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Statement of the Shadow Financial Regulatory Committee on

Fair Value Accounting

December 8, 2008

Section 133 of the Emergency Economic Stabilization Act of 2008 mandates the SEC to “conduct a study on mark-to-market accounting standards as provided by FAS 157” to be submitted to Congress by January 2, 2009. The study is to consider the effects of those accounting standards on financial institutions’ balance sheets, 2008 bank failures, the quality of financial information to investors, and the advisability and feasibility of modifications or alternative accounting standards. This provision is the result of considerable pressure from some financial institutions to suspend the application of FAS 157, which they blame for much of their financial difficulties.

The two relevant accounting standards in this matter are: FAS 115 (Accounting for Certain Debt and Equity Securities) and FAS 157 (Fair Value Measurements). FAS 115 establishes the accounting rules for marketable securities and investments, and creates three categories: trading securities, available-for-sale securities and instruments that are held-to-maturity. The first two categories are typically securities that are in the banks’ trading books, and the banking book (i.e., loans) is usually in the third category. FAS 115 also covers transfers of assets between the categories.

FAS 157 defines fair value, establishes a framework for measuring fair value and stipulates certain disclosures on fair value measurements. In particular, FAS 157 establishes a valuation hierarchy of three levels. Level 1 covers assets for which there are observable market prices. Level 2 applies to cases for which there are observable inputs, essentially market prices for similar assets. Level 3 covers assets for which there is little, if any, market activity and hence few observable inputs to be used (mark-to-model).

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Many influential banking and financial organizations have raised significant concerns about Rule 157, including the Institute of International Finance, the Bank of England, the Bank for International Settlements, and the Financial Stability Forum.

In our view, however, simply suspending FAS 157 would be a mistake. First, FAS 157 is simply a clarification of how to arrive at fair values, which are required for financial assets by several other statements, as for instance FAS 115, which requires the use of fair values for assets in the trading and available-for-sale categories. Second, and more fundamentally, simply suspending the rule will not be credible; investors and counterparties will still have doubts about the value of the assets on bank balance sheets. Third, accounting standards in the U.S. and elsewhere have for over a century used the lower-of-cost-or-market rule, which presents the same valuation issue. So even without fair value accounting, there would be a requirement under historical cost accounting and existing SEC rules to write down financial assets that are impaired and promptly disclose it if material on Form 8-K. The recognition of losses in asset values is not an invention of mark-to-market accounting or attributable to FAS 157.

Public acknowledgement of losses is an essential first step in addressing the consequences of poor investment and operating decisions. Failure to do so in a prompt manner simply prolongs the resolution of the underlying real problems, as it did in Japan in the 1990s.

Having said that, we acknowledge that there are thorny issues with the implementation of FAS 157 and fair value accounting more generally. There are four important issues. First, fair value accounting is often criticized as being procyclical. However, it is important to recognize that the principal difference between historical cost accounting (including the lower-of-cost-or-market rule) and mark-to-market accounting is that the former prohibits asset write-ups, not with respect to taking impairments. In our view, the ability of managers to inflate asset values during booms may be a cause of the asset bubbles that afflict our markets periodically, and the mark-to-market elements of fair value accounting permit write-ups that facilitate excessive leverage and risk taking.

Second, many opponents of fair value accounting assert a downward spiral effect, in which the sale of assets at distressed prices leads to further asset devaluations, which in turn produces more distress sales and still lower prices, as writedowns reduce regulatory capital or trigger collateral requirements in financial agreements. These arguments may well have merit, but in our view they point to the possible need for adjustments in regulatory requirements or contractual provisions—not to alterations in the accounting rules to create higher nominal capital and obviate such adjustments. The primary function of accounting is to provide useful information about asset values to investors and the public and should not be distorted for other objectives.

Third, although FAS 157 recognizes that it is problematic to use market prices (Level 1) or observable inputs from markets (Level 2) when markets are distressed or the market prices reflect forced sales, opponents argued that FAS 157 favors market prices whenever they are available and discourages the use of unobservable inputs, i.e., models and assumptions, even in extreme conditions. In particular, it is alleged that banks could not move the valuations of securities in the trading and available-for-sale categories from

Level 2 to Level 3, even when the market prices were in fact distressed or came from forced sales. However, empirical data from banks' quarterly reports in the IMF Global Financial Stability Report (October 2008) show that the obstacles were not insurmountable. For instance, Merrill Lynch increased the percentage of assets valued at Level 3 starting as early as the second quarter of 2007 by as much as 60% and continued to move assets to Level 3 (increasing this category by 50% or more in each of the two subsequent quarters).

Nevertheless, the continuing complaints by banks and other financial institutions and their organizations about the effect of the mark-to-market requirements of fair value accounting could suggest that while FAS 157 permits such valuations, it is not being administered in the intended way. This may be the result of concerns about litigation by managers and auditors that can to some extent constrain banks' ability to use models when they in fact are appropriate but difficult to support. This litigation exposure can be reduced by more detailed disclosures about the valuations models, their inputs and the reasons for changing Levels, if applicable.

Fourth, some critics have contended that a SEC Staff Letter in March 2008, commenting on FAS 157 and its applicability in current market conditions, was ambiguous and discouraged the use of Level 3 valuation methods as long as any market prices were available. Whether or not this interpretation is a correct interpretation of the Staff Letter, it is certainly not an accurate reading of FAS 157, as the SEC and FASB staff made abundantly clear in a joint statement on September 30, 2008. The joint statement explicitly refers to market prices in inactive markets as data that could not be ignored but were not determinative and only one of many inputs. The Committee agrees that mark-to-market accounting, particularly at Level 3, requires the use of judgment in determining the appropriate values. We note, however, that the process does and should reflect a dialogue between management and auditors, and ultimately the SEC. However, if anything, this crisis has taught us that there was too little information about counterparty risks and banks' exposures, coupled with serious concerns about the reliability of the financial statements.

The Committee's recommendation, therefore, would be a concerted effort, by the SEC as well as the banking agencies, to require more detailed information about the holdings of specific financial assets as well as the methods by which the assets are valued. As one example, particularly germane to this statement, when financial institutions transfer securities across fair value levels (e.g., Level 2 to Level 3) or across categories (e.g., trading to held-to-maturity), there should be disclosures of the reasons for the transfer, the ability of the firm to hold these assets to maturity, and the financial impact of the transfers.

From the beginning the subprime crisis has been a matter, not merely of losses from mortgages which should never have been written, but also, as those losses passed through the securitization chain, of the fact that it became increasingly difficult, if not impossible, to ascertain their amount and where they ended up. This aspect of the crisis has been at its core an information problem, which has yet to be seriously addressed or remedied. Capital infusions and blanket guarantees do not correct this shortcoming, although they may transfer the ultimate costs to the taxpayers.