

Interview: **ROBERT BUSHMAN: ACCOUNTING IS WRONGLY SEEN AS CENTRAL PLAYER IN BANK REGULATION**

The Tilburg University research institute CentER each year organizes so-called Faculty Seminars, supposedly non-technical in nature and of interest to all (business) economics researchers. For the first Faculty Seminar of 2010 they invited Robert Bushman, who spoke about 'Accounting Discretion, Loan Loss Provisioning, and Discipline of Banks' Risk-Taking'.

Robert Bushman is Forensic Accounting Distinguished Professor at the UNC Kenan Flagler Institute of Private Enterprise. He has conducted several ground-breaking studies of the link between financial accounting and corporate governance. His studies, which started in the late 1990s right before the Enron, WorldCom, Tyco, Adelphia and other big financial scandals broke, were well-timed; they have shown just how important accounting information is in supporting effective corporate governance. 'I get calls from around the world,' he says. 'Since Enron, the world has rediscovered accounting.' In fact, many calls now come from bankers, lawyers and regulators, not other accountants. He warns that regulators these days are in danger of thinking that accountancy and accounting rules can effectively help regulate the financial sector. Jan Bouwens spoke with Robert Bushman, while Arne Lasance kept the minutes.

Jan Bouwens and Arne Lasance: Together with Christopher D. Williams of the Ross School of Business, University of Michigan, Robert Bushman recently wrote a working paper on 'Accounting Discretion, Loan Loss Provisioning, and Discipline of Banks' Risk-Taking'. The paper empirically delineates economic consequences, associated with differences in accounting discretion permitted to banks, under existing regulatory regimes. Exploiting cross country variation in loan provisioning practices, the authors have generated country-level measures of the discretion allowed to banks. They then examine the implications of this discretion, for both the information properties of loan provisions and

for bank transparency. Banks in countries allowing higher discretion are expected to use this enhanced flexibility to infuse loan provisioning practices with a more forward looking orientation, relative to banks in lower discretion countries. Bushman and Williams investigated whether in fact this kind of discretion impedes the ability of regulators and outside investors to monitor and discipline bank risk taking.

Their three main findings:

1. There is no evidence that banks in high discretion countries impound more forward looking information in loan provisions, relative to banks in low discretion countries;



2. Sensitivity of changes in bank leverage to changes in asset volatility is lower in high discretion regimes relative to low discretion regimes; and
3. Banks in high discretion regimes exhibit more risk-shifting, relative to banks with less discretion.

These results support the idea that discretionary leeway in loan loss provisioning does in fact degrade the transparency of banks, and thereby weakens the ability of regulators and outside investors to monitor and discipline bank risk taking. They also show that great care must be exercised with respect to allowing more discretion into loan provisioning, and that perceived gains to forward-looking provisioning regimes must be weighed against potential losses in bank transparency due to opportunistic accounting choices.

‘Two things are getting blurred together right now,’ states Bushman at the beginning of this interview. ‘Namely, the desire by governments to regulate their banks on the one hand, and accounting on the other. The financial system’s regulatory side is really reaching into accounting, in a deep way, and at some level I think they’re trying to shape accounting into a sort of regulatory mechanism. Things like “fair value” are on the table, as far as that’s concerned. But what’s really amazing is that they are trapped into a sort of Catch-22. There are

‘The market brings valuation discipline’

many, many proposals out there for accounting, from the regulators, and this loan loss provisioning is only one of them.

They are asking for more discretion – on the other hand they do not like *fair value* accounting. Those two arguments cannot exist simultaneously.’

No – it’s either more discretion, or a fair value valuation.

If you look for example at what IFRS-9 is proposing, they are carving out this scalp for advertising costs – if you look at what’s in them they look like loans! But they are in fact simply establishing an intermediary fair value, because what you are really doing is fair-valuing one small part of a loan, the credit-loss side of it. Anything else is being locked out.

