PacificCPE

Bank Failures and Accounting During the Financial Crisis

Course #2131A

Accounting

2 Credit Hours

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BANK FAILURES AND ACCOUNTING DURING THE FINANCIAL CRISIS

This course focuses upon the demise of three financial institutions: Lehman Brothers, Bernard Madoff Securities, and Bear Stearns. Each of these financial institutions demonstrates the consequences of creative accounting and fraud in the context of balance sheets which did not accurately represent the value of collateral or the magnitude of risk to the investment community.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Bank Failures and Accounting During the Financial Crisis

Study the course materials from pages 1 to 31
Complete the review questions at the end of each chapter
Answer the exam questions 1 to 10

Objectives:

- Recognize the financial instruments that were associated with the credit crunch and some of the creative accounting methods used.

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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Course Objectives

After completing this course, you should be able to:

- Recognize the financial instruments that were associated with the credit crunch and some of the creative accounting methods used.

INTRODUCTION

Jensen and Meckling (1976, p. 9) observed that '[t]he firm is not an individual. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals … are brought into equilibrium within a framework of contractual relations.' Agency theory suggests that management will be self-serving and where information is asymmetrical, this will be exploited to the detriment of the uninformed owner (Schipper, 1989). Creative accounting may be viewed as a technique or form of behaviour whereby management attempts to exploit information or limit its disclosure to maintain its superiority of bargaining power vis-à-vis the owner. Definitions of creative accounting, tend to focus upon the manipulation of levels of earnings in a way which affects reported income but which, in most scenarios, makes no genuine contribution to the economic well-being of the organisation (Merchant and Rockness, 1994).

In the context of the financial markets, creative accounting may occur for complex reasons which significantly exceed the relatively simplistic objective of earnings manipulation derived from traditional agency theory (Kothari, 2001). Owners (shareholders) or investors (for example, bondholders) or lenders in the interbank markets invariably have access to risk evaluation models as well as the ability to exit when management is perceived to be attempting to deceive or withhold vital information. In other words, in sophisticated, highly liquid markets the traditional elements required for the management-owner conflict as deemed necessary by traditional agency theory are absent (Breton and Taffler, 1995). Owners have access to resources and models which deprive management of its ability to manipulate information over the medium term. Informational inequality can be further undermined by ratings agencies which can downgrade credit scores of bonds of shares issued by banks regarded as evasive or involved in creative accounting (Gode and Sunder, 1993). The purpose of creative accounting in such a restrictive context is to describe or value assets or trading activity in a favourable (lawful) manner, entirely within the rules as established by international bodies such as the Basel Committee on Banking Supervision, even if such description or valuation may sometimes be at variance with underlying reality. In the absence of asymmetrical information, presentation becomes paramount.

Financial institutions may embark upon creative accounting, despite the sophistication of shareholders and bondholders and their ability to react adversely to such behaviour, for several reasons including the following:

- To conceal the true state of the organisation's earnings (McNichols and Wilson, 1988). This encompasses the traditional definitions of creative accounting and includes, for example, an attempt by management to hide substantial losses or the existence of fraud. One of the most extreme examples is the Bank of Credit and Commerce International (Sikka and Willmott, 1997).

- To suggest that assets available in the balance sheet for collateral for future lenders to the bank are of greater value or greater liquidity than is the case. Creative accounting in this context would enable a bank to over-leverage its balance sheet, borrowing heavily from lenders on the assurance that it has sufficient asset strength that should the lenders later need to call in their loans, liquidation of collateral will more than suffice to meet their claims.

- To suggest that the level of risk associated with a bank's balance sheet is lower than it actually is. A bank adjudged by the ratings agencies to be overly committed to a particularly volatile market or to a narrow class of borrowers will usually see this reflected in a downgrading of its credit score and a 'knock-on' effect of an increase in its borrowing costs (Morgan, 2002). To circumvent such a downgrading banks have occasionally embarked upon 'off-balance sheet' activities as a means of relocating risky assets from the balance sheet to special purpose vehicles (SPVs) which, through bond issues, pass on this risk to investors who are willing to assume it in return for an attractive premium (Henderson, 2000). Banks holding highly illiquid bonds have been known to 'recycle' these assets, particularly if some are trading in the secondary market at substantial discounts to face value, via securitisation. In simple terms, such assets have been 'bundled up' and sold to an SPV set up especially for this purpose. A 'new' homogenised bond is then issued to investors, the coupon (or interest payments) being met from the cash flows accruing to the 'old' illiquid bonds. In this way an illiquid portfolio is 'freed up' and the balance sheet relieved of the weight of otherwise 'toxic' material (Niu, 2007).

