November 2005

Do accounting changes affect the economic behaviour of financial firms?

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Focus of the discussion

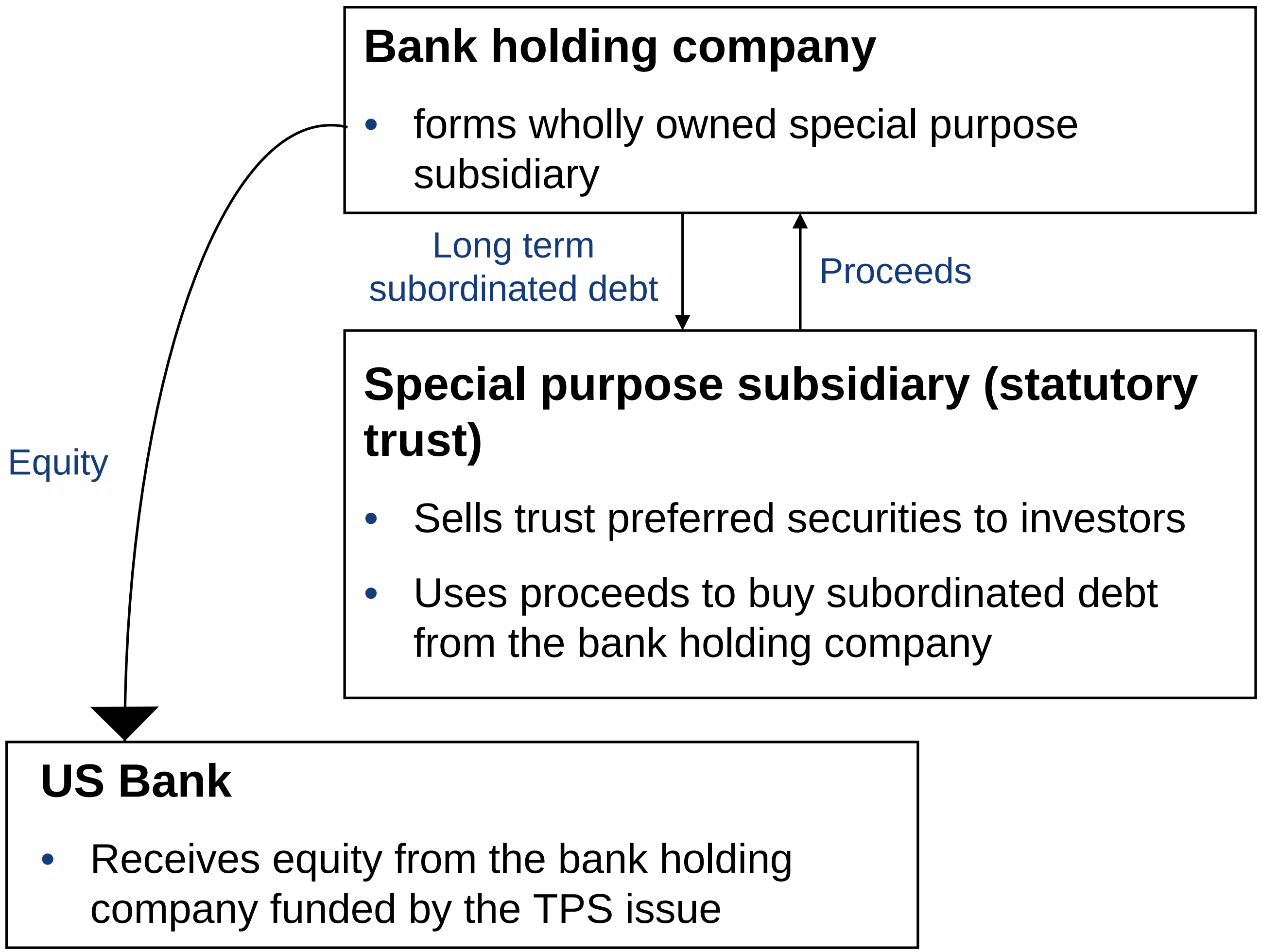
- The issue
- Comments on the paper
- Wider aspects of the issue
- The necessary conditions for accounting changes to affect behaviour
- Implications for Accounting standards

The issue covered by the paper

Do accounting changes affect behaviour of banks even when there are no regulatory implications?

