

LETTER OF COMMENT NO.

13

From: Gina McMahon, CPA

To: Financial Crisis Advisory Group

Re: Written Submission regarding accounting and reporting matters related to the financial crisis

## Fair Value's Unintended Consequences

While studying fair value (FV) during my undergrad years, I learned how it might have prevented the S&L crisis. Therefore, like many others I have been reluctant to recognize its possible failures. Have accountants been focusing on FV's successes and ignoring its failures especially on the aggregate scale? Procyclicality, amplification and contagion may be the serious unintended consequences of FV rules that might have *contributed* to recent bubbles and economic downturns in material ways. Have we concerted too much effort to defend current fair value rules and placed too much emphasis on HOW to calculate/determine FV (i.e. whether level 1, 2 or 3 or whether the market is illiquid, etc.), rather than IF certain changes in FV should flow to the financial statements in order to reflect the true financial position of a financial institution? When changes in values increase volatility and ultimately lead to material changes in equity of historic proportions that may never materialize, we must heighten our objectivity to thoroughly investigate the issue rather than defend the ideology of fair value in the name of transparency. Further, transparency does not require full value changes for certain assets and liabilities to be included in the body of the financial statements; transparency only requires fair values be disclosed.

Conventional wisdom (even for me as a CPA) says current FV standards increase transparency, reflects true value and should be included in the body of the financial statements. However, fair value as implemented has proven extremely problematic beginning with its implicit assumption that "fair" value can always be determined. Value is often extremely subjective requiring many unknown assumptions—market value assumes the market is perfect when it is not.

The subjectivity of fair value is an old debate, but there may be even bigger issues. Scholarly literature exists proposing links between fair value accounting and the economic phenomena of procyclicality, amplification and contagion. Of most immediate importance is literature alleging fair value can actually distort financial position. According to the study *Mark-to-market accounting and liquidity pricing* by Allen and Carletti, banks may appear insolvent in theory when in practice they are not.

When accounting values are based on market prices, the volatility of asset prices affects the value of banks' assets. This can lead to distortions in banks' portfolio and contract choices and contagion. Banks can become insolvent even though they would be fully able to cover their commitments if they were allowed to continue until the assets mature (emphasis added).

Even though current FV rules allow for alternative valuation models not nearly as low as the market prices derived from distressed sales, this is only part of the issue that ignores other factors including how much mark-to-market (MTM) accounting might have contributed to the market procyclicality that occurred. Also, pressure is exerted on financial institutions to use high discount rates that drastically lower values because of the current risk-adjusted market risk premium. In other words, the discounted cash flow models use high discount rates partly because of the absence of an appetite for toxic asset risk, so using high discount rates in this situation is somewhat akin to requiring the market price in an inactive market—it is the inactive market due to the uncertainty of default risk that forces the discount rate up so high in the first place.

Nearly all troubled banks are meeting their obligations without question, have positive cash flows and profits and probably would have even without the government's capital infusions. So must we immediately force these entities towards accounting insolvency when they are meeting their obligations and are likely to properly function in the near future? Going forward—would note disclosure of estimated OTTI declines or allowing gradual write-downs be better options rather than a direct, immediate hit to the firms' financial statements? If Geitner's new plan is to work, we need willing sellers. Many financial institutions with toxic assets are not going to be willing sellers if they are forced to take the immediate write-down.

# Fair Value and Procyclicality- The Amplification of Booms and Busts

Another research paper from 2005 forewarns of fair value's unintended consequences. The theory is that changes in fair values significantly contribute to market procyclicality—the amplification of booms and busts. The authors explain the crisis with foresight what we now know happened with hindsight. The abstract for *Marking to Market*, *Liquidity, and Financial Stability* by Plantin et al sums up the issue well:

This paper studies the financial stability implications of mark-to-market accounting, in particular its tendency to amplify financial cycles and the "reach for yield." Market prices play a dual role. Not only do they serve as a signal of the underlying fundamentals and the actions taken by market participants, they also serve a certification role and thereby influence these actions. When actions affect prices, and prices affect actions, the loop thus created can generate amplified responses—both in creating bubble-like booms in asset prices, and also in magnifying distress episodes in downturns (emphasis added).

