impossible.¹⁰⁰ In such cases prevention is the only effective policy.

In many countries the law concerning criminal procedure gives defendants the right to remain silent.¹⁰¹ This right should not be given, or should be abolished, in cases concerning government or public administration. Whether the defendant is a government employee or not.¹⁰² It should not be given to employees in government organizations or its subordinate organizations as regards their work. Where, as always in the present report, “employees” include the top. Neither do defendants have the right to withhold information relevant to the case. The reason for denial of this right in government-related cases is the priority that should be given by government to responsibility or accountability, and the public interest. Not less but more when things go wrong. The principles should be that everyone in government has to answer for his conduct, and that the public interest is greater than private interest. This should be known to everyone accepting a public function. The absence of a right to silence is meant to have a preventive effect.

Note that it is quite remarkable that the right to remain silent is considered as inviolable (without exception). Even though the judge is free to draw certain conclusions from the use of this right.

The essential change introduced by the measure is the abolishment of exceptions to liability and punishability. Therefore, liability and punishability also apply to lobbying. It may be hard to determine the relative shares of the various contributors to a harmful decision. But since the safeguarding principle is inviolable, this difficulty cannot be allowed to result in non-decision and non-compensation.

Liability and punishability also apply to promises made in public. Even to those made in elections. Promises make liable. (As in contract law). Here too, liability should suppress or end false pretensions, and promote responsible behavior. Promises may still be made, but they are binding as formulated. Reservations or conditions should not remain hidden in the back of the minds of the candidate or his assistants. As elsewhere, liability is meant to protect innocent people.

¹⁰⁰ Inadequate for example if people died or were mutilated. Impossible in cases like wars and financial crises.

¹⁰¹ For the USA see for example section 24.5 of W R LaFave, J H Israel and N J King, *Criminal Procedure*, 3rd edition, West Group, St Paul (Minn.), 2000. For the Netherlands the relevant article is 29 of the Dutch criminal procedure law. See p. 3055 in part 2 of the Kluwer college edition of law texts 2000-01.

¹⁰² Such as employees of corporations working under contract for a government.

Objections against consequent liability.

Introduction.

The resistance against expansion of liability and criminal law is strong. The resistance is due to the fact, that the transfer of risks and costs takes place on a large scale, and that it is intentional. The resistance can be seen as a confirmation of this. The resistance is understandable because it can be very profitable to transfer risks and costs. Lobbying costs can easily be recovered. The possibility to transfer risks and costs makes decision making easier. Liability keeps costs indoors, and therefore increases costs. Fear for unforeseen risks and costs may prevent new and risky activities (adventures). Some people say that liability deprives them of opportunities. Others say that liability makes progress impossible. This is plain nonsense. It is nonsense because of the definition of "progress". Liability implicitly requires proof of progress.¹⁰³ This reduces the probability of regression. Regression such as caused by financial crises. Liability requires decision makers to evaluate all costs and benefits. Not only the benefits and costs for the decision makers or their organization. The crises of 2007-2013, and also for example the BSE pandemic and DES disaster, are unthinkable if the principal decision makers of the responsible organizations (including supervisors) had known that they would be held personally liable, and would have to share personally in the costs of reparation and compensation. They would have felt forced to think much more seriously about risks and potential costs before making decisions about production and distribution, or to rely on misunderstood self-regulation.

Of course, people are free to (voluntarily) share risks and costs to make them bearable. Risk-sharing is a possibility to enable activities which otherwise would be not be possible or permitted. Namely if the risks or costs can be borne by a larger, though not by a smaller group. This only refers however to the risks of events with consequences which can be fully repaired or compensated. Which excludes for example risks of bodily or mental injury.

Consequent liability and criminal law means that product development will change, and probably slow down. The probability of regression is reduced, and demonstrable progress can continue unhampered. The fear for an end to progress is entirely imaginary. It is incorrect to assert that useful innovations cannot be introduced any more. The change required by consequent liability and punishability is that decision makers convince themselves thoroughly that benefits outweigh costs, and that there is no risk for health and welfare of outsiders. In other words: that the supposed innovation truly means progress, and not retrogression.

In this connection it should be noted that the historical and technological development can only be called positive and progress if the hundreds of millions of innocent victims of world wars and innumerable other wars and man made disasters, and therefore innumerable human rights violations, are ignored.

The resistance against more strict and personal liability may not be fully explicable in terms of interests. As suggested by the argument of wars above, and as will be further argued below, the net benefit of the present selectively limited liability is purely fictional. There is neither theoretical nor empirical proof of net benefit, and there are sound arguments for believing the opposite. The apparently widely shared objections against consequent liability may only be explicable fully on the basis of want of reflection, and by indoctrination by people who have much to lose from expansion of liability. Such as politicians, supervisors and heads of enterprises.

Because of the great practical and fundamental importance of liability, and because of the strong efforts at indoctrination against consequent liability, it may be useful to explain some aspects of liability in some more detail.

What liability is: an expression of respect. Its purposes.

¹⁰³ Progress means that benefits are greater than costs. Pareto progress means that no one is worse off, and at least one person better off. In other words: even with "only" a single innocent victim one can no longer speak of Pareto progress.

Liability concerns harm done to innocent people by avoidable human actions or omissions.¹⁰⁴ It concerns respect for, and safeguarding of, people who did not approve of the harm causing activities or omissions. The purpose of liability is: reparation of the damage caused. This is not always possible: someone killed cannot be brought back to life. If restoration of the original situation is impossible, liability requires compensation. If the responsible actor(s)¹⁰⁵ cannot compensate fully (as directed by a judge), then incomplete compensation can be supplemented by punishment. In other words: punishment can be seen as a measure in the case that someone has avoidably caused more damage than he can repair or compensate. Liability, and its extension punishability, have two purposes: reparation or compensation, and prevention. Prevention because causing damage for someone else is forbidden in the first place (even if it can be repaired), and causing a risk of irreparable damage even more. Liability and punishability stimulate actors and decision makers to take adequate account of the potential consequences for outsiders.

Liability is a legal expression of respect. It is intended to prevent harm to innocent people, and to compensate for damage.

From the above it follows that in this report liability always means strict liability. Which means: liability without regard to intentions, predictability or fault. Sometimes the adjective “strict” is added for stress. It also follows that a respectful person should not engage in activities which create the risk of damage which he or she cannot repair or compensate. In other words: one should only engage in activities for which one can bear liability.

Adoption of strict liability, and of the rule that one should abstain from activities for which one cannot bear liability, would mean a major step forward in human society and civilization, and be the basis for other true progress and the prevention of regression.

Selective limitation of liability is unjust.

There are more reasons for expansion of liability than mentioned up to now, even though the reasons are related. A fundamental reason is the inconsequence of the present law. For in general, ordinary citizens are fully liable for their actions, but employees of organizations at most a little. Political bosses are not liable at all.¹⁰⁶ The formal liability of (governmental) organizations may be a complicated story. It is moreover different in different countries. The effective (practical) liability law, the end result of the combination of material and procedural law and legal practice, differs as well. But however complicated the theoretical situation may be, the story of for example the financial crises is very simple. It has not been acknowledged that politics and supervision would have prevented the crises if they had functioned properly. Neither was the principle that people outside the financial system (in the broad sense) should be safeguarded from the consequences of dysfunctioning in the financial system, in supervision and the relevant government departments. The costs of the crises were paid out of tax receipts and in the form of loss of income, retirement benefits, etcetera. Only a minor part was paid back by banks through incidental litigation. Both practice and theory therefore show that present liability law means unequal treatment by the law. The law greatly favors dysfunctioning bosses and large organizations, at the cost of the mass of the common people. It is extremely unjust. Abolishment of existing limitations makes liability more consequent and just.

Liability is a logical consequence of the safeguarding principle.

From time immemorial laws of all nations recognize the safeguarding principle. The principle says that someone who has not agreed beforehand with avoidable activities (or omissions) of other people, has the right to be safeguarded from the harmful consequences of these activities. This is also the basis for criminal law. In other words: an actor is only relieved of liability with respect to people who have

¹⁰⁴ Omission is relevant if there exists a duty to act in certain circumstances.

¹⁰⁵ Including “omitters”.

¹⁰⁶ Important examples are the US presidents as from Reagan (deregulation, AH and CRA), Balkenende, Barroso, Bos, Cox (SEC), Gramm, Greenspan, Jeffery III (CFTC), Karamanlis, Lagarde, Lockhart III (OFHEO), Rubin, Strauss-Kahn, Summers, Wellink (DNB) and Zalm. And many more.

agreed with the activities beforehand, after complete and correct information. Otherwise he is obliged to restore the situation as it existed before his activities, as much as possible.

One could say that agreement with the law was implicitly given by agreement with the political system. And that agreement with a political system implies agreement with everything that resulted from this system, including the law. But apart from office holders- members of governments, parliaments, public administrators, and possibly other functionaries- who swore to abide by the constitution, nobody has agreed with the political system, let alone after complete and correct information. The agreement does not exist. It is no more than a misleading fiction.

Of course, the present report shows that it is very unwise to agree with any of the present political systems.

Criminal law too is founded on the safeguarding principle.

And if criminal law is not explicitly justified by the safeguarding principle, then this principle is premised. It is important to keep this in mind, because this principle, and the requirement that the law should be consequent, imply conditions for both criminal law and liability law.

Liability is implied by “responsible for one’s own acts (and omissions)”.

To be responsible for one’s own activities means that one has to bear the (possibly negative) consequences of one’s actions and omissions oneself. One is not allowed to one-sidedly transfer costs to other people. Such transfer is permitted only if permission for the actions or omissions has been granted beforehand. In other words: limitation of liability is not consistent with the assumption- or fact- of “responsible for one’s own actions”, and with the norm that nobody has the right to impose harm or risk upon others without prior permission. Conversely: without liability, the phrase “one is responsible for one’s own acts (and omissions)” is purely theoretical, and practically meaningless.

Intentions and predictability.

Opponents of consequent liability suggest that it is unjust to impute people with something they did not foresee or intend. Regrettably it is hard or impossible to prove that something was or was not foreseen or intended. The suggestion moreover is an oversimplification. It ignores the fact that intentions are not simple but manifold, have different priorities, and are often inconsistent and subconscious. It also ignores the fact that it is well known that the future is uncertain, and that one may never assume the opposite: that the future is well defined. One should always take account of the fact that predictions are uncertain and ambiguous. Therefore one should never rely on only a single future course of events. One should take account of risks, and of all corresponding scenarios. Including unexpected events. For people who make decisions which may affect other people, this is simply part of the necessary competences. In common parlance one often says that something was unexpected. Of course, really unexpected things may happen. But in general the assertion reflects a primitive kind of thinking. In general one can only say that one expected this or that to be highly improbable, and did or did not take it into account.

In other words: the suggestion that the liability of an actor should depend on a debatable theory about his decision making, reflects incomplete and irresponsible thinking. It very much looks like an effort to replace the 100% sure fact that the victims did not intend being victimized by the fiction that the actor couldn’t help it, in combination with the opinion that this absolves him from liability. As if making an actor liable would be unjust and would make him a victim. In fact however this is turning the world of justice upside down. In addition to the observations made above, it is forgotten that decision makers or actors could have asked permission beforehand.

Not only with respect to liability, but quite generally too, law and judges give unwarranted attention to intentions and predictability instead of competence for a given job. Attention to intentions and predictability should be superfluous in every case where causes of damage are localized, and where the innocence of the victims is clear. Attention to intentions etcetera can only reduce the contribution of those responsible to the costs of reparation. Such attention represents an a priori bias of the adjudication process. The procedure tries to suggest justice with respect to the actor, while justice

with respect to the victims is left out of consideration. If the innocence and right of the victims to be safeguarded would get inviolable priority, the questions about intentions and foreseeability would not even arise. Which would be very much for the better since judges are rarely competent to assess the truth of the answers. Much more is foreseeable (as a risk) than those in the dock admit. They often lie. The hearings of the inquiry commissions and most annual reports of supervisors about the years 2009-2010 provide more examples than one wants.

Liability and the distribution of costs.

Most discussions about liability concern recovery of costs from people who actively contributed to the activities which caused the damage. Including the decision making about these activities, or about not taking adequate measures to prevent damage or risks. It is often argued that if the relative contributions cannot be calculated and proven, and if the predictability is not 100%, then the actors cannot be considered liable. This opinion seems to be inspired by the (seemingly) charitable principle, that one can only be held liable or punished if the harmful consequences had been known in advance or could have been expected, and if malicious intent or negligence can be proven (preferably all of these elements).^{107, 108} This kind of argument does not however justify the conclusion that actors should be safeguarded. The reason being that the argument is incomplete. What is absent is the basic fact is that people have been harmed. So if the charity principle would be accepted, and applied consequently, then the conclusion is at best half of the truth. The charity principle applies just as well to the victims. If the actors shouldn't suffer (from their own acts!), then the victims even less. The victims shouldn't have to suffer at all. The argument which absolves actors from liability clears the victims even more. In their case intent and blame is ruled out with certainty. It follows that the only tenable question is that about the best distribution of damage and costs. Is it just to let the victims bear the costs one-sidedly, or is it better to have the actors pay damages?¹⁰⁹ The question is not difficult to answer. If it is not permitted to let people run risks without their prior approval, then it is obvious that the victims of activities of other people have to be indemnified. This is no more or less than a matter of respect.

Present law is biased: it favors people who do not respect innocent victims.

The argument that one cannot blame or punish someone who avoidably but unintentionally caused damage, is biased. It favors the causal actor. It ignores the question why harming the actor is not justified, while the preceding harming of the victims is to be condoned.¹¹⁰ Answers like: "accidents like this are normal facts of life" apply equally to actor and victims, and therefore are no answer. Implicitly the present law asserts that harming the victims is less blamable than harming the actor. Which is inconsistent with the respect and equality principles. The law should not have more respect, let alone exclusive respect, for people who violate it. Nobody should be more equal than others.

¹⁰⁷ As the sequel shows, there is no good reason for a role of intent in liability. On the other hand: intent should automatically result in punishment. But liability is not a form of punishment. And liability is only accompanied by punishment if the actors cannot fully repair or compensate the damage they caused. Reparation should always be made, costs of litigation should be reimbursed, and where applicable, the costs of investigation. Punishment is restricted to special cases.

¹⁰⁸ In arguments about liability concepts like intent and blame are often used in ways which make erroneous (archaic) assumptions about reality. In particular mechanistic instead of probabilistic predictability. In reality there are always uncertainties and risks. In general one knows that things may, but need not, happen. The meaning and relevance of concepts like intent and blame changes when it is uncertain whether consequences can but need not occur. Therefore reasoning in terms of intent and blame is sometimes incorrect, and often misleading. It is essential that the decision making was responsible (up to modern know how). And that no actions are taken of which the costs may be unbearable, or which may cause irreparable harm. It would already be better if not absence of intent would safeguard from liability, but proof of adequate decision making in the sense of part 2 of *The law of logic*.

¹⁰⁹ There are other distributions of course, but since there seem to be no obvious and sound arguments for any solution other than liability, no time is spent on them.

¹¹⁰ Compare with the rhetoric about "innocent civilians" killed in war situations. Was Bhopal any different?

The argument also ignores the avoidability. That is: the fact that the actor had a choice, could have done things differently, or could have done something entirely different. Could have made his decisions more carefully, taken less risks, taken adequate safety measures, etcetera. Decisions are made differently if there is liability and the possibility of punishment. If damage has to be compensated, it is more risky to pressure consultants to write an optimistic report about one's daydreams. And for consultants to submit to pressure, and to ignore or underestimate risks.

If mutual respect and safeguarding innocent people are accepted as basic and inviolable principles of society and law, then these principles should be satisfied by both liability and criminal law. They should aim at protection of innocent (potential) victims, and at as complete reparation or compensation of damage as possible. Not at the cost of other innocent people, but at the cost of the people who avoidably caused the damage.

Strict liability is necessary for voluntary agreement with the law.

The science of decision making shows that a method for decision making only binds people who have voluntarily agreed with the method beforehand. As already noted by Jean-Jacques Rousseau in 1762, there should be unanimous agreement about the basic rules. The safeguarding principle and liability are principles one can approve voluntarily. (If desired, they can be voluntarily suspended conditionally and temporarily). They embody mutual and self respect. The present law however cannot be approved without giving all kinds of people full powers to parasitize. It cannot be approved without creating masters and slaves, and creating the risk of making a slave of oneself.¹¹¹ In other words, it is extremely improbable that the present constitution will be approved by a well informed majority, let alone unanimously.¹¹²

Strict liability is a safety net.

As in the financial crisis, but also in government and politics in general, specialized laws are circumvented as a matter of fact. More often than not there turn out to be holes in laws or regulation. One could even go so far as to hypothesize that specialized laws are made for the express purpose to offer actors opportunities to find and use the holes, to avoid liability. Such trickery can only be made useless by a general safety net. The net should safeguard innocent victims, and recoup the costs of reparation from people who cannot prove to be outsiders. Hiring expensive lawyers should not help.¹¹³ Only strict liability fits the bill.

The Basel capital requirements¹¹⁴ and the Maastricht convergence criteria¹¹⁵ are examples of trickery in the context of the crises.

Strict liability requires proof instead of blind faith and trust.

Until the so called industrial revolution, strict liability was the generally accepted rule. Limitation of liability was part of economic and industrialization policy. The industrial revolution was a revolution of the law as well. The limitation was also intended to solve problems of hierarchical organization and the financing of corporations. The purported premise was that the general welfare is served by facilitating risk taking by corporations (= their bosses). About this premise, two observations must be made:

1. If there truly is a net benefit, payment of damages need only affect the size of the profitability of the actor(s). It need not affect the profitability as such;^{116, 117, 118}

¹¹¹ That is: it cannot be approved without becoming inconsistent.

¹¹² And this is probably the reason why it is never put to the vote.

¹¹³ Note that the trickery favors people and organizations who can afford good lawyers.

¹¹⁴ See also the hearing of Van Wijnbergen, on p. 23 of the report of the first series of hearings of the CDW: «One permitted very many risks “off balance sheet”, which means: invisible in the annual account. This opened a hole in the supervisory system, which was used as a highway for trucks.»

¹¹⁵ See the chronicle of the financial crises, search for Maastricht.

¹¹⁶ If society benefits, then the benefits are greater than the costs. By definition the costs include the damage. Reparation of the damage does not affect the balance, only the distribution. In other words: less compensation

2. The premise, being a hypothesis, should be evaluated periodically.

But in the debates about the relevant laws, the first observation was not made. As a rule, damages are not paid, at least not on this account. It is not difficult to evaluate liability law in the light of the financial crises and their run-up. One can only conclude that the premise that limitation of liability (and punishability) of organizations and their employees is beneficial for the general welfare, has been falsified. The organizations responsible for the crises clearly have insufficient means to compensate the victims. After these crises the premise of a positive net effect cannot be retained. Together with the crises, limited liability and other legal deficiencies cause a redistribution of power and money which is the opposite of what is just according to generally accepted (even legal) norms. The people and organizations who destroyed welfare on a world wide scale, are systematically favored and spared.

Conclusion.

In sum: rejection of strict liability is inconsistent with the respect principle. Liability:

- is the implementation of the respect principle (and of the limits of freedom);
- implements the best possible safeguarding of outsiders;
- gives a good reason to take all costs, benefits and risks into account when making decisions.

A society where people truly respect one another, and not only in words or when it suits them, acknowledges the duty to repair or compensate damage caused, and strict avoidance of activities which cause a risk of irreparable damage for innocent outsiders. In such a society there are no activities which cause risks which cannot be borne by those who are responsible for them. Rather: all activities are supported by a group of people willing and able to bear the risks, and actually repair or compensate damage caused by their activities or omissions.

Measures connected with consequent liability.

Consistency of the law, in particular consistency with the basic law, and consequent application of the measures mentioned above, require more changes, and not only in the field of law. In specific circumstances moreover it may be insufficiently clear how general measures must be specified or implemented. For example if decisions about activities which caused harm were taken by a group of people. Consequence requires that those who approved the activity are liable and punishable. Not as a group, but each of the members personally. Those who opposed the decision cannot be held liable. This also applies to organizations. Whether in government, parliament, or elsewhere.

The basic law forbids activities, and in case of an obligation to act omissions, which create risks which cannot be borne by the decision makers. This means that proper fulfillment of a duty may require the organization of (explicit) approval of a group of people who are willing and able to bear the risks. And that failure to ensure sufficient support of this kind makes one punishable (in addition to being liable). To help ensure this, citizens who may be affected by the risks and fear that the risks exceed the financial capacity of the supporting group must be justiciable.

In principle employees are personally liable. They are not liable however if they can prove that the damage causing activities took place as an inevitable consequence of orders from their superiors

for avoidable damage means transfer of income from innocent victims to people responsible for causing damage. The last mentioned not only receive the social balance, but are exempted from paying damages. They are remunerated disproportionately.

¹¹⁷ It is sometimes asserted (especially by interested parties) that payment of damages is not efficient because sometimes this person has to pay damages, sometimes another. On the average everyone is claimed to receive as much as he pays. This assertion (hypothesis) is evidently incorrect. In modern states one and the same very small group of people takes all major risky decisions, and a very large group makes only household decisions (except when voting once every four years). The incomes of the members of the first group are several times the incomes of those of the second group. The distribution of benefits if things go well, and of the costs if things go wrong, can only be explained by differences in power and the use of power. The use of power is mainly embodied in the law. Which was made by people of the same group.

