Preserving the Integrity of Financial Markets in North America - Canadian Speaker

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I feel a little bit overwhelmed by this group of people, professional lawyers with deep experience, and people in the policy information area. Those of you who are Canadian will recognize that the Canadian bankers do not have a very good track record of success in the policy area. In areas pertaining to things that are near and dear to us like bank mergers, we have been singly unsuccessful in getting any effective policy. That also goes for a whole series of things that we as bankers have been advocating. So, it is with some trepidation that I stand here in front of you to talk about policy.

It kind of reminds me of that pair of balloonists who were floating over the Californian hills on a lovely sunny summer’s day, like we are going to have in a couple of weeks’ time. They had gone through their champagne, and they kind of lost track. They noticed when they looked over the basket that the clouds had come in, and they did not know where they were. So they let some gas out and floated down. As they came through the clouds, there on the hill was a solitary man walking. They called down to him, “Can you tell us where we are?” He looked up. “You are in a balloon.” The one balloonist said to the other, “That man down there, he is a banker.” The other guy was a little taken back by this and said, “How do you know he is a banker?” He replied without thinking, “What he said was totally accurate, and it was absolutely irrelevant.”

With that, I will talk a little bit about some of the things that I have seen in both the U.S. jurisdictions and the Canadian about integrity and financial markets in North America. I should probably begin by squaring the title, which talks about preserving, because really what we have seen is quite a
strain of corporate malfeasance over the last few years; earlier examples like Safety-Kleen through Enron, and now most recently HealthSouth.¹

CORPORATE DISCLOSURES

From a historical perspective, I think it is, correct to say that the extent and accuracy of disclosure by corporations today has been as good as it ever has been. I would say it is getting an awful lot better. There is a strain, no doubt, of malpractice. I would argue that while it is deep, it is relatively narrow. That does not make it any easier to deal with, because in fact, you have a very large community out there of very honest people who work extraordinarily hard not only to comply with the laws, but to comply with the spirit of good disclosure.

The issue has been tackled in an extremely vigorous fashion. In the U.S., we have had Sarbanes-Oxley.² This is a very good set of conference materials, which I commend you on. I spent at least five hours working through it. I would like to suggest for my colleague, Michael, that you go to page four of seven in the tab that applies to this. The U.S. Government has given the Security and Exchange Commission (SEC) an absolutely intractable legislative obligation. If you look in the second paragraph, the SEC is directed to report to Congress on item two, whether generally accepted accounting practices (GAAP) clearly conveys to investors the economics of off balance sheet transactions. I will suggest to you that there is no way that the SEC in today's state of accountancy and managing reporting is in any kind of position to fulfill that legislative obligation.

There are lots of new things happening. Sarbanes-Oxley has the accounting profession busily looking to see how they can correct their deficiencies in the real base accounting requirements. This is happening both in Canada and the U.S.³ As a practicing businessman, I can assure you that the level of scrutiny that the accountancy professionals are given has dramatically increased. The fact that Arthur Andersen went down has focused their minds in a way they have not been focused in a long time. While in Canada we have had fewer examples of bad reporting, let me just remind you of Bre-Ex and Laidlaw, and suggest that we have not been

³ Sarbanes- Oxley and Corporate Governance Reform Top of Mind with Canadian Banks in 2003, CAN. NEWSWIRE, April 22, 2003.

The burden of my remarks is to suggest that while these steps are all good and go in the right direction in solving our problems of integrity, they will not be sufficient. There is intense fervor; just read the Wall Street Journal, Barron’s, the New York Times, or any other business press. People are very seized with this problem and think that we need to reform things.\footnote{Alan Murray, \textit{Case Study: Turmoil at AOL Shows Need For Wider Changes}, \textit{WALL ST. J.}, Jan. 21, 2003, at A4, available at 2003 WL-WSJ 3957024.} It is a long and difficult road that I believe we are embarked upon.

Fervor is good at the beginning, but we cannot count on that to give us the necessary gas. This has got to be a long-term exercise, particularly in three areas. First, the North American accounting profession is going to have to recognize that it can no longer rely on purely a rules based regime. It will have to move to a principles based regime. I will talk about that in a minute. Secondly, new financing techniques like off balance sheet, special purpose vehicles, swap options, and the like have fundamentally shifted the way in which risk can be managed. The accounting techniques as well as the techniques for enforcement, insurance, and compliance have a long way to go before they catch up with these. Finally, we need to have corporate governance significantly changed.

