

The Fallacy of Fair Value Accounting

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"The narrative fallacy addresses our limited ability to look at sequences of facts without weaving an explanation into them, or, equivalently, forcing a logical link, *an arrow of relationship*, upon them. Explanations bind facts together. They make them all the more easily remembered; they help them *make more sense*. Where this propensity can go wrong is where it increases our *impression* of understanding."

Nassim Taleb

The Black Swan: The Impact of the Highly Improbable
Random House (2008)

This week in *The Institutional Risk Analyst*, we feature a comment by Peter Wallison, "Ideas Have Consequences: The Importance of a Narrative," which was published last week by American Enterprise Institute. Peter is a codirector of AEI's program on financial policy studies, researches banking, insurance, and securities regulation. To read this article online with the related footnotes or obtain a printable copy, please visit www.aei.org/outlook/100960

But before we go to our feature, we need to comment on the latest evolution of "fair value" accounting rules [proposed by the Financial Standards Accounting Board](#). We opposed the adoption of the original fair value rule and likewise reject the latest rule modification put forward by the FASB to require that banks mark all loans to market using the same methodology as for securities. To us this well-intentioned but ultimately erroneous proposal illustrates the above quote from the Black Swan, namely mistaking cause with effect. [Click here](#) to see the comments in *Dow Jones News Service* by former FDIC Chairman Bill Isacc, IRA co-founder Christopher Whalen and others denouncing the FASB proposal.

Does Price = Value?

For the past several years, our friend Robert Herz, Chairman of the FASB, and his colleagues have been attempting to improve the transparency of financial reporting by implementing "fair value" accounting rules, new conventions that are intended to make financial statements more accurate and meaningful to consumers of financial information. These efforts are a reaction to the subprime financial crisis and the enormous losses that occurred in 2007 and thereafter when trading in over-the-counter ABS securities and derivatives thereon collapsed.

A bastard child of efficient market theory, the Utopian vision of fair value accounting is based upon the fallacy of mistaking price and value. Our friend Sylvain Raynes of RR Consulting, who lectures in the Mathematics Department at Baruch College in New York, told a meeting of Professional Risk Managers International Association in 2007

[\("The Subprime Crisis & Ratings: PRMIA Meeting Notes," The IRA, September 24, 2007\):](#)

"So, the problem in the end is valuation. Valuation is not the most important problem in finance; valuation is not the most interesting problem in finance; valuation is the only problem for finance. Once you know value, everything happens. Cash moves for value. More price does not mean more value. If you do not recognize the difference, the fundamental difference between price and value, then you are doomed. Now it didn't really matter in corporate finance because the two were supposed to remain equal forever. Who has been telling us that? These people do not live in New York. They live in Chicago. The Chicago School of Economics has been telling us for a century that price and value are identical, i.e., they are the same number. What this means is that there is no such thing as a good deal, there is not such a thing as a bad deal, there are only fair deals."

We believe that efforts to impose fair value accounting on banks, though well-intentioned, are ultimately misguided. The problem as we see it is not the rules for accounting, but the opaque financial instruments and OTC markets that caused the subprime financial crisis in the first place. [Felix Salmon](#) noted on Saturday, "As a curio, before the financial crisis, banks' fair value numbers were generally above book value. At that point no one really seemed to care about the discrepancy, or mark-to-market, for that matter." Ditto.

Rather than making us all go through a pointless and ultimately futile exercise of trying to "mark to market" assets for which there is no live market, we should be focusing attention on reforming our financial markets so that transparency and public market pricing is built into the system. Then the existing rules will be just fine, thank you. Remember too that centuries of history in the western industrial nations argue that the lending, held-to-maturity side of a depository, insurance company or pension fund is not supposed to be effected by short-term market or economic cycles. The FASB fair value rule and the latest proposal somehow ignore this fact. Implementation of this latest proposal will make banks even less likely to lend to marginal customers. In a collective sense, the FASB fair value rules are the functional equivalent of the Smoot-Hawley tariff increase in 1930.

More important, we need to recall that all accounting systems are subjective. Our friend Alex Pollock, also of AEI, likes to describe a given accounting system as just one perspective on truth, but not truth itself. It's an oil painting rather than a photograph. Each time we change the way in which assets and liabilities are valued, we stand on a different side of and see different aspects of the proverbial elephant. But if the room is filled by smoke -- our metaphor for the OTC markets which spawned subprime debt and the hideous derivatives thereof -- then you cannot see the elephant in any event, no matter where you stand.

Consider an example. At present, [Wells Fargo Bank \(WFC\) \(Q1 2010 Bank Stress Rating: "B"\)](#) is sitting on tens of billions of dollars in second lien residential mortgages,

collateralized debt obligations (CDOs) and variable interest entities (VIEs). Many of these illiquid assets are currently booked using "estimates" of fair value, specifically the dreaded Level Three of the FASB rule for implementing fair value. Where there is no market, accounting fails -- fair value or otherwise.

WFC maintains that its current valuation for these assets in their financial disclosure is correct, while we and others suspect that the "fair value" is considerably lower. But even the fact of "fair value" accounting rules does not help to make WFC's financials more transparent. There are many techniques that can be used to value these securities and loans held by WFC, but the fact is that there is no live market. No configuration of accounting rules will change this fact. Thus we are left in the limbo of estimating the "fair value" of an illiquid asset.

No matter how we re-jigger new accounting rules, assets for which there is no live market will remain opaque and difficult to value. So long as we pretend that the evil ghetto known as OTC is an acceptable formulation for global financial markets, we suspect there will be accounting rules changes every couple of years. Unfortunately, fair value accounting has become part of the collective narrative in the financial community. As Peter Wallison discusses in his comment below, "even intelligent people, once they have accepted an idea, cannot be persuaded to reexamine their position. That is the power of a narrative."

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