¹¹⁸ So that there is progress in the sense of Pareto. That is: at least one person wins, and nobody loses. (Arguably the only social definition of "progress" compatible with the respect and/or safeguarding principle).

(supposing the law requires this kind of orders to be obeyed). An explicit order restricts the liability to a smaller number of people. Who therefore need greater financial capacity. But an order does not eliminate all liability or punishability. From the points of view of adequate control and prevention there should be a duty to report observations of behavior which is incompatible with the mission of the organization or with professional or other codes of conduct; or which create unbearable risks for the outside world. Someone who knowingly fails to report such matters should be liable and punishable.

It will be clear that measures such as indicated, fundamentally alter thinking about whistleblowing. Indeed, whistleblower regulations can be thrown into the dustbin. The risk of reporting misconduct is eliminated, and replaced by the risk of failure to report. To ensure prevention, punishability exists even if no harm is caused.

The following section sketches measures meant to make the legal system compatible with the respect-principle. In other words the right to be safeguarded. Because this right is the same for everyone, it implies equality. In several respects the given legal systems are inconsistent with equal rights and the right to be safeguarded. The following is an example.

To ensure the best possible equality in law, expenses for legal representation and defense have to be shared equally. Both parties should spend the same amount, and be able (enabled) to do so. This in contrast with the present situation, where government organizations and corporations can use practically unlimited amounts of money, and where ordinary citizens, volunteer organizations and everyone with limited financial capacity, can only get justice done in simple cases. Note that the large differences in the rates of lawyers can only be understood if qualitative differences between lawyers matter in court. They are explicable only if justice depends (much) more on the quality of the lawyer than on the judge. It shows that the belief in equality of adjudication is erroneous.

Organizations with a public responsibility, should acknowledge uncertainties. They should note the subjectivity of assertions or policy positions if they are (partly) a matter of choice and chance. Uncertainties should be discussed and taken into account, alternatives mentioned and choices argued. Doing as if policy questions have only one possible answer, is ridiculous and irresponsible. It stifles necessary internal and external (open) thinking and discussion, and hampers necessary changes.

Measures with respect to the legal system.

The measures.

1. Agreements between people are only meaningful if there is a system to ensure compliance. This also applies to constitutions, treaties, and other laws. Laws are misleading unless there is a practical way to bring the actual state of affairs in accordance with them. Therefore all laws should be justiciable in a practically meaningful way. Nobody should be able to prevent any citizen from requiring an independent competent assessment;
2. Judges should have adequate knowledge of the people and subjects they may have to judge.¹¹⁹ This means that their knowledge of both people and these subjects should increase substantially;
3. Arguing exclusively from the position of the actor who caused avoidable harm is untenable from both a logical and social point of view. It should be replaced by arguing on the basis of the right to be safeguarded (and/or the rights which the actor, in actual fact, acknowledged or withheld from others);
4. In the administration of justice, the influence of words spoken in court and (other) subjective judgments should be reduced. It should play a role at most if verified by non-verbal means. The dependence on subjective, non-verifiable judgments of people should be reduced as much as possible. Facts and the right to be safeguarded should be inviolable boundary conditions;
5. Equality before the law requires equivalent legal support in court. The financial means of the different parties should be equal. Whatever the parties want to spend on the trial has to be shared equally;

¹¹⁹ They should make their assumptions explicit. The problem is that they may not be aware of them. Up to now they are not trained to be modest.

6. Both the administration of justice and public prosecution should be fully separate from politics. Especially as regards appointments and finance. This is explained in the next subsection;
7. According to the safeguarding principle, the costs of the legal system, including those of police, prosecution and courts, should be paid only by those who make the system necessary to ensure compliance. That is: by those who violate laws. In civil cases by the parties judged to be in the wrong, and in criminal cases by those convicted. Their financial contribution should be proportional to their contribution to the necessitating. They should pay a surcharge to cover cases where full recovery of these costs is not possible.

Most if not all of these measures can be introduced gradually. It would already help if the principles would be adopted, 1) that reality should agree with the law, and 2) that everyone responsible for a gap should be liable and punishable.¹²⁰ Laws which do not include sections which ensure compliance and show how deviations of reality from the law can be prevented and eliminated (not only theoretically but practically, and within a short time), should be corrected in this sense, or abolished.

The costs too can be gradually shifted from the general taxpayer to those requiring administration of justice in one form or another.

Note that in principle there are strong relations between the administration of justice, the state of the “science” of law, and law education.

Public prosecution and politics.

According to article 3 of the Dutch constitution, all Dutch people have equal access to functions in public administration. In other words: the article forbids preferential treatment of members of political parties or specific parties. Violation of the Dutch constitution is not justiciable however. One cannot submit complaints about supposed violations to a judge. In a time where governments have numerous dependent organizations and innumerable possibilities for influencing appointments, the term “public administration” and even article 3 as a whole may insufficiently express the supposedly desired equality of opportunity. As a consequence, actual practice not only shows systematic discrimination, but even gives rise to the suspicion that organizations are created to create jobs for political colleagues. Making it easier for those in power to replace one politician by another (supposedly) more suitable one.

Political appointments undermine the quality of public administration and the equal administration of justice. They undermine the quality because they create a top that is relatively strongly bound by ties of loyalty, and because they make integrity and competence relatively unimportant. Everyone knows that top officials did not or not only get their job on the basis of merits, but also or mainly through the good offices of political friends. Which create obligations. In other words: these practices have a corrupting influence. Someone who is responsible for an essentially illegal recommendation or appointment cannot be expected to be an unbiased judge of that appointees’ performance.

For similar reasons political appointments undermine equality in the administration of justice. Namely because prosecution and police are subordinate to (political) members of government. And of course the top of the police and prosecutor’s office are party members. In the case of accusations against someone who is politically appointed, the responsible minister will be relatively averse to prosecution. He is loyal to party members and other politicians. The failure of someone who is politically appointed does not shed a favorable light on the appointment and those who are responsible for it. All this applies especially strongly when members of government or their employees are concerned. The cases give many examples of failures to prosecute, and even obstruction of justice by shelving the archive, as in the case of Spijkers. In addition, present (procedural) law may be too deficient to allow successful prosecution of people like ex-minister Bos, Cox, Greenspan, Geithner, and Wellink. Even if such deficiencies need not be the reason why they were not prosecuted. Parliaments and/or governments could have taken action anyway. And didn’t either.

¹²⁰ As always, punishable if liability is insufficient for repair, compensation and/or prevention.

In the case of prosecution of corporations, other political reasons may interfere with the administration of justice as well. About half of national income is spent by governments. They have a great interest in a high employment rate and an undisturbed inflow of tax receipts. They try to avoid everything that will reduce them.¹²¹ In general, politicians want change. To realize change they need the cooperation of the private sector. They make themselves dependable on the private sector, and need good relations. Bothering corporations with lawsuits does not exactly help.

Governments are responsible for the effective and efficient expenditure of the tax money. Everything that goes wrong with activities paid by tax money can be interpreted as a failure of politicians. This means that governments always have to tread carefully. They want to show that the government is reliable, perfect, and law abiding. They want to avoid discovery and prosecution of non fulfillment of legal obligations or illegal activities. Prosecution is detrimental to the image of perfection, and may moreover reveal more than expected. A revelation may be bad as it is, but it probably is not all. It creates the risk of more investigations and attention.

Equality before the law requires a truly independent public prosecutor (and public accounting). And therefore separation of politics and prosecution. Experience has shown that formal independence, independence on paper, is insufficient. It can be completely canceled out by practical factors, such as the appointment of a “suitable” head, and periodic conferences of public prosecutors with the justice ministry. Financial dependence alone can already be fatal, and should therefore be abolished.

The following phenomena show that dependence of the prosecutor on the government is integral part of the successful self protection of the political world:

- The political events related to whistleblowers, and the absence or utter ineffectiveness of justice to stop the harassment of the whistleblowers;
- The hearings about the subprime crisis, giving the culprits room to exculpate themselves;
- The lack of integrity and competence of the inquiry commissions;
- The systematic failure to hold principal persons liable and to prosecute them criminally;
- The absence of a discussion about legal inequality and the effects of leaving very harmful misconduct unpunished.

These phenomena are inconsistent with independent public prosecution, endeavoring to keep reality in line with the law. And with accountable priorities proportional to the interests involved.

The inquiry underlying the present report found no indication of improvement. Rather the contrary: it finds numerous examples of denial of a need of improvement, of fake improvements, and of resistance against more fundamental improvement.

Making education a preparation for participation in real society.

Education has been evaluated in section 2 of the analysis of the financial crises, and in section 4 of the present chapter. Education was found to have several important deficiencies. These deficiencies can be seen as part of the explanation of the financial crises and of the general failure of the political system (or society). The hypothesis of “good education” is completely incompatible with the phenomena described in the cases, their analysis, and what we can daily observe around us.

The deficiencies concern all levels of education, and are related to deficiencies in science. To science as a profession, but also to science as a body of reliable knowledge. The sections mentioned make it quite clear what has to be changed. There is no need to repeat that here. The essence is that education should inform about reality as it is, and prepare for responsible participation in society. Instead of impregnating people with misleading illusions, and making them instruments for the perpetuation of a disastrously faulty system (supposing it could last).

The following may not be more important than remarks made earlier, but should not be overlooked. As many education programs as possible should explain, and teach to think effectively about:

- The concepts of probability, risk, and risk management;

¹²¹ If they can. In general this requires some understanding. In the years before the subprime crisis this was lacking. As shown in the analysis of chapter 7. (The crisis has not caused improvement).

- Instability, especially of the “democratic political system”¹²², climate, and the given financial economic system;
- Relations between phenomena, processes and (causal) sequences of events.

As a consequence of the teaching about probability and risk, thinking in terms of only the most likely scenario should be shown to be too simplistic, and a danger. The reasoning of supervisors in the run up to the subprime crisis is undoubtedly one of the most instructive and important examples.¹²³ It should be made clear that it is irresponsible to take account of only one possible scenario or outcome. Accountability requires risk management.¹²⁴

Quite generally, for example due to subjective estimates, several valid reasonings can be given. Uncertainty is a reality. This fact can only be ignored at great risk.

Remarks on science.

Some defects of science.

This study has given numerous examples of failures of science and scientific education (that is: university education). The failure applies especially to economics, political and social sciences, psychology, history and law. Perhaps the environmental and climate sciences can be excepted because of the Intergovernmental Panel on Climate Change (IPCC). At the same time the IPCC exposes one more weakness of the sciences as a whole, namely the failure to use general education for the purpose of making every citizen know and understand dangers created by man. One of the roots of the failure of politics as regards climate, may very well be the complete lack of understanding by most politicians of risks as a concept, and of what is happening around us. That is: inadequate education (and inadequate selection).¹²⁵

A large part of the failure of the sciences consists of, and may be explained by, a lack of knowledge of, and lack of interest in, a part of reality that is of crucial importance for the welfare and future of mankind. To wit, the reality described in this report. As noted in section 7B2.4, more than ten randomly selected general textbooks on government and political science completely fail to give a reliable picture and explanation of the operation of politics and government and hierarchical organizations. They are neither scientific nor reliable.

Science as a human endeavor is far from perfect:

- Since World War 2 the sciences have become more and more like any hierarchical organization. They have become stratified. They got managers. And as in all hierarchies: in general the competence of the top is insufficient for the job;
- Scientists have become more dependent on one another. It is important to be liked, and to have one's work appreciated. This is important to keep one's job, funding and opportunities;
- There is no adequate system for supervision of compliance with scientific norms and values, and there is no system for the adjudication of complaints (about for example ill-founded or selective rejection of papers, intellectual theft, plagiarism);
- With respect to personal, group and political interests, other norms and values and the interests of mankind and science have become less important.

The first two phenomena are related. For example through assessments and financing. They cause originality and quality to remain within limits. Good (“revolutionary”) new work is an implicit

¹²² Where a single vote can give a majority to the opposite policy, and where coalitions are completely arbitrary.

¹²³ This was written before rereading Shirers' *Collapse of the Third Republic*. The French army too counted on just one scenario, and had no plans for others. Causing the collapse of the third French republic. So there may be more or better examples...

¹²⁴ “Risk management” is understood to be reliable risk management. I.e. in the present report, risk management is by definition good risk management.

¹²⁵ Of course, the phenomenon may also be caused by insufficient mental abilities or self-interest: assuming what is supposed to be a profitable position. A social organization with impossible vital functions should be added to the “roots of the failure of politics”.

complaint about the mainstream. It may require many others to change the subject of their research or their job, and is therefore threatening and unwelcome.

There is a strong dependence on tax money. In combination with hierarchical and social phenomena this explains the dominance of political conformism, and the absence of open and truthful analyses of the political system and its performance.

Necessary but possibly insufficient measures are:

- Journals/ media are legally bound by their assertions and published mission and conditions;
- Papers fitting a journal's mission, and satisfying its conditions, can only be rejected on the basis of objective arguments, whether by the journal or referees. A rejection can be submitted for review by an independent judge;
- There should be good possibilities for the publication of reactions, where applicable through a similar referee process, but fast and on an equal footing with the original paper.

The absence of explanatory history.

Writers of history have produced many useful studies. But up to now history has failed to become an explanatory science. It has remained mainly descriptive. And the descriptions may be interesting and useful, but they don't explain and help understanding what is happening right now. Part of the information which is necessary for an explanation is missing. In fact, no systematic efforts at explanation are made. The present report can be understood as an effort to understand and explain something of the history of our times. Most of the analyses are part of exactly this effort. But although they are essential for understanding what has happened and what happens, and although they are not particularly difficult, such analyses cannot be found in history books.

As noted in section 4, description requires selection, and a selection can only be accounted for if one understands what one seeks to explain. And one only understands if no important questions have to remain unanswered. As long as this is not the case, one cannot know for sure what facts to include in the description. One does not know what one needs in order to understand and explain the relevant facts. Moreover, if one thinks that history need not be explanatory, and that description is sufficient, one forgets that "description" is an ambiguous concept, and that one should specify what one means by "description".

If one would like to avoid wars and other man-made disasters, one should not reject the possibility that one can learn from history. It is easily seen however that history books make no effort at learning. They do not try to draw conclusions from what they describe.¹²⁶ In other words: a lot of work remains to be done. Even giving summaries and drawing conclusions would greatly help. Not in the last place because they stimulate thinking in different ways about the same subject matter. They may reveal unclear or weak parts, and thereby enable improvement or correction.

As elsewhere, in the context of history the concept of "explanation" is ambiguous. The ambiguity can be eliminated by restricting the definition. In the present report it is assumed that something is explained, if it can be shown to be a logical consequence of assumptions which are already accepted, and have been enumerated explicitly. Where there is more than one set of explanatory assumptions, the set with assumptions which are changeable by people is chosen for practical reasons. The goal of the explanation being practical: social improvement. When a further choice has to be made, the smallest set will be chosen for theoretical reasons. Science endeavoring to find the "smallest explanation": the smallest set of explanatory principles or axioms. Obviously these definitions (specifications) overlap, and are compatible, with those of common parlance.

One of the main conclusions of the present work is the conclusion about the characteristics of the principal persons. To a certain extent it is generally known that people differ. But the nature of the differences and the frequency of occurrence of the various characteristics are unknown. People are hardly aware of them. In addition it is obvious that the implications of the differences and the characteristics are very much underestimated (if realized at all). A problem with the present report is that the main explanatory conclusions, about the principal persons, are not generally accepted as yet. The report explains the cases if and only if the conclusions about the principal persons are accepted.

¹²⁶ Of course one has to be careful: there may be exceptions. But I for one have never seen any.

On the one hand the author cannot escape the conclusion. On the basis of the inquire he concludes that he has to accept it for a fact. On the other hand he cannot imagine the thinking and mental world of these persons. He would have liked very much that other studies shed some light on them. As noted before, he has looked for such studies, but in vain.

It is often said or assumed that judges, psychiatrists and related professionals understand the thinking of suspects, and that their understanding is sufficient to be able to evaluate and pass judgment on their behavior. Because of the absence of literature on the thinking and mental composition of at least people like the principal persons of this study, and the fact that these people are rather a class apart, it is completely unclear how judges etcetera can have gathered this understanding. Indeed, there is every reason for doubt. The trial and verdict concerning the real estate fraud give no indication of understanding.¹²⁷ On the contrary, they suggest that the judges do not understand at all.

Use and abuse of knowledge and experts by politicians.

One of the things politicians want you to believe, and which you probably believe because of innumerable press-releases, because it seems so self evident, and because you don't know how politicians really work, is that governments let themselves be advised and led by experts. They want you to believe that they use available knowledge and know how as good as possible. As they should. This belief is entirely erroneous however. Governments only use knowledge and know-how professionally when it suits them. They use knowledge and know how when they are compatible with their a priori ideas. And these ideas are rarely founded on reliable knowledge. Reliable knowledge is unambiguous and consistent; political ideas and actions are multifarious and often incompatible with one another.

The main instruments to obtain "useful" results, are the selection of the experts and their terms of reference. As a rule experts are selected from a very small group of persons known by the minister or ministry concerned. Often the experts are party members. Of the same party of course, or at least of a party of the coalition. They cannot be selected on the basis of the quality of their expertise, for ministers and ministries don't have the competence for judging that. They may have been selected for the suitability of their ideas. Experts are not always experts. In areas of science where reliable knowledge is scarce at best, as in economics, an expert is never really an expert. Remember the financial crises. Experts furthermore are experts at most in their own field. Which rarely coincides with the matter they have to advise upon. In addition, governments more often than not need advice about aspects which are unrelated to any of the given academic disciplines. Talented people can of course relatively easily acquaint themselves with fields neighboring that of their expertise. But this always costs time and effort. Which may not be available.

Terms of reference can be used to avoid committees to tread "dangerous" areas, and to avoid unwelcome discussions. Actual terms of reference may differ greatly from what had been agreed about them, or with what is said in press conferences or press releases. All kinds of tricks are used to realize prepossessed goals, and to eliminate political risks.¹²⁸

In general, advisory committees do not only consist of experts, but also of interested parties and other participants. The secretary often is an employee of the ministry requesting the advice. This employee may be well chosen, to make sure that the commission produces what the ministry (or the superior of the employee) wants. And if this guarantee is not enough, the ministry organizes a coaching committee or something similar, giving the different interested parts of the ministry or ministries the opportunity to make themselves heard. In theory, coaching committees can improve the quality and usefulness of advice or reports. But in practice their primary purpose often is to make sure that the advice or report fits the given political thinking. The advice should not cause (policy) problems.

And finally the text of an advice, recommendations or report may be the subject of negotiations between the authors and the commissioning minister or ministry. In general a draft report is submitted for comment to the person who asked for it. This may be no more than part of a procedure to check the facts and improve the quality. In that case, the comments and the reaction of the various parties can be

¹²⁷ See section 8.10.

¹²⁸ Indeed, some kinds of risk are managed!

published.¹²⁹ However, the draft can also be subject of negotiations between the authors and the commissioning minister or ministry. In that case one may never know the draft report and the changes made. There seems to be no general rule. In specific cases one has to check.

Also, or even, when numbers or statistics are concerned, one has to be careful. The heads of statistical and public research organizations, such as the Dutch Central Statistics Office (CBS) and Economic Advisory Office (CPB), often are active members of political parties, and appointed by politicians. Often politically relevant numbers and statistics are not defined unambiguously and calculable. It may be necessary to make assumptions and subjective choices and estimates before a number can be calculated. And definitions are man-made and changeable anyway. Often a lot can be “proven” by comparison with suitably selected other countries. When time series are used, a suitable period can be chosen. Etcetera. Data do not lie. People do.

The cases have shown many examples of these phenomena. The most important probably being the inquiry commissions. They were neither independent, nor honorable and sufficiently competent. Analysis of their reports showed, that an important goal or boundary condition of these commissions must have been, to shield the responsible politicians. Note that if governments and parliaments were aware of their limited competence or really wanted an independent inquiry, they would not organize it themselves, but ask for example an academy of sciences to organize it.¹³⁰ The fact that they organize inquiries themselves, and sometimes even conduct the inquiries themselves, justifies the suspicion that they wish to control the outcome.

Government organizations have relatively many highly educated employees. In principle such employees have ready access to all available knowledge and know how, and could use them whenever and wherever relevant. But they don't. In part because higher officers and the political leadership are unwilling and/or unable to use or apply this knowledge and know how. Making law and policy consistent with available knowledge might require substantial changes, and that is what governments and higher officers shrink back from. They would not be able to manage that. Adopting more professional work methods restricts their freedom of action, and probably means a reduction of their budget. Politicians find their personal political hobbies much more fun and important. To such an extent even, that a large part of ministries is exclusively occupied with developing these ideas and proposals for their implementation, and refuting everything that might impede it. One of the by-products of this practice is an attitude of resistance towards everything that is incompatible with the politically desired developments. Members of government and their higher officers seem unable to react to criticism in other ways than by defense. Information “not invented here” is not assessed on its intrinsic merits, and not discussed seriously. All mental energy is spent on finding reasons why it can be ignored. Even if it comes from relatively friendly persons or organizations, who are needed to get the ideas realized. Only if objections don't go away, do they get serious attention.

