

Did Fair Value Accounting Contribute to the Financial Crisis?

Concord Vine
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ORCHARD PARTNERS, INC.



YES

"The mark-to-market accounting rule has devastated the banking industry and is destroying the insurance industry." - Steve Forbes

"A bad idea became highly destructive when the SEC decided to continue fair value accounting after the market for mortgage securities evaporated last year... Mortgage securities were marked to a fraction of their true economic value, which destroyed \$500 billion of capital in our financial system." - William Isaac, Former FDIC Chairman

"The government is unwilling to address one of the root causes of investor fears - mark-to-market accounting." - American Spectator

"It is true that the root of this crisis is bad mortgage loans, but probably 70% of the real crisis that we face today is caused by mark-to-market accounting in an illiquid market." Brian S. Wesbury and Bob Stein, First Trust Portfolios of Chicago

NO

“We defend our preference for fair value over historical cost by quoting John Maynard Keynes who stated, ‘I would rather be vaguely right than precisely wrong.’” - Dennis Jullens, UBS Investment Research

“Fair value accounting with robust disclosures provides more reliable, timely , and comparable information than amounts that would be reported under other alternative accounting approaches.” - Center for Audit Quality, CFA Institute, Consumer Federation of America, Council of Institutional Investors, and Investment Management Association

“Suspending fair value accounting because the answer is inconvenient is akin to firing the weatherman because it’s raining.” - Bill Mann, The Motley Fool

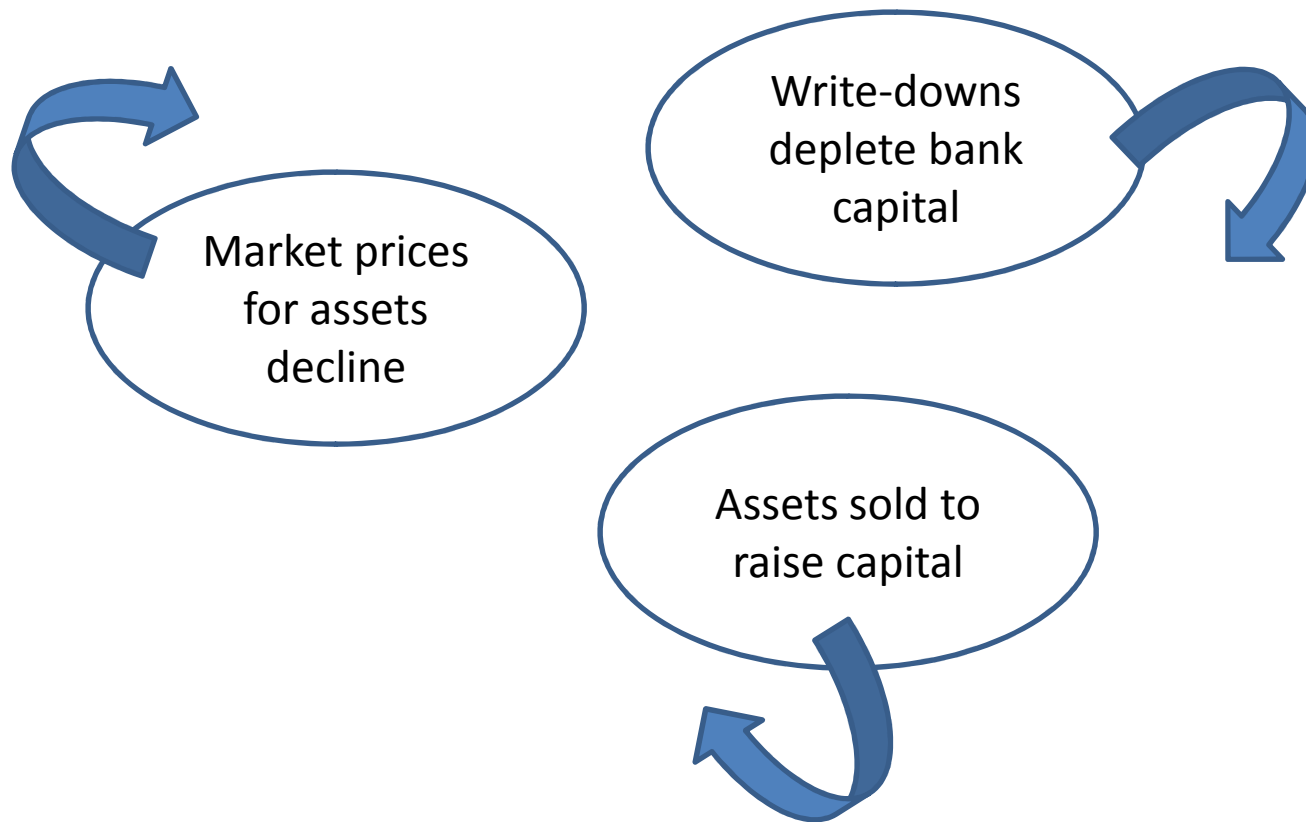
“Blaming fair value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick.” - Dane Mott and Sarah Deans, J.P. Morgan Securities