The interesting theory of fair value's procyclicality is explained in this paper and how accounting regimes such as mark-to-market accounting first ultimately drive increases in values which leads to increases in other values which increases demand and thus creates a loop described as an "amplification of feedback mechanisms operating in financial markets." This is a major oversimplification of the complexities of market interactions, but MTM is believed to significantly feed this demand. This market phenomenon called the "search for yield" leads to endogenous value changes as it feeds itself. This unintended consequence would certainly help explain why we have had two huge market bubbles in the last 15 years. It is not beyond comprehension to envision how perceived increased wealth due to MTM, significantly affected market decisions. The wealthier we feel as individuals, the more we invest and the more we take risks ourselves to earn even higher returns. When perceived wealth begins to evaporate, we become risk averse. The markets are no different than us. Accounting rules on the upside allowed financial institutions to gradually inflate their balance sheets to speculative levels over several years (for we now know those high values were never real intrinsic values); now the rules are now forcing the banks immediately back down towards reality with dangerous volatility. Following is an eerie excerpt from the paper describing their insight:

The advent of deep markets in credit derivatives is removing the practical barriers to marking loans to market. Our paper is an attempt to anticipate (the mark-to-market debate), and air some of the issues at stake. Due to the double-edged nature of marking to market...it would be reasonable to suppose that the conduct of financial institutions will be changed irretrievably by mark-to-market accounting...The greater immediacy of fair values for capital and profitability may become a source of procyclicality...perceived credit risk might decline, leading to a rise in the fair value of bank's assets...so strengthening the economic upswing. These same effects would go in reverse with a vengeance in downturns. As the economy declines, perceived credit risk increases, leading to a fall in the marked-to-market value of banks' assets, which would in turn erode banks' capital. This will result in a credit crunch that could reinforce the downturns...The effects of fair value accounting could, therefore, have far-reaching consequences for the overall stability of the economy.

So in other words, perceived increases in values lead to perceived decreases in credit risk which in turn increases the value of instruments subject to MTM which in turn increases demand and

values, and so the cycle goes on. Under historical or amortized cost, the increases in value would not have occurred. Under MTM with the advent of MBS, a material amount of loan assets were trading or available-for-sale and therefore subject to fair value rules.

## Does fair value make some solvent banks appear insolvent?

Procyclicality is obviously a major issue, but I believe the single most important question at the root of today's fair value debate is does fair value make some solvent banks appear insolvent? While other factors certainly contributed to the crisis such as inadequate risk management, insufficient capital requirements during the boom, poor lending requirements, financial innovation proven unable to diversify risk as it was designed to do, etc., current fair value rules may be the single largest factor prohibiting us from emanating out of this crisis. Further, we should not enter the blame game without investigating fair value's true impact on those same factors we blame.

Does the assertion by some that using fair value during previous economic downturns would have shown solvent banks to actually appear insolvent have merit? Alex Pollock, resident fellow at the American Enterprise Institute with 35 years in banking, recently spoke before a congressional subcommittee and said, "The perverse effects of fair value accounting in a market panic are why almost all banking regulators oppose it. It is too easy for them to think of distressed situations which the banking system would not have survived if it had had to mark to market at the time." This testimony was also submitted in a comment letter, and the arguments presented likely have merit. I have been unsuccessful finding a study proving these assertions, so I suggest any in existence be submitted to this group (or if none exist, one should be done asap). Viable institutions might have already become buyers (assuming market liquidity even with the likely current default risks) if we were under different fair value rules; the risk of appearing insolvent under current fair value rules might be much greater than the default risk of the actual loans.

If a study were to be done to reconstruct previous financial statements under per-MTM rules to reflect statements under current fair value rules and financial institutions appear insolvent but have since survived and thrived, it is quite possible some showing near insolvency today under current standards will become strong again if given time. This may mean that marking to fair value as implemented has proven more detrimental than fair; this may mean fair value has been neither relevant nor reliable. Some consideration must be given to the banks' assertions because we are in a new era with the advent of mortgage-backed securities which transformed loan assets from a traditional hold-to-term investment with its value derived from performance with adjustments for loan losses to a trading investment subject to values based on the market (or ultimately based on the lack of a market). Economic studies further investing MTM's procyclical effects should be done as well.

#### Rebuttals to Recent Assertions

Assertion 1 - Financial statement users want fair value—Giving credence to studies stating the majority of investors desire fair value assumes investors also understand the implications when many experts do not even agree on fair value's superiority or full impact. Users may want fair value, but fair value in an alternate form may be sufficient, more reliable, and produce less unintended consequences.

Assertion 2 - SEC study states only a small percentage of financial instruments are subjected to fair value rules—The recent SEC study asserts that financial assets marked to market on the balance sheet (45%) and through the income statement (25%) represent only a "minority" of assets. These percentages are deceptive for even the study admits the small percentages in fact had a material effect on the financial statements. When we are talking about trillions in asset values, the amounts are hardly minor. Financial markets are highly sensitive to small changes in interest rates, energy price fluctuations, etc., and have proved highly sensitive

to changes in fair value for a minority of assets as well. In addition, impairment rules ultimately subject many more assets to fair value at some point. The current issue is on OTTI declines that hit the income statement, but we must not forget the significance of the full 45% that have been hitting the balance sheet for years on the up and down sides and contributed to procyclicality.