Questions or complaints of citizens to government organizations provide innumerable examples, although these may be explained just as well or better on the basis of the ministers' presumption of infallibility: “I never make mistakes”. The Dutch radio program Argos for example, has shown that justified complaints about harmful medical misconduct were systematically brushed aside by the Health Care Supervisor.^{131, 132} But whatever the reason, it is compatible with the use of experts outlined above. It suggests that experts are not hired for their expertise but because the public sees them as experts. Governments also hire experts who are not expert in the field they are asked to advise about. Governments never want the opinion of really independent people. They try to buy authority

¹²⁹ As done by the GAO. See chapter 7.

¹³⁰ The more so if the head is politically selected and appointed.

¹³¹ In Dutch: Inspectie voor de gezondheidszorg IGZ

¹³² The present author had two similar experiences, with the education ministry and with the ministries of Agriculture (LNV) and Health (VWS). Agriculture did not react at all, the two other ministries did reply, but ignored the contents of my letters. They gave “non-answers”. The letter to the education ministry was about the lack of openness of the discussion about law as a science, and the letter to the two other ministries was about the risks of A1 milk of cows.

and status. What matters to them is that the public believes that an advice or report, and the policy or law supposedly built on it, is the best possible. It is about appearances.

The best proof of incompetence and inadequate education, and the best verifiable and important example of structural neglect of scientific advice, undoubtedly concerns climate change by emissions due to human activities.¹³³ In this field, governments failed their duty for over 30 years, notwithstanding frequent well-founded warnings.

The distribution of duties and responsibilities.

The most radical measure which is necessary to make liability law consequent and realistic- and prevent irreparable harm to innocent people- is a redistribution and adjustment of activities which make the resulting activities feasible for real people. Where “feasible” means that they can be done in a responsible and proper way. Play-acting, and excuses like “as good as possible” (but insufficient), should no longer be necessary and condoned. False pretensions are not permitted. They create the risk of harm that cannot (or will not) be repaired or compensated. This redistribution and adjustment is the most radical measure because it requires the toning down or elimination of many important pretensions, and the reorganization of most activities in modern society. Including (or especially) those of the government. Activities have to be redefined and reorganized so as to make the resulting jobs feasible, and reduce risks to bearable proportions. At present especially the higher functions do not satisfy this condition.¹³⁴ Large organizations may remain possible, but in general, high hierarchies will not. And certainly not in the sense of the present regulation.

One might think that the single head of a hierarchical organization can be simply replaced by a group. But this is only appearance. The point is that the distribution of duties must be demonstrably realistic, and that each employee (group member) can do his well-defined job properly. Which also means that he can take responsibility for it (including liability). As a baker for the baking of his bread, and for the bread itself. Per person it should be possible to assess whether the person can do what he is supposed to do, and bear the risks of possible errors or failure. A coordinator should show for example that he can adequately assess the knowledge, know how and work of his collaborators. Everyone is personally answerable for his functioning. One can no longer (completely) hide behind superiors or a group. In this connection it should be noted that the annual reports of all organizations mentioned in the cases show that they had “management teams”, but that there is no evidence showing that this made the conduct of their organization or CEO more responsible.

To make false pretensions unnecessary, functions and duties should never exceed the competence of the employee. A gap between requirements and possibilities causes violations of integrity, and creates risks for the (human) environment. In the analyses it has been shown, that the inevitable lack of integrity and competence of the top infects the whole organization, and goes a long way towards explaining the failure of these organizations in the cases.

In sum:

- Organizations should redistribute their work so as to make all resulting jobs feasible for real people. Where a “feasible job” means: the job can be done in a responsible and adequate way by real and available people;
- People may only do jobs they can do adequately and responsibly. Where “responsibly” includes the ability to bear liability for errors and risks.

These measures make the play-acting of especially the higher managers largely superfluous. In their new jobs, there will be no need to pretend that they can what they cannot. Most of their

¹³³ The IPCC First Assessment Report was published in 1990. To mention just one milestone. Knowledge and understanding of greenhouse gases is much older. It was included in the astronomy curriculum of Utrecht University in 1964-5, for example.

¹³⁴ The situation might be assumed to have the tacit consent of the population, if it had been fully and correctly informed about the lack of integrity and competence of the top of society (“its leaders”), and the consequences of this lack. Which they aren’t. Therefore the assumption is not justified.

hierarchical power has vanished, in order to close the gap between the requirements of the job and the responsibility one can bear. Decisions for larger parts of the organization have to be made in other ways.¹³⁵ So as to make everyone's responsibility realistic. Only in such a way can a principal cause of dysfunctioning and failure of organizations be eliminated.

It will be difficult to realize a division of work into feasible jobs. Mainly because it requires honorable and competent people. The situation is as it is due to its stability. As shown earlier in this chapter, people lacking integrity and competence have very good reasons to appoint only people of their own kind, and to keep honorable and competent people at a distance. Which cannot be too difficult, since someone who is honorable and competent understands that top jobs are impossible to fulfill properly. He or she would not be honorable if he or she didn't mind. Similar mechanisms may frustrate the required reorganization. This underlines the importance of good internal and external correction mechanisms. They should make dishonorable behavior and incompetence risky and unstable, and proper functioning rewarding and stable.

An internal correction provision is described in the next subsection. In addition, a new external correction provision is necessary to avoid the present dependency on parliament and public prosecutor. They have been shown to be fatally unreliable. The external provision consists of giving justiciability to citizens who have an interest in the appropriate functioning of a public officer or organization. Since everybody has an interest in effective and efficient application of tax money, this will often mean every tax payer. These citizens get the possibility to set correction in motion by appealing to a judge if they think they have reason to assert that the organization does not adequately fulfill a duty, has false pretensions, or does not comply with professional or its published norms. If the judge concludes that the complaint is justified, then the employees whom it concerns are liable. They have to repair the consequences of their misconduct, have to pay the (all) the costs of the lawsuit, and are punished proportionally in order to make the inappropriate conduct unrewarding. Where the punishment is for preventive purposes.

A citizen only pays the costs of the lawsuit if the judge concludes that the complaint had insufficient justification. The citizen may appeal to a higher level court. If the new judge confirms the lack of sufficient justification, the citizen has to pay the costs of the second suit as well.

Redistribution of duties of representative bodies.

This subsection does little more than present a set of ideas. It is not worked out. For a more comprehensive- but still unfinished- discussion the reader is referred to the appendix of this chapter.

Because of the phenomena seen in the cases, the conclusions of the analyses, and the ridiculous combination of size and duties of parliaments indicated in section 4 above, it would be a great improvement to distribute the present duties (or activities) of parliaments over the following mutually independent organizations:

1. An organization for the administration of justice with the following duties/parts:

- Rewriting civil and criminal law to comply with the law of logic.
- Checking laws for compliance with the law of logic and the constitution. (And where necessary, make amendments).
- Finding infringements.
- Prosecution of those responsible.
- Handling requests about infringements. Including requests for prosecution.
- Evaluation and judging (Courts).
- Execution of the judgment.
- Evaluation and improvement of the system.

The organization should try to minimize deviations between reality and the law. This would be its

¹³⁵ Those who decide upon an activity must be able to bear the risks of that activity. They should know that their decision makes them liable.

principal duty. It should either correct the consequences of infringements (as good as possible), or supervise such correction. The duties of the organization refer to reality, not the law. That is: it should improve reality, not the law. But it should advise on the law where it finds this necessary. The judicial part of the organization should also render decisions about for example the validity of decisions taken on the basis of intentionally untimely, insufficient, or incorrect information.¹³⁶

2. One or more autonomous supervisory organizations with sufficient powers to make and keep them independent and effective, and to adequately correct the supervised organizations.
3. An organization with the duty to make at least the principal appointments for public administration. It has the power to veto all appointments in public administration.
4. Organizations for other public services. Such as education, health, litigation support, and public transport.

The people are to be given ample powers to take initiatives, to intervene and to overrule. Also in the field of appointments. It should also be able to form inquiry commissions. The people is the ultimate supervisor. (It is subordinate only to the law of logic).

All public organizations should be open and transparent. They should account for their activities and policies in annual reports. Openness and accounting should not be seen as a burden, but as a civil duty, of which appropriate fulfillment is essential for the proper functioning of society.

The reorganization is meant to improve the mutual independence of law making, judiciary and executive. It represents a step forward in the direction of a social political organization which people can accept voluntarily and unanimously.

A law and policy making body should not control the executive organizations. Supervision of compliance with the law is the duty of the (autonomous) organization of point 1. Supervision of efficiency and efficacy is the duty of a supervisor. Any law and policy making body is obliged to request the public advice of independent competent people or organizations when it wishes to propose changes in law or policy.

Advisors vouch for the reliability of their advice. Employees of an advisory organization should not have or have had any political affiliation. They should not be selected or appointed by politicians. Neither directly nor indirectly.¹³⁷ Among other things, their advice should contain an evaluation of costs and benefits, and an inventory of uncertainties and risks. The advisors are personally liable and punishable for avoidable errors.^{138, 139} A law and policy making body is obliged to give a reasoned reaction to all critical remarks. Where necessary, a judge decides the adequacy of the “reasoned” and their balancing or summing up.

It will be clear that the new duties require better and differently educated and experienced judges and advisors.

Additional measures should be taken to better guarantee that people who have a constitutional duty to represent really represent:

- It should be relatively easy to replace a representative. For example by a (local) referendum;
- It should be relatively easy to have a referendum;
- Referenda may decide (cancel, modify) everything the representative body may decide;
- Including taxes and appointments.¹⁴⁰ Representatives should depend on the people represented, not

¹³⁶ Because of the norms for professional decision making, it is intentional unless proven otherwise.

¹³⁷ Reminder: “employee” includes everyone working for an organization.

¹³⁸ Nobody can know everything, and often it is only wise to admit this. Competence includes self-knowledge. An advisor should know what is reliable and what not.

¹³⁹ The measures to be mentioned below make every officer and his superiors personally liable and punishable. Proportionality and their responsibility require that for example Geithner, Greenspan, Stuiveling (of the Dutch GAO), Summers, and Wellink (DNB, the Dutch Fed) spend the rest of their lives in prison. Their fortune and that of their close family should be confiscated. Not only salary should be proportional, but punishment too. (This note is intended to avoid misunderstanding).

¹⁴⁰ The budget should be balanced, so proposals for tax decreases should be accompanied by proposals for reduction of specific activities or obligations. And something similar for tax increases. The coupling of money-

on politicians or political parties.

The supervisory/ controlling duty is wide and deep. It concerns the operation of all of public administration, and every person and organization paid wholly or in part with tax money.

By removing control from politicians to independent persons, the power of the supervisory bodies is increased. This is necessary, since these bodies should be significantly smaller in size than the organizations being supervised. It should be clear to everybody that the sanctions will work preventively, even when taking account of a limited chance of discovery. The personal costs of irresponsible functioning, as perceived by decision maker(s), should be very much larger than its perceived benefits.

Of the structural failure of parliaments to adequately control the government and its subsidiary organizations, this report has mentioned several causes. Such as the concurring interests of government and coalition parties due to the way governments are formed in many countries, and the dependency of politicians on political appointments by the government. Of course in combination with a crucial lack of integrity, which allows giving priority to government, party and self interests, and posteriority to the sworn duty. Together, the government and the government coalition in parliament have all state power. They have little interest in control. Rather the contrary. To retain their power, they have to hide and cover up their errors and failures. They and their predecessors are responsible for laws being what they are, and for government expenditures. Nobody else can change even a dot or a comma in a law or budget. Control by the given parliaments and by the inquiry commissions installed by them, is largely self control. Self control almost never works as it should. As the cases demonstrate all too clearly.

Obviously the supervisory organizations should communicate with one another whenever necessary for the proper fulfillment of their duties.

The supervisory organizations should indicate what has to be corrected or improved. They should check the implementation of their directives. In case of inadequate implementation, the supervisor decides about the payment of damages and about punishment. The supervised organization may appeal to the judicial system. The costs should be borne by the responsible employees. Not by the organization. If full reparation or compensation is impossible, the responsible employees are personally punishable, and the supervisory organization prescribes appropriate alternative measures. These can include the transfer, degradation, or discharge of responsible persons.

Public accountability requires openness and honesty, and forbids silence, half truths and misleading.

The reports of the hearings of the inquiry commissions of the subprime crisis show numerous examples of dishonorable answers to questions. The answers implicitly draw attention to the problem, that accounting for one's conduct may mean that one accuses oneself. Both in fact and legally. Criminal procedural law acknowledges a right to remain silent. Before the judge you may remain silent if you think speaking will harm you. However, someone who has voluntarily accepted a responsible function, should not have this right as regards the person(s) to whom he has to render an account. In other words: as regards public functions, public accountability has priority over self-defense. Public officials should be obliged to account for their conduct. They should be transparent as regards their functioning. Rights are given by people. The right to remain silent should not be given to public officials. Such a right endangers the public interest. As shown by the hearings about the subprime crisis.

Voluntarily accepted public responsibility requires timely, correct and complete accounting and information, and this obligation should have priority over the right to remain silent.

purpose is binding: the money cannot be used for other purposes. (At present, appealing goals are systematically used to justify tax increases. The goal often being temporary, the taxes permanent).

Agreement should be valid and binding only under the condition of timely, complete and correct information. Decisions depending on agreement are supposed not to have been made if the condition was not satisfied. Those responsible for untimely, incomplete or incorrect information are liable and punishable for the costs which are to be made to redress the situation.

Dismantling the hierarchical organization.

Almost all socially harmful phenomena described in this report are causally related to the hierarchical organization as a regulated form of organization. In theory hierarchical organizations facilitate the effective and efficient cooperation of many people, and the combination and synergy of knowledge and abilities. In practice they often are closed dictatorships. They enable one or a few persons to use or abuse a large number of people to do what they consider important or desirable, and to keep a large number of people in check. Since the top jobs of the larger hierarchical organizations are impossible (theoretically and practically), they are inevitably occupied by dishonorable people with insufficient competences for the job.

The cases show, that in hierarchical organizations repression is a common phenomenon. In particular in government organizations and their subsidiary organizations. But also in private companies like Moody's.¹⁴¹ The combination in the top of rule making, executive powers, and the power to administer justice, makes repression simple. The cases show that hierarchical organizations offer little or no room for opinions which differ from those of the top, even if only marginally. There may be an appearance or illusion of freedom of speech, but the top simply does not listen or take whatever is said seriously. It has the power to ignore whatever it dislikes. And it really uses this power. Beware the employee who doesn't take the hints, and doesn't give up speaking his mind. He will be sidetracked at best.

In a hierarchical organization there is no independent administration of justice, no possibility of appeal, and no possibility to make public what the top doesn't want to be public. There is no independent voice. Even the "independent" internal control (audit) accepts orders which require it to set its professional norms aside. And this is not a pessimistic fantasy, but observed reality.^{142, 143}

In government organizations and their subsidiary organizations the top defends its repression of dissenting views by the argument of democratic control. The top claims to act on orders of the government, which is supposed to be controlled and sanctioned by parliament. Hence whatever it does is good.

¹⁴¹ And by inference in the other rating agencies, for real openness would have produced different ratings and very different publications about risks. Repression is a much more likely explanation than general stupidity.

¹⁴² See for example the first chapters of the present report.

¹⁴³ In the words of David W. Ewing: «Democracy has been called an ideology opposed to silence. It is the ideology of discourse, debate, and interchange. At least part of the disillusionment and cynicism about business that creeps into the outlook of many professional and technical employees comes, I believe, from the discrepancy between life in the corporation and life outside. By the time you've got your degree, society has invested quite a bit of time and money in you. You have been taught by many public-school teachers whose salaries are paid by taxes. You have used public buildings built and maintained out of public funds. You have used expensive equipment in colleges and institutes financed by years of private fund-raising and tuition fees or by state taxes. You have taken the time and the energy of many college instructors whose salaries come out of tuition fees, investment income, donations, or taxes. Throughout this educational process you are taught to think independently, to question freely, to speak articulately. You are taught to value facts, evidence, and the scientific method. You are taught to evaluate an idea on the basis of its merit, not its sponsor. Presumably, society also values such qualities or it would not create and maintain all these facilities for your education.

And then you take a job in an industrial or public organization and, unless you are lucky, presto! All those values and attitudes may screech to a stop or even be reversed. Not your mind but your obedience may be cherished now. The freedoms and civil liberties that schools, religious institutions, and the community impressed on you are turned inside out and upside down. It is as if the organization were betraying the educators and donors who fed it with talent. The organization is too free to go its own way, society seems to complain from time to time, and in particular it is too free to go its own way in secrecy. It is as if the organization had a life of its own and didn't have to heed the rules everyone else must follow.» p. 26 of *Do it my way or you're fired! Employee rights and the changing role of management prerogatives*. Wiley, New York, 1983. For this reference I am indebted and grateful to dr. H. Zandvoort.

It is the purely authoritarian regulation of the hierarchical organization, which in the years before the subprime crisis made it possible to suppress all voices except those of self regulation and deregulation. Which in turn made it possible for financial institutions to exploit (= abuse) gaps in regulation, and for supervisors to continue broadcasting false pretensions about the safety and soundness of the financial system. Similar remarks can be made about the Dutch education and defense ministries, the EU, Greek governments and many other organizations. Everyone has to adjust to the opinions of the top. Which was appointed by politicians, and adopted the views which were considered politically desirable.¹⁴⁴ And which was dishonorable and insufficiently competent anyway. Groupthink may have played a role among the principal persons, though belief in, or submission to, an authority like Greenspan could have done the trick just as well. The cases show however that groupthink and belief in authority are much less likely in the much larger group of other employees. Their general silence can only be due to repression.

Note that the general repression of dissenting views in important hierarchical organizations has the effect of marginalizing the relevance of the freedom of speech.¹⁴⁵

The internal repression is supplemented by external repression. For although parliaments should welcome (well-founded) whistleblowing, they actually allow it to be persecuted and punished excessively. Which is consistent, because these very same parliaments devised and maintain the dictatorial hierarchical organization. Still, the terrorizing of whistleblowers can only be meant to prevent whistleblowing, and to continue repression.

The fact that the state of affairs in almost all of the organizations considered in the course of this report justified or required whistleblowing, and that the whistle was blown only in very few cases, shows that the selection of employees and repression were almost 100% effective.

The cases show the following harmful consequences of the hierarchical structure:

- Dependence on a top which in larger organizations inevitably is dishonorable and insufficiently competent;
- The internal operation of the organization can be screened off from public view;
- Dysfunctioning and potential dangers for society remain hidden. (Even when analysis of annual reports and other documents show much more than inquiry commissions and others have noted). Which precludes correction.
- As a rule, the outside world gets too rosy a picture of an organization. The reason being that all information has to pass the head, who is free to censor. He can say that everything is well, whatever may be going on. There is no basis for the assumption that the outside world will be warned even in cases of gross misconduct or (other) serious problems. Not even by the supervisor(s), who would have to explain how things could run out of hand in spite of its supervision (in preceding years).
- Maintenance of a climate wherein employees cannot work in accordance with generally accepted norms and values or legitimate expectations of the outside world, cannot fully realize their talents, or contribute to a development of society they can believe to be positive;
- Support for the anthropomorphy fiction, and promotion of simplistic thinking about organizations. The head and only the head (or his spokesperson) speaks for the organization. He speaks as if he is the organization, and as if the organization has only one opinion: his.

The following changeable causes can be identified:

- Top jobs and/or duties requiring (much) more knowledge and abilities than anybody possesses. As a consequence there is a wide gap between the responsibility of the job and the responsibility the appointee can actually bear;

¹⁴⁴ One of the great sins of the heads of the supervising organizations. Of course, they must have been selected for exactly this kind of loyalty.

¹⁴⁵ Knowing that these organizations are repressive, and that their opinions should not be taken seriously, does not help much. An ordinary citizen cannot supervise, and in general has no access to much of the information needed to evaluate important situations. He can only conclude that there are important risks.

- Appointment of dishonorable and incompetent heads and other top officers, especially by politicians. (Together with the incorrect assumptions that:
 - “As good as possible” is good enough;
 - in management and public administration, deceit is necessary);
- The dictatorial nature of hierarchical organization;
- The opaque nature of hierarchical organizations;
- Unity instead of separation of powers in hierarchical organizations;
- The impotence of employees and interested outsiders to do anything about dysfunctioning, at least not without creating great risks for themselves, and with a reasonable chance of success;
- Inadequate internal and external control, the internal control being part of the hierarchy, and the external control unwilling to do and say what might be a problem for political powers;
- The absence of meaningful liability and punishability in cases of misconduct and causation of avoidable damage. (In none of the cases a responsible person was punished for failure to do his duty, irrespective of the seriousness and extent of the damage);
- Dependence on a politically controlled public prosecutor for getting people before a judge;
- Acceptance of the anthropomorphy fiction by the law;
- A law and regulation which make this possible, promote, etcetera.

These causes or their effects can be eliminated or reduced by the following measures:¹⁴⁶

- The measures regarding liability, punishability and the redefinition and distribution of activities described above;
- Annual reports which indicate who is responsible for what. Annual reports mention different views on all subjective matters which may be important with respect to the duties and mission of the organization (the anthropomorphy fiction is abolished);
- Separation of powers in organizations;
- There is external supervision which reports at least annually about the effectiveness and efficiency of the fulfillment of the duties and other obligations of government organizations and associated organizations, and about compliance with applicable norms;
- Employees have an obligation to report plans (for) activities which are incompatible with duties, obligations or applicable norms. At first internally to the relevant colleague. Externally if there is no adequate written reaction within two weeks, or correction has not taken place within two months. Failure to report misconduct one does or should know about, makes liable, and is punishable;
- General personal liability, also for employees of organizations. This does not mean that liability cannot be shared. But it does mean that everyone involved in an activity, or a decision to refrain from required actions, bears part of the liability. Where there is a hierarchical line, it automatically participates in the liability;
- If a justified report of misconduct or failure is supposed to make cooperation impossible, those who misbehaved or failed, and those who are responsible for the misconduct or failure, are discharged (dishonorably), and not the person(s) reporting.
- Of course, supervisors are liable and punishable too.