Let me start with a couple of observations. First of all, failure is normal. In this world, both in the business and private sector, we will always have failure. Industries go through cycles. Over time, some of them go out of existence. I know that from personal experience. My family was in the hat business. Hats are a classic example of a business gone completely out of existence. If you look back historically there are many examples. Steam is another. Steam as a means of propulsion, has completely disappeared. We are clearly going to see industries change over time. Even within successful industries in a world of high competition, individual companies go out of business. The business cycle, which we have not yet tamed, is itself going to bunch the timings of failure. This ongoing presence of failure conditions the whole debate.

Second, we live in a world of deception. While companies in preparing their financial reports always enjoy significant gray areas for accounting, recording of their income, and valuing their assets and liabilities nobody should be surprised that most executives put a little bit of a gloss on the results. They shade them. They may move their income up or move it down. Income smoothing has not been unknown, except for the Bank of Nova...
Scotia. Nobody should be surprised that we have executives who put a good
gloss on reports, nor should we be surprised that these practices on occasion
slide into something more sinister.

Management firms undergoing financial distress face particularly acute
temptations to paper over problems, which they believe will prove to be
temporary. In my experience as a banker, I have rarely found a company that
files for insolvency where we do not find after the fact that the accounts have
been moved in a way that obscures the true extent of the underlying
problems. I do not think we should, therefore, be all that surprised at the
amount of fraud that is floated to the top in this period of economic
difficulty.

Let me begin in talking about the approach to correcting these problems
with accounting rules. The U.S, and largely Canadian, accounting
professions believe that the way to go about accounting is to institute very
detailed rules. These are almost Byzantine in their complexity. Debacles
such as Enron have demonstrated the detailed prescriptive accounting rules
are not in themselves sufficient to prevent fraud. Indeed, it is my proposition
that their very prescriptive nature can be used by the unscrupulous as a road
map to find ways of presenting results which conform to the detailed rules
that present a misleading picture. As one of my great friends and workups
used to put it, “It tells the truth in an untruthful fashion.”

The proper approach to solving this problem is not the elaboration of
further rules to fix the loopholes that unscrupulous management of yesterday
managed to unearth. In my view, it is the enunciation of the common sense
objectives that lie behind each of the various rules, or sets of rules, that the
accountancy profession has. The problem with common sense, as Voltaire
says, is it is not common enough. When you try to put it down on paper you
get enormous argument about how you formulate that common sense. It is
not the sort of thing that accountants like to do. They like to deal in
certainties and so it really does run against a lot of the training. If we do not
have that principles based type of accounting, we are going to run the risk of
having more and more Enrons.

If you do have the principles, I propose to you as lawyers, that those
principles will make enforcement easier. Because when the unscrupulous
CFO puts together an SPV that meets the details of the rule, you have
something that is of a nature of generalized anti-avoidance, to use a Canadian
taxation principle, and you can nail them on the fact that he has clearly
violated what is the common sense underlying principle we hope has been
enunciated for this standard. Let me give you an illustration, because all that

6 See generally, William W. Bratton, Enron, Sarbanes-Oxley, and Accounting: Rules
is very fluffy. I am going to take a Canadian example of a prescriptive standard, which illustrates a couple of examples.

DIFFICULTIES IN VALUING LOANS

In the financial sector, one of the most difficult areas is valuing loans on the books of a bank. We will first look at commercial loans. There are two types of difficulties in valuing commercial loans. One has to do with the borrower; whether the borrower is likely to pay back that loan according to its terms. The other has to do with a condition of the lending institution itself. Take the borrower first. We in Canada are blessed with a bunch of accountants who have given us rule 3025, a highly specific rule telling us how to do our loans. If there is any doubt about collection, you have got to do a detailed cash flow quarter by quarter, lay out all the underlying assumptions for this cash flow of collections discounted at a rate that is probably irrelevant to any fundamental economics but is a prescribed rate, and then come up with a calculation of the value of this loan. The difference between that, the book value, and the last quarter is the quantum of your loss. It looks very precise. I can tell you we produce great books of this stuff every quarter. The problem is that the precision is largely spurious. When you look at it, particularly for the junior people in the accountancy firms and the credit areas and audit areas, the precision is seductive and you can easily miss the degree of judgment that is involved. That in itself is a problem.

