THE WORD

FAIR VALUE ACCO

BY LARRY RUBIN, VICTOR SHI AND NADEZHDA TOSKOVA

ON
OUNTING

FAIR VALUE ACCOUNTING has been the topic of many actuarial conversations lately. Here's the latest on what's being said about the subject.

Fair value accounting (also known as "mark-to-market" accounting) has been in the center of criticism in the recent financial earthquake. It was blamed for everything from the subprime crisis, the credit crunch, problems with credit-default-swaps, failures of Freddie Mac and Fannie Mae, AIG's liquidity crisis, bankruptcy of Lehman Brothers, multibillion dollar write-downs, equity market volatilities, concerns of variable annuities business issued by insurers and even, most extremely, the global economic slump.

This accounting measurement has certainly caused violent tremors in its financial epicenter.

FAIR VALUE ACCOUNTING AND MARKET CONDITIONS

Since 2007, fair value accounting in the United States has tied the value of assets to prevailing market conditions. Fair value accounting originated partially due to the savings and loan crisis in the late 1980s and early 1990s in the United States,[1] which lacked appropriate, accurate and effective accounting rules to value the savings and loan business. Assets or liabilities, as defined under FAS 157 "Fair Value Measurements," could be assigned into the following three categories:

- **Level 1 fair values:** observable market prices in liquid market.
- **Level 2 fair values:** "comparable securities" with observable market prices.
- **Level 3 fair values:** unobservable market inputs.

Critics say fair value accounting has led to an unnecessary downward spiral of asset value during the financial crisis and argue that repealing the requirement could allow financial institutions to set a market price for their distressed assets. Proponents of fair value accounting attest that it simply reflects reality, as determined by the marketplace. They contend that the notion that fair value accounting caused the financial meltdown is akin to blaming a doctor for making a diagnosis. This article reviews the arguments of both the opponents and proponents of fair value accounting.

OPPONENTS OF FAIR VALUE ACCOUNTING

The loudest opposition to fair value accounting has come from brokers/dealers, retail banks, insurance companies, specialty lenders, thrifts, mortgage writers, investment companies and hedge funds. These key sectors of the finance system faced massive asset write-downs in this market meltdown.

In the past several months, especially after the AIG liquidity crisis and Lehman Brothers bankruptcy, financial service companies have vigorously called for the suspension of fair value accounting rules. Many of them claim fair value accounting is the primary driver of the financial crisis. For example, the following is one typical heard on the street remark: "… probably 70 percent of the real crisis that we face today is caused by mark-to-market accounting in an illiquid market. What's most fascinating is that the Treasury is selling its plan as a way to put a bottom in mortgage pool prices, tipping its hat to the problem of mark-to-market accounting without acknowledging it. It is a real shame that there is so little discussion of this reality."[2]

Criticism from well-known public figures or academic figures viewed as neutral in this debate or as "outsiders" has attracted broad attention. For example, many journalists seized on former FDIC Chair William Isaac's criticisms of fair value accounting. Isaac placed much of the blame for the subprime crisis and credit crunch on fair value accounting. Isaac[3] recently wrote in *The Wall Street Journal* that:

"The country's 10 largest banks were loaded up with Third World debt that was valued in the markets at cents on the dollar. If we had marked those loans to market prices, virtually every one of them would have been insolvent. … When there are temporary impairments of asset values, due to economic and marketplace events, regulators must give institutions an opportunity to survive the temporary impairment. Assets should not be marked to unrealistic fire sale prices. Regulators must evaluate the assets on the basis of their true economic value (a discounted cash flow analysis). If we had followed today's approach during the 1980s, we would have nationalized all of the major banks in the country, and thousands of additional banks and thrifts would have failed. I have little doubt that the country would have gone from a serious recession into a depression. The Securities and Exchange Commission and bank regulators must act immediately to suspend the Fair Value Accounting rule."

There are also critics from the academic world. Richard Epstein, professor from the University of Chicago, also wrote about the fair value accounting and credit crunch. He noted that "… unfortunately, there is no working market to mark this paper down to. To meet their bond covenants and their capital requirements, these firms have to sell their paper at distress prices that don't reflect the upbeat fact that the anticipated income streams from this paper might well keep the firm afloat."[4]

An article[5] published in *The Economist* did not explicitly criticize fair value accounting, but cited three practical problems of the fair value accounting rules (i.e., the circuit between stock price and banks' capital adequacy; problems valuing level 3 securities; and inconsistencies treating assets and liabilities).

Further, when discussing post-crisis banking reforms, there are voices touting that suspending fair value accounting will enable banks to reduce irrational decisions. For example, in one recent *Wall Street Journal* article,[6] the author argued that "Dropping mark-to-market is no miracle cure, but it would reduce the pressure on banks and regulators to make irrational choices about the disposition of questionable assets."

