

POLICY PAPER

Climbing out of the Credit Crunch



ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 122,000 members and 325,000 students throughout their careers, providing services through a network of 80 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities. Our focus is on professional values, ethics, and governance, and we deliver value-added services through our global accountancy partnerships, working closely with multinational and small entities to promote global standards and support.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest.

Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications. We champion opportunity, diversity and integrity, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting our global standards, and supporting our members wherever they work, we aim to meet the current and future needs of international business.

We are now more than a year into the 'credit crunch'. An issue which began in one relatively obscure sector of the US housing market has unfolded over the last 12 months into a widespread credit and liquidity crisis which, combined with soaring commodity prices, appears to threaten a global slowdown.

While there is general agreement on what has happened, there is far less on why it has occurred and it seems that there is still much to learn about market liquidity.

INTRODUCTION

The last few years have seen unprecedented growth in size and profitability of the global banking industry. Worldwide profits¹ in 2006 were \$788bn – more than \$150bn greater than the next most profitable sector, oil, gas and coal. Global banking revenues were six per cent of global GDP and profits per employee were 26 times higher than the average of all the other industries. Some have argued that such profitability is due in large part to market imperfections arising from the regulatory system such as lack of competition and information asymmetry between parties to transactions.

Independent surveys² also point to a growing differential in remuneration packages for CEOs compared with other Board members. Also, over the last decade, remuneration of senior staff appears to be growing at a faster rate than dividends paid to shareholders.

The prosperity of the banking sector, nonetheless, positively influenced global growth in the so-called 'real economy'. But we are now in the curious position of seeing institutions in a sector which, in early 2007 was seemingly awash with liquidity, now relying on, and receiving public funding in countries like the US and UK. This is in the form both of loans from central banks to provide liquidity and capital injections from other states' sovereign wealth funds.

As a global body representing accountants and finance professionals, ACCA (the Association of Chartered Certified Accountants) has naturally been following developments in the credit crunch closely, and has hosted several events to debate the issues and contributed to consultations from regulators and standard setters. Below, we summarise our views on the immediate causes of the problem, and then briefly examine some of the issues involved in the credit crunch covering five key areas of ACCA's expertise:

- corporate governance
- remuneration and incentives
- risk identification and management
- accounting and financial reporting
- regulation.

We are very grateful to the experts from the banking, investment and academic communities who have helped us in forming these views.

ROOT CAUSES OF THE CREDIT CRUNCH

Key factors

ACCA believes that excessive short-termism, coupled with a lack of accountability both within financial institutions and between management and shareholders, is at the heart of the problem. This has meant:

- failure of institutions to appreciate and manage the inter-connection between the risks inherent in their business activities and management and remuneration incentives
 - remuneration structures/bonuses of banks being characterised by excessive short-termism. This neither supports prudent risk management nor works in owners' long-term interests
 - risk management departments in banks which did not have sufficient influence, status or power
- and
- weaknesses in reporting on risk and financial transactions.

Secondary factors

Further contributory factors were:

- over-complexity of financial products and lack of management understanding of the associated risks – including the fact that, currently, there is no genuine market for certain asset-backed securities
 - over-dependence on debt and an assumption of a continuing low cost of capital environment
 - scale of issuance of securities and the inter-connectedness of financial institutions, especially between retail and investment banking
 - human weaknesses: a failure to appreciate the influence of cultural and motivational factors such as rigidity of thinking, lack of desire to change. An attitude of 'it is not my problem', inappropriate vision/drivers and, perhaps most importantly, human greed
 - lack of training to enable management to understand underlying business models, leading to poor managerial supervision
 - lack of rigorous challenge by non-executive directors possibly caused by poor understanding of the complexities of the business
- and
- bad habits and complacency after a prolonged bull market.

CORPORATE GOVERNANCE

ACCA believes that underlying much of the credit crunch has been a fundamental failure in corporate governance. While the financial institutions involved may have been in compliance with local requirements and codes, they have ignored the key point – good corporate governance is about boards directing and controlling the organisations so they operate in their shareholders' interests. Boards should be answerable to company owners, to account properly for their stewardship and to ensure both sound internal control and the ethical health of the organisations. The use of overly-complex financial products, which thwarted effective supervisory control, and the unethical advancement, at the point of sale, of loans to people with little realistic hope of repaying them shows a lack of basic corporate governance.

A fundamental role of the board is to provide oversight, direction and control but also to challenge where necessary. This does not appear to have happened in many of the banks. No doubt this is partly owing to a lack of understanding of the complexities of the business, but more training is probably only part of the solution. Further research is needed to understand what inhibited boards and managers from asking the right questions and understanding the risks that were being run on their watch.