But, what IFRS is also doing is saying you can use any information you might have. Look forward, to the end of time, at what you expect the loan losses to be over the entire life of this loan. Then bring it back to today, and we shall embed that directly in the interest rate on the loan. And we are going

to recognise interest revenue based on the credit-adjusted spread.

So it's a smoothing device – in the sense that it is actually taking all the expected loan losses on the entire loan, and dropping those into a loan loss reserve, systematically, over the entire life of the loan. That is almost exactly the accounting these guys are asking for.

But in essence it is fair value, because as we start moving forward, we are going to allow companies to change their assessments of the future loan losses – and that could go either way. They are getting fair value, but what they are choosing is the hardest part! They are picking the hardest nut to crack out of a valuation exercise in a loan. That is the part that is going to be valued...

So who do you think does a better job in valuing loan losses, what are the necessary provisions; would that be the market, or would that be the bank's manager who has access to all the information?

I do not think you want to say that one is better than the other – you need both. The extent to which we want to draw the market in – it really is a disciplinary device. To me it is like, who has the better information to make the assessment? The bank manager probably knows more texture about the loan portfolio than the outsiders. But I think of the outside force rather as a governance mechanism, more than I would take that as the primary valuation mechanism.

You can of course not control bubbles in the stock market, they will always be there. But if a bank manager is understating their situation, the outside discipline can bring a lot of force to bear.

This is the way I describe it, the market brings the discipline. Sometimes there may be a bubble, usually there is not, but is just another piece of information you have, that's valuable and that should

be on the table. If I am a bank regulator, I have limited resources. I cannot look at what's going on in all banks at all times. I must deploy my energy in the most effective way. If I am getting a price signal that something strange is going on somewhere, that then is a signal about where to invest my scarce resources.

Look at credit default swaps for instance – you could observe that Lehmann Bros would go bankrupt a year in advance. But no one did anything!

Absolutely. I do not know why they didn't – they should have!

On the other hand, at that time Lehmann was an investment bank. So they'd have been regulated by the SEC, not the Fed. And then it was not the SEC's problem, was it? And in terms of a regulatory standpoint it really was nobody's problem.

The market was seeing the signals out there – the question is, there is no action available there, other than calculating it into your trading decisions. If I am a player there and I'm worried about a weak counterparty, I should be taking that into account when I decide what kind of business I'll be doing with Lehmann.

The moral of that story then is, that if you really wanted to put a regulatory body over investment banks, that is an important piece of data that should not be discarded. And I do not think it will be discarded.

So I do think that the market plays an important role in disciplining the banks.

Banks that take on bad loans have an incentive to mimic that they have good loans. How do we know that one bank is issuing bad loans and another good loans?

We don't. What we do is, we assess the situation and the risks involved. In one study we looked at how much skin-in-the-game the lender had to keep, meaning: what percentage of the loan did the lead-arranger of the loan have to keep in order to get this thing to go through. And then you study what makes this percentage go up or down. To answer your question: you may know by various measures of reputation of the lead arranger. Because they have so much information, people want to know that they are honest. If the borrowing firm is transparent, and we measure that directly by how correctly their accounting data predicts future credit degrades, then I do not have to rely as much on the lead arranger.

‘Reputation is a strong mechanism to assess a bank's trustworthiness’

‘The big debate concerns the question how strong the evidence needs to be’

In other words, the market is very well aware of the different reputations – and reputation is a strong mechanism to deal with that problem.

But one of the Bleck and Goa predictions is that it is the good banks, that must hold on to very high proportions of the loans they arrange...

That is the skin-in-the-game story, a term coined by renowned investor Warren Buffett, referring to a situation in which high-ranking insiders use their own money to buy stock in the company they are running. But the idea also is that corporations are best managed by individuals who share a stake in the company. The best vote of confidence is putting one’s own money on the line, just like outside investors.