Takes as an example trust preferred securities where the accounting treatment changed but regulatory did not.

Trust preferred securities



What made TPS attractive?

Core elements-

Regulatory

- Recognised by the FRB as Tier1 (up to 25% of Tier1) if they met particular conditions-
  - the longest feasible maturity (taken as 30 years)
  - can have maturity shortening call options exercised subject to Fed approval
  - a right to defer interest and dividend payments for up to 5 years.
  - Principal payments can be deferred for 19 years

Tax

Treated as debt for tax purposes –interest tax deductible-reduces cost of regulatory capital

Banking use established after Federal Reserve announced October 1996 that TPS would count a Tier1

Accounting changes

- SFAS May 2003
- Fin 46R December 2003 - required deconsolidation of the Trusts
- Effect - the TPS appears on the liabilities side of the balance sheet of the bank holding company
  - But the Fed continued to allow them for Tier1
  - Paper uses this change in accounting treatment (not affecting regulation) to test if it alone affected behaviour.

The study

- Explores the effect of these accounting changes on new TPS issuance and redemption
- Findings
  - Some decline in issuance
  - Banks with low regulatory capital more likely to issue

(The latter plausible if it is largely a device to boost regulatory capital cheaply - May also be more readily available than equity)

Conditions for accounting to affect behaviour

- A ‘real’ constraint is affected –e.g. a regulatory measure, covenants

- An issue the market has not been focusing on is highlighted –leading to a change in sentiment

- A measure used by the market is distorted and the effect <u>cannot</u> be ‘removed’ –changing market perceptions

- A market measure has been distorted and the market does <u>not</u> use information available to adjust it

Examples

1. A real constraint affected - Definition of Tier 1

   Pensions defaults

2. An issue highlighted by change - Share based payments effect on P&L

3. Distortion of market measure - That cannot be adjusted out?

   Management can disclose information but may be constrained in prominence

4. Credit derivatives - Effect of strategic hedging on P&L disclosures - are shown but equity analysts may not focus on them.

Which are an issue with TPS?

1. A real constraint is affected

Yes, covenants on gearing but these are probably more important for non-banks.

There was however uncertainty about the <u>regulatory</u> treatment –first re how the Fed would react and second whether there would be a Basel change.

Basel did reduce amount –to 15%

And said there would be a later review of the definition of capital – leaving whole question open. So general uncertainty ??

Banks may have felt unwilling to issue such long term debt which could become disallowed

2.Did it highlight an issue the market had not focused on?

This may be the case for some market participants but seems unlikely-

Moody's, with the rating methodology tool kit, had made their position clear – They did not regard TPS as equivalent to equity-

Ability to defer payments provides limited if any meaningful benefit to banks. Unlikely to defer in fact because of dramatic negative effect on confidence.

Only lower investment grade and high yield borrowers more likely to defer

•Noticeable regulators don't recognise TPS for the banks, just the bank holding companies

Moody’s toolkit

The toolkit for assessing hybrid securities – published December 1999 – shows:

Overall in terms of

- maturity
- Ongoing payments
- Loss absorption

For financial institutions and high grade corporates; Moody’s regards TPS as very close to debt

November 2003-Specific guidance

Moody’s introduced specific baskets to reflect debt/equity content of different instruments for assessing financial ratios

