Financial meltdown II

+16

# Bust and boom

What will the financial crisis bring for the accounting profession and how will it change the regulatory environment? *Kevin Voigt* examines

Here come the regulators. If the election of Barack Obama was ever in doubt, the bankruptcy of Lehman Brothers in September sealed the deal. In the last gasp of *laissez faire* business practices by the Bush administration, the government decided to let the market decide the fate of one of the world's oldest and largest financial institutions.

Goodbye Bush, and goodbye to the age of *laissez faire* relationships between government and business.

Strangely enough, this appears to be a good thing for the accounting profession. For now, fingers aren't pointing at the profession for the financial crisis and predictions are that the bear market will turn into a bull market for accountants in 2009. But it's going to be a cold winter for anyone in banking.

"This is not the kind of environment where anyone is taking risks," said an investment banker who did not wish to be named. The risk in question? The reporter's request for an interview.

Indeed, the level of paranoia that now exists in the investment banking business in Hong Kong is unprecedented. The reporter made appointments by phone with bankers for informal chats over coffee, only to be refused after sending a follow-up email to confirm the appointment. The reason why became apparent when another banker agreed to meet up, but cautioned the reporter not to send him an email: "They are reading our emails," he said.

"They" are probably management people looking for places to cut head count.

The blood bath has already begun in banks and financial institutions. November was a bad month to be working for a bank. Citigroup announced it was shedding 53,000 employees globally in the next year –

Photo: Oli Scarff/Getty Images

meaning one in five employees will no longer have a job, based on 2007 company staff levels. HSBC announced the layoff of 500 employees last month, with 90 percent of the cuts in Hong Kong. DBS plans to cut 900 employees in Hong Kong and Singapore.

Goldman Sachs has announced cutting 10 percent of staff globally – by November, 3,200 employees were given pink slips. Morgan Stanley sacked about 100 of 1,700 employees in Hong Kong and aims to cut 6 percent of its staff across Asia, according to the *South China Morning Post*. Merrill Lynch employees are quaking with the inevitable redundancies its merger with Bank of America will bring. Even smaller players have the shakes – Bank of East Asia just finished its year as the worst performing bank on the Hong Kong exchange, surviving a run caused in the panic-stricken weeks after Lehman Brothers' collapse.

Maybe the biggest fear for bank executives is the fear of redundancy itself. "I'm just enjoying my time off," said Jeff Chang, former co-head of equities in Asia-Pacific for HSBC before the position he shared with David Scott was eliminated in September.

### Join the profession

If banking opportunities are running dry, try the accounting profession. KPMG said it still plans to hire 2,000 fresh graduates in Greater China. John Harrison, deputy chairman of KPMG International, said in a recent interview with the *Hong Kong Economic Times* that the global financial storm would last through 2009 and the banking sector would be hardest hit.

"But the accounting and financial management sectors will get more business as companies restructure," he was quoted as saying.

Marty Lau, a senior manager of corporate finance at mid-sized accounting firm Mazar's, says the downturn is a mixed bag for the profession. "There is still a demand for really quality accountants in Hong Kong and China," he says. "I think most of the accountants in Hong Kong and China are in the public practice sector, assuring audit requirements and the like… I don't think (the crisis) will affect these auditors at all, except on the fee side."

For years, the cost of audit fees has risen above inflation in Greater China because of increased demands for qualified accountants. "The Big Four started to choose their own clients, picking off smaller clients by suddenly charging them fees that are 50 percent higher, which then fed the mid-tier firms (with more clients)," he says. "I think these days, however, it would be difficult to ask for an increase in fees because of the economic downturn… Clients will be expecting a discount rather than an increase in fees."

Work on initial public offerings and mergers and acquisitions has substantially reduced. "For example, the Hong Kong stock exchange from August to October had only three new admissions, which raised about US$8 billion," he says, compared to the US$68 billion raised from 15 IPOs during the same period last year.

Accountants who have tied their fortunes to banking clients, however, could be looking for new clients soon. "I imagine if I worked for Citibank or HSBC, I'd be coming to the office each day wondering if I'm going to be handed a (dismissal) letter or not," Lau says.

Robert Half International, the world's largest financial recruitment agency, says tax accountants and staff accountants are expected to be in higher demand in the wake of the credit crunch and new legislation that is expected to follow.

