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Inside Wall Street: Why Hocus-Pocus Accounting Will Perpetuate the Capital Markets Credit Crisis

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I once asked my friend – world-famous magician Lance Burton – if he could show me how he did a particular trick.

"Can you keep a secret?" he asked.

"Of course," I replied.

"So can I," he said.

The point is that the U.S. Federal Reserve, the U.S. Treasury Department and federal regulators are keeping secret the true precariousness of the capital markets credit crisis and the banking system's close-to-the-precipice predicament. They need to give banks and investment banks room to maneuver their balance sheets by whatever "hocus-pocus accounting" methods they can utilize – without being outright fraudulent. It's a matter of putting on a good show to give the banks time to repair their balance sheets and build up capital, however long that takes and with whatever magic can be mustered.

No End in Sight

Contrary to once-prevalent expectations – including the early prognostications from the Fed and Treasury – the capital markets credit crisis is not abating. And as long as sleight-of-hand, hocus-pocus accounting is prevalent, transparency will be thin, liabilities will be buried, losses will surprise investors, and capital will be both inadequate and expensive.

Accounting is not supposed to be that complicated. There shouldn't be any magic, trickery, or sleight-of-hand. The ugly truth is that, until housing prices bottom out, no amount of hocus-pocus accounting will fix the problems that fed into the capital markets credit crisis. Hiding problems only delays the day of reckoning. In short, given our present set of circumstances, ugly is not just skin deep. And there is no rabbit to be pulled from the hat.

Attendant to the magic of hocus-pocus accounting are numerous sideshows that further mask mortgage-related liabilities. One easy-to-spot trick is the lengthening of the measure under which banks consider loans to be troubled, or categorized as non-performing assets. The sleight-of-hand occurs when a bank redefines troubled loans to be non-performing when the borrower is three payments behind versus two payments, or when it moves the target for "anticipation of borrower default" out to 180 days from 120 days.

Pick a target: If you're afraid they'll hit it, just move the target.

The Basel Boondoggle

It's not enough that subjective Financial Accounting Standards Board (FASB) asset-classification standards and subjective fair value accounting methodologies provide the dagger in the heart of transparency; there are additional knives and swords available and widely employed with which to slice and dice asset values in order to cloak capital inadequacy and actual losses.

Besides deferringlosses, banks and investment banks manipulate critical measures of capital adequacy in order to remain, in the eyes of regulators and the public, adequately capitalized and solvent. Tier 1 capital, the principal measure of adequate equity capital, consists of shareholder equity, irredeemable preferred stock and retained earnings. The more Tier 1 capital a bank has, supposedly, the safer it is.

The calculation of Tier 1 was established by the Basel Accord of 1988 under the auspices of the Bank of International Settlements (BIS). The 1988 Accord, known as Basel I, was updated in 2004. The modified accord is known as Basel II.

A bank's Tier 1 *capital ratio* is the ratio of the bank's equity capital to its risk-weighted assets. The ratio is important because it serves as a window into leverage and risk. The problem with the capital-ratio measure is the potential for manipulation in the calculation of "risk-weighting."

How banks weight the riskiness of assets is too often a result of bank's managing their capital. In other words, it's a bottom-up process: Determine what capital is required and then manage the books to meet that measure.

The classification of assets as *available-for-sale* is a perfect example of burying liabilities to meet capital requirements. "Available-for-sale" gives management the option to account for assets as if they might be saleable now and priced concurrently or whether, maybe, they will be held to maturity and not have to be priced according to their present fair value.

What's even better for banks when they use this magic trick is that losses, no matter how large, reside in the netherland of *accumulated other comprehensive income,* the accounting line on the balance sheet that available-for-sale assets flow down to. And those losses are not included in Tier 1 calculations!

There are other problems with implementation of the Basel Accords. Commercial banks, overseen by the Fed, follow Basel I guidelines for Tier 1 ratios. Investment banks, overseen by the U.S. Securities and Exchange Commission, calculate Tier 1 ratios based on Basel II guidelines.