In my view, one of the most fundamental changes in bank accounting is coming through the Basel Group of Supervisors, which is the Fed, the FSE, the U.K., and the Office of the Superintendent of Financial Institution in Canada, and so on around the developed world. These regulators have effectively brought a principle-based approach to accounting for commercial loans.

One of the keys to that is back tasking. Each institution each quarter has to look at its loan losses and back task to what it said a quarter ago, a year ago, and what the loan’s losses were going to be. Through this process, you get much more of a sense of how well the internal processes of that institution are working. If the Basal standard ultimately gets passed as it is forecast to do in a couple of years, they will require the disclosure of the

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7 Canadian Institute of Chartered Accountants, CICA Handbook, s. 3025, Impaired Loans
8 The Office of the Superintendent of Financial Institutions (OSFI), Fact Sheet: Basel Committee on Banking Supervision, available at www.osfi-bsif.gc.ca/eng/issues/basel_e.asp. Established in 1974 the Basel Committee on Banking Supervision is comprised of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States.
9 See generally, SOUND PRACTICES FOR LOAN ACCOUNTING AND DISCLOSURE, BASEL COMM. ON BANKING SUPERVISION (July 1999), available at www.bis.org/publ/bcbs55.pdf
institution's internal management processes. That is a good thing. It flies very much against the rules-based standard of the accountants today, but it gives you an example of the sorts of standards that you can get when you go to principles.

The second set of difficulties in valuing commercial portfolios relates to internal control standards of a company. This applies not only to banks, it also applies to any company. For those of you who read the article Tuesday in the Wall Street Journal on Health South, on how the accountants missed the fraud there; it is very easy to lay out a series of risk based criteria that lets you get yourself to an evaluation of whether or not that management is producing good accounting records. We had a stunning example in Canada a few years ago, a company called Royal Trust, which got into some difficulty. It had been an AAA rated company, lending fairly aggressively in the mortgage area, when got into some trouble. Frankly, we did not know how deep its troubles were. We went in looking, we and the Royal Bank, were looking at a potential bid for the company. We used our most senior real estate lending people to go in and look at the portfolios. In many cases, we knew the actual borrowers and the loans. In quite a few cases, we had actually turned them down, I am happy to say. We were able to evaluate the losses that were on their books that they did not know about. I think it was in the neighborhood of $600 million, not far off the quantum that was actually recognized by the company. The reason we were able to get at that was because we had people on the ground in the field that were able to very quickly bring that information out in evaluating the loans.

Notice, Chartered Accountants do not have this access, because they are not in the marketplace. The best that they can do is be the regulators. The Fed, in particular, who look across whole industries and compare across banks are positioned to do this, but chartered accountants are not. They cannot share information about their clients. It is not surprising that you find accountancy firms who miss the valuation of loans, not because of bad management, but because of information they do not have.

SPOTTING EARLY WARNING SIGNS

That gets us to the types of early warning information that needs to be put in place. The accountancy profession has come some way in the last few

\[See \, generally, \, \textit{The \, New \, Basel \, Capital \, Accord: Third Consultative Paper, Basel Comm. on Banking Supervision} \, (April \, 29, \, 2003) \, available \, at \, \text{www.bis.org/bcbs/bcbscp3.htm}\]

\[Surgery \, Partners \, of \, HealthSouth \, Mull \, Bailing \, Out, \, \textit{Wall \, St. \, J.}, \, April \, 8, \, 2003, \, at \, B1 \, available \, at \, 2003 \, WL-WSJ \, 3964184.\]

\[Jade \, Hemeon, \, \textit{Royal \, Trust \, finds \, a \, buyer \, Royal \, Bank \, to \, take \, over \, ailing \, firm \, for \,$1.6 \, billion}, \, \textit{Toronto \, Star}, \, March \, 19, \, 1993, \, at \, D1, \, available \, at \, 1993 \, WL \, 7246288.\]
years. However, as that discussion in the Wall Street Journal indicated a couple of days ago, accountancy firms are not yet responding to these early warning signs.

