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DESPITE THE RULES — $4 BILLION BANK “ACCOUNTING ERROR”

“I know what you’re thinking: ‘Did he fire six shots or only five?’ Well, to tell you the truth, in all this excitement, I’ve kinda lost track myself.”

– Harry Callahan, “Dirty Harry,” Warner Bros, 1971

The disclosure this week of a $4 billion “accounting error”— or was it only $2.7 billion? — by a major U.S. bank underscores once again the truism that all the banking regulation in the world — perhaps literally — won’t protect the stakeholder or the economy if internal risk controls are lacking. The latest revelation comes on the heels of another highly publicized capitalization failure in March.

Stress Test: The Heart of the Matter

Minimum capitalization requirements under both Dodd-Frank and Basel III mandate that banking institutions maintain strict capitalization cushions not only under “normal scenarios,” but also under theoretical “what if” situations — hence the stress-testing requirements. But oddly enough, it is possible for an enterprise to pass its stress test — yet later is found to be $4 billion dollars short — while another institution fails its stress testing despite holding the requisite minimum capital. As to the figure involved, under transitional rules, it would be considered a $2.7 billion-dollar loss, while under fully implemented Basel III regulations, the figure would soar to $4 billion dollars.

Loss Undetected for Years

The under-reporting of $4 billion dollars in capital ratios apparently went on for several years, and the bank’s outside auditors approved the audits throughout the time period. Now, the Federal Reserve is requiring that the bank resubmit its CCAR (Comprehensive Capital Analysis and Review) capital plan because of “material change” from what was previously reported. Increases in capital distributions have been suspended until the new plan is approved.

The Mere Appearance of Proper Controls

The spirit of the internal control and reporting laws — to truly capture the financial condition of a financial institution as it exists — versus the letter of the law — requiring compliance with various technical reporting — quite possibly diverge: The bank’s internal control and reporting mechanisms were technically complied with, but in reality, those controls were neither sufficient nor substantively accurate. Furthermore, under Securities and Exchange Commission (SEC) rules, although a “material weakness” must be disclosed, a “significant deficiency” need not be. An enigmatic rule if ever there was one.

Genuine Error Versus Pattern and Practice

Although it is clear that the capital ratio calculation methods are difficult and confusing — after all, the Federal Reserve itself “missed this one” — one critic has suggested that the overstatement of regulatory capital forms part of a larger pattern and, therefore, a much bigger problem. Banks will now be looking to internal risk control experts to avoid even the appearance of impropriety.

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