Credit crisis reveals widespread accounting manipulation by top US banks

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The developing credit crisis in the United States, linked to the bursting of the housing market bubble, is beginning to reveal the accounting manipulations employed by major US banks to engage in speculative activities and hide risks. Several major banks have already announced billions of dollars in losses associated with subprime mortgages, and in the next months are expected to announce tens of billions of dollars in further write-downs.

Among those most severely affected is Citigroup—an American financial conglomerate that is the world's largest company measured by asset value. CNBC reported on Monday that Citigroup is planning major cost-cutting in response to its difficulties, with layoffs of up to 45,000 of the company's approximately 320,000 employees.

In a statement, the bank insisted that reports involving specific numbers of layoffs were "not factual," but acknowledged that the company is "planning ways in which we can be more efficient and cost effective to position our businesses in line with economic realities." New cuts would come on top of 17,000 layoffs announced in April.

The announcement, coming amidst Wall Street nervousness over the ongoing credit crisis, sent Citigroup's stock down more than 6 percent. Over the past six months, the price of the company's stock has fallen nearly 50 percent. Citi led a steep market decline on Monday, with the Dow Jones Industrial Average falling nearly 240 points, more than wiping out its increase on Friday.

Chief among the "economic realities" behind Citigroup's announcement is the credit crisis brought on by record defaults on home mortgages in the United States. Citigroup has already announced a $5 billion write-down related to home mortgages, which provoked the resignation of its CEO Charles Prince. It is expected to announce further losses of up to $11 billion in the fourth quarter.

The bank's exposure could be much greater, however, as it may be forced to acknowledge losses that it had previously kept off its books. An article by *Wall Street Journal* reporter David Reilly on Monday ("Citi's $41 Billion Issue: Should it put CDOs On the Balance Sheet?") noted that the bank faces an "immediate threat" from troubles involving off-balance-sheet entities called collateralized debt obligations (CDOs)

The *Journal* notes that Citigroup "was one of the biggest arrangers of CDOs—products that pools debt, often mortgage securities, and then sell slices with varying degrees of risk." The bank may be forced to bring these CDOs onto its balance sheet. "If Citigroup had to include an additional $41 billion in CDO assets on its books," the *Journal* noted, "that could potentially spur a further $8 billion in write-downs, above and beyond those already signaled, according to a report earlier this month by Howard Mason, an analyst at Sanford C. Bernstein."

Throughout the housing boom of the past several years, the CDOs, and related entities known as structured investment vehicles (SIVs), made substantial returns. SIVs are also off-balance-sheet entities, but are more open-ended, investing in other risky securities, including CDOs. Even those entities closely associated with banks have been nominally independent. The "independence" of these entities has been entirely fraudulent, however. They have been critical for the banks' bottom line as sources of lucrative fees, buying up mortgages and other assets from their parent banks.

As the CDOs and SIVs have faltered with the collapse of the housing bubble, the banks have looked for ways to bail them out. The *Journal* notes, "Over the summer, [Citigroup] was forced to buy $25 billion in commercial paper issued by its CDO vehicles because investors were no longer interested in the paper. Citigroup already had an $18 billion exposure to these vehicles through other funding it had provided."

The determination with which Citigroup and other banks have scrambled to bail out these investment entities is itself testament to the fact that they were never really independent to begin with.

Commenting on the way that major banks were able to shift their risks off their balance sheets, *New York Times* economic writer Floyd Norris noted in an article published November 16 ("As Bank Profits Grew, Warning Signs Went Unheeded,"), "Instead of being suspicious, many analysts believed that banks had found a new way to prosper. Making a loan and keeping it on the balance sheet until it was repaid was so old-fashioned. It was far better to collect fees for arranging transactions and passing on the risks to others."

In fact, many of these risks were not really transferred. Norris notes that the banks often made arrangements (called "liquidity puts") with the purchasers of their CDO securities that would allow the purchasers to sell the CDO securities back to the bank if there was no other market. "That risk may have seemed slight when the securitization market was booming. But now the banks are being forced to buy back securities for more than they are worth."

In essence, the puts allowed the banks to sell CDOs and other assets without really selling them. Use of the puts actually increased as the housing market began to unravel, as it was necessary to provide the guarantees in order for the banks to get investors to buy mortgage-backed securities whose value was increasingly in question.

The legality of these operations is highly dubious, since part of the intention appears to have been to mislead investors regarding the financial health of the company. Even if the operations by banks were legal, the fact that they were not reported to investors was likely a violation of accounting rules.

According to Norris, Citigroup and Bank of America were among

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those banks that used “liquidity puts” heavily.