Yes, by keeping a large share yourself you show that you are better than the bad bank. But you are saying that this is not really true!

What we observe is the market looking at you. Somehow the market allows people with good information to distinguish themselves from people with bad information. Sometimes this may even be information I’ll receive tomorrow. The question is also, will I actually do all the work to figure out if this is a good loan or not. Or am I just going to be this middleman, who collects fees and just piles crap into your portfolio, not caring whether they are bad loans or not. The signalling story does not apply to those players. Again, the market assesses you as to your reputation, and the properties of the borrower themselves. And then they look at the lead arranger and say: this is what you yourself will have to hold on to. And this share seems to go up, the lower your quality is perceived.

Still, all these studies have been rather crude. I’d never be able to tell the good ones from the bad, because these signalling stories would be based on ‘Can I have a little secret?’ Not on these data.

One thing they (Bleck and Goa) assume is that bad guys can lower their costs of keeping their bad loans on the balance sheets, because they know they’ll always be bailed out at the end of the day anyway. This argument makes me wonder: what sort of manager would want to bring his own

bank to bankruptcy?

This argument only makes sense in the following way: that force is only operative once the bank is already in trouble. What they are only interested in then is gambling. They think they are going to die, you can only die once, so what the heck? The world is closing in on them – they get desperate and crazy. You’ll only run big risks if there is not much at stake.

Do you think that it would help, if bank managers were forced to hold private equity in their bank?

That’s an interesting question. There is an interesting study by Laeven and Levine, who looked at the ownership structure of the bank. Their story is that if bank management is heavily aligned with the shareholders, they indeed feel an incentive to take risky actions; where if you have a bank manager that is detached, whose livelihood is more dependent on the human capital that he has built in the bank, they are much more conservative.

I think it is all about finding balance, finding the right balance. You do not want to make the bank into ‘government work’ either. In the end then, you’ll attract much less talented people. The way to deal with these issues is through governance and prudential oversight, using these market signals we were talking about. When some bank is getting into trouble, that’s when you move in and monitor the kind of decisions they are taking.

And here we come to this discretion problem. Regulators hesitate to actually foreclose on these banks. When a bank is in trouble, you see regulatory forbearance, the tendency to say ‘let it go on a little longer, maybe things will get better’.

The problem with discretion is that you are allowing the banks themselves to do some regulatory forbearance. ‘What if I see the future a little worse? I am in trouble. Am I actually going to keep my capital?’

The black side of discretion is that when all the arguments are pure and clear, when I look at procyclical behaviour, you know, ‘we have to give them some discretion so they can go out and recognize credit losses earlier in the cycle’.

There is this incurred-loss model. The model is internally inconsistent, because expected losses are implicit in the initial measurement of a loan asset, but the subsequent accounting ignores changes in expected losses until a loss is ‘incurred’. Besides, the model relies on a distinction between ‘incurred



losses' and 'future credit losses' which is often arbitrary. Discretion means we are moving away from hard objective data to incorporating softer data.

The big debate in accounting concerns the question how strong the evidence needs to be in terms of verifiability. That's what it all boils down to. You could now base your loan loss projections on thousands of data, things that are much more difficult to verify. This gives the banker a lot more 'discretion' - you cannot tie him down.

When we wrote our paper we wanted to say, like, you want to give bank managers more discretion; well, surprise! Some bank managers already have more discretion - what are they doing with it? The answer is: it looks like they are mocking up earnings. They are smoothing.

The big concern in the banking field is: are we creating another degree of freedom for regulatory forbearance here, in a system which is in fact asking for less regulatory forbearance?

The question in the end is of course, how is discretion used? And all too often it seems to be abused. Some kind of survival behaviour comes out - if I can hold off regulatory forces by smoothing the numbers, maybe I'll do that.

What seems particularly risky is these so-called structured products, which they can sell off for three months or less than a year - while the underlying loans go on for another ten or fifteen years. It turns out like a sort of Russian roulette: what are the buyer's odds that the loans will default in less than a year? But the bank has to take it back, and on their balance sheet too!