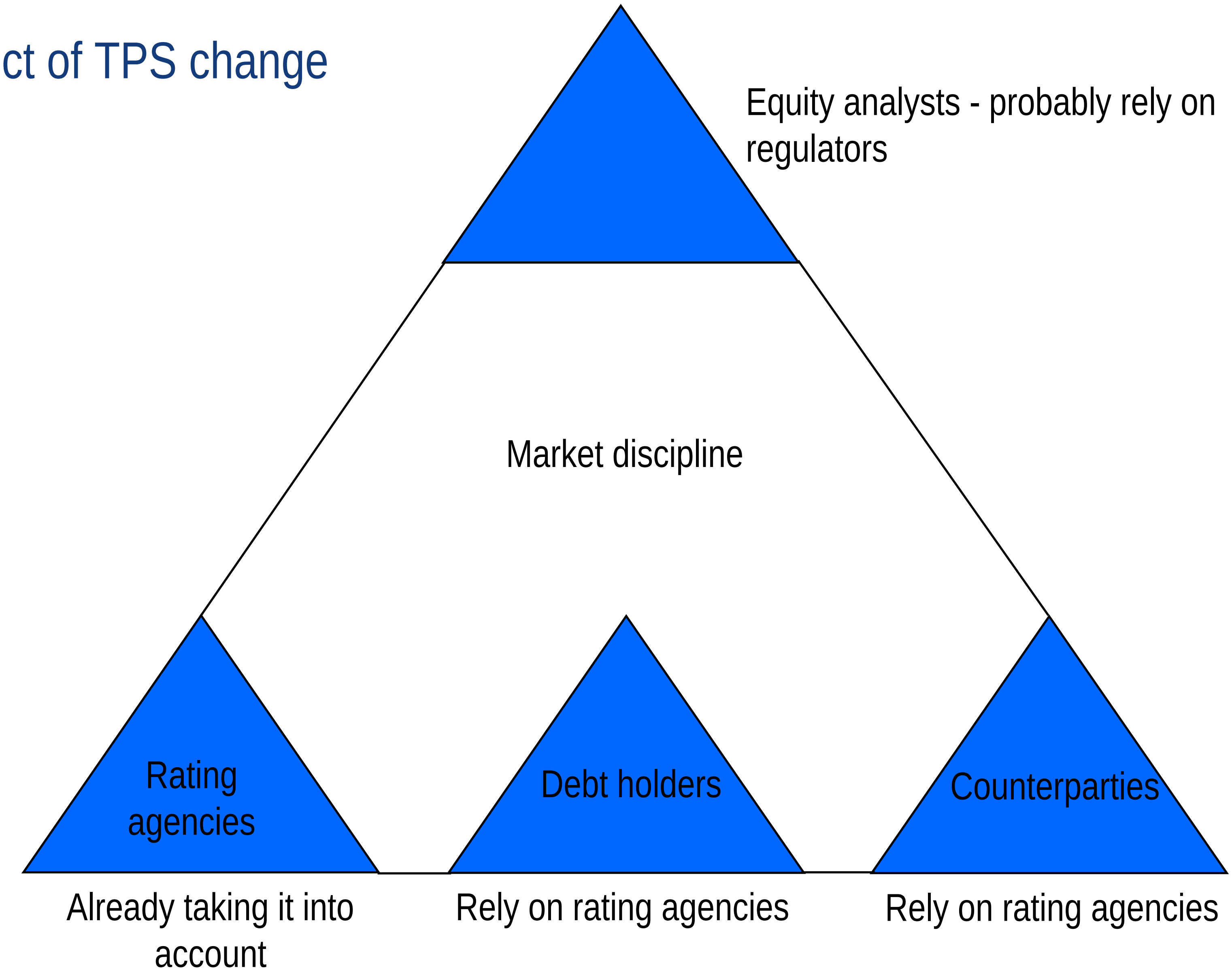
For banks

- Tangible common equity/weighted risk assets
- Equity investments in subsidiaries/equity

TPS treated as 100% debt in these ratios

Market Discipline for banks

Effect of TPS change



Implications for the results of the paper

Findings-

Publicly traded companies less likely to issue TPS after accounting change-

Does the reaction indicate that the market was influenced by the classification of the securities rather than the underlying risks of the transaction?

Moody’s view is that the accounting change aligned the accounts with the market’s view

Then why did the announcement have an effect?

May have reflected concern about Basel review of capital (this applies to internationally active banks) or concern about 15% limit

Or market view may have hardened e.g., Moody’s November 2003 paper

If former – Regulatory

If latter – Market

Neither – reflects the market misinterpreting the economics of the transaction