What's Inside America's Banks?

Some four years after the 2008 financial crisis, public trust in banks is as low as ever. Sophisticated investors describe big banks as **"black boxes"** that may still be concealing enormous risks—the sort that could again take down the economy. A close investigation of a supposedly conservative bank's financial records uncovers the reason for these fears—and points the way toward urgent reforms.

By Frank Partnoy and Jesse Eisinger

The financial crisis had many causes—too much borrowing, foolish investments, misguided regulation—but at its core, the panic resulted from a lack of transparency. The reason no one wanted to lend to or trade with the banks during the fall of 2008, when Lehman Brothers collapsed, was that no one could understand the banks' risks. It was impossible to tell, from looking at a particular bank's disclosures, whether it might suddenly implode.

For the past four years, the nation's political leaders and bankers have made enormous—in some cases unprecedented—efforts to save the financial industry, clean up the banks, and reform regulation in order to restore trust and confidence in the American financial system. This hasn't worked. Banks today are bigger and more opaque than ever, and they continue to behave in many of the same ways they did before the crash.

Consider JPMorgan's widely scrutinized trading loss last year. Before the episode, investors considered JPMorgan one of the safest and best-managed corporations in America. Jamie Dimon, the firm's charismatic CEO, had kept his institution upright throughout the financial crisis, and by early 2012, it appeared as stable and healthy as ever.

One reason was that the firm's huge commercial bank—the unit responsible for the old-line business of lending—looked safe, sound, and solidly profitable. **But then, in May, JPMorgan announced the financial equivalent of sudden cardiac arrest: a stunning loss initially estimated at $2 billion and later revised to $6 billion.** It may yet grow larger; as of this writing, investigators are still struggling to comprehend the bank's condition.

The loss emanated from a little-known corner of the bank called the Chief Investment Office. This unit had been considered boring and unremarkable; it was designed to reduce the bank's risks and manage its spare cash. According to JPMorgan, the division invested in conservative, low-risk securities, such as U.S. government bonds. And the bank reported that in 95 percent of likely scenarios, the maximum amount the Chief Investment Office's positions would lose in one day was just $67 million. (This widely used statistical measure is known as "value at risk.") When analysts questioned Dimon in the spring about reports that the group had lost much more than that—before the size of the loss became publicly known—he dismissed the issue as a "tempest in a teapot."

Six billion dollars is not the kind of sum that can take down JPMorgan, but it's a lot to lose. The bank's stock lost a third of its value in two months, as investors processed reports of the trading debacle. On May 11, 2012, alone, the day after JPMorgan first confirmed the losses, its stock plunged roughly 9 percent.

The incident was about much more than money, however. Here was a bank generally considered to have the best risk-management operation in the business, and it had badly managed its risk. As the bank was coming clean, it revealed that it had fiddled with the way it measured its value at risk, without providing a clear reason. Moreover, in acknowledging the losses, JPMorgan had to admit that its reported numbers were false. A major source of its supposedly reliable profits had in fact come from high-risk, poorly disclosed speculation.

It gets worse. Federal prosecutors are now investigating whether traders lied about the value of the Chief Investment Office's trading positions as they were deteriorating. JPMorgan shareholders have filed numerous lawsuits alleging that the bank misled them in its financial statements; the bank itself is suing one of its former traders over the losses. It appears that Jamie Dimon, once among the most trusted leaders on Wall Street, didn't understand and couldn't adequately manage his behemoth. Investors are now left to doubt whether the bank is as stable as it seemed and whether any of its other disclosures are inaccurate.

The JPMorgan scandal isn't the only one in recent months to call into question whether the big banks are safe and trustworthy. Many of the biggest banks now stand accused of manipulating the world's most popular benchmark interest rate, the London Interbank Offered Rate (LIBOR), which is used as a baseline to set interest rates for trillions of dollars of loans and investments. Barclays paid a large fine in June to avoid civil and criminal charges that could have been brought by U.S. and U.K. authorities. The Swiss giant UBS was reportedly close to a similar settlement as of this writing. Other major banks, including JPMorgan, Bank of America, and Deutsche Bank, are under civil or criminal investigation (or both), though no charges have yet been filed.

Libor reflects how much banks charge when they lend to each other; it is a measure of their confidence in each other. Now the rate has become synonymous with manipulation and collusion. In other words, one can't even trust the gauge that is meant to show how much trust exists within the financial system.

Accusations of illegal, clandestine bank activities are also proliferating. Large global banks have been accused by U.S. government officials of helping Mexican drug dealers launder money (HSBC), and of funneling cash to Iran (Standard Chartered). Prosecutors have charged American banks with falsifying mortgage records by "robo-signing" papers to rush the process along, and with improperly foreclosing on borrowers. Only after the financial crisis did people learn that banks routinely misled clients, sold them securities known to be garbage, and even, in some cases, secretly bet against them to profit from their ignorance.

When we asked Ed Trott, a former Financial Accounting Standards Board member, whether he trusted bank accounting, he said, simply, "Absolutely not."

Together, these incidents have pushed public confidence ever lower. According to Gallup, back in the late 1970s, three out of five Americans said they trusted big banks "a great deal" or "quite a lot." During the following decades, that trust eroded. Since the financial crisis of 2008, it has collapsed. In June 2012, fewer than one in four respondents told Gallup they had faith in big banks—a record low. And in October, Luis Aguilar, a commissioner at the Securities and Exchange Commission, cited separate data showing that "79 percent of investors have no trust in the financial system."

When we asked Dane Holmes, the head of investor relations at Goldman Sachs, why so few people trust big banks, he told us, "People don't understand the banks," because "there is a lack of transparency." (Holmes later clarified that he was talking about average people, not the sophisticated investors with whom he interacts on an almost hourly basis.) He is certainly right that few students or plumbers or grandparents truly understand what big banks do anymore. Ordinary people have lost faith in financial institutions. That is a big enough problem on its own.