These measures mean the end of the hierarchical organization as we know it. The end of impossibly high pyramids. Large organizations no longer have a single spokesperson. The absurd custom of parliaments to communicate with ministries only through the (under)minister, while at the same time absolving him from an impossible responsibility, is ended too. Note that parliaments never seriously tried to solve this risk promoting problem. The measures effectively abolish ministers as heads of ministries. Their responsibility is severely restricted. Their “subordinates” become far less subordinate, and much more responsible. Especially to their supervisor (mainly as regards “how”), and maybe to parliament (mainly as regards “what”).

The measures are preventive. They reduce or eliminate pressure from dishonorable top managers and the influence of false pretensions. In addition they ensure internal control.

¹⁴⁶ Obviously, most measures require (substantial) changes in laws.

The measures do not reduce the possibilities of organizations. Correct functioning is hampered in no way. They do however increase the risks of dysfunctioning for the official, and especially the risk of recklessness: taking more risks than the official can bear.

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9.8. Conclusion.

Correction is a matter of survival.

Given the phenomena described in this report, the measures indicated in the preceding section are no more than logical. Many of them do little more than abolish illogical and unfounded discriminatory exemptions in otherwise well-founded laws. The measures make the law more consequent, and more compatible with mutual respect. It is evident that they will reduce misconduct of top officers, and its consequences. The rather simple nature of the measures moreover shows that it is nonsense to assert that improvement is impossible, and that misconduct and cases as described in this report are inevitable, due only to "human error". If only human error were to blame, governments would have no reason to exempt themselves from laws which apply to all other human activities.

The report has shown that members of governments and other high officials lie and mislead as a matter of course, and that this can only be meant to hide structural misconduct, incompetence and failure. The analyses of the cases show that their lies are understandable, and that the idea that their misconduct and failures are incidental, is a false and dangerous illusion. Politicians do not respect people. If they did, they would not lie. They would not need to. If politicians truly respected people, none of the cases would have happened. If they were honorable and competent they would learn from the cases studied or mentioned earlier. They may be unable to learn, but they may also fear that learning the lessons would reduce their power and endanger their jobs. Journalists and scientists act as if nothing is fundamentally wrong. Because people trust them, they are invaluable as guardians of false and dangerous illusions, and of the given political establishment.

Still, present law is incompatible with mutual respect among people. It is not the law of a human society. Every self respecting human being should be ashamed of it. In particular, the present regulation of government and organizations is indefensible. Its inviolable priorities are the protection of its top officers, and the subordination of everyone and everything else. Almost everything that could discourage irresponsible and dangerous conduct of the top, is missing. The law is not based on voluntary agreement, but on power and force. And worse: a monopoly of power and force is given to those people whose pretensions most exceed their abilities. They are dishonorable by definition. Due to their regulatory power, they can safely ignore the opinions and vital interests of other people, as well as experience, knowledge and know how.

Governments nowadays are the single most dominant force in the development of mankind. Therefore, the characteristics indicated above are not only a matter of theory but of the utmost practical importance.

All this should be considered against the background of human activities which have created, and continue to create and increase, the risk of mankind killing itself. The growth of the risk, or rather risks, is strongly supported by the self-serving development and applications of science and technology.

The conclusion is clear. Unless constitutions and laws are corrected fundamentally, deadly risks are bound to be realized. Don't think that there will be enough time to stop disastrous developments once risks are seen to become realized. That has never been possible, and for an understandable reason. The reason being that it would need governments with very different people. And even honorable and competent people cannot work miracles. There is no time to lose.

In support of the above, the following section specifies some of the risks.

Catastrophic risks exist in numerous other areas.

The problem is that mankind can't afford irresponsible incompetent governments. Its survival depends on fundamentally better laws and government. Since laws have been made expressly to obstruct changes in the organization of political power, it seems highly unlikely that effective improvement will take place in time. The conditions for the necessary changes simply are not

satisfied. The population at large hardly understands the situation, and provides at most little support. Most people are successfully indoctrinated into believing that there is no really better alternative for the present “democratic” political systems. They have never learnt to think about the relation between the law and the operation of the political system. Furthermore, as a consequence of people’s material well-being and ultimately comforting government and media information, there is no sense of urgency. The state of their social environment gives people no reason for worries. They don’t feel threatened. They strongly underestimate the risks of ongoing developments outside their field of view. If only by thinking that governments take proper care.

Appearances mislead especially when helped by selective and politically colored information. The financial crises are a case in point. Until 2008, the apparently prosperous economic development seems to have made many people think that economic catastrophe was something of the past. That due to lessons learnt from past experience, and advances in economic knowledge and know how, the resilience of the financial economic system had increased fundamentally, and that the future was safe.¹⁴⁷ It wasn’t. The same mechanisms for creating erroneous illusions about safety, and repression of better judgment, exist in many other areas. Worse, as in the prehistory of the financial crises, government politicians continue to act as if possessing perfect knowledge and doing all that is necessary. They continue to claim infallibility. They don’t admit the possibility of mistakes, and therefore don’t manage risks. Even though the dangers in some areas are far greater than those in the financial world, and the risks growing day by day. Examples are:

- Foreign and economic policy with respect to for example China and Israel, and with respect to the peoples repressed and threatened by them. Repressive countries are helped to become stronger and to become a greater threat to their neighbors and others;
- The probability of a large scale military conflict and the use of weapons of mass destruction may seem to be small,¹⁴⁸ but the risk certainly is significant, and nothing is done to reduce it. Rather the contrary. Conflicts which were considered highly improbable around say 2010 have rapidly become much more probable. Not due to only one development but many. The consequences of realization of the risks are immense. If nothing is done, sooner or later mass destruction is assured;
- A “defense” and security “policy” based on little more than the idea that more weapons mean more security, and the complete absence of a serious peace policy. Nobody seems to see a need to do something that would make the world safer. For example by efforts to improve international law, the UN, or to replace that organization by something substantially better. No serious (open, non-dogmatic) discussion is taking place;
- The large scale irresponsible dumping of waste and even poison in the atmosphere, soil, waterways, and sea. The risks are largely ignored, and where recognized, insufficiently taken into account. Giving advance warning of inspections is just one of the failures (on purpose?) of governments to ensure effective supervision of compliance with regulation;¹⁴⁹
- The last point includes the risks of climate change. (Dumping of waste in the atmosphere);
- Experiments with, and dissemination of, genetically altered organisms;
- The development of (antibiotics-) resistant micro-organisms. This can also be seen as a manifestation of failing science. Since Darwin the development was predictable, but scientists didn’t give any warning;
- Experiments with, and dissemination of, new materials, such as nano-particles;
- Experiments with, and dissemination of, new products, such as drones, weapons and explosives.
- The ever increasing population. It is evident that even on its own this creates problems. Any level of human activity becomes a problem if the population is allowed to grow unlimited. Conversely: many problems and risks would be reduced by decreasing population pressure.

The list is far from exhaustive.

Policies for none of the examples are compatible with “good education”, and what one could call

¹⁴⁷ An example was quoted in the section about the *History of the American Economy* in 7B2.3.

¹⁴⁸ This was written in 2016. The old text has been kept as a warning.

¹⁴⁹ Of course this is coupled with inadequate sanctioning. The costs of the system should be borne by the trespassers. (In addition to liability). Without this, it is efficient to ignore the law.

“professional”.

In no case whatever are the risks managed at all.

The growth of many of the risks of catastrophe is stimulated by policies for economic growth. The policies for economic growth themselves are a consequence of the inability of economists to develop policies for keeping welfare at a satisfactory level while reducing the volume of economic activities.

Moreover, given present (archaic) economic accounting methods, doing dangerous things is just as good for economics as doing safe things, and often even better. While doing more is better for economic growth than doing less. More efficiency means less economic growth. And what is good for economics is good for the Treasury. This explains why Economics is a politician’s Greatest God. Security, environment, health, integrity, you name it: nothing can compete with the Great God of Economics. Governments have made themselves dependent on a very large inflow of taxes. They depend on risky and outright dangerous activities. (Armies and their suppliers among them). Their incompetence also means that they can’t cope with reducing them.

In chapter 7 it was noted that the financial crises were caused by factors which are present in other areas as well. Due to deficient laws, members of governments and heads of supervising organizations have no good reason to refuse a job they cannot fulfill properly. They have insufficient reason to make decisions in a responsible way. They have no compelling reason to take account of all costs and risks. This applies not only to the financial sector, but generally. In combination with the risks listed above, the given state of affairs is more than enough to make the occurrence of avoidable catastrophe a certainty.

The situation and developments of other areas may be more difficult to see, understand and predict than those in the financial sector. In the financial sector there was some supervision, even if insufficient. Whatever its crucial shortcomings, compared with other areas, the financial sector was closely regulated and supervised. Most people, and especially those with most responsibility, thought too simplistically and irresponsibly about the risks and threats. But they had been given well-argued warnings. Already years before the crisis parliaments could and should at least have questioned supervisors about the situation, risks, scenarios, and (possible) measures to block catastrophic scenarios in an early stage. A marginal minority did, but nothing positive was done. The fundamental reasons for irresponsible government and supervision are unchanged, and not only for the financial sector, but with regard to all examples given above.

Possibly the most important conclusion of this report is that mankind is organized in such a way as to be governed by people who abound with false pretensions. By people who are not what they try to make you believe, and do not and cannot serve people’s (future) interests. The political top does not respect people, and does not give (inviolable) priority to peoples well-being.¹⁵⁰ It has created a world that is beyond anyone’s control. The political top simply lacks the necessary integrity and abilities. It uses its power to keep up the appearance of infallibility, to prevent any kind of fundamental improvement, and to keep itself in power. The report shows that nothing important can be entrusted to them. Like the sorcerer’s apprentice of the fairy tale they will surely fail. The problem is that in the real world there is no sorcerer to stop matters running out of control.

Analysis of the causes of the cases, and of the causes of the stability of the given political system, showed that nothing will substantially improve unless, among other things, liability and criminal law, the regulation of (hierarchical) organizations, and the distribution of activities, are corrected as indicated. They show that if no fundamental improvement is realized, catastrophe or catastrophes on an unprecedented scale are only a matter of time.

¹⁵⁰ To be clear: in these respects there is no significant difference between dictatorships and democracies.

Chapter 9.

Final analyses, conclusions and corrective measures.

Appendix. Draft outline of a constitution of a communicative society.

Preliminary notes.

The nature of this appendix.

Most of the main body of the present work has an observational, logical and/or analytical character. The measures regarding for example liability and criminal law, and those regarding the costs of adjudication, have a logical character too. They are (logical) consequences of the premises of a communicative society. The present appendix has a different nature. Of the measures described here, only elements are logical. Such as boundary conditions. Other elements are not. There is no empirical evidence showing that it is plausible that the proposals will work as intended. There is no theoretical proof either. There may be better alternatives. The appendix should therefore be understood as having a status different from the rest of the report. Of course the author has tried to make as good a set of proposals as he could. But he does not want to suggest that what follows is the only possible organizational framework compatible with the law of logic. It probably is not. What follows is not finished either. It is only as good as it could be made in the time available. It is the tentative state of affairs of work in progress.

Motivation of this appendix.

The norms and values premised by a communicative society do not by themselves create, or constitute, a functioning society. They are not sufficient for that purpose. If only because the norms and values premised by communication are not automatically complied with, and because violations are not corrected automatically. For such purposes, additional stipulations are necessary. To show that we are not living in the best of all possible worlds; to show what a better world could look like; and in that way give the reader a perspective worth believing in and working for; an outline of a possible constitution based on, and consistent with, the law of logic is included in this report. The outline should give an impression of major differences between the present actual constitutions, and a constitution which a self respecting person can voluntarily accept. It tries to give the outline of a truly legitimate constitution. By explaining requirements and indicating major differences, the outline can help with the evaluation of other proposals.

The appendix is meant to show that there is an understandably better alternative to the present constitutions. That there is something to work for. That at least as regards the existence of an acceptable and fundamentally better set of societal rules there is no need to despair. An alternative exists. And just as important: it can be implemented incrementally and gradually. In other words: the set of alternatives is not a matter of all or nothing. Partial realization is possible, and may bring great improvement. There are choices to be made. It is up to mankind to refuse to be ruled by dishonest and incompetent pretenders, and force politicians to adopt a legitimate constitution.

The appendix shows that transition to a constitution consistent with the law of logic is not an unrealistic ideal. Its first and foremost characteristic is that it complies with the law of logic. Which is not utopian but logical. It is a mandatory norm whether one believes it or not. Just as $1+1=2$ is not a matter of belief or choice.

Even though it is not clear how the reliability of the outline can be determined or proven, it seems highly improbable that any of the cases would have happened, or caused so much harm, if the outline would have had force of law.¹ The outline makes irresponsible behavior very risky, and provides several means for timely correction. It requires people in the know to give early warning. People

¹ Wherever the word harm is used, "harm" includes the risk of harm. In general a risk will be realized sometime, and cause real harm.

responsible for cases like those mentioned in the present report can be and will be prosecuted successfully. In public administration, false pretensions will no longer be affordable.

Outline of a constitutional communicative society ("the system").

The formal or paper part of the system consists of the law of logic, the constitution and other laws. The formal part defines the practical part. The practical part consist of organizations. The most important of these are the Administration of justice, the Appointments Service, and the Supervisors. These organizations have more authority than the other public services. They are necessary for compliance with the law of logic. Other public services may be called into being by explicit agreement. Where the agreement may have the form of a subscription or policy (as of an insurance, including "conditions"!). All public organizations are supervised by a supervisor. All allegations of infringement of a law can be submitted to the Administration of justice, and require responsible treatment. The supervisor is supervised by the people. The services are paid by the people who use them, or require their existence and operation.

Laws are defined as sets of stipulations, norms, rules, or whatever a group of people wants to be binding and complied with (to and by the members of the group), and which it wants to be enforced. A law is a special kind of agreement. In the case of the law of logic the agreement need not be explicit. It is, by logical necessity, implicit in all serious forms of communication.²

There are four types of law. To wit: the law of logic, the constitution, the laws which implement the law of logic and the constitution, and the public service laws. Everyone is bound by the law of logic. The constitution should be compatible with the law of logic. Which means that it should harm no one, nor cause the risk of harm for anyone. As long as it respects the law of logic,³ it does not need everyone's agreement. It only needs the agreement of those concerned. Which also means that everyone is permitted to request the Administration of justice to correct the constitution if he finds stipulations which he finds incompatible with the law of logic. The constitution can function properly without everyone having agreed with it. The essential point being that people are only bound by the law of logic and by the laws they agreed with. "Agreed with" always meaning: agreed with explicitly. If not when the law was adopted, then by agreeing when beginning to use a public service. Since this is required by the law of logic, the constitution cannot change this.

To ensure that reality agrees as closely as possible with the law, the people concerned need something like a judge, and instruments for the execution of the judges' verdict. For this purpose the proposed constitution calls into being the Administration of justice, an organization. The next section will discuss it more extensively. Something like an Administration of justice is necessary whenever people want to cooperate. Things like a judge and enforcement are necessary to make agreements meaningful. And indeed, anthropology, history and books like the bible, show that as soon as people formed communities or a society, they had people who played the role of a judge. This logical necessity does not exist for most of the other activities of modern public administration. In ancient times, the people themselves for example appointed, supervised, and discharged officials. Only in large societies this became impractical, and a challenge.

It became not only a theoretical challenge, but a practical challenge as well. A practical challenge first and foremost due to the existence and necessity of arms. Arms are (sometimes) necessary for enforcement. Without a system for enforcement, society must remain simple. The problem is that arms create very great risks. Arms give power, and people with power can abuse it. In principle people possessing arms can do whatever they like with people who don't.⁴ Even a theoretically well-controlled monopoly of arms is risky. Ultimately everything depends on the people who physically possess the arms. Arms make every social system unstable. Except when the power of the state is in the hands of the group which has the exclusive possession of arms. In principle such a system is stable.

² That is, when one wants listeners or readers to assume that one means what one says.

³ In the present work, respect always means strictly.

⁴ If there are more groups with arms, experience shows innumerable examples of what can happen.

It will not implode by a minor perturbation. It can only be eroded. The more so when nobody has been taught to resist and undermine an armed dictatorship.

The problem is how to control the possession of arms, and to avoid abuse. The constitution should make clear that arms do not give any right, and that everyone has a right or even duty to do everything possible to stop or end the abuse of arms. The use of arms should be restricted to the use explicitly defined in the constitution. It should be closely supervised.

Besides the Administration of justice, the constitution creates one or more appointments services, supervisors, and procedures for the creation of other public services. The appointments service(s) appoint all top officers of public services. Each of the public services, including the Administration of justice and the Appointments service, is supervised by a supervisor. The supervisor of the supervisors reports to the public and has no further authority. The “other public services” in principle are voluntary. They render services to “members” only. They are supervised. Their regulation has force of law in this sense, that compliance is supervised by the Administration of justice, and that infringements can be prosecuted. Health care, specific types of care, specific institutions for care, and groups of such institutions may be mentioned as possible examples.

Ultimate supervision resides in the people. The constitution gives it plenty of room for initiatives. Education should thoroughly prepare people for responsible use of their rights.

Like all supervision, the supervision by the people is restricted. The law of logic cannot be changed. Compatibility with the law of logic is an inviolable norm. In principle, decisions regarding compliance with the law of logic or the constitution are made by the Administration of justice. Prosecution of violations of the law, and requests for correction, can be initiated by any individual citizen. The people must be able to overrule even the Administration of justice. But the procedure for doing so must force the people to be aware of what they do. For example by requiring two votes separated by at least two weeks.

Note that there is no evidence proving the competence or suitability of the present “representatives” of the people, and plenty of evidence for the contrary. The lack of integrity of the “representatives” must however be proven beyond any doubt. There is no ground for the assumption that they are substantially better as voters or decision makers than other people. Their education is not substantially better than that of other people (often it is worse). So although regulation should prevent irresponsible voting as much as possible, people should always be free to interfere, in any subject. It should be clear to everyone that someone who refrains from voting, delegates the decision-making to those who do vote. Where meaningful, someone should be allowed to indicate opposition to all proposals in the vote. The choice should never be limited to yes and no, or pose a false dilemma.⁵

Reminder of some observations.

All activities in society which have social importance, are conditioned and/or regulated by laws. The present law, and the political system which it creates and was created by, may appear much better than it really is. All available evidence suggests that this is intentional, and none was found to show that it is accidental or by mistake. The rose-colored appearance supports the system. The appearance is sustained by biased information, and by absent or inadequate analysis in education, media and science. The failure to replace the appearance by a truthful picture can be ascribed to various causes. Such as human shortcomings, inadequate history writing, and the fact that the news, the main stream of information people are exposed to, is selected and biased to suit the political status quo. Politicians use their power, including tax money, to control and manipulate all major streams of information, including that of science.

From the points of view of the security and welfare of people, the law has fundamental and very harmful deficiencies. Some of the more important are listed below. They are meant to be kept in mind while reading the following sections. In current practice furthermore, the law is not upheld as a matter of principle. It can be upheld only if there is a system ensuring compliance, and/or if the public prosecutor deems fit. An enforcement system only exists for specific laws and infringements. And at

⁵ Suggest that there are only the given possibilities, while there are substantially different ones.

least the Dutch public prosecutor does not need to account for a decision (not) to prosecute. In fact, he is not accountable at all, at least not in any meaningful sense. He is not held to account by his formal boss, the minister of justice. Parliament doesn't ask for it.⁶ In other words: the law is upheld at most when the law permits, and where the public prosecutor deems fit.

There are various forms of legal inequality between people. Often very much money is needed to get justice done. More money than a majority of the people can afford. Perhaps people are punished equally for shoplifting and other minor misdemeanors. But as the cases show, the greatest harm avoidably caused by lack of care and/or incompetence in general goes unpunished. Something similar applies to liability. Some damages have to be recovered. But major ones don't. The legal and jurisprudential selection of what is liable and what not, is indefensible. It is based on falsified fictions, inconsequential, and does not respect innocent people. As a rule, both criminal and tort law apply to actions and omissions of the kinds ordinary people are involved with. They apply less or not to the activities and omissions of the organizations of public administration and the people who are supposed to manage them.

Someone understanding past and given laws cannot be amazed by the state of mankind.

Practical deficiencies of given political legal systems:

- People in political power positions are hardly punishable, have hardly any real responsibility (towards other people than their friends), and no personal liability.
- The elected “representatives” do not represent those whom it is their legal duty to represent. The “representatives” of the government majority first of all represent those they are supposed to supervise.
- The power of governments and politicians, and the (ab)use of this power, hampers all forms of supervision or control.
- Governments and politicians exert so much influence on media and sciences, and people tend so strongly to “follow the leader” as to cause the media and sciences to misinform about government, politics, the law and related matters. As a consequence, misconduct and failure, though structural, are rarely reported, and never reliably explained.
- There is no effective control and supervision of the organizations of public administration (including ministries).
- The media are neither open nor sufficiently competent. They leave too much unsaid. They do not analyze, and draw no conclusions. They do not learn, and do not try to promote progress through news information.
- Many topics of great general importance are not discussed openly.

