Shooting the Messenger

TARP Contemplates SEC Suspension of Fair Value

In the last couple weeks, fair value accounting has been under attack, and many have contemplated its role in the current financial crisis walloping the markets. The most recent attack on fair value accounting comes in the form of Sections 132 and 133 of the Troubled Assets Relief Program (TARP) in the Emergency Economic Stabilization Act of 2008 proposed and rejected today by Congress, 228-205. We expect that the language in Sections 132 and 133 will remain in any future proposals. In this note we defend fair value accounting and discuss what we believe are the true culprits in the current crisis.

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The TARP Fair Value Provisions

Based on Sections 132 and 133 of the TARP (see Exhibit 1), it appears that the U.S. Securities and Exchange Commission (SEC) could potentially take the unprecedented step of suspending fair value accounting either on a transaction-by-transaction basis or broadly by completely suspending FAS No. 157, *Fair Value Measurements*.

Exhibit 1. Sections 132 and 133 of TARP on Fair Value Accounting

SEC. 132. AUTHORITY TO SUSPEND MARK-TO-MARKET ACCOUNTING.

(a) AUTHORITY.—The Securities and Exchange Commission shall have the authority under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)) to suspend, by rule, regulation, or order, the application of Statement Number 157 of the Financial Accounting Standards Board for any issuer (as such term is defined in section 3(a)(8) of such Act) or with respect to any class or category of transaction if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors.

(b) SAVINGS PROVISION.—Nothing in subsection (a) shall be construed to restrict or limit any authority of the Securities and Exchange Commission under securities laws as in effect on the date of enactment of this Act.

SEC. 133. STUDY ON MARK-TO-MARKET ACCOUNTING.

(a) STUDY.—The Securities and Exchange Commission, in consultation with the Board and the Secretary, shall conduct a study on mark-to-market accounting standards as provided in Statement Number 157 of the Financial Accounting Standards Board, as such standards are applicable to financial institutions, including depository institutions. Such a study shall consider at a minimum—
(1) the effects of such accounting standards on a financial institution's balance sheet;
(2) the impacts of such accounting on bank failures in 2008;
(3) the impact of such standards on the quality of financial information available to investors;
(4) the process used by the Financial Accounting Standards Board in developing accounting standards;
(5) the advisability and feasibility of modifications to such standards; and
(6) alternative accounting standards to those provided in such Statement Number 157.

(b) REPORT.—The Securities and Exchange Commission shall submit to Congress a report of such study before the end of the 90-day period beginning on the date of the enactment of this Act containing the findings and determinations of the Commission, including such administrative and legislative recommendations as the Commission determines appropriate.

Source: United States Congress.

We should emphasize that the TARP does not appear to be granting the SEC any new authorities it did not already have prior to these provisions. The SEC already has the statutory authority to establish U.S. financial accounting and reporting standards for publicly-held companies under the U.S. Securities Exchange Act of 1934.

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Throughout its history, the SEC has "outsourced" accounting rule-making responsibilities to the U.S. Financial Accounting Standards Board (FASB) and its predecessors which are organized as independent, non-profit, private-sector entities. Note that the SEC is likely to reassign those responsibilities to the International Accounting Standards Board (IASB) in the coming years (see our August 27, 2008 report, *Mind the GAAP: SEC Proposes to Permit U.S. Companies to Elect IFRS in 2010 and Sets Preliminary Roadmap for Potential Mandatory U.S. Adoption Beginning in 2014*). While the SEC has maintained oversight over the FASB, to date, it has not taken the extraordinary step of overhauling or outright rejecting an issued accounting standard. Any future action of that nature would indeed be an unprecedented event with lasting consequences and implications.

Some Historical Context

As these provisions are contemplated, we are reminded of two events that are relevant in this discussion. The European Union's carve-out of parts of IAS No. 39 and the Japanese crisis of the 1990s.

EU carve-out
The European Union's carve-out of parts of IAS 39 was a blow to the pursuit of truly universal, international accounting standards. For universally-consistent international standards to be achieved, there must be consistent application of standards from jurisdiction to jurisdiction and company to company.

In 2002, the European Union published a Regulation which required companies listed in EU countries to adopt IFRS accounting standards from 2005. IFRSs are set by the International Accounting Standards Board (IASB), which is an independent standard-setting body. IASB members are appointed by the Trustees of the IASC Foundation (IASCF). However, the EU retained some political power over accounting standards by only requiring use of those IFRSs which have been endorsed by the EU.

So far, the EU has restricted its powers to a limited "carve-out" of certain paragraphs of IAS 39 (*Financial Instruments: Recognition and Measurement*), which means that the EU-version of IFRS relaxes certain hedge accounting requirements in full IFRS. This followed intense lobbying by some banks, particularly in France[1], and the resulting carve-out has since been used by several of them[2]. Although the EU has endorsed all IFRSs to date, its power to withhold endorsement increases the EU's significance as an IFRS constituent.