But an even bigger problem has developed—one that more fundamentally threatens the safety of the financial system—and it more squarely involves the sort of big investors with whom Holmes spends much of his time. More and more, the people in the know don't trust big banks either.

After all the purported "cleansing effects" of the panic, one might have expected big, sophisticated investors to grab up bank stocks, exploiting the timidity of the average investor by buying low. Banks wrote down bad loans; Treasury certified the banks' health after its "stress tests"; Congress passed the Dodd-Frank reforms to regulate previously unfettered corners of the financial markets and to minimize the impact of future crises. During the 2008 crisis, many leading investors had gotten out of bank stocks; these reforms were designed to bring them back.

And indeed, they did come back—at first. Many investors, including Warren Buffett, say bank stocks were underpriced after the crisis, and remain so today. Most large institutional investors, such as mutual funds, pension funds, and insurance companies, continue to hold substantial stakes in major banks. The Federal Reserve has tried to help banks make profitable loans and trades, by keeping interest rates low and pumping trillions of dollars into the economy. For investors, the combination of low stock prices, an accommodative Fed, and possibly limited downside (the federal government, needless to say, has shown a willingness to assist banks in bad times) can be a powerful incentive.

Yet the limits to big investors' enthusiasm are clearly reflected in the data. Some four years after the crisis, big banks' shares remain depressed. Even after a run-up in the price of bank stocks this fall, many remain below "book value," which means that the banks are worth less than the stated value of the assets on their books. This indicates that investors don't believe the stated value, or don't believe the banks will be profitable in the future—or both. Several financial executives told us that they see the large banks as "complete black boxes," and have no interest in investing in their stocks. A chief executive of one of the nation's largest financial institutions told us that he regularly hears from investors that the banks are "uninvestable," a Wall Street neologism for "untouchable."

That's an increasingly widespread view among the most sophisticated leaders in investing circles. Paul Singer, who runs the influential investment fund Elliott Associates, wrote to his partners this summer, "There is no major financial institution today whose financial statements provide a meaningful clue" about its risks. Arthur Levitt, the former chairman of the SEC, lamented to us in November that none of the post-2008 remedies has "significantly diminished the likelihood of financial crises." In a recent conversation, a prominent former regulator expressed concerns about the hidden risks that banks might still be carrying, comparing the big banks to Enron.

A recent survey by Barclays Capital found that more than half of institutional investors did not trust how banks measure the riskiness of their assets. When hedge-fund managers were asked how trustworthy they find "risk weightings"—the numbers that banks use to calculate how much capital they should set aside as a safety cushion in case of a business downturn—about 60 percent of those managers answered 1 or 2 on a five-point scale, with 1 being "not trustworthy at all." None of them gave banks a 5.

A disturbing number of former bankers have recently declared that the banking industry is broken (this newfound clarity typically follows their passage from financial titan to rich retiree). Herbert Allison, the ex-president of Merrill Lynch and former head of the Obama administration's Troubled Asset Relief Program, wrote a scathing e-book about the failures of the large banks, stopping just short of labeling them all vampire squids. A parade of former high-ranking executives has called for bank breakups, tighter regulation, or a return to the Depression-era Glass-Steagall law, which separated commercial banking from investment banking. Among them: Philip Purcell (ex-CEO of Morgan Stanley Dean Witter), Sallie Krawcheck (ex-CFO of Citigroup), David Komansky (ex-CEO of Merrill Lynch), and John Reed (former coâ€'CEO of Citigroup). Sandy Weill, another ex-CEO of Citigroup, who built a career on financial megamergers, did a stunning about-face this summer, advising, with breathtaking chutzpah, that the banks should now be broken up.

Bill Ackman's journey is particularly telling. One of the nation's highest-profile and most successful investors, Ackman went from being a skeptic of investing in big banks, to being a believer, and then back again—with a loss of hundreds of millions along the way. In 2010, Ackman bought an almost $1 billion stake in Citigroup for Pershing Square, the $11 billion fund he runs. He reasoned that in the aftermath of the crisis, the big banks had written down their bad loans and become more conservative; they were also facing less competition. That should have been a great environment for investment, he says. He had avoided investing in big banks for most of his career. But "for once," he told us, "I thought you could trust the carrying values on bank books."

Last spring, Pershing Square sold its entire stake in Citigroup, as the bank's strategy drifted, at a loss approaching $400 million. Ackman says, "For the first seven years of Pershing Square, I believed that an investor couldn't invest in a giant bank. Then I felt I could invest in a bank, and I did—and I lost a lot of money doing it."

A crisis of trust among investors is insidious. It is far less obvious than a sudden panic, but over time, its damage compounds. It is not a tsunami; it is dry rot. It creeps in, noticed occasionally and then forgotten. Soon it is a daily fact of life. Even as the economy begins to come back, the trust crisis saps the recovery's strength. Banks can't attract capital. They lose customers, who fear being tricked and cheated. Their executives are, by turns, traumatized and enervated. Lacking confidence in themselves as they grapple with the toxic legacies of their previous excesses and mistakes, they don't lend as much as they should. Without trust in banks, the economy wheezes and stutters.

And, of course, as trust diminishes, the likelihood of another crisis grows larger. The next big storm might blow the weakened house down. Elite investors—those who move markets and control the flow of money—will flee, out of worry that the roof will collapse. The less they trust the banks, the faster and more decisively they will beat that path—disinvesting, freezing bank credit, and weakening the structure even more. In this way, fear becomes reality, and troubles that might once have been weathered become existential.

At the heart of the problem is a worry about the accuracy of banks' financial statements. Some of the questions are basic: How do banks account for loans? Can investors accurately assess the value of those loans? Others are far more complicated: What risks are posed by complex financial instruments, such as the ones that caused JPMorgan's massive loss? The answers are supposed to be found in the publicly available quarterly and annual reports that banks file with the Securities and Exchange Commission.

