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Fair Value Accounting: Trouble-maker or Life-saver?

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

This accounting method has certainly been blamed for causing violent tremors in its financial epicenter.

For some background, fair value accounting in the United States, defined under FAS 157 "Fair Value Measurements" and effective for fiscal years beginning after Nov. 15, 2007, assigns values of financial instruments according to current market prices or the latest market information of the same instruments or similar types. 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. Financial assets or liabilities, according to FAS 157, 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.

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.

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This article reviews the arguments of both the opponents and proponents of fair value accounting.

OPPONENTS OF FAIR VALUE ACCOUNTING

The strongest opposing voices are from brokers dealers, retail banks, insurance companies, specialty lenders, thrifts, mortgage writers, investment companies and hedge funds, who face massive asset write-downs in this market meltdown and furiously blame the fair value accounting method of contributing to or even causing their current troubles.

In the past several months, especially after the AIG liquidity crisis and Lehman Brother bankruptcy, financial service companies have vigorously called for the suspension of fair value accounting rules. Many of them have believed that fair value accounting is the primary driver of the financial crisis. For example, the following is one remark typically heard on the street *"... 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]

An article[5] published in *The Economist* did not explicitly criticize fair value accounting, but pointed out three practical problems …

Criticism from well-known public figures or those in the academic world, who are viewed as neutral in this debate or as outsiders, has attracted the broadest attention. For example, former FDIC Chair William Isaac's criticisms of fair value accounting are widely quoted by journalists. He placed much of the blame of 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 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 pointed out three practical problems of the fair value accounting rules (i.e., the

FOOTNOTES:

[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_

circuit between stock price and banks' capital adequacy; problems valuing level 3 securities; and inconsistencies in the treatment of assets and liabilities).

In summary, the following have been the most commonly used basic rationales from opponents who call to modify or suspend fair value accounting:

- 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; and
- Fair value accounting destroyed public confidence. Relaxing fair value accounting is one way to restore investors' confidence and the health of capital markets.

PROPONENTS OF FAIR VALUE ACCOUNTING

However, there are also supporters of fair value accounting or at least voices against suspending it.

The standard setters, SEC (who has the authority to relax the accounting rule)[6] 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. All this comes despite the same regulatory bodies recently encouraging companies to rely more on their own judgment[7] in determining fair values in distress situations.

Some defenders of fair value accounting 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,[8] former chairman of the SEC, wrote in *The Wall Street Journal*, "*... 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,[9] 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 Bloomberg news cited above, one investment strategist

FOOTNOTES:

[6] 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.

[7] FASB and SEC have issued a 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."

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

[9] 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=agj5r6nhOtM*

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

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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 argued 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."[10] *"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 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."*[11] 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."*[12]

Some market analysts hold similar opinions. An analyst from JPMorgan recently wrote, in the same Bloomberg article mentioned above, 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; and
- Japan's lost decade of the1990s 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. This article, however, 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 ways that information being provided is as transparent and objective as possible, no matter whether this information is based on fair value or book value. 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. ■

FOOTNOTES:

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

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

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