Currently a monitoring group is being constructed for the IASCF which will be made up of regulators, to address concerns about the IASB and IASCF's accountability to public authorities. The SEC will likely be a member of that monitoring group. Many constituents have commented that this monitoring group must not interfere with the IASB's independence. Based on historical precedent, we had assumed that the SEC

[1] Jacques Chirac, President of France at the time, even wrote to the European Commission President to argue against endorsement of IAS 39.
[2] A survey for the Institute of Chartered Accountants in England and Wales reported that the carve-out was used by eight out of 30 European banks surveyed.

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would maintain its policy of allowing standard setters to arrive at accounting standards through the appropriate independent, non-partisan due-process. Sections 132 and 133 of TARP make us less comfortable with that assumption.

Japanese Banks in the 1990s

The Japanese banking sector went through a period of significant financial difficulty in the late 1990s. In response, the government revised banking regulations to permit the use of the cost method for investments in marketable securities instead of the lower of cost or market value, thus avoiding reporting of some unrealized losses. In addition, a new deferred tax rule was introduced which permitted the recognition of deferred tax assets with no limit on the amount which could be included in regulatory capital.

It appears that, though the deferred tax standard was based on U.S. GAAP, Japanese banks were permitted to recognize deferred tax assets quite optimistically (despite a five-year limitation on tax loss carry-forwards). One study estimates that in 1998, deferred tax assets amounted to 29% of major Japanese banks' equity and peaked at 60% of bank equity in 2002[3]. Mark-to-market accounting for securities was introduced in 2001. In 2003, the bank Resona collapsed when the auditors refused to sign off on the deferred tax assets reported in the accounts.

The changes to Japanese accounting standards in the late 1990s made banks look adequately capitalised when they were not. As a result of this non-transparency, banking reform was delayed and the crisis had deferred and lingering economic consequences. Appropriate fair value measures would have allowed the Japanese markets to absorb information on a more timely basis and potentially reduced the length of the economic crisis.

In Defense of Fair Value

In our July 28, 2008 piece, *Accounting Issues: Q&A on Financial Instrument Accounting During the Credit Crunch*, we wrote "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." We stand behind this statement.

The reality is that fair value accounting and enhanced disclosures have helped markets quickly identify where problems exist and react to those problems. While we will not deny that at times markets have overacted to some information, such a reality is a part of human nature and likely will persist no matter what accounting is used.

The natural question we must ask is, if fair value is deemed to be an unacceptable measure, then what form of measurement is superior at communicating the potential risks and rewards of an investment to investors? Historical cost is obviously not acceptable as the securities of particular interest in this crisis are substantially impaired. This leaves us with some form of mark-to-model valuation.

[3] *The Rise of Deferred Tax Assets in Japan: The Case of the Major Japanese Banks* (Douglas Skinner, University of Chicago, 2005).

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FAS 157 already accommodates for mark-to-model valuations in its level 3 category (see our July 28 note for more detail). It would seem to us that a suspension of FAS 157 would simply permit more leeway in how companies go about coming up with those mark-to-model valuations and how they disclose information in filings. In other words, instead of having companies look to FAS 157 to present a consistent basis for conducting and disclosing valuations from firm to firm, more management judgment would be inserted into the process.

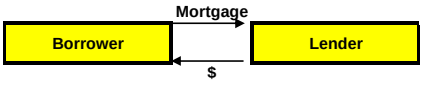
Ultimately, FAS 157 creates a framework for valuation. Prior to FAS 157, there was not accounting guidance in U.S. GAAP that set up a structure that pursued consistent apples-to-apples valuations across firms. We have trouble understanding how injecting more management judgment risk into the process will alleviate the fears of investors.

Isolating Some of the Causes of the Crisis

If blame does not sit with fair value accounting, then where should it be channeled?

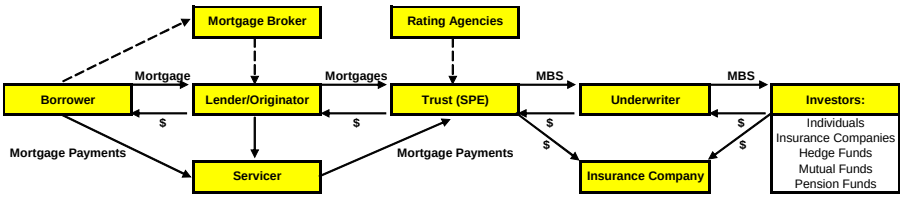
There is no doubt that securitization has played a central role in this crisis. Described in its simplest terms, securitization is the process of converting illiquid assets into more liquid securities. Consider the impact of securitizations on mortgages. Securitization resulted in the traditional, simple borrower/lender relationship in Exhibit 2 being converted into the complex structure presented in Exhibit 3.