The Financial Accounting Standards Board, an independent private-sector organization, governs the accounting in these filings. Don Young, currently an investment manager, was a board member from 2005 to 2008. "After serving on the board," he recently told us, "I no longer trust bank accounting."

Accounting rules have proliferated as banks, and the assets and liabilities they contain, have become more complex. Yet the rules have not kept pace with changes in the financial system. Clever bankers, aided by their lawyers and accountants, can find ways around the intentions of the regulations while remaining within the letter of the law. What's more, because these rules have grown ever more detailed and lawyerly—while still failing to cover every possible circumstance—they have had the perverse effect of allowing banks to avoid giving investors the information needed to gauge the value and risk of a bank's portfolio. (That information is obscured by minutiae and legalese.) This is true for the complicated questions about financial innovation and trading, but it also is true for the basic questions, such as those involving loans.

At one point during Young's tenure, some members of the Financial Accounting Standards Board wanted to make banks account for loans in the same way they do for securities, by recording them at current market values, a method known as "fair value." Banks were instead recording the value of their loans at the initial loan amount, and setting aside a reserve based on their assumptions about how likely they were to get paid back. The rules also allowed banks to use different methods to measure the value of the same kind of loans, depending on whether the loans were categorized as ones they planned to keep for a long time or instead as ones they planned to sell. Many accounting experts believed that the reported numbers did not give investors an accurate or reliable picture of a bank's health.

After bitter battles, turnover on the board, worries about acting in the middle of the financial crisis, and aggressive bank lobbying, the accounting mandarins preserved the existing approach instead of switching to fair-value accounting for loans. Young believes that the numbers are even less reliable now. "It's gotten worse," he says. When we asked another former board member, Ed Trott, whether he trusted bank accounting, he said, simply, "Absolutely not."

The problem extends well beyond the opacity of banks' loan portfolios—it involves almost every aspect of modern bank activity, much of which involves complex investment and trading, not merely lending. Kevin Warsh, an ex–Morgan Stanley banker and a former Federal Reserve Board member appointed by George W. Bush, says woeful disclosure is a major problem. Look at the financial statements a big bank files with the SEC, he says: "Investors can't truly understand the nature and quality of the assets and liabilities. They can't readily assess the reliability of the capital to offset real losses. They can't assess the underlying sources of the firms' profits. The disclosure obfuscates more than it informs, and the government is not just permitting it but seems to be encouraging it."

Accounting rules are supposed to help investors understand the companies whose shares they buy. Yet current disclosure requirements don't illuminate banks' financial statements; instead, they let the banks turn out the lights. And in that darkness, all sorts of unsavory practices can breed.

We decided to go on an adventure through the financial statements of one bank, to explore exactly what they do and do not show, and to gauge whether it is possible to make informed judgments about the risks the bank may be carrying. We chose a bank that is thought to be a conservative financial institution, and an exemplar of what a large modern bank should be.

Wells Fargo was founded on trust. Its logo has long been a strongly sprung six-horse stagecoach, a fleet of which once thundered across the American West, loaded with gold. According to the firm's official history, "In the boom and bust economy of the 1850s, Wells Fargo earned a reputation of trust by dealing rapidly and responsibly with people's money." People believed Wells Fargo would keep their money safe—the bank's paper drafts were as good as the gold it shipped throughout the country.

For a century and a half, Wells Fargo stock was also like gold, which is what led Warren Buffett to buy a stake in the bank in 1990. Since then, Buffett and Wells Fargo have been inextricably linked. As of fall 2012, Buffett's firm, Berkshire Hathaway, owned about 8 percent of Wells Fargo's shares.

Today, Wells Fargo still prominently displays the stagecoach logo at branches, in advertising, on the 12,000-plus ATMs that dot the country, and even at the bank's museum stores. There, visitors can buy wholesome, family-friendly items: a stagecoach nightâ€'light; stagecoach salt and pepper shakers; a hand-painted ceramic stagecoach pillbox. These are more than tchotchkes. They are emblems of the bank's honest and honorable mission.

Buffett's impeccable reputation has rubbed off on the bank. Wells Fargo is widely regarded as the most conservative of the nation's biggest banks. Many investors, regulators, and analysts still believe its financial reports reflect a full, fair, and accurate picture of its business. The market value of Wells Fargo's shares is now the highest of any U.S. bank: $173 billion as of early December 2012. The enthusiasm for Wells Fargo reflects the bank's good reputation, as well as one seemingly simple fact: the bank earned solid net income of nearly $16 billion in 2011, up 28 percent from 2010.

To find out what's behind that fact, you have to read Wells Fargo's annual report—and that is where we began our adventure. The annual report is a special document: it is the place where a bank sets forth the audited details of its business. Although banks also submit unaudited quarterly reports and other periodical documents to the SEC, and have conference calls with analysts and shareholders, the annual report gives investors the most complete and, supposedly, reliable picture.

(Today, big banks have to answer to a dizzying litany of regulators—not only the SEC, but also the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the newly created Consumer Financial Protection Bureau, and so on. The disclosure regimes vary, adding to the confusion. Banks confidentially release additional information to these regulators, but investors do not have access to those details. That regulators have these extra, confidential disclosures isn't much comfort: given the inability of regulators to police the banks in recent years, one of the only groups that investors trust less than bankers is bank regulators.)

Wells Fargo's most recent annual report, covering 2011, is 236 pages long. It begins like a book an average person might enjoy: a breezy journey through a year in a bank's life. On the cover, that stagecoach appears. The first page has a moving story about a customer. The next few pages are filled with images of guys in cowboy hats, a couple holding hands by the ocean, cupcakes, and solar panels. In bold 50â€‘point font, Wells Fargo reports that it contributed $213.5 million to nonprofits during the year, and it even does the math to make sure we appreciate its generosity: “$4.1 million every week or $585,000 every day or $24,000 every hour.” The introduction’s capstone is this: “We don’t take trust for granted. We know we have to earn it every day in our conversations and actions with our customers. Here’s how we try to do that.”