Investment banks are deemed to have it easier because Basel II allows greater management flexibility in weighting risk and allows the incorporation of ratings and internal modeling into that process. It's enough to know that manipulation is manifest. That much is clear, especially with all the pain that trumped-up – and downright corrupt – ratings have already caused in the massive subsequent downgrading of credit instruments. Federal Deposit Insurance Corp. Chairman Sheila C. Bair has actually stated that Basel II essentially lets "banks set their own capital requirements."

One fine point of the Basel I Accord differentiated between banks holding mortgages on their books and those holding mortgage-backed securities, in terms of the capital to be held against these different assets. Holding mortgages required more capital since, technically speaking, mortgages are technically less liquid than tradable security instruments. The result was a wholesale exit from holding individual mortgages and a rush into mortgage-backed securities.

Now You See it …

Having to hold capital against assets as a cushion against future losses ties up otherwise productive capital. Anywhere those capital requirements can be reduced frees up that released capital to be employed elsewhere in leveraging the balance sheet. The ultimate device to free up capital was not merely accounting sleight-of-hand to pare back capital-reserve requirements, it became the ultimate magic trick – *the disappearing act.*

In order for banks and investment banks to make their capital-reserve-holding requirements disappear, they would have to make the assets against which capital needed to be held disappear. And, with a wave of the wand and the magic words hocus-pocus, they did. Welcome to the world of "now you see it, now you don't" – better known as "structured investment vehicles" (SIVs) and conduits.

SIVs are generally offshore entities set up to warehouse assets that would otherwise be subject to bank capital reserve requirements. A conduit is the generic name for an SIV; it is a conduit because it is a reciprocating channel for buying back asset-backed securities (ABS) previously sold into the capital markets by the banks. Banks fund SIVs with short- term commercial paper issuance, massively leverage their borrowed capital, and buy huge amounts of ABS instruments.

They don't need to waste capital on reserve requirements because SIVs are not banks, and are therefore not subject to capital-reserve requirements. They are virtual banks without the regulatory hassles.

Doesn't anybody out there remember what happened when the now-defunct Enron Corp. employed these vehicles and manipulated their earnings?

The problem with this ultimate accounting fraud is that banks are potentially going to have to take their SIV assets back onto their books, haircut capital for reserves and eat the losses that have been hidden by accounting gimmickry at the SIV level. It's massive. But, because it is so massive and dangerous for banks' liquidity and a potentially devastating blow to their capital adequacy, regulators, including the Fed and Treasury, have yielded to delaying until 2010 the requirement that banks take these off-balance sheet assets, or more correctly, liabilities, back on to their books. Citi alone is estimated to have some $600 billion to $700 billion of SIV assets.

Once banks repatriate their SIV assets back onto their balance sheets, they will employ the full magic of accounting sleight-of-hand to bury liabilities in their efforts to struggle to maintain capital adequacy. Understanding some of the hocus-pocus accounting ticks – which I shall unmask in my follow-up piece tomorrow (Thursday) – will help investors look behind the curtain as they attempt to measure the worth of banks and investment banks and gauge the true duration of the capital markets credit crisis.

[Editor's Note: Contributing Editor R. Shah Gilani has toiled in the trading pits in Chicago, run trading desks in New York, operated as a broker/dealer and managed everything from hedge funds to currency accounts. In his new column, "Inside Wall Street," Gilani promises to take readers on a journey through the "shadowy back alleys" of the U.S. capital markets - and to conduct us past the "velvet rope" that guards Wall Street's most-valuable secrets - in an ongoing search for the investment ideas with the biggest profit potential. In Part II of his commentary on "hocus-pocus accounting" tomorrow (Thursday), Gilani will "unmask" three of the actual accounting maneuvers that fed into the capital markets credit crisis.]

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