THE ROLE OF ACCOUNTING IN THE FINANCIAL CRISIS: LESSONS FOR THE FUTURE

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Genesis of the Crisis

- Unusually bad events in 2000-2001
  - Tech bubble burst in 2000
  - September 11, 2001 attacks on the U.S. – fear and wrecked confidence
- Recession was on the horizon
- New administration was in place only a short period earlier from January 2001
- Bush administration and Federal Reserve Bank's response to the impending recession
  - Lower taxes
  - Lower interest rates and easy credit
  - Cheap dollar

Genesis of Current Crisis

- Strategy seemed to work miracles for several years!
  - Lower taxes, low interest rates, and easy credit spurred investment in housing and consumer durables, stimulating demand for construction materials and services, employment, and financial services
  - Trickle down effects from the growth in construction and durable goods industries led to growth all around in almost all sectors of the economy
  - Cheap dollar currency helped export growth and attracted tourists, thus helping the leisure, entertainment, hospitality, and retail industry

Genesis of Current Crisis

- But serious problems were brewing underneath. What were they?
  - Did all the home mortgage borrowers qualify for the mortgages by traditional lending criteria? Not really.
  - Lending criteria were relaxed dramatically, which qualified a whole class of first-time borrowers
    - No documents lending! No down payment, no employment verification, and interest-only mortgages
  - With low interest rates and adjustable mortgages, buyers were able to make payments initially

Banks' incentives to relax lending standards

- Why were lenders willing to lend?
  - Fannie Mae and Freddie Mac bought securtized loan portfolios without asking questions!
    - Securitized loans: Mortgages sold in secondary market by the lending banks, so in effect the lending banks served only as intermediaries
    - Banks collected fees for their intermediary role
  - Fannie and Freddie, quasi government bodies, were encouraged to do so by the Federal Reserve, the administration, and by the Congress – latter perhaps was most enthusiastic – all with the social objective of broadening home ownership and helping the economically disadvatged and minority communities

Who else contributed to the problem?

- Accounting standards, accountants, CEOs, rating agencies, and Wall Street were all accessory to the financial crisis
  - In addition to the fee income, securitization of loans generated immediate profits even though lenders retained the highly risky bottom sliver of the mortgage receivables
    - Accounting facilitated this via lax fair-value accounting rules
    - The immediate gain was a big incentive to the banks' senior management toward maximizing the number and amount of mortgages

Who else contributed to the problem?

- Auditors turned a blind eye to false information in loan applications and helped to compromise lending standards in assessing the risk of the loans
- Same is true of the rating agencies – most of the securitized loan tranches were AAA rated!
  - Rating agencies didn't carefully examine whether borrowers were in a position to repay the loan in the event of interest rate increases or a downturn in housing prices
  - Rating agencies grossly underestimated the default risk – this is not just with hindsight

Who else contributed to the problem?

- Wall Street: Why were they loading up on securitizations?
  - Securitization and credit default swaps were big sources of income for Wall Street
- The enthusiam spread all over the world!
  - Lax lending and securitization became commonplace in many countries, but not all
- Subprime crisis became a worldwide problem
  - Either directly because of bad lending, e.g., in England, Ireland, and Spain
  - Or because of the unsutainable growth it generated in many countries

What triggered the bursting of the housing bubble?

- Robust economic growth means low interest rates were no longer necessary
- Rise in the interest rates was predictable from the upward sloping yield curve
- Subprime homeowners quickly started to default – their mortgage payments doubled or tripled in many cases – no surprise here!

Consequences of mortgage defaults

- Devastating consequences of mortgage defaults
  - Housing prices declined precipitously in areas where lending was particularly reckless – CA, NV, FL
  - Causing slowdown in related activities
    - Construction demand
    - Realtors and mortgage brokers
    - Banking services
    - Goods and services – retail, manufacturing, and service sector – started to slow down
    - Job losses started to mount

Consequences of mortgage defaults

- Ripple effects were devastating, not just in the US, but elsewhere too
- Weakness in the economies initially worst hit began to spread because it led to more defaults and further slowdown
- And then banks started to suffer catostrophic losses from mortgage and loan defaults
- This spread to the entire financial services industry and the rest of the economy, and the stock market dropped precipitously

Role of Accounting

- Accounting played a role via
  - Accounting standards
    - Instant gain from securitization created an opportunity that the management took advantage of
  - Managemet incentives
    - Lack of writing down of loans facilitated excessive risk taking
- Both factors contributed to the crisis
  - Of course, other factors were also important, perhaps more important

Role of Accounting: Lessons for the Future

- Financial information for a few well-known firms
- Accounting is about the past, valuation about the future

Company	# of Employees	Revenue / Employee $’000	Mkt Cap / Employee S’000	PE Ratio	Mkt-to-Book
Apple	34,300	1,870	7,813	24	6.4
Microsoft	93,000	629	2,277	12	4.7
HP	304,000	377	369	12	2.3
Starbucks	142,000	72.5	136	26	5.8

Role of Accounting: Lessons for the Future

- Role of accounting standards
  - High PE ratio and high mkt-to-book ratio firms: Value is in anticipated revenues, growth, and profits
  - Avoid valuation-like accounting standards, e.g., fair value accounting, that make it easier for firms to recognize into income anticipated, i.e., not yet earned, revenues and profits
  - Continue with accounting standards that recognize losses on a timely basis – this too is fair value accounting, but of the lower-of-cost-or-market variety

Role of Accounting: Lessons for the Future

- Role of management incentives
  - High PE ratio and high mkt-to-book ratio firms: Indicators of innovation and growth
    - Nurture these attributes to foster growth
  - But management has incentives to recognize income early
    - To further increase the market value, or
    - To receive more cash and equity compensation, or
    - To avoid a decline in the firm's market value
  - Call for standards accompanied by enforcement, sound auditing, and greater vigilance

Q & A