The sheer volume of “trading” at Wells Fargo suggests that the bank is not what it seems.

Fortunately for Wells Fargo, most people do not read past the introduction. In the pages that follow, the sunny faces of satisfied customers disappear. So do the stories. The narrative is replaced by details about the bank’s businesses that range from the incomprehensible to the disturbing. Wells Fargo told us it devotes “significant resources to fulfilling all reporting requirements of various regulators.” Nevertheless, these disclosures wouldn’t earn anyone’s trust. They are littered with language that says nothing, at length. The report is riddled with progressively more opaque footnotes—the financial equivalent of Dante’s descent into hell. Indeed, after the friendly introduction, the report ought to bear a warning to the inquisitive reader intent on truly understanding the bank’s financial positions: “Abandon all hope, ye who enter here.”

The first circle of Wells Fargo’s version of the Inferno, like Dante’s Limbo, merely hints at what is to come, yet it is nonetheless unsettling. One of the main purposes of an annual report is to tell investors how a company makes money. Along these lines, Wells Fargo splits its businesses into two apparently simple and distinct parts—“interest income” and “noninterest income.” At first blush, these two categories appear to parallel the two traditional sources of banking income: interest from loans and customer fees.

But here the descent begins. Suddenly, this folksy mortgage bank starts showing signs of a split personality. It turns out that trading activities, the type associated with Wall Street firms like Goldman Sachs and Morgan Stanley, contribute significantly to each of Wells Fargo’s two categories of income. Almost $1.5 billion of its “interest income” comes from “trading assets”; another $9.1 billion results from “securities available for sale.”

One billion dollars of the bank’s “noninterest income” are “net gains from trading activities.” Another $1.5 billion is income from “equity investments.” Up and down the ledger, abstruse, all-embracing categories appear: “other fees earned from related activities,” “other interest income,” and just plain “other.” The income statement’s “other” catchalls collectively amounted to $6.6 billion of Wells Fargo’s income in 2011. It will take the devoted reader 50 more pages to find out that the bank derives a big chunk of that “other” income from, yes, “trading activities.” The sheer volume of “trading” at Wells Fargo suggests that the bank is not what it seems.

Some bank analysts say these trading numbers are small relative to the bank’s overall revenue ($81 billion in 2011) and profit (again, $16 billion in 2011). Other observers don’t even bother to look at these details, because they assume Wells Fargo is protected from trading losses by its capital reserves of $148 billion. That number, assuming it is accurate, can make any particular loss appear minuscule. For example, buried at the bottom of page 164 of Wells Fargo’s annual report is the following statement: “In 2011, we incurred a $377 million loss on trading derivatives related to certain CDOs," or collateralized debt obligations. Just a few years ago, a bank's nine-figure loss on these sorts of complex financial instruments would have generated major headlines. Yet this one went unremarkedâ€'upon in the media, even by top investors, analysts, and financial pundits. Perhaps they didn't read all the way to page 164. Or perhaps they had become so numb from bigger bank losses that this one didn't seem to matter. Whatever the reason, Wells Fargo's massive CDO-derivatives loss was a multi-hundred-million-dollar tree falling silently in the financial forest. To paraphrase the late Senator Everett Dirksen, $377 million here and $377 million there, and pretty soon you're talking about serious money.

Even conservatively run banks can be risky, as George Bailey learned in *It's a Wonderful Life*. But the Bailey Building and Loan Association did not earn money from trading. Trading is an inherently opaque and volatile business. It is subject to the vagaries of the markets. And yet in the past two decades, as profits from traditional lending and brokering activities have been squeezed, banks have turned more and more to trading in order to make money.

Today, banks' trading operations involve more leverage, or borrowed money, than in the past. Banks also obtain a form of leverage by promising to pay money in the future if some event doesn't go their way (much like an insurance company must pay out a lot of money if a house it covers burns down). These promises come in the form of derivatives, financial instruments that can be used to hedge against various risks—like the possibility that interest rates will rise or the likelihood that a company will default on its debts—or simply to place bets on those same possibilities, hoping to profit. Because many of these bets are both large and complex, trading carries the potential for catastrophic losses.

The cryptic way Wells Fargo describes its trading raises many questions. The bank breaks what it calls "net gains from trading activities"—which doesn't cover all of its trading income, but is an important part—into three subcategories, leaving the annual-report reader to play a kind of shell game.

Look first at "proprietary" trading—activity a firm undertakes to make money for its own account by buying or selling stocks, bonds, or more-exotic financial creations. Self-evidently, this activity might involve big risks. When this shell is lifted, the bank's exposure seems reassuringly inconsequential: the reported loss is just $14 million. Still, there may be more under this shell than meets the eye: that $14 million might not be indicative of the bank's true exposure. Was Wells Fargo just lucky to finish slightly down after a roller-coaster year of wild gambling with much bigger gains and losses? Without more information about the size of the bank's bets, it is impossible to know.

A second subcategory is "economic hedging." An activity labeled "hedging" might sound soothing. Wells Fargo says it lost an inconsequential $1 million from economic hedging in 2011. So maybe there is nothing to worry about under this shell, either. In its pure form, hedging is supposed to reduce risk. A person buys a house and then hedges the risk of a fire by purchasing insurance. But hedging in the world of finance is more complex—so much so that it requires advanced mathematics and computer modeling, and still can be little better than guesswork. It is difficult to anticipate how a portfolio of complicated financial instruments will respond as variables like interest rates and stock prices go up and down. As a result, hedges don't always work as intended. They may not fully eliminate large risks that banks think they've taken care of. And they may inadvertently create new, hidden risks—"unknown unknowns," if you will. Because of all this complexity, some traders can disguise speculative positions as "hedges" and claim their purpose is to reduce risk, when in fact the traders are purposely taking on more risk to try to make a profit. That is what the traders within JPMorgan's Chief Investment Office appear to have been doing. Was Wells Fargo's "economic hedging" like buying straightforward insurance? Or was it more like speculation—what JPMorgan did? Do the reported numbers suggest low risk when in fact the opposite is true? The bank's disclosures don't answer these questions.