“People who blame fair value accounting are like Wile Coyote thinking he won’t fall as long as he doesn’t look down.”

- Bob Herz, FASB

The primary argument against fair value accounting is that it has a “pro-cyclical” effect.



From a Forbes commentary, “Suspend Mark-to-Market Now”:

“Declining housing prices reduce the value of all mortgages”

“Companies must value the assets on their balance sheets based on the latest market indicators of the price that those assets could be sold for immediately. Under such a rule, declining housing prices don't just reduce the value of defaulting mortgages. They reduce the value of all mortgages and all mortgage-related securities because the housing collateral protecting them is worth less.

“Market-bottom prices becomes the new standard”

Moreover, when a company in financial distress begins fire sales of its assets to raise capital to meet regulatory requirements, the market-bottom prices it sells out for become the new standard for the valuation of all similar securities held by other companies under mark-to-market. This has begun a downward death spiral for financial companies large and small.

“Firms scramble to maintain capital”

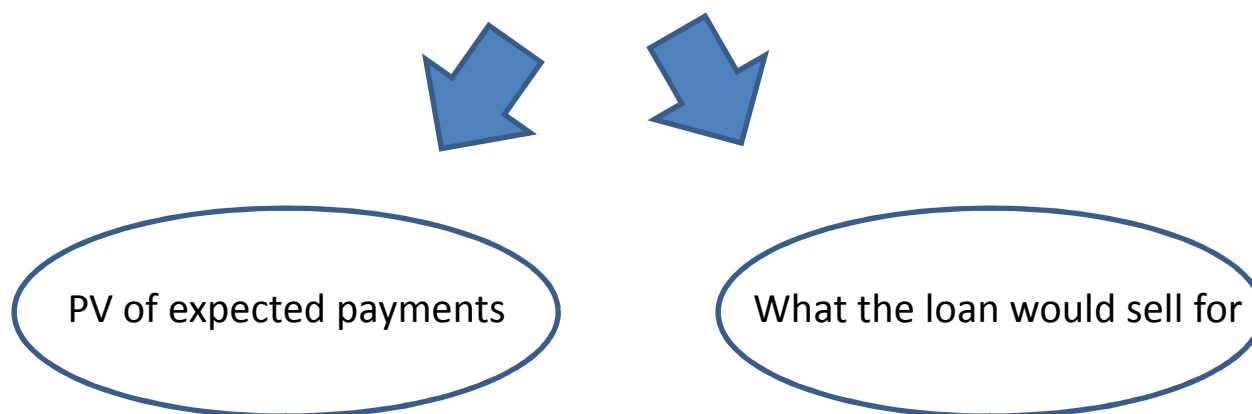
More foreclosures and home auctions continue to depress housing prices, further reducing the value of all mortgage-related securities. As capital values decline, firms must scramble to maintain the capital required by regulation. When they try to sell assets to raise that capital, the market values of those assets are driven down further. Under mark-to-market, the company must then mark down the value of all of its assets even more.

