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A brief history of the financial meltdown so far…

Kevin Voigt examines what landed the global economy into its current mess

"As a person involved in the front end, I don't think I've ever been this nervous in my career because I think the financial system was so close to locking up. I think we were real close to the abyss – the ultimate freezing of the financial system."

– a Daiwa Securities trader speaking to National Public Radio in Washington D.C., 3 October

You know you are living in strange times when esoteric accounting terms such as "mark-to-market" are suddenly making headlines.

And that never bodes well for the accounting profession. As the old joke goes, an accountant "is someone who finds problems you didn't know you had and solves them in ways you don't understand."

On 1 October, there was a rare White House spectacle – spokesperson Tony Fratto trading questions with reporters about the U.S. Securities and Exchange Commission's accounting practices. Neither side appeared to know what they were talking about, noted Floyd Norris, the chief financial correspondent for *The New York Times*.

"They should not feel bad. A lot of accountants feel the same way," Norris wrote on his blog. "Some think (relaxing mark-to-market standards) changes nothing; others think it opens the way for banks to pick any value they want."

In the hailstorm of information on the financial crisis, one concept swirls at the centre that explains every event that led to this maelstrom: trust. The trust that the value of things sold is equal to its worth. Trust that credit given to people and institutions is credit earned. The confidence that the architects of the world economy – corporate and political leaders, regulators, credit rating agencies and, yes, accountants – are trustworthy stewards. And while the blame trial is just starting, the jury has already reached a damning verdict against the trust that once held the world economy aloft.

Even as events continue to spiral, the past six weeks will shake the accounting profession to its core. *A Plus* takes a two-part look at the credit crisis: This first installment sorts through headlines and news stories stretching back a decade to shed light on how this mess came about; next month, we'll examine how the new administration in Washington will shape the profession worldwide and how accountants in Hong Kong and China will be affected.

What goes up must come down

When distant historians try to make sense of how the world economy tumbled so far, so fast, the date that will be remembered is 15 September 2008. That was the day the financial crisis stopped being Wall Street's problem and became everyone's problem. That was the day mighty U.S. Treasury Secretary Henry Paulson became a supplicant, literally kneeling before congressional leaders and issuing dire warnings that without government intervention, "we might not have an economy by Monday."

What caused the economy to sputter for real is the commercial paper market, a financial tool as mundane as the motor oil that sits in the engine pan of every automobile. Imagine, however, the oil in every car in the world suddenly drying up below manufacturer specifications – poorly maintained cars start choking, creating traffic jams worldwide and even Ferraris begin to ping and rattle.

The commercial paper market keeps companies running day-to-day because a going concern's accounts receivable rarely matches its accounts payable. Large companies regularly borrow millions for one-day, low-interest loans via investment banks so they can, for example, make payroll while waiting for clients and customers' cheques to clear. When Lehman Brothers went bankrupt, however, the Reserve Money Fund – the market's oldest money fund that is fed daily by the commercial paper – "broke the buck." For the first time ever, every dollar invested in the fund was worth only 97 cents.

When you hear about "the collapse of the world financial system," this is the ground zero event. Investors in the traditionally safe fund suddenly ran for cover, exacerbating the crisis. Well-run, profitable businesses with no connection to the subprime mortgage debacle suddenly faced a liquidity crunch. And Henry Paulson fell to his knees.

The world grew rich

Like every tragedy, this story starts with a rosy beginning. According to the International Monetary Fund, the amount of money in the world doubled from 2002 to 2007, thanks to rising economies such as China, India, Russia and Brazil. With that came a thirst for "safe" investments. The policies of former U.S. Federal Reserve Chairman Alan Greenspan, however, kept interest rates on U.S. bonds – traditionally the safest of bets – extremely low. The U.S. therefore provided what was considered the next safest bet: real estate.

The problem was, since the mid-1990s, U.S. homeowners worthy of

Photo: Timothy A. Clary/AFP/Getty Images

Photo: David McNew/Getty Images

Pasadena, California — A customer withdrew his life savings from an IndyMac Bank on 14 July after it reopened following a takeover by the U.S. federal government three days earlier. Regulators said it was the second biggest bank failure ever in the U.S.

Photo: Karen Bleier/AFP/Getty Images

Capitol Hill, Washington D.C. — Richard Fuld, former chief executive of Lehman Brothers, the No. 4 U.S investment bank that has now gone bankrupt, testified on 6 October before the U.S. House Oversight and Government Reform Committee.

good credit already had most of the mortgages they needed. So lenders began expanding into the controversial subprime market. Although this exploded into public consciousness last year when mortgage defaults began taking down lenders, a search through the public record shows every step of the way naysayers were predicting subprime doom.