Finally we come to a third shell—and there's unquestionably something to see under this one. It carries an innocuous label: "customer accommodation." Wells Fargo made more than $1 billion from customer-accommodation trading in 2011. How did it make so much money merely by helping customers? This should be a plain-vanilla business: a broker sits between a buyer and a seller and takes a little cut of the transaction. But what we learned from the 2008 financial crisis, and what we keep learning from incidents such as the JPMorgan scandal, is that seemingly innocuous activities that appear highly profitable can be dangerous to a bank's health—and to our economy.

Don't look to the annual report for clarity. Here is the bank's definition: "Customer accommodation trading consists of security or derivative transactions conducted in an effort to help customers manage their market price risks and are done on their behalf or driven by their investment needs."

That might seem safe, but the report notably fails to explain why this activity would be so profitable. In fact, at many large banks, *customer accommodation* can be a euphemism for "massive derivatives bets." For Wells Fargo, the subcategory of "customer accommodation, trading and other free-standing derivatives" included derivatives trades of about *$2.8 trillion* in "notional amount" as of the end of 2011, meaning that the underlying positions referenced in the bank's derivatives were that large then. By way of explanation: if we were to make a bet with you about how much the price of a $70 share of Walmart would change this year—we pay you any increase, you pay us any decrease—we'd say the "notional amount" of the bet is $70.

Wells Fargo doesn't expect to gain or lose $2.8 trillion on its derivatives, any more than we would expect the payment on our Walmart bet to be $70. Bankers generally assume that the likely risk of gain or loss on derivatives is much smaller than their "notional amount," and Wells Fargo says the concept "is not, when viewed in isolation, a meaningful measure of the risk profile of the instruments." Moreover, Wells Fargo reports that many of its derivatives offset each other, as yours might if you placed several wagers that Walmart stock would go up, along with several other bets that it would go down.

Yet, as investors in bank stocks learned in 2008, it is possible to lose a large portion of the "notional amount" of a derivatives trade if a bet goes terribly wrong. In the future, if interest rates skyrocket or the euro unravels, Wells Fargo might sustain huge derivatives losses, just as you might lose the full $70 you bet on Walmart if the company went bust. Wells Fargo doesn't tell investors how much of the $2.8 trillion it could lose in a worst-case scenario, nor is it required to. Even a savvy investor who reads the footnotes can only guess at what the bank's potential risk exposure to derivatives might be.

One reason Wells Fargo is trusted more than other big banks is that its notional amount of derivatives is comparatively small. At the end of the third quarter of 2012, JPMorgan had $72 trillion in notional amount on its books—about five times the size of the U.S. economy. But even at Wells Fargo levels, the numbers are so large that they lose their meaning. And they put Wells Fargo's seemingly immense capital reserves—$148 billion, you'll recall—in a rather different light.

How much risk is the bank actually taking on these trades? For which customers does it place a requested bet, then negate its risk by taking an exactly offsetting position in the market, so that it is essentially acting as an agent simply taking a commission? And for all these trades, what risk is Wells Fargo taking on its customers? Many of these bets involve the customers' promises to pay Wells Fargo depending on how certain financial numbers change in the future. But what happens if some of those customers go bankrupt? How much money would Wells Fargo lose if it "accommodates" customers who can't pay what they owe?

We asked Wells Fargo officials if we could talk to someone at the bank about its disclosures, including those concerning its trading and derivatives. They declined. Instead, they suggested we submit questions in writing, which we did.

In response, Wells Fargo public-relations representatives wrote, "We believe our disclosures on the topics you raised are comprehensive and stand on their own." In answering our written questions about the annual report, the representatives simply pointed us back to the annual report. For example, when we inquired about the bank's trading activities, Wells Fargo responded: "We would ask you to refer to our discussion of 'Market Risk-Trading Activities' on pages 80–81 in the Management Discussion and Analysis section of the Wells Fargo 2011 Annual Report."

Yet it was precisely those pages that generated our questions about the bank's various categories of trading. When we specifically asked Wells Fargo to help us quantify the risks associated with customer-accommodation trading, its representatives pointed us to those same pages. But those pages don't answer that question. Here is the most helpful of the bank's disclosures related to customer-accommodation trading:

For the majority of our customer accommodation trading we serve as intermediary between buyer and seller. For example, we may enter into financial instruments with customers that use the instruments for risk management purposes and offset our exposure on such contracts by entering into separate instruments. Customer accommodation trading also includes net gains related to market-making activities in which we take positions to facilitate expected customer order flow.

Bankers, and their lawyers, are careful about the language they use in annual reports. So why did they use the word *expected* in discussing customer order flow in that last sentence? Is Wells Fargo speculating based on what one of its traders "expects" a customer to do, instead of responding to what a customer actually has done? The language the bank pointed to for answers to our questions only raises more questions.

Wells Fargo's annual report is filled with similarly cryptic declarations, but not the crucial information that investors actually need. It doesn't describe worst-case scenarios for customer-accommodation trades, or even include any examples of what such trades might involve. When we asked straightforward questions—such as "How much money would Wells Fargo lose from these trades under various scenarios?"—the bank's representatives declined to answer.

