

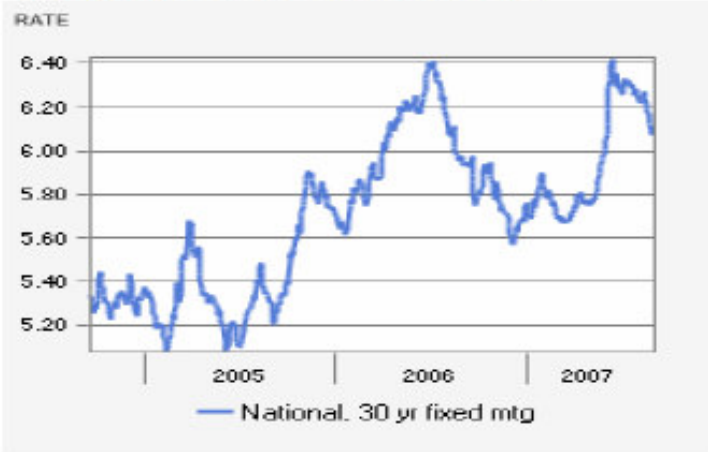
Lessons from the credit crisis from an accounting perspective

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The perfect storm

Mortgage rates increasing...



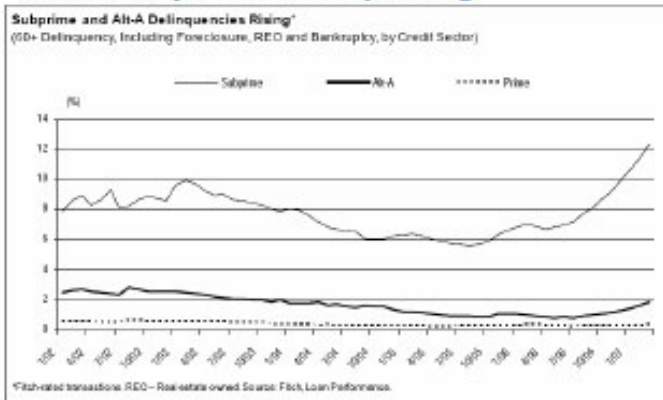
...Housing prices falling

DB Home Price Forecast ^(A)

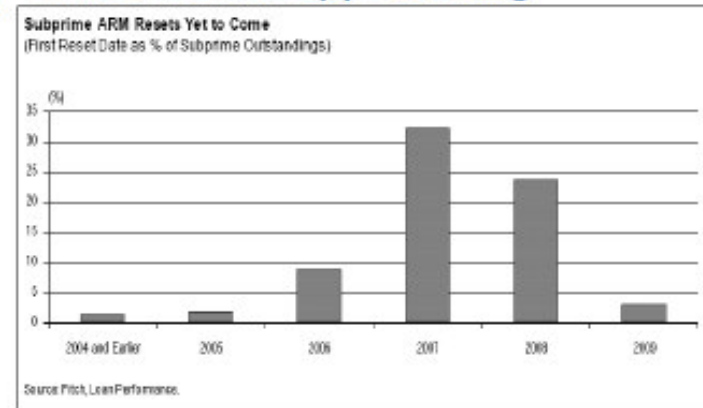
Los Angeles, CA	↓ 8-13%
Riverside, CA	↓ 9-14%
New York, NY	↓ 8-12%
Washington, DC	↓ 8-13%
San Diego, CA	↓ 9-12%
Orange County, CA	↓ 7-11%
Oakland, CA	↓ 4-7%
Phoenix, AZ	↓ 12-16%
Chicago, IL	↑ 3-5%
Las Vegas, NV	↓ 12-16%