Fundamental deficiencies of the given laws:

- The most fundamental being the absence of the right to be safeguarded as a fundamental principle of law.⁷
- Another being the granting of unlimited hierarchical/dictatorial powers to a single political top, enabling it to make an army of the population.
- The law offers no guarantee for compensation of damage caused by acts or omissions contrary to the law, and for the prosecution of crimes.
- The law contains hardly any provisions to ensure responsible public administration. It practically safeguards public administrators.
- The law itself, and law enforcement (itself partly defined by the law), are biased in favor of those responsible for public administration, and those with more money. (“More money makes more equal”).
- The law creates and tolerates impossible duties (“responsibilities”), which require false pretensions, and thereby generate a “leadership” which lacks both integrity and (appropriate) competence. Such a leadership is bound to cause great harm. (As it is found to do very often).

⁶ At least Dutch parliament doesn't.

⁷ Reminder: this is the right to be safeguarded from harm due to activities of others, and from harm due to people's failure to do their duty.

As a consequence, nitwits, and even criminal nitwits, can occupy top positions, and take risks which may harm and/or doom virtually unlimited numbers of innocent people, with impunity.

Human rights and the law of logic.

What are called “the human rights” can be assumed to be defined by the universal declaration of human rights, and international treaties like the (European) treaty for the protection of human rights and fundamental liberties. The set of human rights has several important shortcomings. The shortcomings are important because their reparation is necessary for the survival of mankind. The suggestion that the given human rights are an endpoint, or even adequate, blocks the view on the shortcomings.

A theoretical or fundamental weakness of the given set of human rights is its subjective nature. There is no proof of its objective nature, or of its adequacy (in any sense). People are supposed to accept the set without proof, just because the rights are supposed to look nice, or because some people have decreed them (as they are). The rights are decreed by the present powers. They are a product of the given political legal system. This should be a warning. Given the state of government and politics, a set of human rights supported by those in power cannot be assumed to contain elements which may endanger their positions.

The absence of agreement of the people who are supposed to comply with the rights, is the more objectionable since what is referred to as rights, actually are not only rights. The given set of human rights include or imply obligations. That is: the opposite of rights. A principal error of some of the purported human rights is that they impose duties without prior agreement.

The main point is not that the duties are objectionable as such, but that they need acceptance by those assuming the obligations. People can only be expected to accept them conditionally. If only to be protected against possible negative consequences of granting rights without obligations, and against biased distributions of costs and benefits. At present there is no guarantee of any kind. The lack betrays the Santa Claus like origin of the set of rights. It was established by people who did not really represent those who have to pay the price. It also betrays the authoritative nature of the rights. They are imposed, and implicitly require blind obeisance of an authoritative government.

Note that imposing duties on people without their prior agreement shows a main deficiency: that the “rights” do not truly respect people. It shows that some people are assumed to be more equal than others.

As it is treated in practice, the set of human rights is misleading. It suggests that an ideal has been realized, and that as regards human rights nothing is left to be desired. This simply is incorrect. Fundamental and important guarantees are missing. The set does not even guarantee true respect. It only respects some human values. It is true that these are important. But they are not the only important ones, and depending on ones views, not necessarily the most important. They certainly are not the most fundamental ones. The most fundamental one being the right to be safeguarded. In particular against incompetent and deceitful governments. There is no human right to responsible government.

The law of logic is the set of rules premised and implied by an agreement to communicate. More specifically: to use a language to communicate. The set of rules includes rights and obligations. The two fundamental observations being, that as far as known there are no a priori rights and obligations, but that meaningful communication requires acceptance of conditions set by the person or persons one wants to communicate with. Such as: you only say what you mean and believe in: honesty. The agreement about the conditions for communication required by the communicants is referred to as the communication or language agreement, and the set of rights and obligations as the law of logic. The following requirements are meant to convey an idea of the law of logic, and no more than an idea. For more comprehensive information, especially definitions and elucidation, the reader is referred to the paper *Communications and Norms*.

- Communication requires acceptance of the definition of a language. In other words: honesty and

reliability.⁸

- Voluntary communication, the voluntary willingness to communicate, requires mutual respect, as defined by the communicants involved.

The following requirements are little more than implications of these most fundamental norms.

- Agreements, commitments, contracts, etc. should be honored (this being a consequence of: one means what one says).
- Contradictions and inconsistency violate the language agreement, and are therefore not allowed.
- No statement, proposition, text etc. should be untrue, or incompatible with the common reference frame. The common reference frame being the basis for the definition (teaching, learning) of the language. That is: objects, phenomena, texts, experiences, etcetera used to define or explain a language or elements thereof.
- Communication requires agreement about facts. What they are, and whether something is a fact or not. “Fact” being a word; its definition (meaning) being part of the language definition.

One is under no obligation to communicate with anyone, or to accept the law of logic. However, denial or rejection of the law of logic means that one outlaws oneself. The law of logic offers protection. (More than any present law). Non-acceptance means that one is not protected by it. It means that one cannot claim respect. Making claims requires communication, which requires acceptance of the rules needed for communication. In other words: acceptance of the law of logic. Complete freedom, including freedom of any obligation, is possible and permitted, but means abandonment of each and every right.

Since denial of the validity of the law of logic includes rejection of the rights and protections it provides, non-communicants can be treated as if bound by the law of logic.

Law of logic, constitution, and administration of justice.

The relationship between constitution and law of logic.

A constitution is understood to be a set of propositions constituting a society. A constitution sets inviolable boundary conditions for all (other) laws and for all activities. It sets up a set of functions (in the sense of jobs) and organizations, their duties, authority, financing, and whatever may be required or suitable. Including the way in which functionaries/employees are selected and appointed, the way in which persons and organizations account for their activities, and the way they are supervised. A constitution regulates the way laws are made and modified. Together, the functions and organizations make a collection of people into coherent society which functions in accordance with these people's needs and wishes.

In the present appendix, a “law” is understood to be a set of rules and, or in, a framework which enforces supervision and compliance. A law is not only valid, but also enforced. Laws are made and only made to form and condition reality. They are not made for appearances' sake. Therefore there always should be mechanisms ensuring or promoting compliance, and correcting deviations. It should be stressed that this is not the reality of today. Legal and practical reality may differ greatly, and only the government may be able to narrow the gap. Often the indicated mechanisms are missing, or only used when some politically appointed administrator deems fit.

“Inviolable” has the meaning of the dictionary: no violation is permitted. None at all, strictly. This means in particular that no compromise is allowed between an inviolable condition and any other purported value or interest.⁹

By definition the constitution of a communicative society includes the law of logic. But the constitution is not logically implied by the law of logic. At least not entirely. A constitution is more

⁸ The word “true” should mean true, and “yes” yes. This note is meant as an illustration of the fundamental relationship between communication and norms.

⁹ In actual reality, human rights, including life, may be, and are, traded against economic (= financial) interests. As when risky activities are legally allowed. The right to life (and integrity of the human body) may also be set aside by participation in an armed conflict, and even more by conscription in combination with armed conflict.

than the law of logic. A society is not logically necessary. It can have many forms.¹⁰ The law of logic is an inviolable boundary condition. However, since the law of logic premises or implies the requirement of compliance, it does require a set of functions and organizations ensuring compliance as good as practically possible.

It is important to note that one may accept the law of logic and a compatible constitution, without accepting any other law. Neither the constitution nor any other law is a logical consequence of the law of logic, excepting the laws necessary to ensure compliance with the law of logic. In other words: one may accept laws selectively. Of the constitution one may only accept the (coherent) part regulating compliance with the law of logic.¹¹

The law of logic requires internal consistency of any law, and consistency of any one law with any other. Where the set of laws includes the constitution. No parts of any law should be incompatible or contradictory. No part should be inconsistent with the law of logic or with any fact.¹²

Proof of incompatibility makes the corresponding coherent part of a law invalid as from its (purported) coming into force. It has never been valid. The law of logic requires laws, or parts of laws which are not implied by the law of logic, to have the prior agreement of those who are required to comply with it. Such laws or parts of law only apply to those who agreed with it. Where agreement (always) means voluntary agreement, after full, timely and correct information. This also means that a law is only generally valid if adopted by a unanimous vote. But it should be accepted that some laws are accepted by, and valid for, only part of the population. As not everyone is a member of the same or all associations, and does not subscribe to the same or all periodicals.

The law of logic is an inviolable boundary condition for the constitution and for all other laws. The constitution is an inviolable boundary condition for all other laws (except of course the law of logic). Alleged incompatibilities and contradictions should give everyone the right to ask a judge for a judgment. The constitution should provide an efficient procedure for this purpose. The costs of the execution of the procedure are to be borne by those responsible for the incompatibility and/or contradiction, or, if no incompatibility and/or contradiction is found, and the judge finds the allegation insufficiently founded, by the applicant.

Stability is recommendable and in some respects imperative.

Mutual respect implies, and the law of logic includes, the right to be safeguarded from harm due to activities of others, and from harm due to people's failure to do their duty. Changes in laws and administrators should harm nobody. Not now and not in the future. The reason being that the law of logic is unchangeable and inviolable, and that an agreement can only be invalidated by another agreement.¹³ With the prior agreement of those affected, even the law of logic can allow harmful effects. But only under the conditions that the harmful effects can be and are compensated when required, and prior agreement. In present day practice there often is no compensation. The lack of compensation justifies doubts about the net beneficial effect of the changes for society as a whole. For if a change really is advantageous for society as a whole, costs and benefits can be redistributed in such a way that everybody benefits. Without exception.

From the fact that the law of logic is unchangeable, it also follows that risks of future violation of the law of logic should be reduced to a minimum. This is of importance for both laws and appointments. Administrators should not only comply with the law of logic, but in doing their duty do everything necessary to prevent violation of the law of logic. Not only violation at that moment, but also in the future. Risk or power loving people should not be appointed, and chances of their appointments should not be improved. Small changes in laws or the composition of the top should

¹⁰ In agreement with the actual and historical evidence.

¹¹ Note that all this is compatible with historical and present day evidence. Societies differ greatly, but not as regards the main elements of common or civil law, which are more or less equivalent with the law of logic. The cause of course being that the law of logic is logical.

¹² Inconsistency with facts violates the language agreement, and thereby the law of logic. Without facts, a language cannot be defined, and no language agreement is possible.

¹³ It is thought to be unchangeable as regards logical aspects and its fundamental contents. New discoveries regarding subordinated aspects cannot however be excluded. And the formulation may undoubtedly be improved.

never be allowed to have large effects. The political legal system should be, and be made to remain, stable.

The constitution should prevent changes which endanger compliance with the law of logic, or which may start developments facilitating its violation. It should ensure stability, at least in this respect. The change of an administrator should not be allowed to cause substantial changes. As it can in systems using majority decision making. Apart from the unchangeable law of logic, and as a consequence of its requirements, the legal system should at most change marginally and slowly.

Protection of the law of logic. Decentralization is to be maximized and central power minimized to reduce risks.

In connection with the following, the reader is reminded of the prisoners dilemma model as an aid in thinking about the benefits of social organizations. A system for the maintenance and recovery of a lawful situation is the primary example.

The history of the past century shows that the given political legal systems allow for drastic and even catastrophic changes. The changes regard both the law, including their practical implications, and matters of life and death. The top of politics can change laws, given time almost arbitrarily. It moreover has far reaching “discretionary” powers. In the present systems political power is very important. At the same time the election of the top is flawed fundamentally. There are no significant conditions for candidacy, and no guarantees for reliable information of voters. The most fundamental and important flaw may very well be the fact that there are only elections for appointing people. There are no elections enabling people to depose them. Even while appointments are only based on words and promises, while depositions can be based on deeds, actual performance. And while in the most important cases deposition is the only recourse to avoid catastrophe.

Of course, everyone should consider elections for deposition a fundamental right. As everyone should consider the law of logic a natural and inviolable law. Only the absence of such ideas can explain the actual general and harmful, if not catastrophic, abuse of power.

Under the law of logic political power will be greatly reduced. If only because changes in principle require the properly informed prior consent of those affected. Majority decision making, that is: dictatorship of a majority, is essentially abolished. Since the required transformation cannot be realized overnight, it is probably useful to consider what can be seen as intermediate arrangements. At present, and speaking in practical as opposed to theoretical terms, society has a hierarchical structure. The top is seen as boss and leader. Even though it isn't. A top official is seen as having to be obeyed. Whenever a non-specific problem arises somewhere in society, people expect the political top to address and solve it. People often talk as if God has been replaced by the government. They have never learnt to think otherwise, and politicians only confirm their misconceptions. (The “people” include those in the media and science, who of course should know better). The main point anyway being that in present society political power is extremely important, and even more important than in the time of kings and emperors.¹⁴

When power is important and centralized, much depends on the quality of just a few people. With the laws of up to at least 2020, there is a real possibility of getting an outright dangerous person in a top position. Such a person can do immeasurable harm. History abounds with examples, even in supposedly democratic states. To a large extent, the problem arises from the stipulation that persons are elected for several years. Often 4 years. Without people having any possibility to depose such a person. No matter what he or she does or fails to do. Obviously, in a truly democratic state, people should not only be able to elect an official, but to depose him as well. This should be possible on the initiative of a relatively small number of people, and by a procedure similar to the election procedure. Or of course by a purely legal procedure, if the official violated the constitution.

Even if such a high-risk situation is maintained, the risk can be reduced by decentralization. That is: by transferring power from the center to administrative units as close as possible to the people. Decentralization is one of the ways to reduce central power. The risk of structural violation of the law of logic, and of the growth of such a risk, can be reduced by systematic decentralization, and as far

¹⁴ As measured for example by the part of the national income at their disposal.

from the center as possible. By removing power from the center, the same probability of misconduct at the center has less consequences, and poses less of a threat.¹⁵

Concentration of power increases the disproportion between the actual competence and true abilities of administrators. It reduces the possibilities of control and correction. In combination with modern day technical possibilities, abuse of power can render correction even impossible. Decentralization does the opposite.

The above argument is supported by a quite different observation. To wit, the observation that under the law of logic, everyone and every group has the right of autonomy. Membership of any group is voluntary. Whether the group is a private association or a state. Since this right is part of the law of logic, the constitution or other laws cannot change or reduce it. One can choose to be a member of a larger group only for specific purposes. Remember that acceptance of even the constitution is voluntary.

The following sections describe the main elements of the constitution. Together with the law of logic, an improved and implementable version of the contents of the sections form the constitution.

A principal characteristic of the constitution is the non hierarchic organization of society, and the existence of separate independent organizations for separate duties.

The administration of justice.

Summary.

The system for law enforcement has the duty to ensure that laws comply with the constitution, and that the constitution complies with the law of logic.¹⁶ The system has the duty to ensure as good as possible that reality complies with the law. When the law has been infringed, the best possible corrections are made to realize the situation that would have developed if no infringement had taken place. Harm is undone as good as possible, at the cost of the people who are liable for the infringement.

The system maintaining and enforcing the law is independent. It is accountable to the people.

The system is paid by the people who violated the law, and only by them. As good as possible in proportion to the harm caused by the violation.

The main duties and parts of the law enforcement system are:

- Rewrite civil and criminal law to comply with the law of logic (in a transition period).
- Check laws for compliance with the law of logic and the constitution. (And where necessary, propose appropriate amendments).
- Prevent those infringements which might cause irreparable harm, and/or develop proposals for preventive measures to be voted by the people.
- Find infringements and the people responsible for them.
- Prosecute of those responsible.
- Handle requests about alleged infringements. Including requests for prosecution.
- Evaluate and judge (Courts).
- Execute verdicts.
- Evaluate and improve the system.

The Administration of justice is the only organization with power over everyone, but only as regards the law of logic. It also has jurisdiction with respect to all other laws and/or agreements, and the people who voluntarily accepted a law or subscribed to an agreement.

¹⁵ Of course, decentralization should include decentralization of financial resources. Local units should not depend on a more central unit for money. To a large extent, power is about money.

¹⁶ This means that neither “the system for law enforcement” nor “Administration of justice” properly fits the job the organization is meant to do.

Main characteristics.

This section sketches an outline of a system meant to maintain the law and minimize the consequences of infringements. The need for such a system arises from the fact that laws are made to be complied with, and from the empirical fact that laws are sometimes violated. Compliance is not self-evident. People have an interest in protection against harmful violations and against the risk of such violations. Especially against the risk of irreparable harm. People harmed need to be compensated. These things need to be organized.

The practical implementation of the law of logic needs to be worked out. It needs to be worked out mainly in terms of a civil and criminal law. This is the duty of a part of the Administration of justice. For a large part, this job is temporary. It can be seen as a project. Use can be made of existing laws. Once rewritten to comply with the law of logic, changes are only necessary when required by improved understanding or fundamental and substantial changes in circumstances.

Laws are made to be complied with by those who accepted them. Once a law has been accepted, no one has the right to interfere with the contents or applicability of the law, and where unclear, only the judge interprets. No one in public administration has any power over the administration of justice.¹⁷ To avoid interference by people elsewhere in society, and to minimize risks due to abuse of power, the system for law enforcement should be independent. In particular independent of the rest of public administration, and of politics. In any case of conflict between verdicts of judges and assertions by others, only the verdict of judges has practical relevance. The system of law enforcement is independent and not subordinated to any other institution.

The system for law enforcement is complete in this sense, that it includes everything that is needed to handle requests for litigation, to trace or find law infringements, to have them judged, and to do what is necessary to execute the verdict. The verdict asserts at least whether or not the law has been infringed, which law(s), to what extent, what has to be done by whom to undo the consequences of the infringement (as much as possible and sensible), whether or not people are to be punished and how, and who is to pay which part of the costs of the work of the system. The costs include a surplus contribution for the operation of the system. The costs to be paid may be an estimate, to be corrected when the costs of the system in the current accounting year have become known.

All costs of the system are to be borne by the people who infringed the law. This is a logical consequence of the law of logic. Innocent people, that is, people having nothing to do with the infringements, are to be safeguarded. A contribution is also to be levied when the infringement was not intentional. The reason again being that outsiders are to be safeguarded. The more so since intent can almost never be established objectively, and because the relevance of an intention is debatable. Intentions, and the final or fatal decision, can almost never be isolated from prior decisions of the actor. As noted in the main text of chapter 9.¹⁸ A drunk may “unintentionally” cause an accident. But he simply should not have drunk, and not have stepped behind the steering wheel after having drunk. Of course, more or less blameworthy from a legal point of view may be taken into account in the determination of the proportionality factor. But to evaluate blameworthiness one should not only look at the fatal event, but also at the relevant condition setting circumstances.

The indicated financing system makes the administration of justice, and therefore law enforcement, independent from political whims. In contrast to the present, it eliminates the financial need to set priorities according to political fashions or interests, and to restrict action to only a minority of law violations.

With the exception of the law of logic, one is only bound by laws one agreed with. The law of logic is exceptional because it is needed for communication, and because it is all that is needed for that purpose. It is a premise of communication, independent of explicit agreement. All other laws are man-made, and in principle arbitrary. Our ancestors hunted and maybe even tilled the soil without any (other) law. The need of voluntary acceptance means that one can only be brought before a judge for

¹⁷ Although the administration of justice could be defined as a part of public administration, its independence and primacy make this inconvenient. Therefore the administration of justice is defined as separate from public administration.

¹⁸ See the section *Liability due to a blamable prior choice* in (sub)section 7B4.3.

infringement of the law of logic or laws one has explicitly accepted. In case of infringement one can be brought before a judge notwithstanding one's right to be safeguarded. This does not violate the law of logic since law infringement is equivalent to violation of either the law of logic, or a law one voluntarily accepted.¹⁹ This can be interpreted as one sided denial of, or withdrawal from, a contract. This can be seen as a matter of principle, as a matter of all or nothing (unless agreed otherwise). Since people only have rights due to laws which they accepted, this would mean that infringement causes loss of all basic rights (that is: those of the law of logic). But although this may be true theoretically, it seems unwise to apply rigorously in practice. Infringements and loss of rights can better be treated proportionally. Still, since non actors are to be safeguarded, actors are the only ones liable for reparation of the consequences. In case of irreparable harm, it may even be necessary to mete out punishment. It is the actors who cause the need for a system of law enforcement, and therefore are to cover its costs.

In this connection it is noted that someone who has violated the law cannot be considered the equal of someone who has not. To the last person the law of logic applies in full. But after the violation the first person can no longer claim the protection of the law of logic. His wrongful act, wrong according to the norm of the law of logic, contradicts his purported acceptance of the law of logic and all it implies. Strictly speaking he or she does no longer belong to the communicative society.²⁰

Laws are only meaningful if they include provisions for what to do in case of infringement. If they don't, they mislead by suggesting a state of affairs which has no practical significance, and can be ignored with impunity.

If it turns out that there was no sufficient reason to suspect infringement, the suspect is to be (fully) compensated. Note that there may be sufficient reason to suspect infringement even if infringement, or responsibility for it, cannot be proven.

The Administration of justice may have separate departments for various types of activity. Each requiring specific expertise. For example regarding specific industries and/or kinds of activity. Such as affecting the environment.

The Administration of justice should not be organized hierarchically. Given hardly overlapping duties, coordination is possible without hierarchical authority.

Everyone has the right to request redress. There is an obligation to prosecute.