“Panic sets in”

Panic sets in, and no one wants to buy mortgage-related securities, which drives their value under mark-to-market regulations down toward zero. Balance sheets under mark-to-market suddenly start to show insolvency. This downward spiral shuts down lending to these companies, so they lose all liquidity (cash on hand) needed to keep company operations going. Stockholders--realizing that they will be wiped out if the companies go into bankruptcy or get taken over by the government--start panic selling, even when they know the underlying business of the company is fine. “

Critics claim that fair value accounting confuses market value and long term economic value.

- Long term economic value is the present value of future cash flows.
- Market value may be less than long term economic value when investors become risk averse and no longer want to buy certain types of assets.
- Mark-to-market accounting confuses “credit default risk” (the loan won’t be repaid) with “changes in liquidity” (the market for these loans dries up).
- Suppose a bank makes a subprime loan but the borrower is current on his payments. How should the value of the loan be reported?



Who is to blame?

- The Regulators: “There's a heck of a difference between selling your house in the next 10 minutes and the price you'd get in a distressed market than doing it over a normal period of time. And regulators can't seem to distinguish between the two.” - Steve Forbes
- The Congress: “The criminal liabilities imposed under Sarbanes-Oxley have driven accountants to stricter and stricter accounting evaluations and interpretations and have prevented leading executives from resisting them.” - Newt Gingrich
- The Lawyers and Accountants: “The accounting profession, scarred by decades of costly litigation, just keeps marking down the assets as fast as it can.” William Isaac

What is the solution?

- “Doing away with the current mark-to-market accounting rules will safeguard against destructive pricing volatility, needless bankruptcies, job loss and huge taxpayer bailouts.” - Newt Gingrich
- “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).” -William Isaac
- Alternatives to discounted cash flow analysis include historical cost and a rolling average of market prices.

Flaws in the attack on fair value accounting

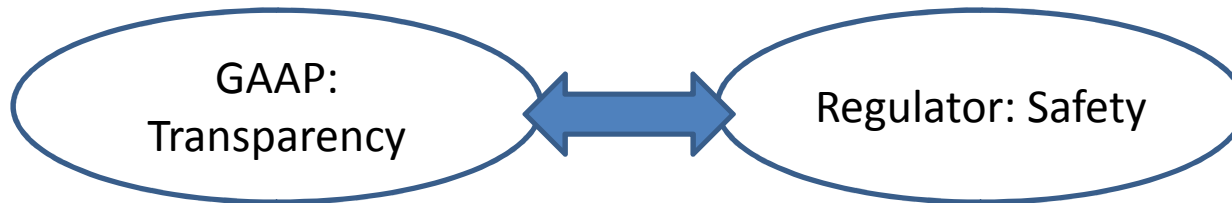
- It assumes the new fair value standard requires fair value reporting. It doesn't.
- It confuses financial reporting requirements with regulatory requirements.
- Most bank assets are not reported at fair value.
- If declines in reported values cause market panic, why do declines in market value precede declines in reported value?
- The proposed solution – discounted cash flow analysis – already is part of the fair value standard.

FAS No. 157 and the Emergency Economic Stabilization Act of 2008

- Section 133 required the SEC, in consultation with the Federal Reserve and the Treasury, to conduct a study on mark-to-market accounting standards as provided in FAS 157, including its effects on balance sheets, impact on the quality of financial information, and other matters, and to report to Congress within 90 days on its findings.
- FAS 157 entitled “Fair Value Measurements” became effective for financial reporting periods beginning after November 15, 2007.
- In its summary on page 1, FAS 157 states “this statement does not require any new fair value measurements.”
- Rather, FAS “defines fair value, establishes a framework for measuring fair values ... and expands disclosures.”
- The SEC report to Congress acknowledges “SFAS No. 157 does not itself require mark-to-market or fair value accounting.” The SEC notes, “For many years, accounting standards have required measurement of financial instruments on a financial institution’s balance sheet at fair value.”

For bank regulators, GAAP is the starting point, not the determinant of bank capital.