...Delinquencies spiking

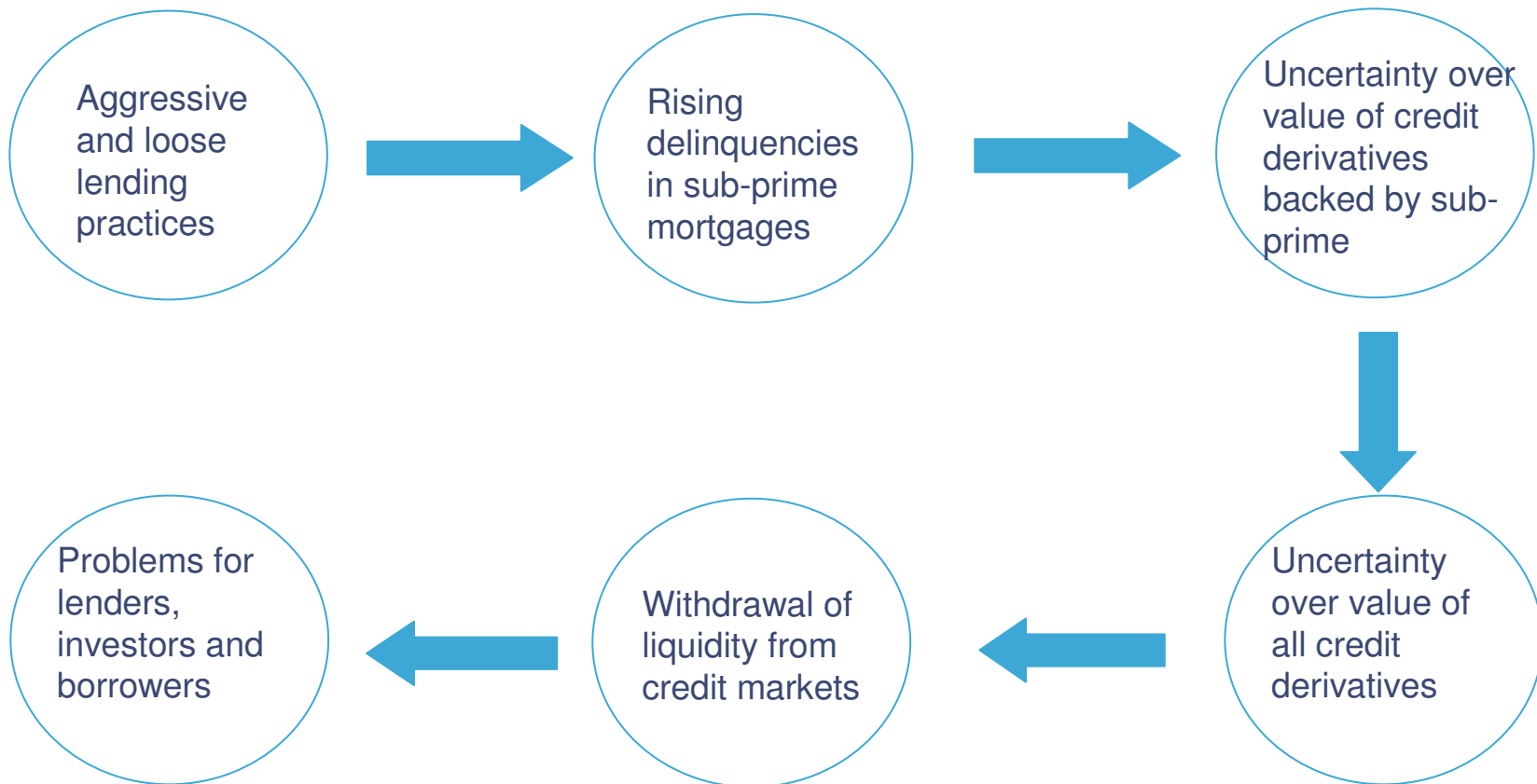


...Resets fast approaching

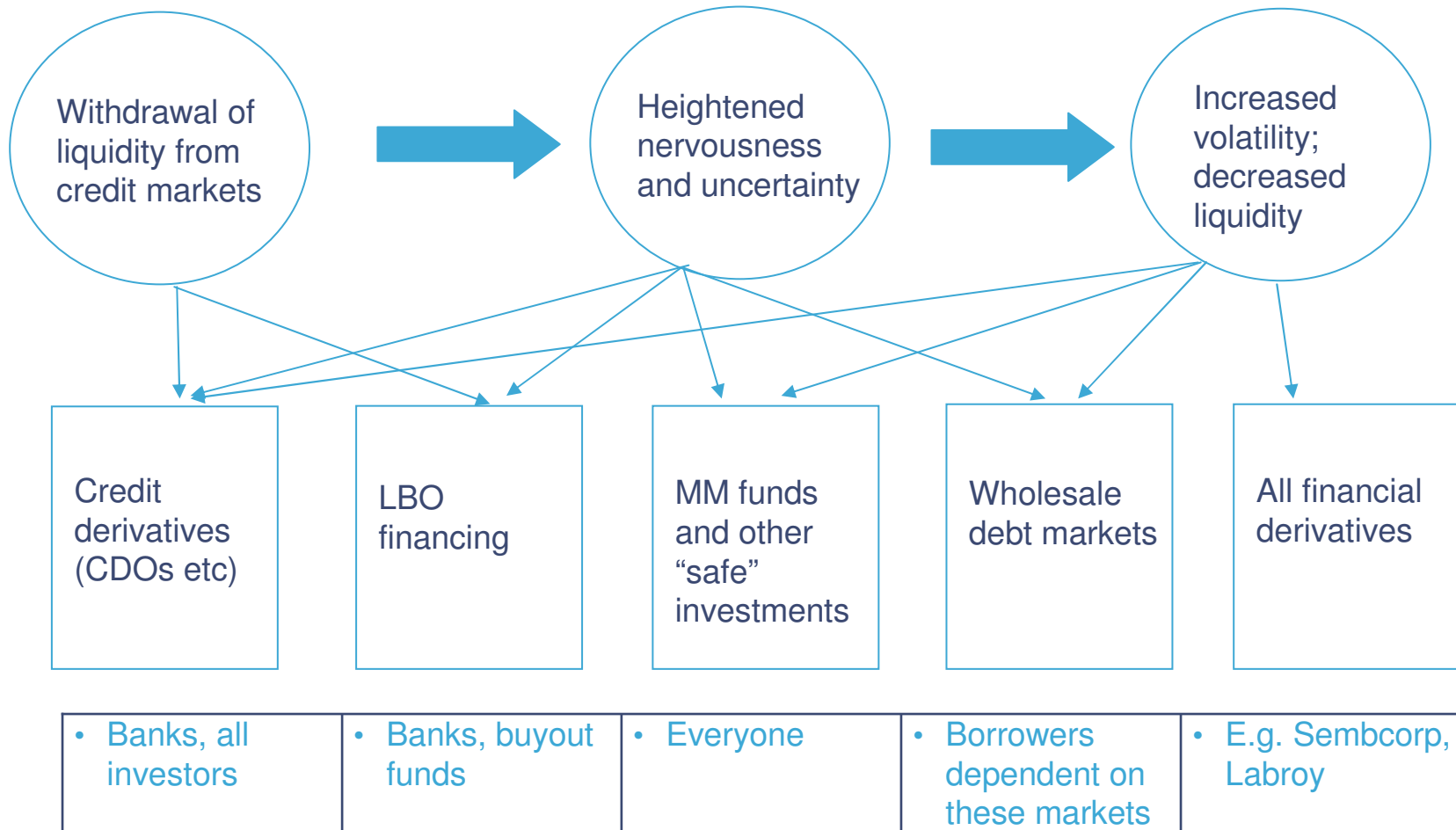


RMBS...
CDO...
SIV...
All tranches
impacted

The transfer of risk in a globalised derivatives market



...and it goes on



Why this should not be a surprise

- In traditional markets, the losses on sub-prime would have been restricted to the lenders to those markets (and those with exposure to these lenders)
 - Loan losses occur over time, and the bad news can be managed and contained
- With securities/derivatives, the exposure is spread around much more
 - MTM accounting discounts future expectations
- Problems in the sub-prime market have been known about since Jan 07 at the latest (HSBC)
- The participants in the market all had an interest in ignoring the bad news for as long as possible
- Recent research has shown that models are deeply flawed

The accounting distortion

- Under IAS 39, financial instruments have to be marked to market
 - MTM for a bond includes market's expectations of future loss (expected loss)
 - Effectively, provisioning for expected loss is mandatory
- Under IAS 39, on balance sheet loans have to be held at (effectively) cost
 - Provisions are made only when there is evidence of impairment
 - Provisioning for expected loss is expressly forbidden
- Thus changes in expected losses on securitised assets are reflected by a sudden change in fair value, whereas losses on balance sheet lending are absorbed gradually over time
- Basel II partly adjusts for this by deducting the excess EL over provisions from capital
 - Impact on capital ratios is thereby equalised
 - Impact on headline earnings is not equalised

Two mechanisms to spread the problem

- The accounting distortion accelerates the recognition of expected loss over time
- The re-packaging of risk into securities/derivatives allows risk to be spread over markets
- Both of these mechanisms should have been obvious to any impartial observer
- The existence of underlying problems in the US sub-prime market was known some 6-7 months before the crisis hit
- But it easy to be wise with hindsight!

Some lessons

- Fair value accounting is here to stay, and that will bring increasing volatility to earnings
 - More disclosure is not the answer – FI's need better disclosure and communication
- Risk managers need to pay more attention to the impact on accounting earnings, and not just capital
 - Risk managers need to learn accounting
 - Accountants need to learn risk management

*connectedthinking

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