I really think this market too will move more

towards a skin-in-the-game design. The banks will have to keep a substantive chunk of the product on their own balance sheet, to convince prospective buyers that they themselves really believe in this 'product'. The securitisation rules will be more strict. The ability to move these things off the balance sheet is only going to happen, when you're really selling it off. It's all reputation of course.

CitiGroup brought some of those deals back on their balance sheet, even when they absolutely were not legally obliged to do this. They did it, because of long-term business interests.

Getting something off your balance sheet is becoming ever more difficult now. The new securitisation regime will be much more conservative than it has been the last couple of years. After Enron they already did take some measures, but these were mushy. Now they have rethought these again - though I think even the latest version of IFRS is not quite solid there yet.

The idea being of course that if something will come back on your balance sheet, it shouldn't be off it at all.

Exactly. The Financial Accounting Standards Board has almost with one sweep wiped out all that securitisation. The mechanism they used, called Qualified Special Purpose Entities, are dead now. After Enron, it is one unified set of rules that cover all off balance things including securitisation. No more special treatment for special vehicles. Is there risk here, or is there no risk? Are you the primary beneficiary, or not? Everyone is equal - while before, securitisation had its own special regime with its own calculus.

Going back to the Mark to Market- Historical Cost debate. One of the accusations surrounding the current crisis is that the massive write-downs banks made, had to make, only exacerbated the situation.

It's not a particularly helpful argument, but I understand they're making it. The problem is, that's beyond any accounting rule – the alternative wouldn't be very good either. If I have a security sitting on a bank's balance sheet, and I do not know how to value it because some kind of panic dried up all the liquidity and it's hard for me to sell – I have a problem! But this is a problem beyond accounting. Is this bank still solvent? How do I deal with this?

The alternative, to let it lean on the bank's costs, could not see as a better alternative in that sort of situation. We know we have uncertainty – we have to deal with it. It's going to be hard to value, and that's it. We must accept that.

So you think Mark to Market is better for that product?

If you're simply talking about accounting, without the disclosure etcetera, yes. But you'll have to give a whole lot of information on that thing you're not writing down.

Those packages that you hold into maturity are priced at cost of issue on the balance sheet, and there nothing happens unless you are forced into a severe write-down that goes beyond the provisions you made.

Yes. I think there is a whole lot of thinking going on, because a lot of the arguments here, like contagion or correlation... everybody is holding loans on their balance sheets that if you're in a mark-to-market setting, if they all go down, then everything goes sour and everybody has to sell more and more.

But that has more to do with not being on time, right? If the overseeing bodies had monitored market prices, how they developed over time, they could have signalled that some banks were getting in trouble and could have taken measures earlier. Then maybe we would not have had this credit crisis.

All the arguments work the same way – somewhere there is a capital requirement in there. What happens is, the market changes, everybody is correlated, and some have to sell because of a leverage ratio, or because they have to deleverage the firm and soon everybody is deleveraging. The alternative would be that they would not have to do anything and everything would be fine. If we'd just ignore the change in value everything would be fine.

It is possible to deny that there would be a contagion effect. But we have seen panics before the time of fair value accounting too! I think this is putting too much weight in the wrong place.

And that is the real topic of this conversation, I think. Everything is blurred – accounting is seen as the central player in regulation. What you want to do is set the accounting rules.

If you are really concerned about correlation and those kind of things, then you need to come up with a way of pegging capital or something to measures of correlation, or measures of macro-movements. You have to get a system that is solid and in place on the accounting, and then you have to build a regulatory system around it.

In other words, accounting itself is not the right mechanism to regulate banks. What you want to do is what accounting always has wanted to do, which is to get the best representation of reality, and not let managers lie and cheat. It is making the numbers have some kind of credibility, by forcing some sort of reliability on the numbers, making objective evidence the basis.