Internationally, the profession is taking steps to position itself away from the credit crisis blame. Bob Bunting, president of the International Federation of Accountants, said recently that the accounting profession is part of the solution, not the problem.

"The financial crisis has clearly demonstrated how interconnected global markets are. This makes IFAC's *(continues on p.20)*

## Derivatives woes

*Will structured products survive the credit meltdown?*

The financial world waited in dread for 21 October.

Unlike the string of previous catastrophes that caught the planet off guard – the fall of Bear Stearns, the bailouts of Fannie Mae, Freddie Mac and American International Group and the bankruptcy of Lehman Brothers – this date loomed as the next Dark Tuesday of the credit crisis. This was the deadline millions of counterparties had to pony up their share of more than US$400 billion in Lehman credit default swaps, a privately traded derivative that in theory allows buyers to insure against companies failing to honour their debt.

Industry groups that oversaw the swaps, such as the International Swaps and Derivatives Association, assured the world the actual cost would be only US$6 billion. Many didn't believe it.

"That's not credible," Andrea Cicione, credit chief at BNP Paribas, told *The Daily Telegraph* in London shortly before that fateful day. "They keep coming up with these numbers by 'netting' but we think the amount is going to be anywhere from US$220 billion to US$270 billion. The chain broke in the CDS market when Lehman Brothers went down. We may now see other counterparties defaulting."

When 21 October hit, cost to counterparties was US$6 billion, just like the derivatives industry officials predicted. "You will see the agreements work just like they're supposed to," Robert Pickel, head of the International Swaps and Derivatives Association, told *A Plus* the day before counterparties' cost was due. "Their exposure is nowhere near what you're hearing."

It was a victory for the derivatives industry and these days they'll take their victories where they can. These complex financial instruments are facing one of the greatest public relations crises in modern history.

Derivatives have been wildly popular in Asian markets. "Everyone thinks the U.S. is the largest market for derivatives – but it's not even close," says an executive at a multinational investment bank who did not want to be identified. "In Europe, it's less than 5 percent of portfolios and in the U.S. less than 1 percent… in Asia, it's around 15 percent."

### Rising complaints

But that has come to a grinding halt, as complaints of derivatives products such as accumulators have reached a fevered pitch. In Hong Kong, the Securities and Futures Commission froze any new structured products from hitting the market, in the wake of nearly US$2 billion losses in Lehman-related products – almost all the badly named minibonds sold by third-party banks – while the Hong Kong Association of Banks stepped in to promise some payback to minibond victims. Lawmakers set up an inquiry last month to look into how banks sold Lehman minibonds, despite concerns voiced by bankers that a public investigation might force them to compromise client confidentiality and tarnish Hong Kong's image as a financial centre.

Minibonds aren't the only product drawing investor ire – high-net worth local investors are also complaining about accumulator-type derivative structures. "I started receiving complaints in March this year," says Hong Kong legislator Chan Kam-lam, past chairman of the Legislative Council's financial affairs committee. "Most of them claimed investment banks were selling them this unregulated product without giving them the full details about the downside of this."

Chan has received more than 50 complaints from investors who lost cash from investing in accumulator products and these high-net worth individuals don't want publicity about their problems, he says. An accumulator contract obliges investors to purchase a security, currency or commodity at a fixed price – often set at a discount to prevailing market rates – at regular intervals. When the market price is above the fixed purchase price, the investor makes money, but when it falls below the fixed price, the investor can suffer huge losses because he or she has to keep buying the product until the contract term expires – even when the price is falling.

Panicky investors and financial institutions in Asia are now moving toward capital-protected products, but their potential profits are nowhere near what accumulators can bring. Not that it matters right now – interest in structured products in November "was somewhere near zero," according to an investment bank executive who did not want to be named.

Chan is pushing for the minimum requirement of professional investors to be doubled to protect newly rich but inexperienced investors. Hong Kong law prohibits marketing of "collective investment schemes," such as structured products and hedge

Photo: Steven Bronstein/Getty Images

funds with high buy-in premiums, to non-professional investors, who are defined as those with a portfolio of less than US$1 million or total assets less than US$5.1 million.