In summary, those calling for suspension or change in fair value accounting have used some or all of the following arguments:

- When a company is in financial turmoil it has to sell its assets at distress prices that do not reflect anticipated cash flows.
- Market prices of many intricate financial derivatives (level 3) are highly reliant on complex computer models, which in turn are highly subjective to model risk, thus distorting the "real" fair value.
- Fair value accounting does not provide a true view of long-term value. Financial items valued under mark-to-market rules have distorted the companies' balance sheets.
- Mark-to-market has triggered the margin calls for many mortgage-backed securities (MBS), thus exacerbating the financial crisis.
- Fair value accounting has caused market volatility to increase dramatically.
- Fair value accounting has prompted huge asset write-downs and has decreased companies' capital due to distressed financial conditions, thus triggering credit downgrades and pulling companies' stock prices down.
- Fair value accounting destroyed public confidence. Relaxing fair value accounting is one way to restore investors' confidence and the health of capital markets.
- In the post-crisis period, dropping fair value accounting can reduce banks' pressure to recover and help them to regain investors' appeal.

RESTORING CONFIDENCE IS THE KEY TO UNFREEZING THE CREDIT MARKETS THAT MAKE THE WHOLE ECONOMY GO. …

PROPONENTS OF FAIR VALUE ACCOUNTING

There are also supporters of fair value accounting or at least those against suspending it. Defenders of fair value accounting—found largely within the regulatory community—worry that suspending the rules will sacrifice the U.S. financial system's long-term equilibrium in pursuit of illusory, short-term relief.

The standard setters, SEC (who has the authority to relax the accounting rule[7]) and FASB (who issued the FAS 157 standard), both defend fair value accounting when facing calls to suspend rules blamed for exacerbating the global financial crisis. In December 2008, the SEC issued a report on the results of its mandated study of mark-to-market accounting. This report recommends that fair value accounting should be improved, but not suspended. All this comes despite the fact that recently the same regulatory bodies have been encouraging companies to rely more on their own judgment[8] in determining fair values in distress situations. Similarly, recent proposal from IASB addressed concerns arising from the financial crisis and aimed to modify fair value rules. For example, IASB defines the conditions where financial assets or liabilities could be measured at amortized costs. In addition, it also rejected exit value in determining fair value of insurance liabilities. These represent modifications of fair value rules in response to pressures from financial crisis.

A number of prominent former government officials have expressed strong concerns that suspending fair value accounting rules will throw the U.S. financial system off its long-run equilibrium path. For example, Arthur Levitte,[9] former chairman of SEC, wrote in *The Wall Street Journal* that: "… to ask for a suspension in fair value accounting is to ask the market to suspend its judgment …it is accounting sleights-of-hand that hid the true risk of assets and liabilities these firms (banks) were carrying, distorted the markets, and have caused the investors to lose the confidence for our markets to function properly. … Fair value does not make markets more volatile; it just makes the risk

profile more transparent." He further added that "it may be painful for some companies, and even for the markets as a whole, as we transition to fair-value accounting. But it is the rough medicine we must take in order to vastly improve financial reporting, bring transparency to the market, and restore investor confidence."

There are also worries that, in removing fair value accounting, investors would go back to "darkness" again. Federal Reserve Chairman Ben S. Bernanke expressed similar concerns. He said that, according to *Bloomberg News*,[10] removing the rule would erode confidence that firms would own up to losses. He also commented that "(if it is suspended) … nobody knows what the true mark-to-market price is."

Though rare, there are some supporters from the traders/asset managers. For example, according to the same issue of *Bloomberg News* cited above, one investment strategist who oversees $500 billion in assets has commented that "Suspending the mark-to-market prices is the most irresponsible thing to do. … Accounting does not make corporate earnings or balance sheets more volatile. Accounting just increases the transparency of volatility in earnings."

Some also emphasized that fair value accounting is NOT the cause of the current financial crisis. For example, Neal Lipschutz, a managing editor of *Dow Jones Newswires*, is one of those against suspending the rule. Here is what he wrote in an article titled "Don't Shoot the Accounting Rule:"[11]

"Two things played big roles in creating the credit crisis: an abandonment of mortgage lending standards in the U.S. and opacity in mushrooming niches of the capital markets. So why would we now—in the middle of the worst of the crisis that those factors precipitated—want to dilute accounting standards and create less transparency for investors? Ask the 60-plus members of the House of Representatives who think shooting the accounting rule commonly called mark to market will help get us to a solution. It won't. Restoring confidence is the key to unfreezing the credit markets that make the whole economy go, and lower standards don't restore confidence. But legislating the problem away in favor of a less rigorous standard that might vary in its application from company to company isn't the answer."