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REMUNERATION AND INCENTIVES

ACCA believes that executive remuneration arrangements should promote organisational performance. Existing incentive and career structures of banks meant enormous rewards but have reinforced short term thinking, which has been one of the major causes of the credit crunch.

If not addressed, remuneration issues will continue to frustrate other attempts for reform. This is a human behaviour challenge. Risk management and remuneration and incentive systems must be linked. Executive payments should be deferred (eg held in an escrow account) until profits have been realised, cash received and accounting transactions cannot be reversed. Instead of paying out on paper profits, there must be a much stronger link to genuine operational cashflows. These measures would make the risk management function more important in organisations - risk managers should be regarded as having a status equal to those in the 'front office' and should be remunerated accordingly.

We question whether the relative share of bank income paid as remuneration compared with dividends has been in the best interests of long-term shareholders. Investors and shareholders have limited ability to influence companies they own. Not all shareholders invest for the long-term and not all of them have an interest in holding boards to account for their stewardship. This is a fundamental governance challenge in capital markets where shares are widely held, and is not confined to the banking sector. The emergence of new strategies (eg using derivatives) for participating in corporate profitability and new types of shareholder, such as sovereign wealth funds, compounds the challenge.

One way to help address both challenges is to ensure that boards and shareholders receive appropriate, clear, timely and reliable information on risk and financial results.

RISK IDENTIFICATION AND MANAGEMENT

Banks have highly sophisticated risk management functions yet recent events have tested them and found many wanting. A report from UBS in April 2008 to its shareholders explaining the reasons for its write-downs provides a very clear example of risk management failings, with a clear disconnect between incentives to senior staff and risk management.

In early 2007, few senior managers thought they were betting on the viability of their banks. It appears they did not understand the risks and were using risk assessment with tools which were inappropriate. Boards may not have expended the necessary time and energy, and/or lacked the expertise to ask the right questions.

There seems to have been widespread misunderstanding about credit ratings. Some investors may have believed that an AAA-rating meant 'safe'. Others were allowed by their employers to buy AAA-rated instruments with little or no further diligence or consideration of risk. As referred to above, the risks of such an activity were not matched to the incentive system. This meant that traders were able to buy large volumes of mortgage backed security and receive a bonus based on the difference between the yield on the security and the bank's internally charged cost of funds. There was no downside risk for them individually. The inherent risk to the bank from such a trade was enormous yet was either ignored or not recognised.

Such activity generated a huge demand for AAA-rated securities. Selling derivatives of securities became akin to selling betting slips. Products were created, packaged and marketed which were a 'bet' on the performance of the reference assets. Collateralized debt obligations (CDOs) were created, in part, because there was an insufficient volume of underlying mortgage-backed security (MBS) origination to meet investor demand. These products relied for their existence on credit grades as there was no claim on the underlying assets in difficult circumstances as there was in an MBS.

In a low inflation environment, banks' search for increased yield has encouraged derivative trading. Derivative traders are, however, very different from traditional retail bankers, and the chief executives of banks may have lacked the necessary training in these new products. This, accompanied by complexity and volume of transactions in turn facilitated by the continuing increase in computing capacity, meant that traders were effectively allowed to 'get on with it' with minimal control from the board. The yields which seemed to be created, aided by AAA ratings, mesmerised top management of many of the major financial institutions. There was not enough questioning about what AAA actually meant.

The way risk is accounted for is a primary driver of capital value. Present prices, showing points (rather than ranges) in time are not a good indicator of future asset values. Many of the risk management tools such as VaR (value at risk) assume that 'efficient market theory' works. Efficient market theory in turn assumes a normal distribution around a mean, and does not take proper account of the huge risks posed by derivative market variables which may not move in line with normal distributions.

ACCOUNTING AND REPORTING

The problems of markets' efficiency have had a similarly major bearing on accounting valuations. Have accounting standards inadvertently made the credit crunch worse by turning a crisis of liquidity into one of solvency?

In recent months, there has been a keen debate in the accountancy profession about the so-called 'fair value' practice of valuing assets not at original purchase price, or 'historic cost', but using current market value. While in normal times, this seems sensible, the question arises: what do you do when there is no genuine 'market' to mark to? Subjective models have to be used which do not adequately reflect the extreme conditions of the last twelve months. This has contributed to huge bank write-downs, which can then pressurise other players to use the new lower benchmark. This in turn leads to a temptation to sell now, before the price gets even lower, and so the vicious spiral gains momentum.