"From the perspective of many people, including me, this is another thrift industry growing up around us," Peter Wallison, a resident fellow at the American Enterprise Institute, told *The New York Times* in 1999 when Fannie Mae, the biggest underwriter of U.S. mortgages, announced its plan to enter the subprime market.

"If they fail, the government will have to step up and bail them out the way it stepped up and bailed out the thrift industry," Wallison said, referring to the U.S. bailout of the savings and loan industry, which took deposits from individual savers and lent funds for home mortgages during a real estate boom in the 1980s. When that went bust, U.S. taxpayers had to foot most of the US$160 billion bailout.

Who enabled this subprime feeding frenzy? Check this headline from the October 1997 edition of *American Banker*: "Home equity: Conti offers a chance to bet on its accountants." The article went on to describe ContiFinancial Corp.'s huge inroads into the subprime market, noting "gain-on-sale accounting makes this investment vehicle possible… home equity lenders make loans, then book expected profits before the loans are repaid." Detractors, the article noted, criticized the tool because it relies on company – and accountant – presumptions of future value.

Bad bet. ContiFinancial went belly-up last year.

The rise of "quants"

Financial service companies, in response to demand, developed more and more exotic financial products born from the minds of quantitative analysts, or "quants" – the new Einsteins of Wall Street. But the computations of these financial mathematicians for carving up debt into smaller slices, called "tranches," and mixing them back together make E = MC2 simple by comparison. Derivatives are an unregulated tool that aims to serve as insurance in case things go very wrong. But companies quickly learned derivatives could also be used to make extremely risky bets for great rewards – which they did. Right up to the moment they didn't.

Market players in *nouveau riche* nations like China pounced on mortgage debt as safe bets, since homeowners have traditionally tended to pay back their loans. Unfortunately, they were buying debt that had been

Photo: Mark Wilson/Getty Images

Washington D.C. — U.S. Treasury Secretary Henry Paulson spoke at a news conference on 14 October about the market stability initiative while Federal Reserve Chairman Ben Bernanke watched on.

Photo: Timothy A. Clary/AFP/Getty Images

New York — An artist let people sign his painting of U.S. Treasury Secretary Henry Paulson on Wall Street outside the New York Stock Exchange.

carved up and repackaged in such ways that its good credit rating was more mathematical wizardry than actual worth. To keep up with foreign investors' hunger for these products, lenders at the frontline began bilking homeowners for more – people like my father. When he decided to sell the family homestead for a smaller house, he was worried his age, 69, might be a problem when he went to borrow for the new house while awaiting sale of the old. Instead, he left the bank with a 30-year mortgage.

"You know, I might not be around for 30 years," he told the loan agent. "That doesn't matter" was all the explanation he got.

We now know why it didn't matter – the bank sold it to Wall Street, who in turn sold to the global market. It evolved from a local bank problem to one for distant investors, like the Hong Kong buyers of minibonds from Lehman Brothers. Meanwhile, my father is the owner of two houses and a victim of exceptionally bad timing: Although many have expressed interest in buying the old house, few would-be buyers can get a mortgage despite repeated drops in sale price.

IPO = IOU

The great investment banks, in a rush to gain more capital, became publicly traded companies. Their businesses grew astronomically – since going public in 1995 until 1997, Lehman Brothers saw profits jump more than 17 times. As James Surowiecki, a staff writer at *The New Yorker*, noted in a recent article that publicly traded companies have a daily referendum on whether they should stay in business or not: their stock price. But the investment banks became less risk averse at a time when they actually should have become more conservative.

Until 1970, the New York Stock Exchange forbade investment banks from going public but after the exchange lifted the ban, nearly every prominent firm went public, the last being Goldman Sachs in 1999. Surowiecki wrote, "If Procter & Gamble's stock plummeted tomorrow, people would still keep buying 'Tide.' By contrast, if an investment bank's price tumbles, it not only wrecks people's confidence but can also lead to credit-rating downgrades, which provoke a further decline in stock price…" For investment banks, this is a death spiral.

"Long-term survival really depends on remembering the fundamental truth about playing with other people's money: It's a lot of fun until they suddenly decide to ask for it back," he concluded.

Short little attention spans

From chief executives to sales staff, success in mortgage companies and

Wall Street investment firms was largely – and in many cases solely – tied to quick turnaround of profits. The drive to expand market share and profit margin outstripped all other goals, such as the quality of the product, or the ethics underpinning trust – who should be given credit.

This could be described as the malady of short-termism – the ability only to see to the next business quarter or the next salary review. Short-term fixes are what led Enron into trouble, as lie upon lie compounded quarter after quarter until insider Sherry Watkins finally predicted the company would implode "in wave after wave of accounting scandals."