The Hong Kong government may introduce a cooling-off period, where buyers of structured products can unconditionally terminate contracts. "With the Lehman Brothers saga, this is one of a range of possible solutions the government will be looking at," says Roger Tam, a spokesman for the Financial Services and the Treasury Bureau, adding that a report on possible revisions to Hong Kong law by the SFC and Hong Kong Monetary Authority are expected by the end of December.

Shareholder rights activist David Webb says Hong Kong made similar moves in 2003 when the Hong Kong Federation of Insurers established a 21-day cooling off period for new life insurance policies. "The government basically told the industry, 'do this yourselves or we'll do it for you'," Webb says. "You may see the same thing this time with investment banks."

Webb, who was among the first to propose a cooling-off period, also recommends the government require disclosure of commissions in all marketing products and contractual documents. "The issuer shouldn't be pretending to be your financial advisor to pocket the commissions," he says.

## Single regulator

He says Hong Kong should move toward a unified regulator, rather than four large regulatory bodies – the Hong Kong Monetary Authority, the SFC, the Mandatory Provident Fund Schemes Authority and the Office of the Commissioner of Insurance – and four "sub-regulators," namely the Stock Exchange of Hong Kong, the Hong Kong Federation of Insurers, the Confederation of Insurance Brokers and the Professional Insurance Brokers Association. "A unified regulator would remove the gaps and overlaps and the excessive costs," he says.

So far, the industry seems to be making the same argument of the gun lobby in the U.S. – a variation of the "derivatives don't kill balance sheets, people using derivatives kill balance sheets." And they have a point. At a recent Hong Kong workshop given to attorneys and bank managers who are new to derivatives, Anatoli Kuprianov, director of technical analysis for the International Swaps and Derivatives Association, warned about the risks of not understanding these products – or, even worse, not making your boss understand the risks.

He gave the example of a German mining operation that hedged risks without understanding the downside and lost US$1.5 billion in the process. "The senior managers didn't understand how they worked," he explained, and continued to use derivatives like a blank cheque to increase capital.

"When hedging works to the upside, you look like a genius, but half the time hedging works against you," he said. "The only perfect hedge you will find is in a Japanese garden."

Derivatives strategies won't go away, but investors' understanding of them will increase. "The one thing no one ever anticipated was that an issuer would go bankrupt," the investment bank executive says. As a result, the industry in the next few years will move toward more of a clearing house system, where if an issuer defaults, other private parties will pick up the bill.

A recent editorial in *The Economist* points out that 20 years ago, the equity futures market was blamed for the crash of 1987. Yet the market survived and has thrived after new restrictions were placed on trading. *The Economist* predicts a similar fate for derivatives like credit default swaps. "In 20 years, the CDS may well be as little remarked as the equity future is now. But only with reform."
— *Kevin Voigt*

Photo: Mike Clarke/Getty Images

initiatives to achieve convergence of international standards ever more urgent. Convergence to a common set of high quality accounting and auditing standards is essential to assuring the quality of the profession's services and is vital to the effective operations of markets," Bunting said.

## New regulations?

For now, the world is waiting to see what changes the Obama administration makes to regulations in the U.S., which will have a ripple effect across the world. Watchers expect unregulated areas of the financial world, such as hedge funds, derivatives and credit ratings agencies, to come under some form of federal supervision. New York state perhaps is leading the way the rest of the world may follow by treating credit default swaps with the same regulations it does insurance companies.

"One principle of the new regulatory system must be that regulations are based on what people do, not on (what) they are," writes Floyd Norris, a columnist for *The New York Times*. "If two products accomplish the same objective, they should be regulated the same way. Hedge funds that raise money from pension funds should not be allowed to wave a magic wand and be treated far differently from other institutional investors."

Some governments aren't waiting on the Obama administration. The European Union heads of state are calling for development of an "early warning system" for crises and more transparency in financial institutions, *The Independent* reported in November. The EU plan would strengthen the International Monetary Fund and bring new global rules to govern financial markets, which it is planning to have ready for the Washington G20 summit at the end of February, less than a month after Obama takes office.

Meanwhile, the G20 meeting in November was long on messages of unity, yet short on any specifics regarding regulation, other than the establishment by April of "supervisory colleges" for major cross-border financial institutions to discuss safety and status of the world's largest banks.

While North American and European regulatory environments will likely unify, Asia will not – and China, in particular, will remain an exception, according to Robert Pickel, head of the International Swaps and Derivatives Association. "The markets in Asia are too numerous and too

different," he says. "The regulation in China is slower to advance than in other markets."