Everyone is to be able to start a procedure aimed at closing the gap between reality and the law. To start a procedure aimed at correction of a state of affairs caused by infringement of the law. Personal harm need not be a condition. A justified suspicion of infringement of the law is necessary and sufficient for action by the Administration of justice (as an organization). Because of its duty, the Administration of justice is not free to reject such a request. The person submitting the request will only have to pay the costs if the judge finds that the request was ill-founded. In all other cases those who are suspected of law infringement pays the costs.

This regulation is meant to ensure the relevance of the law and avoid arbitrary law enforcement or worse: its use to protect or further specific interests. It is meant to keep the Administration independent. Formally and financially. There should not be reason for debatable or arbitrary priority setting. (Laws not having indicated their own relative importance). The threat of having to pay the costs of the judicial process is assumed to be a sufficient brake on requests for redress.

Where finding suspects is concluded to be infeasible, this has to be explained and accounted for. Publicly of course, and with a realistic possibility of appeal.

If parties are to be supported or represented by lawyers, and if support by a lawyer matters, -as it does at present-, then parties in litigation are to have equivalent support. They should have approximately equal financial means for their support. This can be realized for example by pooling funds. But one may also think of (equivalent) lawyers provided by the Administration of justice. For in the end, the costs are only to be shared, or paid by the requester, when there were insufficient

¹⁹ Violation of a law one voluntarily accepted is a violation of the law of logic, which requires that one means what one says. One's "yes" and "no" are binding.

²⁰ This should be explained clearly at school.

indications for the accusation. When the judge asserts that the accusation was justified, then the party having violated the law bears all of the costs.

Violation of equal treatment is to be punished heavily, as being violation of a very basic equality, and obstruction of the administration of justice. In order to supervise compliance, officials of the administration of justice have the right to check the books of parties and their lawyers.

Any proof is legal proof. Remember that the language agreement (the law of logic) requires agreement between assertions and reality. Denial that a proof is a proof is a violation of the language agreement, the law of logic. A proof is legal proof at least when it is logical and/or scientific proof. It is inconsistent, and violates the law of logic, to reject a proof. When the law has been violated to obtain or complete the proof, this does not change the nature and truth (or untruth) of the proof. The violators may have to be punished, but the criminal need not be compensated or set free. His crime deprives him of his rights. In particular his right to redress.

At present, some if not many important judgments about law infringements are made not by independent judges, but by interested members or majorities in parliaments. For example as regards correct, complete and timely information, and harmful but uncompensated consequences of the implementation of policies. This is not only a matter of unified powers, but also undermines the principle of a state (society) based on the rule of law. It replaces the rule of law by arbitrary power. That is: by a power which is free to ignore the law, including the constitution and the law of logic. Giving such a power to interested parties creates inestimable risks (as exist at present). This violates the law of logic. The constitution should ensure the independent administration of justice, as good as possible. Decisions about discrepancies between reality and the law should only be made in that framework. Nowhere else. The constitution should therefore prohibit all forms of judgment in legal matters outside the system of law enforcement.

Criminal law and punishment.

The law of logic, and true mutual respect, do not allow anybody to harm somebody else, or to create risks of harm. It requires reparation of reparable harm, and compensation for harm that is not reparable. Since harm is subjective, reparation should be to the (consistent) satisfaction of the victim. Harming someone deprives one of one's rights under the law of logic. Especially the (hypothetical) right to measure someone else's harm

There is criminal law and there is punishment for the following situations or purposes:

- Full reparation or compensation is not possible;
- Prevention of irreparable damage, and damage that cannot be adequately compensated;
- Whenever the person(s) suspected of having violated the law does not cooperate with the administration of justice and/or is in hiding or unknown: to cover the costs which have to be made to find and apprehend the suspect(s), to determine and prove illegal behavior, and to establish damage done and means of reparation and/or compensation.

Examples of punishment as a means of prevention can be found in traffic regulation and laws regarding emissions of harmful substances.

Civil law can be understood as the part of the law where all relevant parties are known, where full reparation is possible, and where prevention is not crucial.

Criminal law and actual punishment should satisfy the condition that the balance of costs and benefits should favor the desired behavior beyond any reasonable doubt. This especially, but not only, applies to prevention. This means that personal circumstances have to be taken into account, and that different people may be punished and charged differently. People who always respected one another, and thereby the law of logic, are equal, but different from those who didn't. People who violated the law of logic no longer have the right to be treated equally.

Once the strict conditions of reparation, compensation, and prevention are satisfied, and the costs made by the system of law enforcement (investigation, prosecution, litigation and whatever) have been paid, the remainder of the charge/punishment can be proportional to the harm caused. The remainder

is meant as a contribution to the maintenance of the system of law enforcement. It would not be necessary if everyone paid his own costs. But it probably is necessary because not all people who violate the law may be able to pay what the judge decides they should pay.

There is no need to restrict the means of punishment to a financial penalty and prison. One may also think of prescribed work, payment during a number of years (a kind of taxation), and partial instead of almost complete deprivation of freedoms. Of course, costs made for the punishment are costs of the system of law enforcement.

Decisions affected by violation of the law have never been taken.

When more or better information is available, someone giving incorrect and/or incomplete information in the framework of decision making is liable for the harm caused by the deficiencies in the information provided. If the decision causes harm which likely would not have been caused had the information been correct and complete, then the provider of the information is liable.

An agreement or vote partially based on incorrect or incomplete information never was binding. Such an agreement or vote has to be considered as never having been made. This rule is made to prevent trickery. To avoid the express taking of a decision in order to (ab)use it in the (maybe short) time it is seen as binding.

Note that the costs of erroneous decisions may be very high. Providing incorrect or incomplete information should therefore be deterred very strongly.

The International court of logical justice.

One of the most important characteristics of the law of logic is its objectivity. The law of logic is independent of opinions other than the most basic: self respect. Its validity does not depend on agreement or acceptance. Like $1+1=2$.²¹ As a consequence, the validity of the verdicts of an international court (henceforth denoted: Court) judging suspected infringements of the law of logic, does not depend on agreement with, or acceptance, of this Court.²² Every person on earth should know and understand this.

The main point of the proposed international court is its status in the eyes of the citizens of the earth. The law of logic should be recognized by every human being as the one and only basic law. It should be understood to be inviolable. It should be seen as a law everyone should respect, and respect rigorously. Deviations (violations) should be understood to be permissible only with voluntary agreement of everyone (potentially) concerned, after full and timely information. The Court should be seen as the court judging (suspected) infringements of the law of logic by any organization or person. Especially infringements by governments: by their acts and their laws.

The Court need not be recognized formally by anyone. It need not, and should not, be recognized by governments. It is not dependent on anyone's approval or authority.

In the opinion of the present author, the status of the Court should be founded on impeccable honesty and soberness. The Court should uphold the law of logic, and no more. Its verdicts should be simple and understandable (logical) for everyone. Assertions which cannot be convincingly explained should remain unsaid.

Even if the decisions of the Court would not have immediate consequences (such as recovery, payment of damages, or punishment), the verdicts in combination with the status of the Court will undermine the power of persons, organizations, laws, and activities found to be guilty of wrongdoing or impermissible.

If the Court cannot take direct action with respect to parties found to be in the wrong, supporting people and states can (and should) still take actions. The actions should try to execute or support the verdict of the Court as good as possible. They should be aimed at limiting and/or reducing the harm done and being done.

²¹ With this difference, that $1+1=2$ presumes agreement about the meaning of "1", "2", "+", and "=".

²² Obviously, the Court too is subject to the law of logic. It should only decide what can be decided beyond reasonable doubt. It should be clear about undecidability and uncertainty.

A Court as meant in this subsection can be instituted independent of any of the other proposals or measures mentioned in the present report. It would be a major step forward for mankind. In the first place because it would recognize the existence of an objective, logical basic law, independent of the opinions and power of any authority. The law of logic would replace, correct, and improve the (subjective, arbitrary, and even dangerous) rights of man. Recognition of the objective character places the law of logic above any government or authority. In the present world, it would greatly improve people's rights and position of power, and very much reduce the power of governments and everyone else.

Appointments.

There is a separate and independent public service entrusted with the appointment of the top officers of all organizations of public administration. Including the principal appointments in the Administration of justice. After maintaining and enforcing the law, the appointment of the (next) most important officials is the second most important duty of the Administration of justice.

Due to the very different organization of society, the abolition of the dictatorial hierarchical organization, and the dominating importance of the law of logic and the administration of justice, the importance of top officers and their appointment is far less important than it is at present. The power of officials is greatly reduced. They can no longer act as dictators. Everybody can force the Administration of justice at any time to prosecute any officer for failing to do his or her duty. It is not sufficient to have friends in high places, if such places would still exist; which they don't.

The Appointments Service or a law should stipulate requirements for the various top officers. Before an election, it publishes a report with evaluations of the various candidates in the light of the requirements.

As regards the administration of justice and appointments, there may be a nearly unsolvable difficulty. To wit, assuring the quality of the highest judges.²³ Where quality refers to both integrity and competence. Integrity including independence. A judge should say what is true even if everyone finds the truth inconvenient, or great interests are at stake. Given the empirical evidence of whistleblowers and that of for example the book *Reporter* of Seymour Hersh, mental independence may be the rarest quality. Of course, the system described here is expressly devised to reduce the gap between truth and reality, and to eliminate grounds for the fear of speaking the truth. But it remains to be seen how the new constitution works in practice, and how it will be changed before changes become irrelevant. Especially in the first decades after its institution surprises cannot be excluded.

(Ultimate) Supervision.

The present study has unambiguously shown a general lack of effective supervision. It has shown that the self proclaimed representatives of the people don't supervise the supervisors. The proposed constitution creates supervisors. The measures for organizations described earlier should reduce the risks due to hierarchical organization. They ensure transparency. It will moreover be much easier to call organizations to account. This should substantially improve the quality of the supervision. As an additional guarantee, people are always free to take the initiative and interfere and overrule whatever they want (within the framework of the constitution of course). This ends the complete lack of effective power of the people whom everyone in public administration is supposed to serve.

Every public service organization is supervised by a public supervisory organization. A single supervisory organization may supervise more than one public service organization. Every year the supervisors publish evaluations of the organizations they supervise. These reports are required to give a judgment about the performance of the service, and of the efficiency with which the service is produced. Where a supervisor deems appropriate, the report makes recommendations. Where it deems necessary it prescribes changes to be made. Supervisors are authorized to discharge officers. They may

²³ Highest because of the appeal system, not because of hierarchical organization.

evaluate their appointment, and ask the Appointments service to correct its procedures and provide a replacement.

The supervisors are to represent the people for whom the service(s) is provided. Remember that the service is called into being by and for a group of people.

Needless to say that supervisors and people are bound by the law of logic, and the supervisors moreover by the constitution. Nobody can amend the law of logic.

The supervisors are responsible and liable for their annual and other reports.

Ultimate supervision is exercised by the people. People are to be given many more rights than they have at present. (At present, and with regard to public administration, people are practically powerless). On the other hand instruments and/or mechanisms should be introduced to force people to act responsibly. The obligation to pay (all) the costs of invalidated prosecution requests is one of them. People should have ample opportunity to take initiatives. To prevent harm, impulsive actions should be prevented as much as possible and necessary. They should not be allowed to have far reaching and/or lasting effects. Rules and/or procedures should prevent impulsive actions. People should know that they have to think seriously about what to do (choose). They should be trained to act responsibly. People should have the opportunity to correct themselves. They should be allowed to learn from experience. They should not claim that they never make mistakes.

However, decision making by common people should not be subjected to more or stronger conditions than that of people in a public service.

The people concerned can appoint and discharge officers. Any relevant officer. People can overrule decisions of the Appointments Service. No public service should get the idea that it has independent power, or that there is no effective control. The present dangers of elections of persons, the abuse by candidates of elections, are to be greatly reduced. What may be the most important measure has already been mentioned: the possibility to fire any officer, including elected officers. In the section on appointments it was already noted that candidates must satisfy requirements appropriate for the function they aspire to. Not everybody can be elected in every function. The false fiction of generalists, people who are said to be suitable for every top job, irrespective of education, experience and proof of ability, is abolished, at least as regards public administration.

Candidates are bound by what they say. Especially in election campaigns. The information they give is to be correct and complete in all relevant respects. (Misleading half-truths automatically wipe a person off the list of candidates, and are punishable). Candidates are bound by their promises. If promises are conditional, the candidate should mention the conditions.

A public service can be rendered by a private organization. But every public service is supervised by a public supervisory organization.

(Other) Public services.

Main characteristics and their motivation.

Public services denote services which a group of people wants to be done in such a way as to be able to supervise and control the service. Public services can be distinguished from private services, which some people may appreciate and pay for, but see no sufficient reason to control. By means of laws they may nevertheless exert the influence they think necessary.

The Administration of justice is the most basic and important public service. It is a consequence of the desire to communicate. Communication requires a power that guarantees agreements and other communicative acts. Otherwise the language agreement or law of logic is meaningless. Contrary to all other public services therefore, the Administration of justice requires no additional or separate agreement of the communicants. Though the specifics of the organization do.

In the subsection on the law of logic the reader was reminded of two important dangers of centralization of power, especially in combination with hierarchical organization of the state. In the first place centralization increases the gap between required capabilities and actual competencies of top officials. In the second place it means that errors or misconduct have more negative consequences and pose greater risks. Already with the present rather solid guarantees of freedom of the press one can

observe essential gaps and biases in public information. The gaps and biases prevent correction, and conserve the status quo. For the powers that be, censorship would be far worse. It would show that the appearances are no more than a facade. As it is, the illusions of freedom of the press, objective information and a critical press can be upheld without difficulty.

It follows that concentration of power is to be avoided as much as possible. Power should be as limited as possible. It follows that as much as possible should be decided, regulated, and done, as locally as possible. As far away from the center as possible. Literally and figuratively. No power should be transferred to a larger geographical area if this isn't absolutely necessary.²⁴

Another form of deconcentration is making organizations which produce separate coherent sets of services autonomous. At present governments consist of a group of ministers, each of whom is responsible for one or a few of such sets of services. In order to fulfill his duty, each of the ministers is provided with a hierarchical organization, and made its head.

In the present world, a government would seem to have two principal purposes. In the first place it is required to decide on the distribution of the taxes over the various government departments. In the second place it enables ministers (and politicians in general) to help each other to retain power. A prime minister is not only helpful as chairman of cabinet meetings, but also suggests unity of government. A prime minister also suggests or represents hierarchical organization. This way of organizing things helps individual politicians to retain power. It is much easier to fire just one minister than a complete cabinet, and it is much more difficult to argue against a block of ministers than against a single one.

Cooperation and coordination do not require a cabinet however. Taxes need to be distributed only if levied as a percentage of income, capital, etcetera. That is: if taxes are independent of the activities to be paid by them. There is no need to redistribute the income a coffee producer. One pays for the coffee, and that is that. No one will suggest a tax increase to fund a new government food service, to provide coffee specified by law. Someone looking at the practical reality of government will easily see that almost all work in the separate fields of government is entirely independent of the work in all other fields, and doesn't even need coordination. To a very large extent, the existing ministries are separate kingdoms. In other words: the operational reality of the actual arrangement suggests that a structure with separate autonomous services is feasible.²⁵

A public service can be provided for everyone who has agreed with the regulation calling it into being. Public services can be thought of as associations. The organizations have no hierarchical relations with respect to each other. They are not subordinated to any organization or person. In principle at least they are financed independently. Their regulation (law) stipulates how they are financed. For example by entrance fees, taxation, and/or paid services. Since avoidance of concentration of power is a principal purpose of the new structure, there are no personal unions: a person is allowed to work for at most one of the organizations mentioned in this appendix.

Experience shows that hierarchical relations do not guarantee (internal) coordination, while autonomy hampers neither coordination nor cooperation.²⁶

The public service organizations are transparent. They account publicly at least once a year by means of an annual report.²⁷ They are supervised. Their principal officials are appointed by the Appointment service.

²⁴ In theory concentration may sometimes be more efficient. But where no comparison is possible and where organizations are 100% opaque, proof is entirely lacking. Evidence of inefficiency on the other hand abounds. See the first book of the present report, and the growth and excessive size of the US National Security Agency (NSA). Experience clearly shows that in the absence of any serious form of control, abuse of money and power is to be expected. Self restraint has nowhere been observed.

²⁵ But note that notwithstanding the umbrella-like framework of a unified government, coordination may at present actually be insufficient.

²⁶ In fact, the main activity of governments and parliaments with respect to its many agencies seems to be the appointment of political friends as their heads. And of course providing them with a budget. But the budget power clearly has not been effectively used to ensure appropriate operation. The history of the financial crisis provides ample proof.

²⁷ An annual report should describe the activities in the year under consideration and the results obtained. It should give a picture of the state of internal affairs and those in the relevant environment. Including problems

Publishing a clear annual accounting is one of any organizations duties. Purported inadequacies in the report, or any report of a public service for that matter, can be submitted to the appropriate supervisor and court.

A person who thinks that a service does not fulfill its duties properly- in accordance with its regulation- can submit a complaint to the Service. When the reaction is thought to be inadequate, the complaint can be submitted to the appropriate Supervisor. When the reaction of the Supervisor is deemed inadequate, the complaint can be submitted to a court. With respect to the Service and the Supervisor the court has far reaching authority. The Administration of justice being the foundation and principal pillar and power of society.

Principles.

By definition, for a given person, none of the public services is strictly necessary. The services can be established on a voluntary basis, by and for those who want to use it, and are willing and able to pay for the services rendered. Although this may be hard to believe for someone living in the present era, a look backwards in history quickly shows that not the present is representative, but situations with at most marginal public services. Early civilizations began with only a part-time judge. As a rule- valid even today- governments were/are possible and could/can grow only thanks to a monopoly of weapons which were/are the most advanced or costly of their time.

In organizing public administration the following principles should be taken into account as boundary conditions:

- To prevent the risks of the abuse of power and impossible duties, hierarchy is to be avoided as much as possible.
- Someone charged with a duty should have the personal abilities to execute it properly, in accordance with applicable norms.
- Everyone is liable for his own activities and omissions, including activities and omissions in the framework of his duties (job).
- This does not mean that liability cannot be shared (voluntarily). But it does mean that everyone involved in an activity, or a decision to refrain from actions, bears part of the liability. Where there is a hierarchical line, it automatically participates in the liability.
- Annual reports make known who is responsible for what.
- Annual reports mention different views on all subjective matters which may be important with respect to the duties and mission of the organization (the anthropomorphy fiction²⁸ is abolished).
- In organizations, the three powers are separate. That is: the executive power, the power to make and prescribe internal rules, and the power to judge violations of these rules.
- Every public service is supervised by a public supervisory organization (which itself is a public service).
- Supervisors report at least annually about the effectiveness and efficiency of the fulfillment of the duties and other obligations of the agencies under its supervision. Where it deems fit, it makes recommendations. This provision is intended to make evaluation more professional, and thereby to serve the public.
- Every employee has an obligation to report plans (for) activities which are incompatible with the law, duties, obligations or any other applicable norm.²⁹ He or she should first report internally to the relevant colleague. He or she should report externally if within a month no correction has taken place and no satisfactory written reaction has been received. Failure to report misconduct which one does or should know about, makes liable and is punishable (because it should be prevented).³⁰
- If a justified report about misconduct or failure is thought to make cooperation impossible, those

and risks. The annual report should account for policies. The annual report can be used as an aid for fulfilling (other) duties. The annual report includes financial accounts, plus explanations.

²⁸ The anthropomorphy fiction= the fiction that an organization can be seen and treated as a natural person.

²⁹ As everywhere in the present report, “employee” includes the managers.

³⁰ The defense “I didn’t know” is inadmissible. One is expected to do one’s duty according to all relevant norms. One can at most be exonerated if one proves having tried, but could not etcetera.

who misbehaved or failed, and those who are responsible for the misconduct or failure, are discharged (dishonorably), and not the person(s) who reported the misconduct or failure.

- Like everyone else, supervisors are liable and punishable.

Reasons to prefer a public over a private service.

There seem to be two main reasons for preferring a service to be public instead of private. The first being the belief that public management and control are better than private. Due to absence of a profit motive, all attention and energy can be directed at optimization of the quality and quantity of the service or product. The present work has amply shown that this belief can only be ascribed to illusions and an almost complete lack of knowledge of the facts. Where the lack of knowledge can be ascribed to the opaqueness of public organizations, terroristic repression of whistleblowing, and the bias and self censorship exerted by the media and science. The analysis of the cases described in the present report shows, that illusions about public organizations are contrary to experience, and dangerous. In the management of public organizations, integrity and professionalism in general is absent or inadequate. There is no reliable supervision, and supervisors are seen to be lying.³¹ The present report has shown beyond any doubt that the present politicians cannot be trusted with anything important. There is no ground for confidence in the management and control of the given public organizations.

The second reason to prefer public to private service comes into play when it is thought that everyone should be able to use a service equally, and that this is impossible if people have to pay for the service by themselves. Some public services could be financed by what can be seen as an insurance premium. Sometimes this may be sufficient. At other times a problem may be, that for some people the premium is considered to be “unreasonably” expensive. The difficulty resides in the combination of income differences and the average (“reasonable”) costs of the service to be rendered. For a substantial number of people, the price which many other people are willing and able to pay for a service exceeds their capabilities. In the case of Dutch health insurance, the problem is “solved” by requiring everyone to pay a relatively low premium that does not cover the costs, and finance the deficit by (very unequal, but generally >40%³²) taxes.