Short-termism explains why mortgage loans quickly descended from SIVAS (stated income, verified assets) to SISAS (stated income, stated assets) to finally NINAS (no income, no assets). It explains why quants kept coughing up new products to sell. It explains why high-pressure sales staff convinced unemployed people to take out mortgages and why foreign investors kept the spigot flowing for dubious investments.

Herding

The corrosive power of greed on common sense is an old story, but the follow-the-leader mentality behind subprime mortgage crisis is stuff straight out of the Bible. People knew better – and many people stopped many times (as far back as a decade ago) and said this will all go south. But the herd moved on toward the cliff.

Herding, a common term in behavioural finance, explains the knee-jerk reactions on the Hang Seng Index to the New York Stock Exchange, even if events on the New York exchange have no direct bearing on companies listed in Hong Kong. In the current crisis, the herding by investment banks into bad credit bets is now faced with investor herding away from *any* credit investments.

> "People knew better – and many people stopped many times (as far back as a decade ago) and said this will all go south. But the herd moved on toward the cliff."

But standing away from the herd can reap huge rewards. Case in point: Bank of America. Unlike its New York competitors, the bank is headquartered in Charlotte, North Carolina. According to a 2001 article in *The Wall Street Journal*, Bank of America dabbled with subprime loans but began pulling out by 1999, in part because North Carolina enacted stricter laws as mortgage foreclosures on low-income residents in the state began to increase.

In other words, Bank of America stopped making bets on the subprime market in part because it was in a closer location than New York banks to the people being fleeced by high-risk mortgages. As a result, the bank today is the proud new owner of Merrill Lynch.

Foxes minding the chicken coop

Remember Arthur Andersen? How the Big Five firms became the Big Four is a well-known ghost story told around accountant campfires, but the spirit of that story – how signing off on Enron's bogus books brought down the firm – haunts this spiraling crisis. The reason why so many investors – like those in Hong Kong who lost millions on Lehman's minibonds – bought into the subprime fiasco is that credit rating firms such as Moody's and Standard & Poor's gave such investments top ratings.

Investors depended on these independent firms for credit ratings and they blew it big time, giving their highest ratings – AAA – to collateralized debt obligations, or CDOs, now known to be next to worthless. How culpable they are remains to be seen (as of this writing, the head of the credit agencies were nervously waiting their turn under the klieg lights of the U.S. House of Representatives committee investigating the crisis). But all industries that signed off on this mess – including an army of accountants – can expect scrutiny as to how this happened and recriminations for any culpability (perceived or real).

The haves versus the have-nots

Richard Fuld, former chief executive of Lehman, has seen better times. The day his firm declared bankruptcy, an employee punched Fuld out while he was working off some stress in the company weight room. The physical attack was followed by verbal bruising when Fuld was grilled by U.S. congressmen over the US$350 million he earned from 2000 to 2007, largesse earned in part from spiraling profits from subprime lending. The golden parachute for failed executives is an old story – we saw a lot of this

Photo: Reuters/OTHK

in the aftermath of Enron, Tyco and WorldCom – but this time it touches on what many believe will be the defining social issue of the 21st century.

For years, in both developed and developing countries, the schism in pay between top executives and line workers has grown into a canyon. The failure of quick action by the U.S. leadership to respond to the crisis was in part due to extraordinarily bad timing – one month before presidential and congressional elections – but beneath this is the simmering anger of taxpayers who are being asked to shell out 5 percent of their GDP to solve a problem they don't understand while at the same time taxpayers can see the emergence of a class of hyper-rich executives who taxpayers think caused the problem. The perception is brewing that Wall Street's fat cats believe in "privatized reward" but "socialized risk."

Wall Street meets Main Street

Unlike the 1929 stock crash, when only a small percentage of the U.S. population played the market, half of America now has a stake in the stock market – either through direct investment or investment in retirement accounts. As the cracks in the U.S. economy appear, rage grows in towns around the country. And where rage grows, new regulation sprouts.

As accountants know from the Sarbanes Oxley legislation, passed in the wake of Enron, what U.S. legislators do directly affects the accounting profession in Hong Kong and mainland China.

No one knows what shape this new regulation will take – that will be for the new U.S. president and congress to sort out. But inevitably, especially for the financial services industry, new regulation will make Sarbanes Oxley seem like treating a gunshot wound with a plaster bandage.

While the accounting profession won't be taking the full-weight of the fall as it did with Enron and WorldCom – there is plenty of blame to go around in this mess – accountants will still feel the pain. And again, the cycle of restoring trust in the profession will start over. A+

Next month: Part two – the new Washington regime, the crisis and accounting in China