Assertion 3 - Banking regulators do not have to use fair value for regulatory capital purposes—
This is a fair suggestion, but recent market booms, the subsequent write-downs, and the uncertainty of estimated future write-downs have a huge psychological effect in and of itself. Is asking regulators to use some other measure for regulatory capital purposes really going to overcome these psychological effects? Current blame and focus is on the failures of banking regulation including inadequate monetary and banking policies that contributed to the increased liquidity and leverage during the boom years. While such monetary policy certainly played a role and are seemingly outside of the realm of accounting regime choices, we cannot deny that MTM accounting may have been an important factor that significantly amplified market procyclical effects. Market leverage, liquidity and even risk management are functions of balance sheet values. When perceived equity increases, perceived risk decreases and liquidity increases and vice versa. It is now especially apparent how perceived risk increases actually deflate values further.

In addition, audited financial statements are the gold standard and should remain so even for regulatory capital purposes. If FV is here to stay, we may need more balancing factors to counteract its alleged ills. For example, suggestions have been made to create reserve accounts for potential asset declines, so balance sheets do not become too inflated and subsequent decreases in values and impairments do not have such perverse effects on the financial institutions and the financial system as a whole.

Many banking experts believe regulators could allow re-capitalization to span over several years without jeopardizing solvency because operating profits are robust. We see a relaxing of regulations occurring in other parts of the world. If they believe financial institutions are sound enough to gradually recapitalize, then maybe the financial institutions should not be forced into appearing accounting insolvent also. Therefore, maybe we should allow them to gradually write off the decreases in value.

In conclusion, requiring financial institutions to mark their financial instruments to market because a market now exists (or *did* exist) may have been the wrong decision for many reasons. Providing strong guidance on the allowance of discounted cash flow valuations in lieu of market prices in an inactive market has been a step in the right direction, but fair value's effects on solvency determination and on the market in the aggregate during upswings and downturns should be further evaluated. Also we should not take for granted that fair value as implemented is the best form of transparency just because conventional wisdom dictates it should. Many proponents of fair value demand it for transparency, but is this transparency really relevant and reliable if it contributed to the bubble and makes solvent, viable banks appear to be *insolvent*? We accountants can no longer ignore the systemic implications of our rules in the name of transparency especially if the rules prove to distort true financial position.

The partial tradeoffs between historical cost and mark-to-market accounting are summed up in Sapra's 2008 paper *Do accounting measurement regimes matter? A discussion of mark-to-market accounting and liquidity pricing*:

- Under historical cost accounting, even though fundamentals are sour, the solvency requirements rely on past prices and therefore may incorrectly allow the banks to continue until date 2 when the bank should be liquidated at date 1. By the time regulators intervene at date 2, it is too late. The size of the banks' assets may have considerably shrunk and everyone is worse off. Thus under historical cost accounting, there is *inefficient continuation* of the banks at date 1.
- Under mark-to-market accounting, the solvency requirements at date 1 rely on current price signals and are therefore informative about the value of the banks' assets at date 2, allowing

regulators to efficiently shut down the banks early before losses escalate. However, as (Allen and Carletti) show, in the presence of liquidity pricing, *contagion* is a necessary evil.

If you also factor in the possible procyclical effects of MTM along with contagion, it shows MTM accounting is far from perfect or at a minimum needs more checks and balances.

After researching fair value's role in the current financial crisis for a graduate research paper and reading 20+ scholarly articles on the subject, I felt compelled to express my findings and opinions on fair value to your group. All of this research leads me to believe we accountants made rules in response to the SL crisis, but these rules—made with the best of intentions— may be a major factor in the current crisis; however, more importantly we may have the ability to directly strengthen the financial stability of the market by modifying fair value rules for financial institutions while maintaining transparency if we so choose.

Permitting a gradual impairment of write-downs or by using a 3-year average with full disclosure in the notes would be transparent, relevant and reliable and likely have stabilizing effects on the economy by preventing misperceived bank insolvency. Disclosure of pending write-downs over the next few years would allow the institutions time to make up the losses they have been unable to immediately absorb without collapsing the whole market. Disclosure of value models with "what if" scenario analysis would allow investors to see what would happen to values if certain variables used in the model (e.g. default rates, risk discount rates, etc.) increased or decreased by x percent.

Note how the analysts reacted positively to the recent rumors of the easing of FV rules; this would imply investors believe FV rules are somewhat more arbitrary than fundamental. We can infer they would not have reacted so positively if they truly believed an easing of FV rules would decrease transparency.

## Sincerely,

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