- To justify excessively generous remuneration schemes. In exuberant, booming, highly volatile markets in which banks need to attract and retain 'star traders' or deal makers, the generosity of remuneration structures becomes paramount. However, if a bank's fundamentals, as revealed in its balance sheet, are insufficient to sustain such structures, perhaps because of unrealised losses accruing to a particular class of assets such as complex derivatives, creative accounting may provide a short-term solution (Pourciau, 1993). For example, if assets which would otherwise generate substantial unrealised losses when 'marked to market' are reclassified into an asset category in respect to which no market price reference can be made, unrealised losses decline, increasing the level of profits from which high levels of remuneration can continue to be funded. In the longer term if such assets recover in value, a re-transference can be made and a more favourable mark-to-market undertaken.

During recent years banks have become preoccupied with the accurate measurement of portfolio risk, using highly sophisticated models to 'stress test' assets and their vulnerability to normal fluctuations in

equity markets or mild disturbances in secondary bond markets. The exercise is not an academic one. The degree of risk pertaining to particular assets must be taken into account when deciding upon the level of capital provision made in accordance with the Basel capital adequacy rules. Recently three principal activities have affected this risk-assessment process. First, the use of so-called value at risk or VaR models. Second, the involvement of banks in off-balance sheet activities such as securitisation. Third, the accumulation by banks of highly complex, highly illiquid assets in the balance sheet, such as derivatives and repackaged debt. All three of these, it may be argued, ignored the 'black swan' phenomenon, consciously or by accident. A black swan phenomenon is the occurrence of a highly unusual, 'once in a trader's lifetime' set of circumstances or even a single event which, in happening, undermines all previous assumptions. The recent 'credit crunch' may be described as such a 'black swan' event: the meltdown in the markets, the drying up of interbank lending, coupled with a stagnation affecting many markets in such a way that it became impossible to 'mark to market' assets held because there was no such market in existence against which prices could be estimated. VaR, it has been suggested, failed to prepare banks for the recent turmoil since it substantially underestimated the possibility of extreme and unexpected events and the potential impact that these might have in precipitating liquidity crises.

In recent years, VaR gained an aura of infallibility, leading many banks to rely upon it to the exclusion of consideration of any other forms of internal stress testing. When the credit crisis began, many banks were unprepared since the event had not been factored into their calculations using internal VaR models.

VaR models are used to hypothesise the probability or likelihood of losses on a particular portfolio over a particular time horizon based upon a statistical analysis of prior trends and price fluctuations (Duffie and Pan, 1997). As such VaR is a useful tool for evaluating the necessity or otherwise of hedging specific types of risk accruing to a portfolio, bearing in mind that such a strategy itself is a cost which, all things being equal, will reduce potential gains on that portfolio should the need to take advantage of the hedge not arise. For example, if a series of options are taken against shares held in a portfolio which enables the financial institution to sell at certain prices notwithstanding a general fall in market prices this will be a successful hedging strategy. The losses which would otherwise have arisen in respect of those shares will have been avoided. However, if instead the price of those shares has risen and the hedge is not implemented and the options are allowed to expire then the cost, the premium paid for that quasi-insurance, will be written off against the gain on the shares. In this latter scenario a 'naked' or unhedged position would have resulted in profit undiminished by the cost of the hedge. But the benefit of hindsight is by definition never available when the decision whether or not to hedge has to be made. A further criticism of VaR models is that they inevitably fail to provide for or anticipate 'black swan' events (Beder, 1995).

The purpose of this course is not to consider in detail the causes of failure of each of the many banks, including Icelandic bank Kaupthing, Royal Bank of Scotland and Northern Rock in the United Kingdom, Hypo Real Estate Bank in Germany, to name but a few. Instead the course will focus upon the demise of three financial institutions, Lehman Brothers, Bernard Madoff Securities, and Bear Stearns, since each demonstrates the consequences of creative accounting in the context of balance sheets which did not accurately represent the value of collateral or the magnitude of the risk presented, and thus reported, to the wider investment community. Brief mention of the causes of failure of Hypo Bank, Fortis Bank,