“Although GAAP informs the definition of regulatory capital, the Federal Reserve is not bound to use GAAP accounting concepts in its definition of capital. Regulatory capital requirements are regulatory constructs designed to ensure the safety and soundness of banking organizations, not accounting designations established to ensure the transparency of financial statements.” - The Federal Reserve



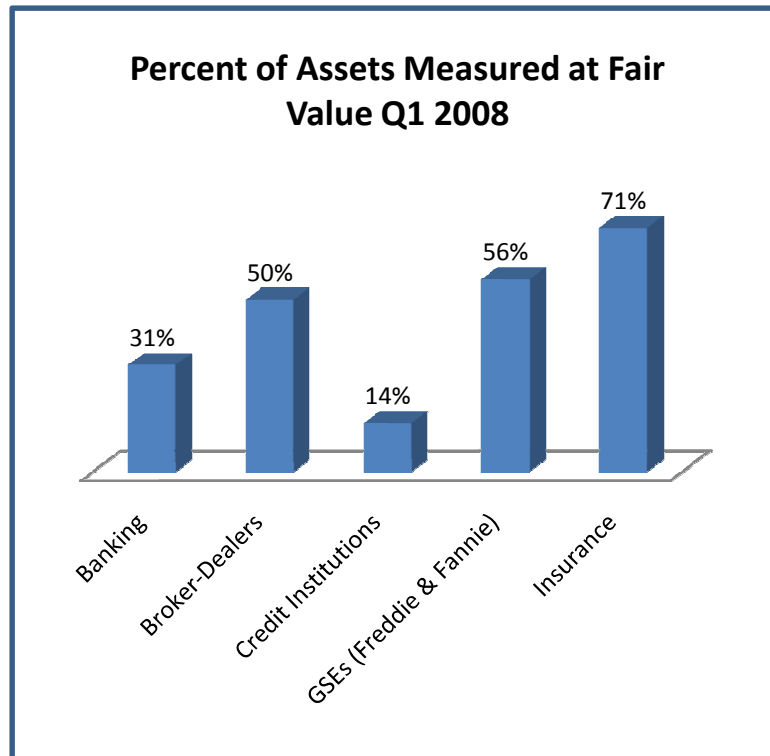
- Includes unrealized gains & losses in equity
- Adjusted for goodwill
- Reduces liabilities as credit worthiness declines

- Excludes unrealized gains & losses from equity
- Excludes goodwill
- Does not allow liability write-downs to boost capital

Companies using mark-to-market accounting write-down liabilities as well as assets.

- “Merrill Lynch & Co., Citigroup Inc. and four other U.S. financial companies have used an accounting rule adopted last year to book almost \$12 billion of revenue after a decline in prices of their own bonds. The rule, intended to expand the “mark-to-market” accounting that banks use to record profits or losses on trading assets, allows them to report gains when market prices for their liabilities fall. “
- “Merrill, the third-biggest U.S. securities firm, added \$4 billion of revenue during the past three quarters as the market value of its debt fell. That was the result of higher yields demanded by investors spooked by the New York-based company's \$37 billion of writedowns from assets hurt by the collapse of the subprime mortgage market. “
- “Lehman, the fourth-biggest securities firm, has reported \$1.9 billion of gains related to a widening of its own bond spreads. Citigroup, the largest U.S. bank by assets, has booked \$1.7 billion; Morgan Stanley \$1.7 billion; JPMorgan Chase & Co., the third-biggest bank, \$1.7 billion; and Goldman Sachs \$550 million.” - Bloomberg June 2008
- The rule referred to is not FAS 157, but FAS 159: “Fair Value Option for Financial Assets and Financial Liabilities.”

The SEC found that most bank assets are not reported at fair value.



Banks generally carry investment securities, trading assets & derivatives at fair value. A loan which is “held-for-investment” is accounted for at amortized cost. If a bank plans to package a loan and sell it, the value is reported at the lower of cost or fair value.