That's what the game is, and that's what accounting should be allowed to do.

What is happening now is that regulators are reaching in and grabbing accounting and shaping it into a regulatory mechanism.

It's not going to work, and it is likely to cause the opposite effect. Because if you start mocking up the reality you are describing, you make it less easy for the market to impose its discipline on the firm, like we discussed earlier.

One of the arguments in your paper, and you see the same in Laux and Leuz, is that it would be a good idea to separate Basel II rules from accounting rules.

Basel should be talking to the accountants and saying: 'Here is what we think is the way to represent the underlying reality.' They should be able to feed in, just like any other major constituent or stakeholder feeds into what good accounting should look like in terms of representing the firm subject to reliability.

But they must base their judgement on our accounting, do they not?

Another buzzword used these days is 'prudential filters'. We know for example that we are not computing regulatory capital. Basel actually puts some of these in, but then country by country uses diffe-

rent prudential filters. Countries have discretion in how they define and enforce capital requirements.

In other words, the regulators can define those capital rules any way they want, and those capital rules could start with financial accounting and then add these prudential filters on. What we are trying to do is balance two things: if the accounting is done correctly and properly, you could marshal market discipline, these outside forces that are scrutinizing the firm; and at the same time also achieve your regulatory ends, by applying regulatory prudential filters that you think you should be doing to comply with capital requirements.

This is our best representation of reality! A level playing field, in terms of available information.

We should get the best information system that we can, and use that as the center for our regulation – but we have to think about what our regulatory objective is. The prudential filters are already well established and accepted – if you don't want that to be counted in, take them out! You could also make your capital requirements very, very conservative – do what you want, but, if you work through accounting, the risk I see is that you'll make it harder for people to see what is going on. And that weakens the system overall.

Transparency is really the limitation here. By using accounting as a regulatory mechanism, I think we risk losing the informativeness of accounting information. Which is going to weaken the other forces that work to your advantage as a regulator.

You can get all you want by getting the best accounting, marshalling all those market disciplinary forces, and then choose how you can best control the investor's behaviour.

How do you want to set capital standards? There is a lot of discussion going on about how to link capital standards to macro and all kinds of correlation variables. I say, go for it! Knock yourself out! But you do not want to destroy the transparency of the bank in the process now, do you? But then again, maybe some of them do, I really have no idea!

I really think that people are playing with fire, by using accounting to regulate banks.

Accounting should be part of the regulation of banks, through representing banks with the best possible information system. But bank regulation has to start *from* there, and make a lot of hard decisions, like how to manage capital, what are the risk adjusted capital numbers, what should they

actually look like, how should we compute this. The problem is of course that we are creating incentive schemes that create forces, that make managers and accountants mock up the true reality they know is there. What we should do is try and build a system with enough checks and balances.

But even if we have systems that invite people to commit fraud, do they represent the majority or not?

Of course there are downright criminals out there. But a lot of the frauds we see are committed by good people, put into pressure situations, and they crack under the pressure. We have to understand that it is all about understanding pressure points; you should always go and look: which guy here is under real pressure, where will somebody be tempted to try and save himself.

In terms of loan loss provisioning, they may be totally in compliance with the law. In a perfect world we could assess risk very carefully, and have a very sensitive system, that adjusted capital instantly; and they would have no incentive to do this. And you really wouldn't even care if they did or didn't, because they'd be paying the price.

This whole result here is coming through the value of the put-option on deposit insurance.

Deposit insurance... the function of both the risk of the assets and the capital that the bank holds, if I get those things responding enough, so that when the risk goes up the capital will go up to the right level, I could completely neutralize the risk and people would be indifferent – in fact if I knew this was going to happen I would not take the risk to begin with. It would just cost me too much.

Another way to do it would be if I again had this very sensitive system, and every time I'd take a risk without upgrading the capital accordingly, I'd charge you a fee and you'd pay me more deposit insurance premium.