There also being the requirement of efficiency. The service should be used when necessary, but only then. And it should only be used for the purpose for which it was instituted. People should have reasons to think, and do what they can do independently, before asking support.

Another reason for preferring public over private organization may be, that some people say that on certain kinds of service no profit should be made, or that profits should only be used to maintain and improve the service. Profits on these services should not be used for private purposes. This looks like a legitimate argument, related to efficiency. One should not however let ideals blind oneself to good reasons for allowing profit making. In essence, making a profit means that the financial situation of the organization is healthy. It means that it can be continued without major reorganization, price increases or something similar. Profits cannot and are not only handed out to shareholders, but are also used for salary increases, improvements, innovation and other constructive ends. The incentive to make or increase profits supports the effort to improve efficiency and make room for more or better service. Such ends at least are desirable. Experience does not particularly abound with examples showing such ends to be realized by non profit organizations. Rather the contrary: many non profit organizations never stop asking for more money. More money meaning: more than warranted by efficient operation and inflation. Education, health care and public transport being three very costly examples.³³

In public as in private organizations one should keep in mind that making or not making profits may only be appearance. It does not say anything about the efficiency of the organization of the work,

³¹ For example the financial supervisors before and during the financial crisis, and de Dutch General accounting office (the Dutch GAO) with regard to integrity and ICT.

³² Including indirect taxes such as value added taxes (VAT).

³³ From personal experience the present author knows that proposals to realize significant efficiency gains by ICT applications were shelved by the ministry. The inquiry he was asked to make seems to have been ordered only to support claims for more money, not to show that education could be improved with less money, as it actually did.

the efficiency of the organization structure, and last but not least salaries. Which most of the times account for more than half of an organizations costs. Raising salaries can easily turn profits into losses. Both making and not making profits can be coupled with an inefficient organization structure (redundancy of personnel) and high or excessive salaries. Healthcare is an important example. The organization structure is far from simple, and may easily escape scrutiny. Many doctors having salaries far exceeding the national average salary. The profits may be negligible as compared to the sum of the salaries of the better paid employees of the organization. It is in other words rather strange to complain about profits while being silent about salaries which are unheard of in most other sectors of the economy. It does not seem likely that people who object to profits, would at the same time support doling out salaries which disproportionately enriches a specific class of people. Salaries which by definition are used for private purposes.

So when considering the choice profit or non profit, one should understand the relativity of these concepts, and ask oneself what other goals one wants to see realized, and how they can be realized, simultaneously and reliably.

Note that everyone needs food, but that food production and food distribution are not only private, but that nobody even proposes to make them public. Notwithstanding frequent food related scandals.³⁴ Leaving food production and distribution private can be defended by pointing out that for almost everyone (in the so-called developed world) the total costs of food is only a relatively small part of his income. This differs greatly from the potential costs of medical care.

The free rider problem.³⁵

The free rider problem is the problem of people taking a “free ride” when they are required to pay; payment being required to cover the costs of the service rendered. The problem exists whenever people can use products or services paid by others, and checking payment is relatively expensive. It also exists when some people pay much more than others, while the benefits are the same for everyone.

In the present political-legal system, public transport and various social benefit systems may serve as examples. The problem can sometimes be solved by supervision and by cost-effective penalties. In the case of social benefits the problem sometimes seems difficult to solve. Abusers may be unable to pay a penalty, and imprisonment also costs money.

The free rider problem is not an artificial problem, and need not be caused by obstructors or saboteurs. There is no basis for requiring people to contribute financially or otherwise when they really do not want to use a service and actually don't. (They may still contribute voluntarily of course). The problem is especially hard if the service requires a minimal but large outlay in order to be meaningful, and even more if a large part of the costs is not incidental but recurrent. As for defense. In situations where there is an objective possibility (probability) that people will use the service whatever their (present or past) opinion, or cannot avoid using the service, it may be possible to show that the law of logic requires objectors to contribute to a fund or provide a loan, under the condition of refund when the service has not been used during the lifetime of the contributor. The present author does not know. Some additional observations are presented below, in the section on defense.

Transition and financing.

To minimize unjustified harm and risks, the transition from the present political-legal systems to the new should be piecemeal. As regards taxation and the payment of public services, this suggests piecemeal transition by gradual reduction of taxes and increasing reliance on voluntary participations and memberships. This allows time for services to get accustomed to transparency, accountability and reliable supervision. It gives them time to improve services in such a way as to convince citizen-buyers by better products (services).

³⁴ Examples: spreading very serious illnesses (BSE, Q-fever, salmonella), maltreatment of animals both at farms and slaughterhouses, use of pesticides, pollution of water and soil.

³⁵ For a more comprehensive discussion the reader is referred to the literature on public choice.

Examples of public services.

Please note that in principle, most if not all public services can be rendered by private organizations. Making a service public is a matter of choice. The service need not be a monopoly. For a given set of services there may be more public (and/or private) service organizations, doing approximately the same things. The supervisor concerned should try to compare their efficacies and efficiencies, and make suggestions or recommendations to improve them. Note that having a number of organizations doing similar things may sometimes be less efficient than a single organization theoretically, but that it is very hard or impossible to prove that a monopoly organization is as efficient as can be. While it is obvious that a monopoly has great opportunities for inefficiency.³⁶ Several of them were seen in the empirical parts of this report.

The following sketches examples of possible public services. Only more important differences with the present system are mentioned.

Education.

The primary purpose of education is to enable participation in society. In the first place: to take part in social decision making processes.

The law of logic embodies mutual respect. Experience shows that mutual respect is not self evident. Giving respect often requires mental capabilities. One should for example understand what “respect” means. And that it imposes conditions on the organization of society. Including the law. It should be understood that mutual respect requires social decision making by unanimity.³⁷ The “social” indicating that everyone in a given society is concerned.³⁸

A world based on mutual respect needs adapted and better education than we have at present. Whether education is organized publicly or privately, this requirement should be fulfilled, and supervised. This can be seen as a consequence of the law of logic.

An important reason for making education a public service is the idea, or norm, that every child should be given equal opportunities, in combination with the belief that this can best be realized by having a uniform education system, and by reducing the potential influence of the incomes of parents to a minimum. Indeed, substantially higher entry fees of decidedly better schools reduce the chances of children of lower-income parents at for example the labor market. In other words: such a system causes harm, which is not permitted. The law of logic would seem to require that everyone be allowed to develop him or herself as good as possible. At the same time, it seems harmful to create separate, hardly or badly communicating classes of people by separate school systems (used as a general term, including universities).

As part of the preparation for participation in society, education should show and explain the failure of present constitutions, liability law etcetera, as this work has done, or better.

Healthcare.

This example is well known and widely discussed, without however yielding a generally accepted solution or approach. An open, comparative, international study would be most welcome. Since it seems impossible to do justice to the subject in a short discussion, and since time is in short supply, the subject and its unsolved nature are only mentioned.

Public transport.

³⁶ “Competition” does not however always mean what economist want us to believe: a guarantee for optimal efficiency. If only because competition does not require optimization. It only requires being at least as efficient as the competition. Doing part of the (inefficient) job in low-pay countries may suffice, for example. In other words: choosing is not simple. More empirical research into the internal operation of large organizations may help. As the first chapters show: opaqueness of an organization may hide excessive waste.

³⁷ And that this would be equivalent with majority decision making if acceptance of the proposal would really increase the general welfare, and not only the welfare of some at a greater cost to others.

³⁸ It could be called political decision making, if such a designation did not have so many (justified) negative associations.

For the present version of *Governed by lies* it seems sufficient to note that in the present world there are both private and public transport corporations. The private ones may be subsidized as much as public ones, in order to keep prices low.³⁹

Roads by the way, and all other services needed to enable the use of the appropriate vehicles, should of course be financed by their users.

This example is well known and widely discussed. As for healthcare, an open comparative international study would be welcome. Since time is in short supply this subject too is left without comment.

Security (formerly called defense).

At present, mankind lives in many separate and different political-legal states. Each with its own government and army. In quite a few states, the army controls the government. Where the government seems to control the army, the army often is a state in the state. To some extent this is the case in the Netherlands⁴⁰ and in the USA^{41 42}. The evidence shows that the top of armies is just another form of politics, and cannot be relied upon. Control and supervision are dire necessities. Obviously the control of armies is a major problem.

At least two measures can be taken to promote the attitude, out and inside the army, that it exists, and only exists, to serve the people. The first measure is education. The second is the method of budget control. For its budget an army should depend on its supervisor. An army (the defense service) should not have its own system for collecting money.

Armies are necessary only because other countries have an army, and pose a risk. Even if for the time being they seem to pose no risk whatsoever. As long as the policies and officers of states may change, the risk may vanish or explode at any moment. The risks posed are proportional to the size and quality of the armies, to be measured relative to that of the state under consideration. Political circumstances may reduce the risk (even greatly). But as noted, political circumstances may change. Given these facts, it is hard to decide what to do precisely. In general there will be more than one solution. Cooperation will help, over-arming does not: it may be seen as a challenge and initiate or stimulate an armaments race.

Already for centuries, armies can hardly be considered solutions of a problem. Wars can be seen as means to an end even less. They make very many innocent victims. Everything should be done to keep the peace. But in fact, next to nothing is done to prevent armed conflicts. There is no evidence of any significant risk management. Knowing that an attack by a foreign power, and the employment of one's own army, will cause immense suffering and irreparable destruction, professional policy making requires the greatest possible efforts to timely reduce the risk, and to find, develop and realize alternatives. Evidently, nothing like that is happening. The budgets of defense systems are large. At the same time, there is at best a microscopic budget for efforts aimed at reducing the risk of the use of armies. Less than one person per thousand would mean: less than 0.1% of what is spent on the army.⁴³ In the past decades, years passed without a sign of any serious effort of this kind.

Everyone can see that nowadays and in the past decades, politicians only pay attention to defense budgets, and none to any other (or rather real) means of protection. This supports the conclusions of chapter 9 about the characteristics of politicians and top officials. One can only rely exclusively on the present armies and arms if one has no true respect for human life and is insensitive to human suffering. And if one has no knowledge of history, and no knowledge of the extremely destructive power of modern arms. The situation in 2020 seems no better than that of 1910 or 1935. There is definitely no convincing evidence to the contrary.

³⁹ That is: at an unrealistic level, the “unrealistic” being at least partly caused by heavy taxation. It is a deformed world we live in.

⁴⁰ See the case Spijkers, and the way it was formally ended (somewhat), and the many (even similar!) cases of decades-long duration which continued to show that no effective correction had taken place.

⁴¹ See for example the book *Reporter* by Seymour Hersh, and *A Problem from Hell* by Samantha Power. In the last mentioned book see especially chapter 12 on Kosovo.

⁴² For France there is strongly supporting evidence from the time of the Dreyfus affair (1894-1906, see the book of Reinach quoted before), and from the decades after WW1 or before WW2 (Shirer's *Collapse*, also quoted before).

⁴³ In many states, this would mean a very large budget for efforts to reduce the risk of armed conflict.

In other words: the problem of defense is not easy, and the present policy is indefensible. The situation can only be explained by assuming dictatorial power in the hands of dishonest, incompetent and irresponsible people. Defense policy is utterly unprofessional and unconvincing, if not outright aggressive and suicidal.

Payment for defense poses the free rider problem. The more so because people need not agree that an army is necessary. They may think that the cure is worse than the disease. They may agree with the principle and disagree about the size of the budget, about the specific armaments, and the suitability of the top brass and policy makers. They may have good reasons. To at least some extent the problem is unsolvable. "Adequate defense" seems impossible to define unequivocally. It is no better with the practical requirements of an adequate defense (once defined). A minimum outlay is obviously necessary for an army to be able to discourage potential attackers. But too large an outlay can be interpreted as a challenge. The ensuing process may require ever higher budgets. As in the cold war. Given this manifold of real problems, much more efforts should be spent on the development of reliable and convincing defense, peace and disarmament policies. History abounds with examples of expensive armies which completely failed. Justifying the refusal to contribute and participate.

It seems risky to let defense depend on voluntary contributions, on sharing the costs equally, or according to income or capital. Defense costs might be covered by insurance policies. But there are at least two important differences with a "normal" insurance. First: for defense expenditures the sky is the limit. Second: no reliable guarantee can be given. In such a situation, a normal insurance would not be bought. And the insurance interpretation does not solve the free rider problem. Getting rid of armies everywhere clearly is the best if not only real solution.

It seems clear in any case that potential participants and contributors need more and better convincing than with respect to the other public services, and much more and better than in a "representative democracy". Those making defense policy and those managing the army need to understand that they need to be open, and act responsibly and accountably. They should be exemplary. Their words and deeds should broadcast the message that they are working honorably and professionally for the common interest, and have very good reason to be convinced of the necessity and quality of what they are doing. They should understand that they need the trust of the people, and that this trust has to be earned. Not once but permanently. Questions and comments of the people should be taken seriously. Perpetual requests for more money for planes, ships, and tanks, without credible argumentation for need and adequacy won't do. Requests which are not very well founded only prove lack of respect and exceptional arrogance. Scandals and repression or manipulation of information make matters worse.

A convincing defense (or rather security) policy first of all requires a very much greater effort to show that everything possible is done to avoid the need and use of arms, and to reduce armaments. Very much more should be done to improve relations between states, to improve and develop instruments directed at conflict resolution, and reducing armies and armaments. Showing what a good state looks like should be part of the policy.⁴⁴ The risks of armed conflict are excessive, and risk management therefore requires very substantial efforts (including budget) to prevent it.

Though the problem of defense isn't unique, it certainly is the problem with the biggest budget. Due to general conscription and advanced technology, credible and effective defense requires a cooperative and painful effort. More than every other public service.

Reaching the outlined goals may be helped by gradually making the security budget more dependent on voluntary contributions, while simultaneously introducing better discharge and appointment policies, and better supervision.⁴⁵

Litigation support.

By definition, the law, and first of all the law of logic, is to be upheld. With respect to the law of logic, everyone is an autonomous being. In this sense everyone is equal and has to be respected equally. When reality is to conform to the law, the law is to be upheld equally. It should not be upheld

⁴⁴ This is why the status quo supporting state of the quasi-science of law is so shameful and harmful. A science of law could greatly help develop a more peaceful, stable, and durable world.

⁴⁵ Where necessary, discharges should be initiated by the supervisor.

differently for different people. The law moreover is the law, and the same for everyone. It is meant to have the same meaning and practical implications for everyone. Together this means that differences in legal support should not affect the outcome of litigation. People in a conflict should not therefore have assistance of significantly different quality. They should be supported equally. This can be seen as a reason to provide legal support by means of a public service. Everyone involved in a legal conflict paying an equal or income-proportional contribution, and the service providing equal support to parties in litigation. This service could be included in the Administration of justice.⁴⁶ The parties in the wrong paying the costs of the legal support of all parties in the litigation.

It is rather amazing that such a service has not yet been realized.⁴⁷ Insurance for legal assistance obviously is not the same, since insurance is meant to guarantee assistance, not necessarily assistance of the same quality as that of other parties.

Remarks.

A fundamental difficulty: the variety of mental abilities.

The law of logic gives everyone equal rights to begin with. One can only lose rights by abusing them. One can lose rights which were abused, and proportionally. The use of rights is not allowed to violate rights of others, for example by creating or increasing risks. Redress and payment of a penalty do not restore the initial state however. Infringements show risks. One cannot equally rely on someone who broke an agreement, and someone who never did. Education should explain this, and warn of the consequences of misconduct.

The equality with respect to the law of logic arises from the autonomy of persons as communicants. It does not arise from anything else. It does not arise from any form of biological or psychological equality or equivalence. It cannot. Biologically and psychologically people are different. They are not equal at all. The question is: in which circumstances are the differences irrelevant, and when do they matter? In the last situation: how are they to be taken into account?

Quite generally, a decision maker should know and understand his options. In particular he should understand the consequences and risks of the different options. The ability to make choices is not in doubt: every animal, being able to move freely, has this ability. In the context of collective decision making, the problem therefore is not whether people can choose. They can. The problem is rather: can they choose consistently? Consistent with the facts, and consistent with their prior choices. Consistency is one of the few requirements of the law of logic. The reason being simple: communication is meaningful only under condition of consistency.

Sometimes inconsistency is easy to prove. But not always. And worse, it may not be a matter of yes or no, but rather a matter of more or less. This is an important practical problem. But however this problem is resolved, the essential point is that more inconsistency should reduce the weight of a voice and a vote.⁴⁸

At present this problem is fully ignored. It is quasi resolved by allowing people to vote only once every two or three years, and only for "representatives". That is: by making votes relatively insignificant. This is a solution at most if those who actually select the candidates and put them on the list to be voted, those who vote for a candidate (or rather a political party), and the candidates themselves, are sufficiently competent to do properly what is asked of them. The cases prove that these conditions are not satisfied. Not at all.

The above facts clearly show that politicians do not really take (other) people seriously.

The present report shows that according weights, or relative influence, proportional to the level of education is not justified. Perhaps better educated people could in principle make better choices. But

⁴⁶ A practical reason being that enforcement should be possible, and better be close at hand.

⁴⁷ The more so since the suspicion of undue influence of money is already known for centuries. On p. 358 of volume 1 of the *Debate on the Constitution* in the Library of America one reads the following text, published by Civis Rusticus in the Virginia Independent Chronicle of 30 January 1788: «The rich here, as in all other countries, will have an advantage over the poor, in all cases where the services of eminent and learned men are to be commanded by the influence of money.»

⁴⁸ And influence in general.

in practice they mostly don't. In at least an estimated 999 out of 1000 cases they attach too much importance to secondary or irrelevant factors, to properly do what their duty requires.⁴⁹

In a more distant future, votes could be registered, and checked for consistency by machines (computers). The working of the machines to be open to public scrutiny, and the data themselves inaccessible to any human being. Of course, this requires far better machines (at least far better software) than available at present.

For the time being, equal voting rights can be retained. Elementary exams, checking only for elementary abilities, excluding evidently mentally incapable persons, may be considered. At least for the first part of the transition period, better education, preparing for responsible active citizenship, and reduction of the power of present politicians, seems much more important than voting rights. Another kind of check on consistency might be voting twice on important matters, after a fixed, predetermined, period. What is important to be determined by the Administration of justice. Voting twice would resolve the problem posed by the often observed phenomenon that elections and referenda are followed by communicative processes of a very different nature than those before the vote. Sometimes discussions only start after an election or vote. Instead of before.

Power lusty people are to be removed to positions where they can do no harm.

A major problem is the existence of excessively arrogant, insensitive and power lusty people, who have very few analytic and synthetic abilities. People who until now think they have no better career choice than politics, as it was and is. Politicians and their cronies should be removed from all positions requiring integrity. They should be rigorously kept out of harms way. Interviewing them or publishing their opinions should be punishable. They should not be heard (or read) and heard of any more. It is a very dangerous mistake to think that for example their hypothetical experience is useful. (It is only useful in a positive sense in fundamentally better people). Their competence is only apparent, an illusion created by themselves and their peers. The evidence shows that they do not only don't have the integrity and competence they claim, but- as a class- are responsible for inestimable suffering and harm.

It is a very great shame that someone like Napoleon is still considered "great", and remains to receive the greatest honors.

Minimizing risks requires careful transition.

It should be obvious that the new constitution has to be introduced piecemeal, and not abruptly, in a revolutionary way. This is a matter of risk management. Unnecessary risks should be avoided, and correction kept possible. It is easy to see that most if not all of the measures allow for piecemeal introduction or implementation. The method of introduction should allow for correction of unforeseen harmful or dangerous effects, and for prevention of such effects getting worse.

It will not be possible to realize the transition without harming anyone, if only because all top officials will lose their job. In this regard it should be kept in mind that the right to be safeguarded is not absolute. The right depends on compliance with the communication agreement. One loses the right by breaking that agreement. For example by deceiving or harming other people. In other words: people who did not respect other people's right to be safeguarded have no right to complain if they suffer from the transition. If such people should pay damages and/or be punished, or harming them is unavoidable, these should be as proportional as possible to the harm caused, and the lack of respect demonstrated, in the position(s) a person occupied in the former political system. The most innocent people should be safeguarded most.

⁴⁹ The estimate is only of orders of magnitude, and based on the frequency of whistleblowing, and the failure to blow the whistle.

Personal afterword.

Introduction.

In this afterword I would like to discuss three topics. First I would like to elaborate a little on a conclusion which may be the most fundamental and important of this report. Even though it may be the most difficult to accept. To wit, the conclusion that man has far too high an opinion of himself. In respects of great practical importance, man does not know himself. And whatever he knows and understands is not taken into account sufficiently to ensure the security and welfare of everyone. In the hands of people as they are, (hierarchical) social organization and technology guarantee catastrophe.

Secondly, given the findings of this report and the experience gained by trying to get Wellink prosecuted, I would like consider options for initiating a development towards a more respectful and less dangerous society.

In the third place I draw attention to the betrayal of society by journalists and scientists. Without their de facto collusion, the present political-legal order would be untenable. Much more would already have been done to correct and improve it. It is of the greatest importance that they start to do what they promise in their codes. Not only because it is of vital importance that the full truth be told instead of lies in the guise of suitably selected half-truths, but mainly because a fundamentally better alternative to the present political legal system should be available when the next catastrophe strikes. Lack of a better alternative means resumption of politics as usual, and ever more and bigger man-made catastrophes.

Man strongly overestimates his mental abilities. Survival requires modesty.