Source: SEC

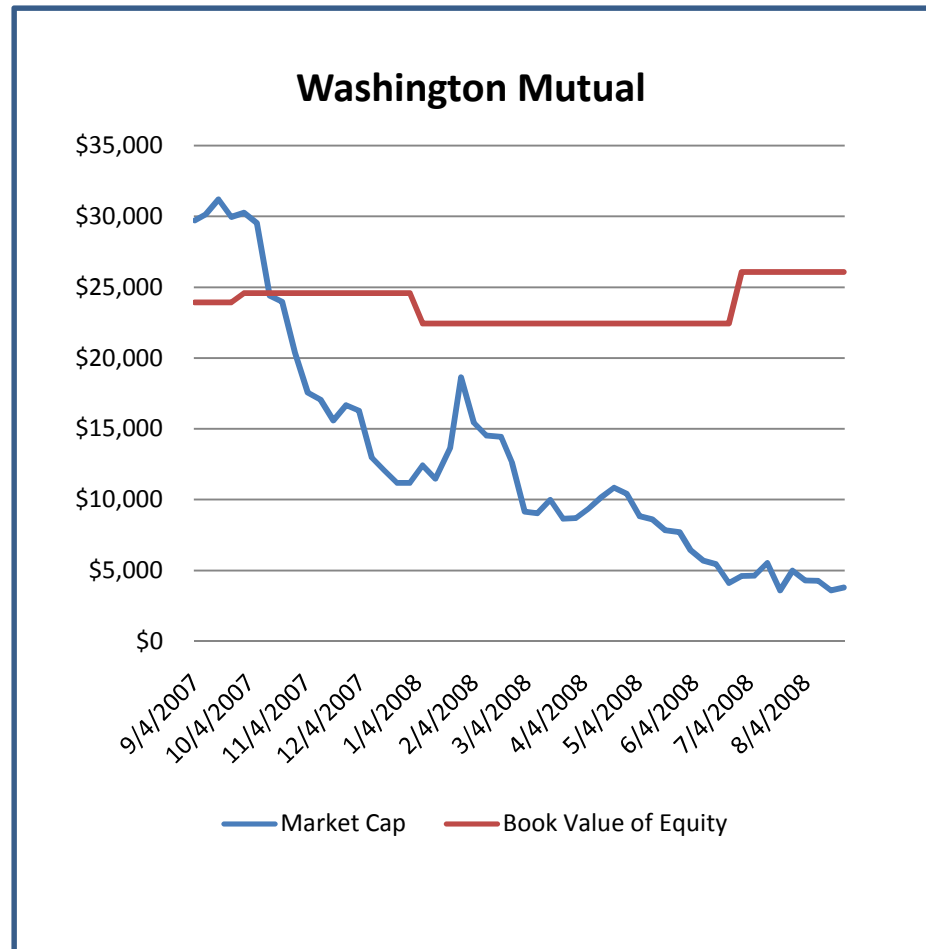
Assets & liabilities are reported using a “mixed-attribute” model

- The accounting measurement varies according to the type of asset or liability being measured: equity securities, debt, securitized assets, debt securities & derivatives.
- The accounting measurement also varies according to the intended use: available-for-sale (AFS), held-to-maturity (HTM), held-for-investment (HFI), held-for-sale (HFS).
- When measured at fair value, impairment may be “temporary” or “other-than-temporary.”
- Derivatives (credit default swaps, forward contracts, etc.) are measured at fair value.