One of the big problems, quite frankly, is that accountants are not trained in failure. I meet a lot of the young people that come into the bank to do both corporate and commercial lending, chartered accountants, MBAs, and I ask how many of you have had any experience or teaching in failure. None of them have. They worry about successful companies and they learn how to value things according to very careful rules. But in getting any sense of the early warning signs, very few of them have it. I think one of the most important things the profession has to do is to begin to put together a much better understanding of these early warning signs and move this information out to their field officers.

That brings me to off balance sheet transactions, swaps, and so on. These have been marketed as ways of avoiding or insuring against risks. Swaps can do that. Off balance sheet transactions can do that. The problem with them is that they can also be used to create risk and most frequently fragment risk, so that becomes very difficult to follow. At the risk of boring people on a lovely Saturday afternoon, let me give you a couple of quick examples.

A lot of companies, probably quite a few of your clients – the more financially challenged clients, have sold their receivables. It is a very frequent technique. It is a nice technique because it makes the financial ratios of the company look better, usually lowers the cost of capital, and generally is well accepted in the marketplace. The problem with it is that in most cases, it is done with the company remaining as the collection agent of the receivable. They also keep a small portion, five to ten percent of the receivable, against which the first losses are charged. You rarely have more than five percent loss on receivables. If they sell 95 cents of every dollar of receivables and keep five cents, that receivables purchase vehicle has not bought any risk at all. All the risk has remained on the books of the company that sold them.

There is no way that the financial position of this company has improved even though the ratios look better. We in banking insist whenever that has happened that the company tells us how much of this residual risk remains. We call it toxic waste. We either add back the full amount of the receivable financing onto the balance sheet for financial calculation purposes or we deduct that residual receivable from the equity. Either way, it gives you the same result, but it also produces liquidity risk.

Liquidity risk, in this example, happens because the financial covenants in the SPV are typically much tighter than the company has in its own borrowing. When there is a problem with the company, the SPV hits a trigger; the receivables are forced to run off. As they are collected, the SPV is paid out. The poor company now has to finance all its receivables on its
own balance sheet and does not have the resources to do it. Frequently, that is the trigger that brings these companies down. I defy you as an investor through most of the accounting that you see, to get a good sense of how great this risk is, either the residual collection risk or the liquidity risk.

I have a section here that deals with swaps and off balance sheet vehicles. Let me just refer to long-term capital. It is not widely recognized how long-term capital actually came to a failure. Long-term capital got into trouble not because the swaps and options did not work. In fact, they worked incredibly well. The math and the statistics were really stunningly good. The problem was that the management of that company thought they were better than they really were. Based on incorrect information they borrowed too much money; the leverage was too high.

Secondly, there was an imbalance in their liquidity given the peculiarities of the contracts. When you had a significant price move, as long-term capital had post collateral and they did not get any from the banks, they simply ran out of liquidity. The long-term cap merely came undone. In their last few days, they borrowed from a line with a bunch of other banks and the banks got into a fight as to whether there had been a default. If the banks had declared a default it would have crossed defaulted into all of the contracts and the long-term cap would have gone.

The banks called a vote on that bank syndication agreement. They needed a two-thirds to do a vote of non-default. The large commercial banks in New York are going to put the rest of the money in insisted on a positive vote. The American banks in that syndicate were hung. There was a foreign bank. If that foreign bank had not gone along and voted in favor of non-default, long-term cap would have gone. I can tell you that there were a number of very panicked phone calls from the most senior levels. My illustration of that is that the accounting rules are insufficient to tell us these risks. We have to get to a much more effective illustration of the risks underlying these portfolios if we are going to have good and full disclosure.

Canadians think that they have a much better system. I would tell you that Royal Trust on three occasions was within a hair’s breath of failing on liquidity and failed payments. We came within a hair’s breath of an even more dangerous failure. So, it is an issue on both sides of the border.

Just one quick word on management. I am all in favor of all of these moves to make sure that boards are more accountable. They need the tools. The key tools are changes in internal management and accountancy rules. Without that, the boards will not be in a position to be able to play the rules. I do not think it is sufficient for accountancy firms simply to walk away. They have to be able to be held accountable for the fairness of their disclosure. With a lack of the standards, I come back to where I first started. The SEC is without the tools to fulfill its mandate of assuring the President
that the GAAP will allow the SEC to fulfill its mandate. Thank you very much.