WALL STREET & MARKETS

The Accounting Trick Behind Thirty Years of Scandal

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BRENDAN MCDERMID / REUTERS

Traders work at the Goldman Sachs kiosk on the floor of the New York Stock Exchange, April 16, 2012.

Once upon a time, New York City's Times Square was plagued with Three Card Monte dealers who made their living bilking unsuspecting tourists out of their five and ten dollar bills with the aid of paid shills and a little prestidigitation. These sleight-of-hand artists were mostly chased from the streets in the 1990s during the city's broader renaissance, but according to a new paper from law professors William Bratton and Adam Levitin, a more sophisticated shell game was just getting going in the skyscrapers that overlooked the financial capitals of the world.

America has been afflicted with one financial scandal after another over the past generation – culminating in the 2008 financial panic, the effects of which we are still suffering under. It has widely been assumed that each of these scandals have had disparate causes, but in their new paper Bratton and Levitin argue that three of the most notorious scandals of the past generation — Michael Milken's junk-bond-related securities fraud in the 1980s, the Enron scandal of the early 2000s, and the subprime mortgage meltdown of 2007-08 — are all linked by their use of an esoteric accounting mechanism called a "special purpose entity," or SPE. When used dishonestly, SPEs are nothing more than financial sleight of hand, the clever shifting around of assets to trick regulators and investors into seeing something that isn't there.

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So what exactly are SPEs? Broadly speaking, they are legal entities that are separate from the firms that have created them. They can hold assets and owe debt, but as Bratton and Levitin write, "they never fully coalesce as independent organizations that take actions in pursuit of business goals." They are companies running on autopilot that serve one purpose: removing assets and liabilities from the parent company's balance sheet.

Companies can use SPEs for legitimate purposes. For example, an oil company might want to finance an expensive and risky exploration project without putting the whole firm at risk of its failure. So they'll set up an SPE with limited resources, put only those resources at risk in pursuance of the new project, and fully disclose the arrangement to potential investors. But as Bratton and Levitin's paper shows, special purpose entities can be — and frequently are — a recipes for disaster.

Their story begins in the late eighties when junk-bond king Michael Milken and his firm Drexel Burnham Lambert, who fueled the 1980s takeover wars with their seemingly endless issuance of high-yield debt. As the decade drew to a close, however, the firm was running out of demand for their junk bonds. Their solution: deposit the bonds into SPEs and slice and dice them in such a way that the ratings agencies would give them an investment-grade rating — allowing insurance companies and pension funds, which have rules against putting money into high-yield debt, to invest. These special vehicles were, according to the paper, "entwined in the failure of one of the nation's largest life insurers — and the world's largest investor in junk bonds — First Executive Corporation."

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Enron then famously used SPEs to hide underperforming assets and book phantom profits that kept its stock price high even while the firm was imploding. According to Bratton and Levitin, Enron "received its final kick into bankruptcy when those off balance sheet obligations came due."

And the subprime mortgage crisis was also caused, in part, by excessive and irresponsible use of SPEs. These vehicles allowed banks to hide risky subprime assets off their balance sheets and away from the prying eyes of regulators, freeing them to lever up even more in search of higher profits. Goldman Sachs was one of the more famous users of SPEs, when it created ABACUS, a synthetic collateralized debt obligation, which like most of these collections of subprime mortgages ended up in default. Goldman was fined $550 million by the SEC for not disclosing the true nature of this collection of mortgages to the investors that eventually bought them, but the greater problem with vehicles such as ABACUS were that it enabled banks to appear to regulators and investors as if they had moved the risk of the mortgages off their books, when in reality, many banks (and ultimately the taxpayer) ended up bailing out their special purpose entities when they went under.

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These SPEs have been lambasted in the press for years, but Bratton and Levitin argue that because of their culpability in so many of the most recent financial scandals, they deserved special and immediate scrutinty. The good news, however, is that regulators have made serious strides in addressing the dangers posed by these accounting structures. The Financial Accounting Standards Board, a non-profit organization that is charged by the SEC with writing accounting standards, adopted rules in recent years which forced banks to bring many of their SPEs onto their own balance sheets.

Even more important, the paper argues, is that a "conceptual barrier has been surmounted" rearding how regulators view the non-academic question of what, exactly, a firm is. With these new rules, regulators now understand that just because a firm doesn't have a formal equity stake in a toxic asset, it isn't completely walled off from the risk. That alone, write Bratton and Levitin, is "a cause for celebration."

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