NJIT business prof says first-quarter bank profits will soon prove ephemeral

May 27 2009

NJIT finance professor Michael Ehrlich predicts that the strong profits reported by banks in the first quarter will soon be followed by more losses. Credit: New Jersey Institute of Technology

NJIT finance professor Michael Ehrlich predicts that the strong profits reported by banks in the first quarter will soon be followed by more losses. Ehrlich, a market failure expert, notes that the unexpectedly strong profits reported in the first quarter by many large banks were the result of significant accounting manipulation. For some of the banks, these earnings were a crucial addition to their net equity positions at a time when government "stress tests" were evaluating their future viability. With more losses, serious pressure could mount on the Federal Deposit Insurance Corporation, which, of course, insures bank deposits.

"Accounting rules allow banks to use their judgment in reporting profits," Ehrlich said. "And this quarter, they were quite optimistic." These and other issues will be further explored by Ehrlich in the "The Unexpected Consequences of Financial Innovation" to be published in Bank Accounting and Finance (August, 2009).

Earlier this year, financial news readers learned about exotic structures like Collateralized Debt Obligations (CDO), Credit Default Swaps (CDS) and Structured Investment Vehicles (SIV) as banks reported enormous losses. Soon readers will learn of more three-letter losses: Collateralized Loan Obligations (CLO), especially those with Payment In Kind (PIK) provisions that allow corporate borrowers who are in trouble, to make little or no payments while the loan balances grow without creating a default or forcing the banks to mark down their positions.

A much better way, Ehrlich believes, is for the Fed to establish new rules to control future risks as it works to contain the damage to the financial system. In this case, there should be tighter regulation of the establishment of loan loss provisions to offset expected future losses.

Ehrlich was a government arbitrage trader at Salomon Brothers and senior managing director for fixed income emerging markets at Bear Stearns before joining NJIT. He received his bachelor's degree from Yale University and doctorate from Princeton University.

Source: New Jersey Institute of Technology