There are also proponents of fair value accounting from major accounting firms. Beth Brooke, global vice chair of Ernst & Young, was quoted by *The Wall Street Journal* expressing the opinion that "Suspending mark-to-market accounting, in essence, suspends reality."[12] Similar remarks were made by Sam DiPiazza, chief executive officer of PricewaterhouseCoopers, during an interview with *Financial Times*: "To suggest you don't track and report fair values means you end up in a world where management still knows the real prices, as do market counterparties, but not the investors."[13]

Some market analysts hold similar opinions. An analyst from JPMorgan recently wrote, being cited in the *Bloomberg News* article referenced earlier, that "… blaming fair-value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick." The following points summarize the arguments of proponents:

- Fair value accounting has not caused the financial crisis but has been telling the truth.
- Without mark-to-market giving early warnings, the problems of credit-default-swaps could have hurt the financial sector even more.
- Fair value does not increase volatility; it only unveils the problems.
- Swift write-downs in fact help to re-establish stability.
- Suspending fair value accounting is suspending the market judgment.
- Suspending fair value would not restore market confidence. On the contrary, without fair value, the already low transparency will diminish even further, sentencing investors to financial darkness.
- Current fair value accounting is not perfect, but there is no better alternative especially when valuing complex derivatives and structured products. Alternatives are "mark-to-myth" accounting.
- Legislating accounting rules in favor of less rigorous standards could only result in even worse problems.
- Japan's "lost decade" of the 1990s was prolonged by lack of fair value accounting (through which banks were able to ignore their problematic loans). The United States certainly does not want to bring upon itself a decade-long recession by suspending fair value accounting.

"GO BACK TO BASICS"

Both sides of this debate have strong arguments and supportive facts. In this article, however, we would like to revisit the two primary purposes of financial reporting rather than immediately joining the debate in favor of either side: 1) providing investors with comparable information with which to make decisions, and 2) providing regulators with the information necessary to determine if financial institutions can fulfill their obligations when they are due. It is possible that the financial crisis has demonstrated the inability of a single set of financial reporting rules to serve both purposes.

Regardless of suspending or keeping fair value accounting, market players and regulators have to join efforts in securing both the investors' rights to gather comparable and reliable information, and the regulators' needs to understand the risks posed to the financial system. Accounting in itself should not serve as a tool to conceal financial problems, nor mislead with unreliable information.

If an accounting or financial reporting framework serves to maximize investors' benefits, it must evolve in that information being provided is as transparent and objective as possible, no matter whether this information is based on fair value or book value. Certainly, like any other accounting rules, current fair value accounting rules are a product of compromise of theoretical correctness and practicality that reflect the needs of and perceived benefits to different types of business and enterprises. If fair value accounting were to be abandoned, one must find an alternative that, for sure, better serves investors' interests. If it serves to provide information to regulatory authorities it must provide both information that is a reliable estimate of future obligations and the resources needed to meet those obligations. A

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Larry Rubin, FSA, MAAA, CERA, is partner at PricewaterhouseCoopers LLP in New York. He can be contacted at *larry.rubin@us.pwc.com*.

Xiaokai (Victor) Shi, FSA, MAAA, is manager at PricewaterhouseCoopers LLP in New York. He can be contacted at *victor.shi@us.pwc.com.*

Nadezhda Toskova is associate at PricewaterhouseCoopers LLP in New York. She can be contacted at *nadezhda.toskova@us.pwc.com.*

FOOTNOTES:

[1] The S&L crisis in late 1980s and early 1990s resulted in failures of 747 saving and loans associations in the United States.

[2] Newt Gingrich, "Suspend Mark-To-Market Now!" Sept. 29, 2008, *Forbes.com.*

[3] William M. Isaac, "How to Save the Financial System," Sept. 19, 2008, *The Wall Street Journal.*

[4] Richard Epstein, "Greed, Or Incentives?" Sept. 23, 2008, *Forbes, http://www.forbes.com/2008/09/22/libertarian-mortgage-lease-oped-cx_re_0923epstein.html.*

[5] "Accounting: All's Fair," Sept. 20, 2008, *The Economist, http://www.economist.com/finance/displaystory.cfm?story_id=12274096.*

[6] Holman Jenkins, "The Unmentionable Bank Solution," Feb. 11, 2009, *The Wall Street Journal.*

[7] As part of the "Emergency Economic Stabilization Act of 2008," U.S. government reiterated the SEC's authority to relax the fair value accounting rules. See the Section 132, "Authority to Suspend Mark-to-Market Accounting" of this Act.

[8] FASB and SEC have issued joint "Staff Clarifications" on Sept. 30, 2008, saying that "when an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable." FASB issued additional guidance SFAS 157-4 in April 2009, saying that companies do not have to use transactional prices as fair value when transactions are not orderly.

[9] Arthur Levitt Jr. and Lynn Turner, "How to Restore Trust in Wall Street," Sept. 26, 2008, *The Wall Street Journal.*

[10] Jesse Westbrook, "SEC, FASB Resist Calls to Suspend Fair-Value Rules," Sept. 30, 2008, *Bloomberg News http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agj5r6nhOtpM.*

[11] Neal Lipschutz, "Point of View: Don't Shoot The Accounting Rule," Oct. 1, 2008, *Dow Jones Newswires.*

[12] Judith Burns, "Auditors Resist Effort To Change Mark-to-Market," Sept. 30, 2008, *The Wall Street Journal.*

[13] "Politicians rail against fair value accounting," Sept. 30, 2008, *Financial Times http://www.ft.com/cms/s/0/b7bc1b2e-8f24-11dd-946c-0000779fd18c.html.*