Only a few people have publicly expressed concerns about customer-accommodation trades. Yet some banking experts are skeptical of these trades, and suspect that they hide huge risks. David Stockman, who was the federal budget director under President Reagan, an investment banker at Salomon Brothers, and a partner at the private-equity firm Blackstone Group, calls the big banks "massive trading operations." Stockman has become so disillusioned by America's financial system that he is now regarded, in some quarters, as a wild-eyed heretic, but his expertise is undeniable. He recently told reporters for "The Gold Report," an online newsletter, "Whether they called it customer accommodation or proprietary is a distinction without a difference."

Bankers and regulators today might dismiss warnings that customer-accommodation derivatives could bring down the financial system as implausible. But a few years ago, they said the same thing about credit-default swaps and collateralized debt obligations.

The penultimate stop on our expedition through Wells Fargo's annual disclosures brings us to one of the most important concepts in bank reporting: fair value. It's the topic that led Don Young to conclude that he could not trust banks' accounting after fighting about it on the Financial Accounting Standards Board. Banks hold huge amounts of assets and liabilities, including derivatives, and are supposed to record them at their "fair value." Fair enough? Not so fast.

Like other banks, Wells Fargo uses a three-level hierarchy to report the fair value of its securities. Level 1 includes securities traded in active, public markets; it isn't too scary. At Level 1, *fair value* simply means the reported price of a security. If Wells Fargo owned a stock or bond traded on the New York Stock Exchange, fair value would be the closing price each day.

Level 2 is more worrisome. It includes some shadier characters, such as derivatives and mortgage-backed securities. There are no active, public markets for these investments—they are bought and sold privately, if at all, and are not listed on exchanges—so Wells Fargo uses other methods to figure out fair value, including what it calls "model-based valuation techniques, such as matrix pricing." At Level 2, fair value is what accountants would charitably describe as an "estimate," based on statistical computer models and what they call "observable" inputs, such as the prices of similar assets or other market data. At Level 2, fair value is more like an educated guess.

Many banks' stocks are below "book value" today. This indicates that investors don't believe the stated value of the assets on banks' books, or don't believe banks will be profitable in the future—or both.

Level 3 is hair-raising. The bank's Level 3 estimates are "generated primarily from model-based techniques that use significant assumptions not observable in the market." In other words, not only are there no data about the prices at which these types of assets have recently traded, but there are no observable data to inform the assumptions one might use to generate prices. Level 3 contains the most-esoteric financial instruments—including the credit-default swaps and synthetic collateralized debt obligations that became so popular and prevalent at the height of the housing boom, filling the balance sheets of Bear Stearns, Merrill Lynch, Citigroup, and many other banks.

At Level 3, fair value is a guess based on statistical models, but with inputs that are "not observable." Instead of basing estimates on market data, banks use their own assumptions and internal information. At Level 3, fair value is an uneducated guess.

Surely, one would assume, Wells Fargo's assets would mostly reside on Level 1, with perhaps a small amount on Level 2. It's just a simple mortgage bank, right? And it seems inconceivable that Wells Fargo would be loaded with Level 3 investments long after regulators have supposedly purged the banks of toxic assets and nursed them back to health.

Yet only a small fraction of Wells Fargo's assets are on Level 1. Most of what the bank holds is on Level 2. And a whopping $53 billion—equivalent to more than a third of the bank's capital reserves—is on Level 3. All three categories include risky assets that might lose value in the future. But the additional concern with Level 2 and Level 3 assets is that banks might have errantly recorded them at values that were inflated to begin with. There is no way to check whether reported values are accurate; investors have to trust the bank's managers and auditors. Scholarly research on Level 3 assets suggests that they can be misstated by as much as 15 percent at any given time, even if the market is stable. If Wells Fargo's estimates are that far off, the bank could be sitting on billions of dollars of hidden losses.

Wells Fargo discloses in a quiet footnote in small print on page 133 of the annual report that its Level 3 assets include "collateralized loan obligations with both a cost basis and fair value of $8.1 billion, at December 31, 2011." In English, that means that the bank is recording the value of some of its most complicated investments (composed of packages of loans to companies) at exactly the price it paid for them (the "cost basis"). Were these products bought a year ago? Two? Before the crash of 2008? Have they actually retained their value? Don Young finds it curious that the fair value and cost basis would be the same. "With interest rates much lower than most expected, why didn't the CLOs rise in value?" he asks. But he's the first to admit that he's really in no position to say. Without more information about the composition of the loan packages and when they were purchased, an outsider cannot determine what these assets might be worth.

Accountants and regulators insist that categorizing an investment as Level 1, 2, or 3 is better than simply recording the investment's original cost. But the current system permits bankers to use their own internally generated estimates. Who oversees those estimates? Auditors who are dependent on the bank for significant revenue, and regulators who are endemically behind the curve. Such a setup erodes trust. And when that trust disappears, so does any confidence in what the bank says its investments are worth.

The Level 3 issue isn't simply theoretical. One major problem during the 2008 crisis was that banks and investors didn't know what to trust about Level 3, so they panicked. We just suffered through a crisis in Level 3 assets. We can't afford another.

There is an even lower circle of financial hell. It is populated with complex financial monsters once known as "special-purpose entities." These were the infamous accounting devices that Enron employed to hide its debts. Around the turn of the millennium, the Texas energy-trading firm used these newly created corporations to borrow money and take on risks without recording the liabilities in its financial statements. These deals were called "off-balance-sheet" transactions, because they did not appear on Enron's balance sheet.

Suppose a company owns a slice—just a small percentage—of another company that has a lot of debt. The first company might claim that it doesn't need to include all of the second company's assets and liabilities on its balance sheet. Let's say we owned shares of IBM. We aren't suddenly on the hook for all of the company's liabilities. But if we owned so many IBM shares that we effectively controlled it, or if we had a side agreement that made us responsible for IBM's debts, common sense dictates that we should treat IBM's liabilities as our own. A decade ago, many companies, including Enron, used special-purpose entities to avoid common sense: they kept liabilities off the balance sheet, even when they had such control or side agreements.