‘Incentive schemes force managers and accountants to mock up reality’

‘People are playing with fire, by using accounting to regulate banks’

The problem we have with deposit insurance is: how do I price that correctly? It is based on a given level of risk, and a given level of capital. And once I give you the price, you have an incentive to make the bank riskier. You’re paying a premium based on low risk, and then you increase the risk and you get the benefit because the premium is fixed.

We as accountants did not do much research into banks and banking did we?

I have looked at 99 papers on the question of ‘do banks smooth?’ But we did not do much indeed. There is a lot of promise in young accountancy theorists, who are making significant contributions to banking theory I’m sure.

So do you think that better accounting rules would make the banks behave more prudently and with less risk taking?

Yes, absolutely. I think, if you have the right accounting system; meaning an optimal representation of reality subject to reliability, you maximize the chances of disciplinary behaviour. Because stakeholders with their own interest on the line can then see what you are doing.

The question here is of course, and there is a big literature on this: what’s the difference between the concept of monitoring versus influencing? Or in other words: if I’m standing outside but can see what you’re doing, what can I do about it? There of course also needs to be a mechanism whereby I can do something about it. Investors can price, and that’s what they can do about it. So in regulatory literature the challenge is: how does market discipline actually convert into regulatory oversight?

There are those who argue that transparency actually is bad for banks, because it makes them more fragile. I do not know whether I can agree. There are models out there that indeed do show that transparency can lead to some fragility.

Say you have a bunch of banks, and all of a sudden the rumour starts that the banks are in trouble. So what do I do? Do I rush to the bank because I want to be the first in line and there will be still some money left when I get there? But think for a moment - what if the banks were transparent, and if the rumour got out I’d be able to look at the bank and say: these are all healthy, except this one which is unhealthy. Would that reduce the panic? To put it differently: if banks were totally transpa-

rent, and there was a continuous oversight of these banks, would you ultimately be less likely to get in such a panic, as with your DSB bank?

Wouldn’t it be sufficient to look at credit default swaps, and see the assets of some banks go up much faster than those of other banks? Shouldn’t you be alarmed then?

I agree. CDS prices hold an incredible amount of information. A very powerful measure indeed. They are transparent now – they used to be a sort of underground, dealer kind of thing. But now they are an excellent information source, having a huge potential for accountants.

Based on what I am planning to do, and I know others are as well, in the next few years is going to come out, on the relationship between accounting and credit default and credit risk generically. You can now dissect things like liquidity risk, which we are getting better and better at, and default risk. Techniques have been developed, where you can take the default risk and break that down further into the probability of default. And the market’s assessment of the loss of this default.

One of the great unexplored frontiers is the notion of ‘collateral’. If you look at the accounting arguments for conservatism, you do not want to overstate your collateral. We should be asking the question, if the market assesses the liquidation value too low, that has consequences as well. In terms of banking accounting and in terms of big debt contracting, these are indeed very exciting times for researchers. It’ll be a decade of new ideas, in which we’ll hopefully finally penetrate into the heart of the matter – the debt-side of the balance sheet.

Literature

- Bushman, R. and C. Williams (2009), *Accounting Discretion, Loan Loss Provisioning, and Discipline of Banks’ Risk-Taking*, working paper, Kenan-Flagler Business School
- University of North Carolina-Chapel Hill.
- Laeven, L. and R. Levine. 2009. Bank governance, regulation and risk taking. *Journal of Financial Economics* 93 (2): 259-275.
- Laux, C. and C Leuz (2009), The Crisis of Fair-Value Accounting: Making Sense of the Recent Debate, *Accounting, Organizations and Society*, 2009, 34(6-7), pp. 826-34.
- Alexander Bleck and Pingyang Gao (2009), *Where does the Information in Mark-to-Market Come from?* Working paper, Chicago Booth November 11, 2009