All of these arrangements amount to attempts by banks to gamble on risky investments without acknowledging the risks they were taking on. As the market for these investments has begun to collapse, the real extent of the losses is only beginning to reveal itself—and no one knows how severe the crisis really is.

Most banks were involved in such activities. Earlier this month, the Securities and Exchange Commission opened an investigation into investment bank Merrill Lynch that, according to the *Wall Street Journal*, is intended to examine how the bank “has been valuing, or ‘marking,’ its mortgage securities and how it has disclosed its positions to investors.”

In a November 2 article, the *Journal* reported that Merrill arranged one deal with a hedge fund to sell $1 billion in commercial paper related to mortgages, while giving the hedge fund the right to sell it back after one year at a set price. The newspaper later corrected its article to note that this deal, similar in many ways to the arrangements at Citigroup, was rejected because the bank determined that it was a violation of accounting rules.

Nevertheless, Merrill is highly exposed to the housing markets. Earlier reports suggested that Merrill hid its own exposure to the subprime mortgage crisis by shifting its assets to different parts of the company subject to less strict accounting regulations. (See “Wall Street hides impact of subprime mortgage meltdown”)

As late as July 2007 executives at the bank, including former CEO Stan O’Neal, were assuring employees that its mortgage risks were under control. At the end of October, Merrill announced a $7.9 billion write-down, which was followed by O’Neal’s departure.

The crisis facing banks is an international phenomenon. The stock market sell off on Monday was provoked in part by an announcement from British-based HSBC—Europe’s largest bank and the world’s fourth largest corporation in terms of assets—that it would bail out two of its SIVs and transfer their assets onto its balance sheet.

Since the credit crisis began in full force this summer, banks have scrambled to stave off a reckoning with the enormity of the losses involved. The hope has been that the economic crisis will be short-lived and that the housing market will eventually recover, restoring the value of the assets in question.

It is unlikely that this will happen, however, and there is an increasing likelihood of a recession. In an article published in the *Financial Times* on Sunday (“Wake up to the dangers of a deepening crisis”), Lawrence Summers, former Treasury Secretary in the Clinton Administration, warned, “[T]he odds now favor a US recession that slows growth significantly on a global basis.” Summers noted, “Forward-looking indicators suggest that the housing sector may be in free-fall from what felt like the basement levels of a few months ago.”

The initial revelations of accounting manipulations and indications of fraudulent activities are only a small indication of the extent to which the American economy is pervaded by financial speculation and out-and-out criminality.

It was the collapse of the dot-com boom in 2001 that ultimately unwound the elaborate structure of corruption at companies such as Enron, WorldCom, and Tyco. These companies were no longer able to perpetuate their fraudulent activities once the stock market ceased its continual upward march.

The major banks were heavily involved in the activities exposed at that time. In 2003, Citigroup and JP Morgan Chase were forced to pay out fines for aiding Enron in disguising loans as cash to reduce reported risk and liabilities, thereby defrauding investors. Essentially, the banks gave Enron loans, but cloaked these loans in an apparent purchase of assets. This manipulation improved Enron’s financial reports, which was beneficial for banks that were heavily invested in Enron stock. (See “Citigroup, Morgan Chase fined for Enron deals: corruption at the heights of American finance”)

The operations involving CDOs and SIVs bear a certain resemblance in that they too were evidently intended to disguise risk. Much of the risk was ultimately held by the bank itself, but this was not readily apparent to investors.

Though the banks were involved in the manipulations at Enron and other companies, the fraud was generally explained by the media and the political establishment as the product of a few “bad apples.” Several executives were put on trial and imprisoned, but the underlying conditions remained and the banks remained largely untouched. The dot-com bubble was quickly replaced by the housing bubble, which had the effect of extending the speculative mania of Wall Street to a much broader section of the economy.

The pervasiveness of accounting manipulation is closely linked to the increasingly dominant role that speculation has come to play in the American economy. Vast sums of wealth—including tens and hundreds of millions of dollars to top executives and hedge fund managers—have been made through mechanisms that are largely divorced from any relationship to actual production. The importance of these forms of speculative wealth accumulation has increased as the underlying health of the American economy has decreased.

The housing market has been a case in point, as a small layer of the population has made billions through high-risk loans to working class Americans who are now bearing the burden of a crushing level of debt. The loans have been used to transfer wealth into the hands of the ruling elite, and at the same time became a means of speculation.

Entities such as CDOs and SIVs were set up as a means for Wall Street to extract enormous profits, while at the same time cloaking the extremely fragile foundation for this supposed economic growth. As the housing market deflates, this whole structure is beginning to unravel.

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