Curtis C. Verschoor, CMA, Editor

Who Should Be Blamed the Most for the Subprime Loan Scandal?

Once again, an ethics scandal has resulted in a number of people who need to bear some blame. The list of major contributors to the subprime loan fiasco includes many of the usual suspects: greedy CEOs, disengaged boards of directors, unsuspecting investors, compliant lenders, and other facilitators. But most disturbing is the substandard performance of the gatekeepers despite the enactment of laws designed to solve problems uncovered in Enron, WorldCom, and other prior ethical scandals.

Credit rating agencies conferred investment-level grades on newly designed investment products, such as collateralized debt obligations (CDOs) and mortgage-backed securities (MBSs), that were obviously based on loans of dubious quality. Regulators such as the Securities & Exchange Commission (SEC) failed to require sufficient disclosure of the magnitude of the risky—and sometimes exotic—loans that financial institutions were adding to their balance sheets. Bank regulators ignored their responsibility to oversee the banking industry's wishes to grant ever-larger mortgage loans to borrowers with unknown resources and little or no credit history. And the activities of hedge funds aren't currently regulated by any agency.

In particular, the role of credit rating agencies was critical to the very existence of the subprime lending market. The agencies failed to limit themselves to expressing an opinion on the creditworthiness of CDOs and MBSs. They also were paid as consultants to guide securities issuers to meet the "requirements to attain the desired rating" and largely performed the role of defining the "requirements of the [security's] structure to achieve target [investment-grade] ratings." Once the rating agencies conferred investment-grade ratings on CDOs/MBSs, the issuers of those securities were able to sell them to institutional investors. This sounds very similar to how Arthur Andersen was paid high consulting fees to advise Enron on how to meet the letter but not the principle of various GAAP requirements and then expressed a favorable "independent" opinion on the fairness of the result.

The list of direct casualties from the scandal continues to grow, and it appears to have many more months to go. According to Bank of America, about $515 billion in adjustable rate home loans, with more than 70% made to subprime borrowers, will have interest rate "resets" by the end of 2007. Nearly $700 billion will be "reset" in 2008. Borrowers unable to support higher interest payments likely won't be able to refinance their loans. The wave of defaults and foreclosures will grow and result in lower home prices, which will cause further deterioration of the values of the financial instruments supported by the loans.

In October 2007, the financial services firm Merrill Lynch ousted Stan O'Neal, its chairman and CEO, because he was responsible for leading the firm into a headlong race with Goldman Sachs for supremacy in the subprime market. For Merrill Lynch shareowners, an $8.4 billion third-quarter 2007 write-off of subprime assets culminated in a stock price drop of nearly 40% from the January high. But don't worry about O'Neal, who negotiated a stellar $160 million exit package.

Shareholders in a Bear Stearns hedge fund, the inelegantly named Bear Stearns High-Grade Structured Credit Strategies fund (High-Grade fund), which opened in 2003, saw strong early gains. So did the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage fund (Enhanced fund), which opened in 2006, but both collapsed into bankruptcy in July 2007. This experience conjures up memories of the Long-Term Capital Management fund that imploded in 1998.

Use of fair-value accounting may have facilitated the reporting of strong early performance by the hedge funds. In the case of the High-Grade fund, 70% of its net assets at the end of 2006 were being valued in such a manner, up from just 25% in 2004, while 63% of the Enhanced fund's net assets, or $589 million, were "fair valued." Bear Stearns's auditor Deloitte noted that a high percentage of net assets at both funds were being valued using estimates provided by management "in the absence of readily ascertainable market values." Deloitte went on: "These values may differ from the values that would have been used had a ready market for these investments existed, and the differences could be material." A Bear Stearns spokesperson called these disclosures "standard."

Unfortunately, the Deloitte warning came too late for most investors to respond to developments in the subprime mortgage loan market in the spring of 2007. Investors didn't receive the 2006 audited financials for the High-Grade fund until mid-May, just two weeks before Bear Stearns suspended redemptions in the Enhanced fund, and many say they never received a copy. "Valuation fraud is one of the touchstones of hedge fund fraud," says a New York securities attorney who has litigated several hedge fund fraud cases. "It typically occurs when people don't start out to commit a fraud, but have losses they are trying to cover up."

The first company to signal subprime trouble was New Century Financial (NEWCQ), a real estate investment trust (REIT). NEWCQ originates and purchases primarily first-mortgage loans from individuals whose borrowing needs generally aren't fulfilled by traditional financial institutions because they don't satisfy the credit, documentation, or other underwriting standards prescribed by conventional mortgage lenders and loan buyers. After trading over $50 per share on the NYSE in mid-2006, NEWCQ restated its 2006 results in early 2007 and later sought bankruptcy protection.

Others sustaining injury in the subprime meltdown include home purchasers with limited resources who have been or will face foreclosure and the need to move. Another way to look at their situation, however, is that they have lived for some time in a home they couldn't otherwise afford. And no tears should be shed for the home builders who pressured lenders to accept substandard borrowers in order to sell more houses.

Largely avoiding the finger of blame in the downturn of subprime lending so far has been the auditing profession—both the internal and external portions. In their audit planning and risk assessments, external auditors should perhaps have done more to satisfy themselves about the real market value of an asset rather than merely peer over the shoulder of their client and gaze at their computer screens showing a calculation based on a formula. Conceivably, external auditors should require that a valuation allowance be recorded to recognize the flimsy evidence available to support the market valuation of derivative assets of this type. But perhaps the real cause of murky financial statements involving subprime mortgage loan assets is the fact that the Financial Accounting Standards Board (FASB) hasn't provided sufficiently clear guidance to account for these types of derivative products.

Internal auditors, charged with the oversight of corporate risk management processes, apparently didn't sound sufficient alarms or display enough red flags to the audit committees of financial institutions that had heavy investments in subprime assets. Although a high-risk strategy can certainly be profitable, and greater risk must be assumed to earn greater returns, internal auditors should ensure that companies have processes in place to carefully assess the significance and probability of every business risk before the risk is undertaken.

In summary, the clearest call for change appears to be the need for greater regulatory oversight. The Credit Rating Agency Reform Act of 2006 should provide a welcome improvement since it's designed to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. Since the SEC's final rules implementing the Credit Rating Agency Reform Act (Release No. 34-55857) were issued in June 2007, Nationally Recognized Statistical Rating Organizations (NRSRO) registered with the SEC should have a *continued on page 59*

[ETHICS] *cont'd from p. 12*

better appreciation of the critical role they play in protecting the public.

Additionally, the SEC should be given the legislative mandate to oversee the activities of the hedge fund industry. When the costs and other effects of market volatility and investment failures clearly extend far beyond the boundaries of the "sophisticated" and "high networth" individuals that invest in such products, the SEC should provide oversight. ■

Curtis C. Verschoor is the Ledger & Quill Research Professor, School of Accountancy and MIS, and Wicklander Research Fellow in the Institute for Business and Professional Ethics, both at DePaul University, Chicago. He is also a Research Scholar in the Center for Business Ethics at Bentley College, Waltham, Mass. His e-mail address is curtisverschoor@sbcglobal.net.