Accounting Issues Hiding in Plain View

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The Glass-Steagall Act separated commercial and investment banking activities in 1933, to help limit the financial excesses of the 1920s that helped create the Great Depression. Bill Clinton, with all his financial acumen, signed the Gramm-Leach-Billey Act in 1999, which effectively repealed Glass Steagall. This has proved to be just another of President Clinton’s Oval Office dalliances with ramifications misunderstood at the time. What could have brought the two Morgans back together again with a lot more names (J.P., Stanley, Dean, & Witter) instead fostered the betrothal of J.P. Morgan and Chase as well as Citicorp and Salomon-Smith Barney.

In 1999, Glass-Steagall was a dinosaur, traipsing weightily across the landscape of the new economy. The stock market was booming. The vaunted productivity improvements of the new economy were rapidly changing the way we do business. Banks were well capitalized and well regulated. Accounting standards in the United States were viewed as the best in the world. SEC oversight and reporting requirements provided investors with the rubrics of making informed investment decisions. There were not any financial excesses in the system. Why shouldn't commercial banks and investment banks merge? The synergies were tremendous. Why not take additional costs out of the banking system, keep some of the savings and lower the cost of capital for businesses and consumers? One-stop shopping. Wal-Mart has the lowest prices and tremendous selection under one roof. The banks would too.

2002. What a difference three years make. The broad stock market averages have lost more than half their value. The new economy wasn't and the old economy currently isn’t. Productivity improvements are now recognized as not being so unusual. Each day it seems that somebody is publicly questioning accounting. The SEC struggles to put in place new rules to provide appropriate oversight. Meanwhile, some banks may be incorrectly perceived as bulwarks of strength.

Now banks are able to provide both commercial banking and investment banking services and the line between the two services has become blurred. Commercial banking can be used as a loss leader to garner lucrative investment banking fees. It's not so different from Toys "R" Us advertising diapers at discount prices with the expectation that customers will pick up some full-priced toys as they travel down the aisles to reach the diapers’ thoughtful location at the back of the store. Many banks now lend money to good investment banking customers at a discount to their non-investment banking clients. Toys "R" Us cannot sell diapers at different prices to different people, but banks have more discretion in pricing their loans. Such flexible banking behavior exposes bank balance sheets to credit risk that may not be properly priced into their loans. Traditionally, the riskier the loan, the higher the interest rate. Today, the reverse is all too frequently true as you will see the greater the potential underwriting or consulting fees, the lower the customer’s borrowing cost.

The evidence that many commercial banking relationships provide a below-market funding cost rests in the active-credit default swap market. Such companies as Verizon can borrow money at LIBOR +10-25 basis points, but some of their bankers put on a credit hedge by selling a portion of the risk to an insurance company for what is now 450 basis points over Verizon’s current cost. The importance of keeping a borrowers bank revolver interest cost low is that ratings agencies and public borrowers key off of it to help guide them as they divine credit quality. I can only imagine what would happen to Verizon’s cost of money if the cost of the revolver jumped 450 basis points. Ford’s credit default swaps trade at least 300 basis points richer than their underlying bank revolver. Even GE has credit default swaps trading at 30 basis points over the current cost of their $30-billion credit line that totals a $90-million annual subsidy. I have no idea how much exposure some of these large multi-line insurance companies have. I can only hope that the counter-party risk is manageable.

I would be surprised if the money J.P. Morgan Chase derived from Enron in all its forms offset the losses at the end of the day. However, this additional credit risk that banks are assuming is just the proverbial tip
of the iceberg. How the loans and fees are accounted for on both parties' financial statements is where the larger issue rests. A bank books a loan as an asset at cost even if it is a below-market rate loan. Over the life of the loan, interest is received and booked as income. A discount loan such as this one cannot be sold for the price at which the lender carries it on its book. If a five-year loan at 6% should have been 8%, then the appropriate carrying cost would be 8% less. That might not seem like much but banks are highly leveraged entities with equity typically supporting assets that are twelve times greater. If 20% of a bank’s loans were used to support their investment banking business in this way, then equity would be overstated by 19% (8% discount x 12x leverage x 20%). The bank might argue that such discounted loans are justifiable because of the underwriting fees they receive. However, this loan may stay on the books for five years and the corresponding investment banking fees might occur in just one quarter. A pure investment bank such as Goldman Sachs, on the other hand, also treats the loan as an asset but must mark such a loan to market, negatively impacting its financial statements and creating a competitive disadvantage to the commercial banks.