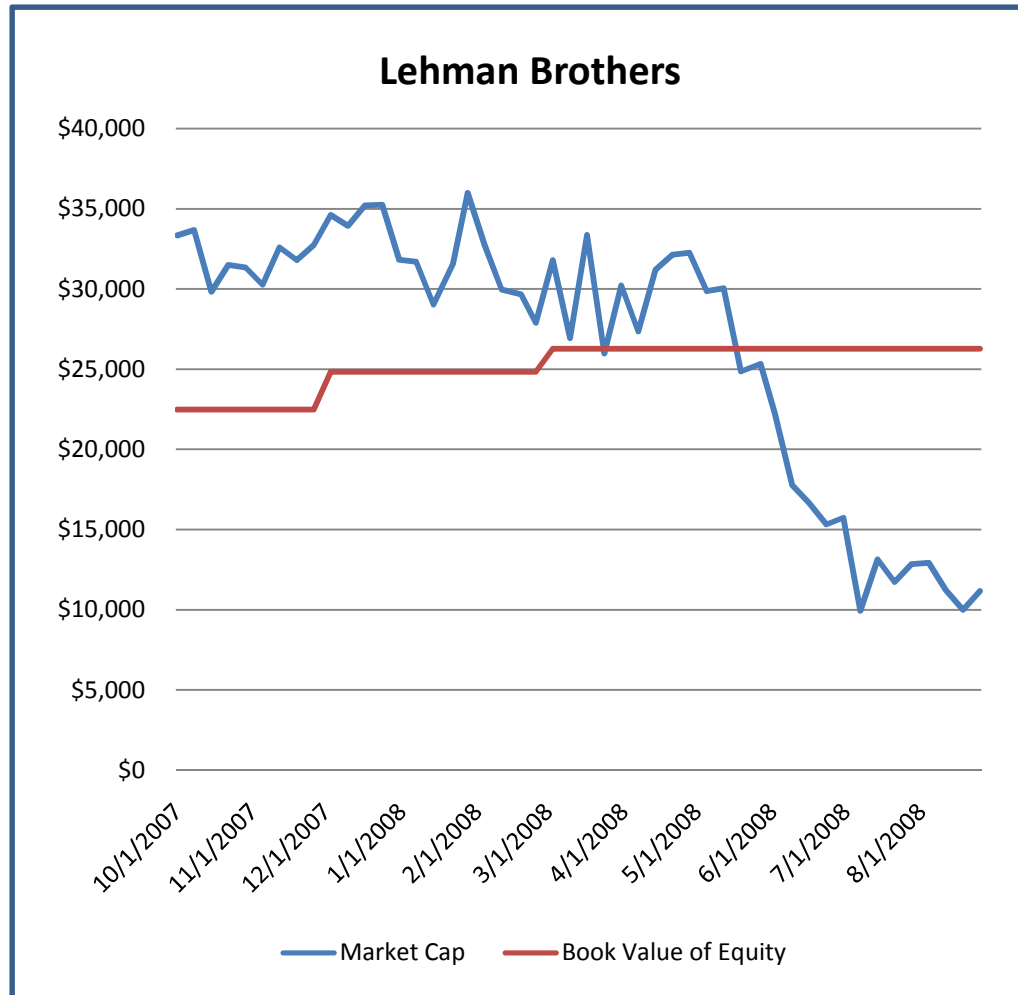
“The Board believes that fair value is the only relevant measurement attribute for derivatives. Amortized cost is not a relevant measure for derivatives because the historical cost of a derivative often is zero, yet a derivative generally can be settled or sold at any time for an amount equivalent to its fair value.” - FAS 133

As a bank’s reliance on derivatives increases, so does its use of fair value accounting.

WAMU's market value declined as the book value of its equity remained flat or increased.



Lehman Brothers



Lehman has not reported August 2008 equity.

Is the proposed solution really that different from the existing standard?

- Forbes: there's a "big difference" between selling your house in 10 minutes and over a normal period of time.
 - FAS 157, paragraph 5: "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."
 - FAS 157, paragraph 7: "An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction (for example, a forced liquidation or distressed sale)."
- Isaac: assets should be measured at their true economic value using discounted cash flow analysis.
 - FAS 157, paragraph 18: "Valuation techniques consistent with the market approach, the income approach, and/or the cost approach shall be used to measure fair value."
 - FAS 157, paragraph 18b: "The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted)."

Conclusions of the SEC Study on Mark-to-Market Accounting

- “Rather than a crisis precipitated by fair value accounting, the crisis was a ‘run on the bank’ at certain institutions ... This was, in part, the result of the massive de-leveraging of balance sheets ... and the reduced appetite for risk.”
- “Fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008.”
- “The Staff’s research on this issue reflects that ... investors generally support measurements at fair value as providing the most transparent financial reporting of an investment.”
- “Most of the panelists indicated that they do not share the view that fair value accounting is pro-cyclical.”
- Areas for improvement
 - “Investors are often not provided sufficient information to fully assess whether declines in value are related to changes in liquidity or whether declines relate to probable credit losses.”
 - Best practices guidance & disclosure should be improved
 - Simplify the accounting for financial assets