### China and the big boys

That doesn't mean China doesn't want to appear at the table with the big boys. China briefly buoyed world markets with the announcement of a four trillion yuan economic stimulus package last month. But within days of the announcement, stock traders were viewing the plan with skepticism.

"What I'm hearing is that they took a bunch of infrastructure projects that were already planned, tacked on 20 percent and called it a 'stimulus package'," said a Hong Kong-based trader who did not want to be named. A Singapore-based equity trader added, "It's a red herring."

Merrill Lynch economist Lu Ting wrote in a research report days after China's 10 November announcement that "as so many numbers have been out there since mid-October, even those who have closely followed China's macro data are confused. While some take this (stimulus package) as a totally new plan, others say it is nothing new." The plan contains projects that were already on the books, such as reconstruction for earthquake-torn Sichuan province and railway improvements. Lu calculates that only 1.7 trillion yuan of the plan was previously unannounced.

But the plan is expected to buoy the Chinese economy with public works through the end of 2010, and while economists predict China will slip below double-digit growth, most estimate that it will maintain a healthy 7 or 8 percent growth rate – a receding dream for developed economies.

With continued, if contracting, growth in China and inevitable regulation changes both at home and abroad, 2009 is actually shaping into a very good year for accountants. A+

## Look on the bright side

Watching the financial crisis unravel convinces me that something wonderful is happening.

Maybe it's just the fact that crisis is a necessary backdrop for greatness: the deeper the problem, the better the solution. Perhaps that's why U.S. voters went for someone who inspires over someone with experience – because, really, who has "experience" in the face of this mess? Innovation is what's needed.

Case in point: The stock market crash of 1987 created thousands of accidental entrepreneurs, contributing to the explosion of new businesses – and the creation of millions of new jobs – in the U.S. during the 1990s.

In the wake of the Great Depression, a stockbroker named Bill Wilson lost everything he had in the crash and descended into alcoholism. He was near death when, speaking with an Ohio proctologist who had lost himself to alcoholism, the pair realized that just talking to one another kept them from a drink. They founded a group, later named Alcoholics Anonymous, which after 70 years is still considered the best treatment for addiction. So the Great Depression helped millions of people out of, well, depression.

A friend of mine who has been a stockbroker for 20 years believes the financial crisis will turn people away from careers as investment bankers. Ironically, he believes this is a good thing. "For years all the best and brightest have been going into investment banking," he says. "Maybe now they'll go for careers in science." Turning down a career earning millions can be tough, but wouldn't the world be better if smart people turned their keen minds to, say, a cure for cancer?

Losing your shirt in the stock market can make you reassess what's important in life. Scientific studies on "happiness" consistently show what folk wisdom has known for centuries – you can't buy it. A classic study compared people who won US$1 million or more in lotteries with people who suffered spinal cord injuries – both groups returned to their "pre-event" level of life satisfaction within a year.

There's been plenty of pain to go around. In the first 10 months of 2008, global stocks lost 51 percent of their value. So you won't find anyone who hasn't been hurt by the crisis. The financial crisis has replaced the weather as a failsafe conversation starter: "So, how much have you lost?"

If you find yourself sitting at a bar next to Hank Greenberg, however, you may want to stick with the weather. Depending on how much he's had to drink, he could angrily ask you to mind your own business, or give you a resigned sigh and tell you the truth: "Me? I lost US$2.7 billion…"

Pity this poor guy for having a bad decade. He survived storming the beaches of Normandy in 1944 to become the golden boy at American International Group. During his tenure as chief executive and chairman of AIG, he turned it into one of the largest insurance companies on the planet. But the 83-year-old should have quit while he was ahead: In 2005, he was forced out as head of the company under a flurry of fraud accusations.

In recent months, after AIG fell victim to the credit crisis, the U.S. government stepped in to keep the company afloat. In the meantime, Greenberg – still the company's largest individual shareholder – dropped from billionaire to only multi-millionaire status and in November, the value of his stock was around US$100 million. "It's not a very pleasant feeling," Greenberg recently told *The New Yorker*.

With possible criminal charges ahead, Greenberg may be trading in his monogrammed shirts for prison coveralls. So have a thought for him next time you're feeling sorry for yourself – it truly could be worse.

*— Kevin Voigt*