As in a horror film, the special-purpose entity has been reanimated, and is now known as the variable-interest entity. In the alphabet soup of Wall Street, the acronym has switched from SPE to VIE, but the idea is the same. Big companies create these entities to borrow money and buy assets, but—like Enron—they do not include them on their balance sheets. The problem is especially worrisome at banks: every major bank has substantial positions in VIEs.

As of the end of 2011, Wells Fargo reported "significant continuing involvement" with variable-interest entities that had total assets of $1.46 *trillion*. The "maximum exposure to loss" it reports is much smaller, but still substantial: just over $60 billion, more than 40 percent of its capital reserves. The bank says the likelihood of such a loss is "extremely remote." We can hope.

However, Wells Fargo acknowledges that even these eye-popping numbers do not include its entire exposure to variable-interest entities. The bank excludes some VIEs from consideration, for many of the same reasons Enron excluded its special-purpose entities: the bank says that its continuing involvement is not significant, that its investment is temporary or small, or that it did not design or operate these deals. (Wells Fargo isn't alone; other major banks also follow this Enron-like approach to disclosure.)

We asked Wells Fargo to explain its VIE disclosures, but its representatives once again simply pointed us back to the annual report. We specifically asked about the bank's own reported corrections of these numbers (in one footnote, Wells Fargo cryptically says, " 'VIEs that we consolidate' has been revised to correct previously reported amounts"). But the bank would not tell us anything about those corrections. From the annual report, one cannot determine which VIEs were involved, or how big the corrections were.

Don Young calls variable-interest entities “accounting gimmicks to avoid consolidation and disclosure.” The Financial Accounting Standards Board changed the accounting rules that govern them in recent years, but the new rules, he says, are easy to manipulate, just like the old ones were. The presence of VIEs on Wells Fargo’s balance sheet “is a signal that there is $1.5 trillion of exposure to complete unknowns.”

These disclosures make even an ostensibly simple bank like Wells Fargo impossible to understand. Every major bank’s financial statements have some or all of these problems; many banks are much worse. This is an untenable situation. Kevin Warsh, formerly of the Fed, argues that the SEC should tell the biggest banks that their accounts are unacceptably opaque. “The banks should give a full, fair, and accurate account of their financial positions,” he says, “and they are failing that test.”

In the decades following the 1929 crash, banks were understandable. That’s not because they were financially simple—that era had its own versions of derivatives and special-purpose entities—but because the banks’ disclosures were more straightforward and clear. That clarity sprang from the fear of consequences. The law, as Oliver Wendell Holmes Jr. said, is a prediction of what a court will do. And the broadly scoped laws of that time gave courts wide latitude.

Going to jail for financial fraud was a real risk back then, and bank executives worried that their reputations would be destroyed if a judge criticized what they had done. Richard Whitney, a broker who had been the president of the New York Stock Exchange, was sent to Sing Sing prison in 1938 for embezzlement. “Sunshine Charlie” Mitchell, the president of National City Bank, the predecessor to Citibank, was indicted for tax evasion after the 1929 crash and was also the first of many bankers to testify before the famous Senate Pecora Committee in 1933. The Pecora investigation galvanized public opinion, and helped usher in the landmark banking and securities laws of 1933 and 1934. The scrutiny and continuing threat of prosecution convinced many bank executives that they should keep their business simple and transparent, or worry about the consequences if they did not.

In the wake of the recent financial crisis, the government has moved to give new powers to the regulators who oversee the markets. Some experts propose that the banking system needs more capital. Others call for a return to Glassâ€‘Steagall or a full-scale breakup of the big banks. These reforms could help, but none squarely addresses the problem of opacity, or the mischief that opacity enables.

The starting point for any solution to the recurring problems with banks is to rebuild the twin pillars of regulation that Congress built in 1933 and 1934, in the aftermath of the 1929 crash. First, there must be a straightforward standard of disclosure for Wells Fargo and its banking brethren to follow: describe risks in commonsense terms that an investor can understand. Second, there must be a real risk of punishment for bank executives who mislead investors, or otherwise perpetrate fraud and abuse.

These two pillars don't require heavy-handed regulation. The straightforward disclosure regime that prevailed for decades starting in the 1930s didn't require extensive legal rules. Nor did vigorous prosecution of financial crime.

Until the 1980s, bank rules were few in number, but broad in scope. Regulation was focused on commonsense standards. Commercial banks were not permitted to engage in investment-banking activity, and were required to set aside a reasonable amount of capital. Bankers were prohibited from taking outsize risks. Not every financial institution complied with the rules, but many bankers who strayed were judged, and punished.

Since then, however, the rules have proliferated, the arguments about compliance have become ever more technical, and the punishments have been minor and rare. Not a single senior banker from a major firm has gone to prison for conduct related to the 2008 financial crisis; few even paid fines. The penalties paid by banks are paltry compared with their profits and bonus pools. The costâ€'benefit analysis of such a system tilts in favor of recklessness, in large part because of the complex web of regulation: bankers can argue that they comply with the letter of the law, even when they violate its spirit.

As rules have proliferated, arguments about compliance have become more technical, and punishments have been rare. Not one senior banker from a major firm has gone to prison for conduct related to the 2008 financial crisis.

In an important call to arms this past summer, Andrew Haldane, the Bank of England's executive director for financial stability, laid out the case for an international regulatory overhaul. "For investors today, banks are the blackest of boxes," he said. But regulators are their facilitators. Haldane noted that a landmark regulatory agreement from 1988 called Basel I amounted to a mere 18 pages in the U.S. and 13 pages in the U.K. Likewise, disclosure rules were governed by a statute that was essentially one sentence long.