The conclusions of the present report, and the apparent absence of something similar in the literature, has thoroughly changed the way I look at “man”, human society, and history. As a result of this work, I think history and the present state of mankind can only be understood if it is realized that it is misleading to think in terms of a general concept of “man”. The differences between people being far too important. Interpreting people in terms of a general concept (model) leads to important erroneous conclusions. Of course everyone knows that people differ. Many people will even acknowledge that people differ a lot. At the same time people often argue in terms of a generalized concept “man” as if this can be done in a consistent and meaningful way. In general it cannot. In the explanation of many social phenomena, the differences between people are much more important than the similarities. The findings of the report show that lack of awareness and knowledge of these differences hamper understanding of social phenomena and history. Only the distribution of different characteristics in mankind as a biological population, together with relatively weak mental abilities and the specific characteristics of “political leaders”, can explain the horrors of history and the present sorry state of mankind. Conversely: the evidence is completely incompatible with well intentioned competent heads of public administration. It is incompatible with the hypothesis of their being “normal”, or just like any other “man”.

That (all) people have “relatively weak mental abilities” is easily explained. Namely by the relatively short time which has elapsed since our ancestors were just animals among animals, and lived lives no more complicated than the lives of any other animal. Given the speed and chronology of the evolution of species, it seems impossible to explain substantially greater abilities than those of animals. Given the relatively short time span of man’s evolution as man, it would be more than a miracle if man had become adapted to the present (social) world in a way deserving of respect. Taking his short evolution into account, there is nothing amazing in mankind’s shameful history and present. Animals are adapted to their way of life and to their environment. Man is not and cannot be. In a relatively short time, man’s way of life and environment have changed fundamentally and to a very large extent. In the given time span, the species of man cannot have changed substantially.

The phenomena discussed in this report, and the fact that there is as yet no other publication which openly analyses and explains them, are incompatible with the assumption that man is a highly

intelligent being.⁵⁰ Where it is assumed that inconsistent thinking and inconsistent behavior are incompatible with “highly intelligent”, or even “intelligent”. Obviously, simply claiming to be intelligent proves nothing. What is shown in the present report is compatible however with the assumption, that hardly any evolution has taken place since man’s existence as an animal. It is compatible with the assumption that man is simply not adequately adapted to the world he lives in. Hardly any adaptation to the given artificial circumstances is observable.

The phenomena discussed in this report are compatible with man as a species of animal able to communicate among themselves. Somewhat at least, and within subgroups. At the same time man seems to have hardly more mental abilities than necessary to survive as a species, and to procreate as other animals do. Where the ability to survive more than a few thousand years of writing remains to be proven. For one thing, up to now mankind has been unable to get rid of its respectless, arrogant, and incompetent rulers, who nevertheless wield unimaginable destructive power. If man has the illusion of being a superior being, that illusion can only stem from selective observation, inability or lack of reflection and analysis, the silence of those killed and maimed by wars and other misdeeds, and the invisibility of most of what has been destroyed.

There is no proof of large mental powers whatever. None at all, and in nobody. Rather the contrary. It is true that there is an apparent (at least temporary) success of the ability to communicate. (Though not on balance). At the same time there is a complete inability to improve the world in a way that is consistent with almost universally avowed, and anyway logical, norms and values. Survival has never been more at risk than today. Wars and mass killings continue to take place on an unprecedented scale. In general without anything effective being done to stop them. People who are not directly involved try to profit as much as possible by selling arms and other instruments of destruction (without prior press releases). They do little or nothing to stop the destruction. The profiteers include governments of countries claiming to be democratic and to respect human rights.

The illusion of man as not only a relatively, but even absolutely superior being can only arise from misinterpretation of mankind’s technological accomplishments. As argued in the next paragraph, these accomplishments signify very little, and do not justify a conclusion of superiority. The accomplishments do not mean that anyone can even derive Pythagoras’ relatively simple theorem. They do not mean that even top officials understand that in decision making one should not base oneself exclusively on the most probable assumption if other assumptions imply the risk of unbearable costs. Topics like this fall outside almost all education curricula. And outside almost all people’s powers of reasoning. Including those of the people who make decisions about the lives and well being of hundreds of millions of people.

In fact, the misinterpretation of “man’s accomplishments” can be understood as an example of man’s weak mental abilities. The misinterpretation manifests a complete lack of imagination of what strong mental abilities would be. The misinterpretation is greatly helped by a tremendous underestimation of the effects of communication. Of both communication between generations and those between contemporaries. Almost everything people know is learned from other people and from books. Of course, communication and remembering are mental abilities. But these abilities are imperfect and limited. They have little or nothing to do with analytical or creative abilities, or with explanation and understanding. People are able to learn (somewhat), and this ability is important. But like other human mental abilities, the ability to learn is very limited. The ability to add something new and meaningful to the aggregate knowledge, or to understanding, or know how, is restricted to only very few people.⁵¹ And what contemporaries see as breakthrough, always turns out to be marginal in hindsight.

The crucial observation is, that what we know and know how is not so much due to our abilities as individuals, as to the fact that as a group, and by the use of clay tablets, books or hard disks, we can retain what is known by anyone anywhere and anytime in the history of mankind. (Only in principle,

⁵⁰ Intelligence: «**1a (1): the ability to learn or understand or to deal with new or trying situations: reason; also the skilled use of reason (2): the ability to apply knowledge to manipulate one's environment or to think abstractly as measured by objective criteria (as tests)**» Merriam Webster 2002 CD edition. Note that this definition is 100% elastic: even the least ability makes a person (or animal!) intelligent.

⁵¹ Even most scientists don’t.

by the way).⁵² Even the development of paper, printing, the book, and distribution took more than thousand years, and thousands of people.

Already the present report shows that man can hardly be called intelligent if intelligence refers to mental abilities other than communicative abilities. Obviously moreover, mental abilities are not a matter of yes or no, but of more or less. And just as obvious is the observation that from a theoretical point of view mental abilities could be very much greater than they actually are. Even man's communicative abilities are very limited. How many people speak and write more than a single language?

This picture is strongly supported by the empirical evidence of societies without a writing system, books, and means to mass-produce and distribute them. There is every reason to call such societies primitive. However, they need not be primitive due to the weakness of their mental abilities as compared to those of modern man. They probably are primitive only because previous generations gave them little knowledge and know how to begin with. But even primitive societies give too rosy an impression of human mental abilities. They do have substantial means of communication. They can use this to pass on their knowledge and know to the next generation, and in the process retain improvements. Without communication, the growth of knowledge and know how would not have started at all.

The picture is consistent with the slowness of historical development ("progress"). Which can be interpreted as a sign of limited mental abilities by itself.

Obviously then, whatever people see as great accomplishments of man or mankind is not due to superior mental abilities, but to microscopic abilities in combination with the use of information carriers which enable addition and sharing.

It follows that there is no good reason to see man as a sufficiently adapted or intelligent being. There is no theoretical reason to expect a species which has hardly evolved beyond the stage of apes to be organized in accordance with norms like mutual respect, and to be able to realize a world in which people coexist peacefully. In other words: organized in a way that respects the norms and values regarded as the most important. The empirical evidence is incompatible with more than very limited abilities. The idea of man as an intelligent being, without regard to the limitations of this intelligence, can be ascribed to misinterpretation of what is seen, of disregard of evidence contradicting the erroneous interpretation, and to (very) limited intelligence. Upon open reflection, the state of mankind and its gloomy perspective should not come as a surprise. Which is not to say that they are inevitable. And to say it once more: an explanation is no excuse.

To prevent accidents and worse, man should be much more modest, very much more. Taking account of limited abilities is a condition for survival. But it is not sufficient.

Can a society based on the power of liars be transformed into a respectful society?

A fundamental element in the explanation of the irresponsible behavior of governments was found to be the lack of reasons for behaving responsibly. Governments have de facto exempted themselves from laws which force common people and organizations to act responsibly. The law seems expressly made to allow government by people who lack integrity and competence.⁵³ These observations mean that there is nothing inevitable about the given state of affairs. Indeed, no evidence was found showing that continuation of the virtual dictatorship of dishonorable incompetent people is unavoidable. There is no reason for fatalism, and no reason for believing that nothing can be done against the continuation of shameful and harmful government. In history, irresponsible and harmful government may be normal. But this does not mean that such government is logically inevitable. Bad government is not due simply to people being (only) people. Better still, the chapters 7B and 9 have shown that and how government and society can be organized responsibly. And that correction, and the creation of a fundamentally better world, require little more than extension of well-known and generally accepted laws. Which is not to deny that the conceptually simple correction will have far reaching consequences in practice. But the extent of the consequences is not due to the size or complicated nature of the

⁵² The inheritance is biased. Especially knowledge and know how threatening the hierarchical social structure and its top have little chance of dissemination and survival.

⁵³ If such an intention existed, it could hardly have been realized better.

necessary correction. It is due to the fact that the gap between the present and desired state of affairs has grown and widened by centuries of irresponsible government. Correction will require inventiveness, careful planning and capable management. But the most important thing to realize is that a well-founded alternative exists. A credibly sustainable world based on true mutual respect is possible. We know what its laws look like, at least approximately. As regards attitudes, the correction first of all requires the replacement of false pretensions by modesty and honesty.

The problem is not therefore whether or not a better world is possible and what it looks like. The problem is rather how to realize the required change. The next paragraphs discuss difficulties and possibilities.

For the process of correction to succeed, broad diffusion of knowledge and understanding of the main messages of the present report seems necessary. People need to be aware of the fundamental defects and dangers of the present system. They should know that there is a safe and respectable alternative. It should be shown why it is foolish to believe in self-correction by the present politicians. It should be explained why fundamental correction of the law is necessary. People should understand that continuation of the present system guarantees catastrophes. It should be explained why correction is possible and necessary. It should be explained that the required changes are nothing really new or revolutionary. They are no more than logical. Knowledge and understanding help to reduce or preclude the effect of the lies of representatives of the status quo.

Information of the public seems much simpler than it is however. All efforts made until 2018 to get something like the present report published have failed. Neither publishers, journalists nor scientists showed more than superficial interest. The same applies to the well founded request for prosecution of former DNB president Wellink for perjury. A letter to the Dutch academy of sciences about the falsification of history and the inadequacy of the methods used in official inquiries, and requesting to speak up for the purported values of science, went unanswered. None of these persons and organizations published truthful histories of their own accord. None of them gave explanations of events revealing the responsibility and the falsity of the assertions and pretensions of the politicians involved. Obviously, getting the present report across will be extremely difficult.

The sections explaining the stability of corrupt government by collusion of media and scientists, were written more than a year before the publication and distribution of *Wellinks perjury*. I should not have been surprised by the reactions. But I was, and still am. The cause obviously being my inability to sufficiently reduce the effect of the continuous bombardment with illusions by the media. As a consequence I remain amazed and disappointed by the absence of any reaction.⁵⁴ I had much rather seen my analysis proven to be wrong.

As a consequence of the lack of interest from publishers in texts like the one before you, and of the failure of the effort to get Wellink prosecuted for perjury, I see no credible possibilities any more. Let alone a sequence of steps ending in a world one need not be ashamed of. The problem is exacerbated by the imminence of the threats of war and climate change, and maybe more. I don't think this is just a pessimistic view. I think it is realistic, based on history and reliable analysis. According to me, it is an error to think that mankind will survive the next world war, or a drastic change in climate, just because it survived all catastrophes of the past. Such an illusion simply reflects a lack of understanding of the present state of affairs. In particular of the size and nature of the growth that has taken place in the past century. Mankind is not a marginal element of the biosphere anymore. Mankind has transformed, and recklessly continues to transform, the basic foundations of its existence, including those of life on earth. Almost blindly. A large majority of people, including governments, hardly knows and understands the consequences of what it is doing. It has no idea whether there is a (timely) way back. There is no risk management.⁵⁵ If mankind wants to survive, there may not be much time for correction. Supposing there still is. There are compelling reasons for making haste.

⁵⁴ On the contrary: in 2018 I still saw Wellink being interviewed as an expert by widely circulating Dutch newspapers.

⁵⁵ This empirical fact alone can be seen as sufficient evidence for the incompetence of all present governments, without exception.

The immortality of mankind is not the only dangerous illusion. That of learning lessons being learned is another. The evidence shows that it is an illusion to think that a new catastrophe will make people see the light, and induce necessary changes. The aftermath of the financial crisis shows explicitly how governments mislead people into thinking 1. that the catastrophe was caused by others, and 2. that repetition is precluded by appropriate governmental measures. In the more distant past, catastrophes sometimes gave rise to revolutions. Revolutions always led to widespread bloodshed. At best they brought minor improvements. The relatively recent revolutions in Russia and China brought an amount of human suffering possibly surpassing that of the world wars. Obviously, the suffering was not the price for a better world. History is full of warnings. The recent financial crises may have led to improvements of some banking rules. Maybe not. But the purported improvements certainly guarantee nothing. No correction of supervision and the political system has taken place at all. Neither of the two world wars gave rise to constitutional improvements in the countries which could and should have prevented these wars. At least no improvements in the sense of chapter 9. In other words: the idea that things will get better because lessons are learned, is worse than an illusion. It is contrary to historical evidence. One should know better. Of course, the illusion ignores the explanations of the stability of irresponsible government which are given in the present report. The illusion greatly underestimates the power of governments to manipulate and control the media, and to prevent dangerous discussions and changes. It greatly overestimates the integrity of journalists and scientists.

Theoretically, active participation in politics is an option. A little reflection shows however, that in the present state of affairs this is not an option deserving credibility. It is rather an assured waste of time and money. The cases and the analysis have shown that all present politicians actively try to prevent correction of the observed defects of the political legal system. None of the given (or historical) parties has ever seriously broken with the tradition of dishonesty and incompetence. In these respects all political parties are the same. As regards the subjects they choose to discuss, their differences may have some relevance. But what they have in common is much more important. Acquiring and retaining power is the overriding goal of all political parties. It justifies every means. All politicians effectively agree to keep the population as much as possible in the dark about their structural misconduct, including that of their colleagues. This is witnessed most clearly by the (“non-partisan”) inquiry commissions, and by the total absence of discussions like those in the present work in any of the political parties.

Already for centuries, politics attracts the wrong kind of people. It attracts people who don't mind dishonesty, incompetence and abuse of power. So one would at least have to start with brand new parties, with new people. Without fundamentally different people, political reform is impossible. It is the present political population that is the problem. (Of course in combination with a legal system that allows irresponsible behavior). Trying to reform “from within” is not noble or courageous, but stupid. It ignores the unambiguous evidence of innumerable cases, and the total absence of contrary evidence.

Beginning a new political party may theoretically be possible. But in the given educational and legal circumstances it offers very little chance for success. I never saw any able person willing to enter politics as it is. In addition, only very few people are capable of withstanding the pressures and temptations of the powerful, and remain honorable.⁵⁶ Finding a group of such people, and a way to succeed in a corrupt and vindictive political environment, is bound to be time consuming at best. Whistleblowers unambiguously prove the extreme intolerance of practically all politicians as soon as personal or class interests are at stake. For as long as almost nobody sees the need for substantial correction of the political legal state of affairs, it is a waste of time and energy to try and initiate change by starting a new political party, or any political action. It seems necessary first of all to broadly inform, educate, and see if better knowledge and understanding can create an open discussion climate and meaningful discussion. If this happens, steps can be taken towards correction.

Then there is the law. Is it really true that nothing in the law can stop dishonorable and incompetent politicians from irresponsibly spending more than half of peoples incomes, and harming them by not doing what they should? I always found this difficult to imagine. Of course I knew that government is only (somewhat) responsible to parliament, and that parliament is not responsible to anyone. That

⁵⁶ Like Scheurer-Kestner in the Dreyfus affair. See chapter 8.

actually the “democratic” states have something like 4-year periods of dictatorship.⁵⁷ Still, I could not imagine an apparently decent legal system to allow cases as described to go wholly unpunished. For many years I thought it would somehow be possible to use the law as a lever to force more responsible government. Even though I did not see a concrete opening. Rather the contrary. I did hear about unsuccessful, shameful trials. And almost never about successful ones. I moreover suspected that politicians had protected themselves against legal attack. That this was one of the things they had taken every precaution to do foolproof. I could nevertheless not imagine that they had left no holes. This seems to be a mistake. Worse: even if there is solid ground for prosecution, it turns out to be extremely difficult, if not impossible, to get prosecution started. The reason being that criminal procedures can only be set in motion by a public prosecutor. And in the USA as in Netherlands, at least the top of public prosecution is appointed by the government. And the Office of the Public Prosecutor is of course financed by the ministry of justice. The Office is said to be independent. But the minister of justice not only pays. He is also “politically responsible” for the Office. He is its hierarchical head. So he is definitely in control. The answers to my request to prosecute Wellink for perjury show that in practice the public prosecutor can turn down such a request without giving any argument. At least in the case of a request by a citizen. Not always that of a corporation (in the legal sense). In the case of Wellink’s perjury it moreover turned out to be difficult, if not impossible, to find a lawyer willing and able to actively support the effort to get Wellink prosecuted. Presumably out of fear for political retaliation.

So for the time being it has to be assumed that an appeal to the law is useless.

Not only politicians, but journalists, scientists, and teachers too betray the public trust.

Almost all of this work was devoted to the conduct of politicians. They were suspect from the beginning. They are responsible; and their slippery double talk and unreliability are only too obvious. None of them openly acknowledges and criticizes this. None of them gives a substantially better example. None of them tries to do something credible about it. In other words: a simple logical analysis is sufficient to show that something must be fundamentally wrong with the political system. The results of this study should come as no surprise.

There is no a priori reason however to suspect journalists, scientists, and teachers. What they say seems rather consistent. Their words give little reason for doubt. A look beyond the words however shows that what they say is incompatible with what they do. They make promises which they don’t keep. They break their promises in an extremely harmful and abject way. Their selection methods and other customs amount to self censorship, and produce a misleadingly rose colored picture of government and public administration.⁵⁸ They fail to provide the people with the information it needs to make the choices it needs to make in order to survive. Much of what they journalists, scientists, and teachers in favor of their profession is false propaganda, spread to serve selfish goals. They keep people asleep, by suggesting that journalists and scientists are critically watching.

To teachers in general education this applies somewhat less than to journalists and scientists. Teachers probably trust the textbook writers, and the democratic process. But they cannot be considered innocent. Like everyone with brains in his head and responsibility towards other people, they may be expected to see that the standard textbooks do not discuss and explain the reality of politics, government and the hierarchical organization, and do not prepare for reality. At the same time teachers can hardly be expected to be able write fundamentally better textbooks, let alone get better textbooks to replace the misleading ones.

It is different for journalists and scientists. Given their voluntary professional codes (= norms and values) and their frequently publicly advertised claims, they should inform the public about what is

⁵⁷ Contrary to what is often thought, dictators too mind public opinion. But remember: public opinion is not the opinion of an independent, well informed public, but the hypothetical result of all kinds of manipulation and interpretation.

⁵⁸ Examples of “other customs” are: blindly copying press releases, trusting utterances of government officials, asking government officials to comment on reports of citizens (and not the other way around), letting themselves be led by press releases instead of their own news collection and inquiries, rapidly forgetting inconvenient information, indulgent, uncritical and unchecked interviews.

essential for its future well-being. They should not be silent while the population is being deceived. Without their selective filtering and withholding of information, the present constitutions would be untenable. They would have to be corrected. Without their filtering and withholding of information the present governments could impossibly stay in power. Journalists, scientists, and teachers are de facto collaborators of governments. They can and should know that politicians and governments are dishonorable and incompetent. Not only in theory, but also in practice. Journalists, scientists, and teachers are accomplices of the politicians, which the politicians cannot do without. Together they endanger the well being and future of the population. Not only politicians, but journalists, scientists, and teachers too betray the public trust.

Conclusion.

I have no idea what to do next, apart from trying to improve this report. I cannot believe that there is no solution. I do not want to give up. Giving up would make me feel even more ashamed and despondent. There is hope as long as impossibility has not been proven. I would very much like to find grounds for believing that mankind will rid itself of rulers without integrity and competence, and will reorganize law and the state in a way that respects and serves everyone. That mankind is able to stop and reverse its murderous and destructive activities. That it is able to understand what true progress means, and able to realize it.

I don't want to be someone who imagines himself to know and understand man and mankind, who sees mankind hurrying down the slope to the abyss, and remains standing idly by. Part of the problem being that it is impossible to stand idly by. The present states do not allow anyone to stand idly by. Everyone is forced to pay the government about half his earnings as taxes. Everyone is forced to actively and substantially contribute to the activities of the government. Everyone participating in elections moreover supports the appearance of agreeing with the given political system. Modern man has no meaningful way to show disagreement. Even though nobody seems to notice, and nobody seems to require the system to offer opportunities for manifesting disagreement. Anyway, innocent citizens do not exist.

This report has made me feel ashamed to belong to mankind. Of being a member of the most destructive and stupidly arrogant species of animals on earth. In over 2000 years, it has not been able to organize itself in accordance with true mutual respect. It allows itself to be governed by lies. As for now, I see no light at the end of the tunnel. There may be undiscovered possibilities. I do hope so, and hope that time will tell. But at this moment it seems quite possible that the road to survival and justified self-respect is barred. Barred on the one hand by conspiring politicians, journalists and scientists, and on the other by a large majority of stupid and submissive followers, who lack the mental capabilities and self-respect which are needed to replace these politicians by people who are honorable and competent, and to force journalists and scientists to do what they claim and pretend to do.

If I'm too pessimistic, please show me why.