What makes the above issue more significant is the way the borrower treats the loan and investment banking fees on its respective financial statements. The customer keeps a below-market rate loan as a liability on its books. As long as the loan remains outstanding, the customer’s costs of funds are less than what they would be if they did not have investment banking fees. Since interest expense is understated, net income is overstated.

The commercial bank customer does not always have to expense investment banking fees. Investment banking fees are capitalized as an asset that stays on the books forever in an M&A transaction unless there is an impairment charge. The customer pays hard cash but does not have to expense the cost on its income statement. Fees derived from an equity underwriting are paid as a reduction of proceeds. Again, a fee is paid but this time by the shareholders. Loan financing fees are also capitalized but they are amortized over the life of the loan, an accurate representation of the true loan cost unless there is a quid pro quo below-market rate commercial banking relationship. However, if it is a thirty-year loan, it is a good trade to pay the fee over such a long time. In each of these three examples, the company’s reported earnings are overstated.

As an example of the above, let’s imagine two publicly traded companies, Bank Whiteshoe and Houdini, Inc. Whiteshoe covets the huge investment banking fees that the acquisitive Houdini generates annually so Whiteshoe makes a 5-year $100 million loan to Houdini at six-month LIBOR +25 basis points – 2% less than a company of Houdini’s credit rating would normally receive. Whiteshoe now has a $100-million loan on their books, but all they would get if they sold the loan is $92 million. However, thanks to bank accounting, as long as the loan pays off at the end of its 5-year term and even if its term is extended, an $8-million adjustment never appears. I argue that shareholder’s equity is overstated. Whiteshoe gambles that they receive investment banking fees to offset the below market loan they have made. Break-even would be $1.6 million per year in investment banking fees (somewhat oversimplified because one would assume that Whiteshoe’s investment bankers are paid more than their lending officers).

What if Houdini pays Whiteshoe $10 million in investment banking fees in the first year of the loan? Whiteshoe’s bet pays off big as they book $10 million of revenues. You would think that Houdini would book a $10 million expense, but they do not. They capitalize the investment banking fee as an asset and, depending on the nature of the fee, might never have to amortize this funny money. If the investment banking fee was for M&A, then the investment banking fee is capitalized as part of the purchase price and shows up on the asset side of the balance sheet under goodwill unlikely to ever be expensed.

The ramifications of this are broad. Not only are the income statements of both Whiteshoe and Houdini overstated but both Whiteshoe and Houdini have the same income statement benefit of $10 million. Such double counting shows up in our nation’s economic data positively benefitting gross domestic product, but it is nothing more than smoke and mirrors. I am sure that the economic impact is minor, but I do not like the direction. What is not minor is that companies like Houdini have overstated earnings which means that their price/earnings ratios are understated, making their stock prices higher than their earnings would otherwise support. Public companies can save real money by doing business with a commercial
bank/investment bank rather than a stand-alone investment bank. Last fall, J.P. Morgan Chase “won” the lead on a large credit line for Cendant. Not long after, J.P. Morgan Chase, not particularly well-known for its institutional convertible bond presence on Wall Street, captured the lead on a $1-billion Cendant convertible offering. Coincidence?

The sum total of the above is that corporate America has had and continues to have a huge subsidy. The borrowing cost for many companies is greater than it appears. If this spigot were to close, a credit crunch would logically follow with the likely remedy being the Fed driving interest rates lower. Understated interest expense, overly optimistic pension return assumptions, unaccounted stock option costs, along with other aggressive and all too common accounting elements serve to overstate the income of publicly traded companies in the United States. Conservative accounting and a higher truer cost of capital for corporate America would not help a stock market and economy already on tenuous ground. I am inherently an optimist -- but I am also a pragmatist and advocate caution when investing.

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