Basel II, the second iteration of global banking regulation, issued in 2004, was 347 pages long. Documentation for the new Basel III, Haldane noted, totals 616 pages. And federal regulations governing disclosure are even longer than that. In the 1930s, a bank's reports to the Federal Reserve might have contained just 80 entries. Yet by 2011, Haldane said, quarterly reporting to the Fed required a spreadsheet with 2,271 columns.

The Glass-Steagall Act of 1933, which Haldane said was perhaps "the single most influential piece of financial legislation of the 20th century," was only 37 pages. In contrast, 2010's Dodd-Frank law was 848 pages and required regulators to create so many new rules (not fully defined by the legislation itself) that it could amount to 30,000 pages of legal minutiae when fully codified. "Dodd-Frank makes Glass-Steagall look like throat-clearing," Haldane said.

What if legislators and regulators gave up trying to adopt detailed rules after the fact and instead set up broad standards of conduct before the fact? For example, consider one of the most heated Dodd-Frank battles, over the "Volcker Rule," named after former Federal Reserve Chairman Paul Volcker. The rule is an attempt to ban banks from being able to make speculative bets if they also take in federally insured deposits. The idea is straightforward: the government guarantees deposits, so these banks should not gamble with what is effectively taxpayer money.

Yet, under constant pressure from banking lobbyists, Congress wrote a complicated rule. Then regulators larded it up with even more complications. They tried to cover any and every contingency. Two and a half years after Dodd-Frank was passed, the Volcker Rule still hasn't been finalized. By the time it is, only a handful of partners at the world's biggest law firms will understand it.

Congress and regulators could have written a simple rule: "Banks are not permitted to engage in proprietary trading." Period. Then, regulators, prosecutors, and the courts could have set about defining what *proprietary trading* meant. They could have established reasonable and limited exceptions in individual cases. Meanwhile, bankers considering engaging in practices that might be labeled proprietary trading would have been forced to consider the law in the sense Oliver Wendell Holmes Jr. advocated.

Legislators could adopt similarly broad disclosure rules, as Congress originally did in the Securities Exchange Act of 1934. The idea would be to require banks to disclose all material facts, without specifying how. Bankers would know that whatever they chose to put in their annual reports might be assessed at some future date by a judge who would ask one simple question: Was the report complete, clear, and accurate?

The standard of proof for securities-fraud prosecutions, meanwhile, could and should be reduced from *intent*, which requires that prosecutors try to get inside the heads of bankers, to *recklessness*, which is less onerous to prove than intention, but more so than negligence. The goal of this change would be to prevent bankers from being able to hide behind legalese. In other words, even if they did not purposefully violate the law, because they had some technical justification for their conduct, they still might be liable for doing something a reasonable person in their position would not have done.

Senior bank executives should face the threat of prosecution the same way businesspeople do in other areas of the economy. When a CEO or CFO sits holding a pen, about to sign a certification that his or her bank's financial statements and controls are accurate and adequate, he or she should pause and reflect that the consequences could include jail time. If bank directors and executives had to think through their institution's risks, disclose them, and then face serious punishment if the disclosures proved inadequate, we might begin to construct a culture of accountability.

A bank seeking to comply with the principles we've laid out wouldn't need to publish a 236-page report with appendices. Instead, it could submit a statement perhaps oneâ€'tenth as long, something that a reader who made it through the introduction to Wells Fargo's current annual report might actually continue reading. Ideally, a lay reader would be able to understand how much a bank might gain or lose based on worst-case scenarios—what would happen if housing prices drop by 30 percent, say, or the Spanish government defaults on its debt? As for the details, banks could voluntarily provide information on their Web sites, so that sophisticated investors had enough granular facts to decide whether the banks' broader statements were true. As the

2008 financial crisis was unfolding, Bill Ackman's Pershing Square obtained the details of complex mortgages and created a publicly available spreadsheet to illustrate the risks of various products and institutions. Banks that wanted to earn back investors' trust could publish data so that Ackman and others like him could test their more general statements about risk.

Is this just a fantasy? The changes we've outlined would certainly be difficult politically. (What isn't, today?) But in the face of sufficient pressure, bankers might willingly agree to a grand bargain: simpler rules and streamlined regulation if they subject themselves to real enforcement.

Ultimately, these changes would be for the banks' own good. Banks need to be able to convince the most-sophisticated people in the markets—investors like Bill Ackman—that they are once again "investable." Otherwise, investors will continue to worry about which bank will be the next JPMorgan—or the next Lehman Brothers. Today, Ackman says the risk of investing in a big bank is too great: "I think the JPMorgan loss was a really bad loss for confidence. If the best CEO in the industry has a loss like that, what about the other banks?" he says. "If JPMorgan can have a $5.8 billion derivative problem, then any of these guys could—and $5.8 billion is not the upper bound."

The banks provide "a ton of disclosure," Ackman notes. There are a lot of pages and details in any bank's annual report, including Wells Fargo's. But "it's what you can't figure out that's terrifying." In the gargantuan derivatives-trading positions, for instance, he says, "you can't figure out whether the bank has got it right or not. That's faith."

A combination of clearer, simpler disclosure and stronger enforcement would help clean up the system, just as it did beginning in the 1930s. Not only would shareholders better understand banks' businesses, but managers would have the incentive to run their businesses more ethically. The broad cultural failure on Wall Street has arisen in part because disclosure rules encourage the banks to be purposefully opaque. Today, their lawyers don't judge whether statements are clear and meaningful but rather whether they are on the bleeding edge of legality. If bank managers faced real consequences when their descriptions proved inaccurate or incomplete, they would strive to make those descriptions as clear and simple as Strunk and White's *The Elements of Style*.

Perhaps there is a silver lining in the loss of sophisticated investors' trust. The disillusionment of the elites, on top of popular outrage, could foment change. Without such a mobilization, all of us will remain in the dark, neither understanding nor trusting the banks. And the rot will spread.

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