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Highlights

Highlights of GAO-05-131, a report to agency officials

Why GAO Did This Study

Federal banking regulators reported that commercial banks held about $1.6 trillion in syndicated loans in 2003. Loan commitments—a promise to make a set amount of credit available in the future—represented $1 trillion (about 64 percent) of these loans. Issues have been raised whether commercial banks systematically underprice loan commitments and whether generally accepted accounting principles provide meaningful disclosure of the economics of these commitments.

This report discusses (1) differences between the pricing of loan commitments and loans, and assesses data that are available about the trading of loan commitments; (2) the extent to which credit default swaps are used to reduce the credit risk from loan commitments, and what credit default swap prices indicate about the prices of loan commitments; and (3) differences between commercial and investment banks' accounting treatment of loan commitments, and the strengths and weaknesses of fair value accounting.

What GAO Recommends

GAO is making no recommendations in this report.

www.gao.gov/cgi-bin/getrpt?GAO-05-131.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

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LOAN COMMITMENTS

Issues Related to Pricing, Trading, and Accounting

What GAO Found

Loan commitments and loans have different characteristics, making it difficult to directly compare the prices of these instruments. First, a loan commitment gives a company the option to borrow a certain amount in the future, while a loan actually provides funds to the borrower. Second, lenders typically charge fees for making credit contingently available through a loan commitment but charge interest on a loan. Third, loan commitments are typically unsecured—that is, borrowers do not have to pledge collateral—while loans are typically secured. Most of those we interviewed told us that loan commitments are rarely traded in the secondary market because selling them could jeopardize relationships with borrowers and because institutional investors were reluctant to purchase them. Some investment bankers expressed concerns that loan commitments were systematically underpriced, but the available information did not support such assertions.

Commercial bankers told us that they used credit default swaps—contracts that can transfer the credit risk of a loan or loan commitment to another party—to reduce credit risk on small amounts of their loan commitment portfolios. Some investment bankers contended that credit default swaps and loan commitments were similar instruments and that credit default swap prices could provide information about the appropriateness of prices for loan commitments. We found that it was not possible to use credit default swap prices to determine the appropriateness of prices for loan commitments. Specifically, they differed in triggering events, payment schedule, trading, and financial covenants.

Under current accounting standards, designed to reflect their respective business models, commercial and investment banks account for loan commitments differently, causing a temporary difference in the recognition of fee income. Further, revenue from fee income appeared to be relatively small compared with revenue from other bank activity and the difference would be resolved by the end of the commitment period. As a result, we did not find any evidence that following a different accounting model offered the commercial banks a consistent competitive advantage over investment banks. Further, commercial and investment banks have similar fair value financial statement disclosure requirements and, as a result, provide similar information about the fair value of their financial instruments. It appears that the economic substance of loan commitments is recognized in the financial statements and related footnotes in a clear, measurable, and evident fashion under both the historic cost and fair value approach. While some have indicated that fair value accounting might disclose more relevant information than the historical cost model, all the conceptual and implementation issues have not been resolved. Until these issues are resolved, commercial and investment banks will continue to follow different accounting models for loan commitments.