Some banks and regulators have argued that fair value – one of the key tenets of the International Financial Reporting Standards (IFRS) regime now used in Europe and by listed companies in 100 countries – is making a bad situation worse. Even some accountants have called for a 'smoothing' of assets values at average market price over a 12-month period to take the sting out of the downwards slide in an abnormal situation.

ACCA believes that for all the current troubles, the increased transparency of IFRS and fair value makes it still the best model available. Any sort of smoothing will ultimately lead to a diminution of market integrity and openness. It should not be forgotten that historic cost led to stagnant loans and lack of transparency in the Asia-

Pacific economies which was shown up in the 1997/8 crisis, and which in turn led to the drive for international accounting standards. More appropriate than yet another revision of accounting standards would be to provide fund managers with better and more consistent guidance for implementation of existing standards.

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All parts of the accountancy profession – preparers, standard-setters, and auditors – must learn from the last year and strengthen the fair value model. They need to define the parameters where profits and losses are struck under fair value. Poor quality loans sliced, diced and parcelled up in a new wrapping with an AAA sticker should not be accepted as assets worth billions of pounds or dollars. Banks balance sheets which included these CDOs did not represent a 'true and fair' picture – and even other banks' willingness in early 2007 to buy them at a falsely high price does not change that fact. The credit crunch is not another Enron as far as the accountancy profession is concerned – though in the extensive use of off-balance sheet vehicles there is a superficial resemblance – but preparers and auditors of accounts in the affected organisations legitimately face questions. If credit ratings agencies and mortgage brokers are most culpable, the accounting profession must learn the lessons from its various roles in this sequence of events.

REGULATION

ACCA does not believe that poorly drafted and inadequately implemented regulation is the main driver of the credit crunch and too great a focus on this area risks deflecting blame from specific banks and individuals concerned. Nonetheless it must be considered.

Retail banks have a fundamental role in society and both they and their depositors need protection. Arguably, investment banks do not need the same protection, but with most large banks now having both retail and investment activities in-house, there has been a blurring of the dividing line. The issue is that banks are now too big for regulators to ensure proper protection of all depositors. In the US, only direct government intervention to support Freddie Mac and Fannie Mae led to the safeguarding of people reliant on these huge mortgage providers. A collapse of either could have had a larger effect on society if the depositor base lost faith in the banking system. This leads to the issue of moral hazard, with banks being too big to be allowed to fail.

Clearer rather than heavier regulation is needed. A separation of retail from investment banking should be the regulatory goal.

Regulators around the world must be clear about the purpose that regulation is trying to achieve. Depositors must be protected as a primary objective with adequate compensation arrangements being crucial to maintaining public confidence in the banking system. Simplification of over-complex investment products would also help the position of the consumer as would measures to increase financial literacy. On a fundamental level, the regulatory system must recognise that the relationship of bank and customer should be one characterised by trust.

To help achieve this, a separation of retail from investment banking should be the regulatory goal. Retail banks should be segregated from other financial institutions in terms of the activities they can engage in. Any new product that does not resemble a deposit or a loan to an individual or a

corporate body should be presumed to be a non-retail product and not permitted. All banking regulatory bodies, nationally and internationally, should aim for this distinction as a key policy objective.

It is vital that the public know what they are putting their money into. Normal retail bank customers were not to know that banks were taking on wholesale market risks. There has to be a clear stratification of savings products. Transparency is key.

The capital requirements regime for banks should be reviewed. Consideration should be given to retail banks being offered more protection against crises in liquidity with larger buffers built into the Basel 2 framework. The adequacy of the close link between accounting numbers and regulatory capital also needs reviewing.

ACCA would add one final point about regulation – credit ratings agencies do not have any sort of statutory regulation. Given their considerable role in the credit crunch, the industry has not been any sort of example for self-regulation. This anomaly should be addressed immediately and agencies brought into line with other players in the financial regulatory field.

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CONTACTS

For more information, please contact:

Steve Priddy, Director of Technical Policy and Research, ACCA
+44 (0)20 7059 5971
steve.priddy@accaglobal.com

Veena Hudson, Public Affairs Manager, ACCA
+44 (0)20 7059 5615
+ 44 (0)7736 800 393
veena.hudson@accaglobal.com

Ian Welch, Head of Public Affairs, ACCA
+ 44 (0)20 7059 5729
+ 44 (0)7739 862 928
ian.welch@accaglobal.com

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