Exhibit 2. Traditional Borrower/Lender Relationship



Source: J.P. Morgan.

Exhibit 3. Securitization of a Mortgage-Backed Security



MBS - Mortgage-Backed Securities
Mortgage Broker - An agent who helps borrowers locate lender for a fee.
Lender/Originator - Most typically a commercial bank. Loans are often "warehoused" until pool of loans can be transferred to the SPE.
Servicer - An agent who manages the mortgage payments (interest and principal) for a fee. While this role is often done by the originator, it can be done by another entity.
SPE - Entity is typically created by the lender/originator. The lender/originator transfers mortgage loans and its ownership stake in those loans into SPE. Once the loans are housed in the SPE, mortgage-backed securities (MBS) are created.
Rating Agencies - Assign ratings to the tranches of MBSs created in securitization for a fee.
Underwriter - Locates buyers for MBS and sells them to investors for a fee.
Insurance Company - Insurance company will stand in and assume elements of risk related to mortgage portfolio for a fee.

Source: J.P. Morgan.

In a traditional borrower/lender relationship, the lender manages its loan book closely to ensure that it is taking appropriate levels of risk. As a result, all responsibility for the lending decision and loan maintenance resides with the lender. In addition, the lender's leverage is transparent since the loans stay on the lender's books.

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It is our sense that the complexity of the securitization structure where all of these traditional responsibilities of the lender got parceled out to separate stakeholders was simply too much for the system to manage. If we look across the securitization structure, some level of blame can be assigned to regulators and each party to the structure. Whether we talk about regulators, Congress, financial institutions, rating agencies, the FASB, borrowers, or investors, each stakeholder will need to assess their role in this catastrophe and changes will be needed.

At the loan origination point, inadequate and sometimes fraudulent information was often collected about borrowers which ultimately undermine the ability of all other portions of the securitization structure to operate effectively. To put it bluntly, without detailed and accurate information about the borrower and the property, it's garbage in, garbage out. The fact that fair value measures have been difficult on some of these instruments is not a cause of our current problems but rather a symptom.

One reason we believe fair value accounting has been challenged recently is because regulatory capital adequacy measurements are based largely on book value. On September 23, the CFA Institute sent a letter to Congressional leaders defending fair value measurement and making the following point:

> Complaints about fair value arise largely in the context of their impact on capital adequacy. Rather than suspending fair value and thereby the transparency and relevance of financial information, perhaps the focus should instead be on flexibility in capital adequacy requirements in times of distress. This is a much more direct and transparent means of dealing with the capital issues.

We want to emphasize that we do not view the securitization structure as a bad structure, but it has obviously been abused. Whether the securitization market will exist on any substantial level going forward will depend on how quickly and effectively reform can be achieved at each stakeholder's level.

If blame to is to be credited to the FASB, we do not believe it should be for FAS No. 157, but rather for the rise of off-balance sheet special purpose entities that were structured under FAS 140 and FIN 46(R) and made leverage non-transparent and often rewarded risk-taking through gain-on-sale accounting.

To address its part in this mess, the FASB has released exposure drafts which will seek to correct deficiencies of FAS 140 and FIN 46(R). Under these proposed accounting pronouncement revisions, it will be much more difficult for companies to gain off-balance sheet accounting treatment for these entities. The implication is that there will be more consistency between economic leverage and leverage for accounting purposes. We believe that if appropriate standards had been in place in this area throughout the decade, these leverage problems would have been detected much earlier and these activities would not have been able to grow to these extraordinary levels. For more on FAS 140 and FIN 46(R), please see our previous pieces on this topic.

In addition, the FASB has also issued FASB Staff Position (FSP) No. 133-1 and FIN 45-4, *Disclosures about Credit Derivative and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the*

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Effective Date of FASB Statement No. 161. Through this FSP, the disclosure related to credit derivatives such as credit default swaps and swaptions will be significantly enhanced. The credit derivative market is estimated to be as large as $75 trillion, yet disclosure related to this enormous market is very limited. Under this FSP, effective for reporting periods (annual or interim) ending after November 15, 2008, the seller of a credit derivative will be required to disclose the following information for each credit derivative or each group of similar credit derivatives:

- The nature of the credit derivative
- The approximate term
- The events and circumstances where performance would be required of the seller
- Current status of payment/performance risk of the credit derivative
- The maximum potential amount of future payment (undiscounted) that the seller could be required to pay
  - If no limitation to potential payments exists, this must be disclosed
  - If potential payments cannot be estimated, this must be disclosed
- The fair value of the credit derivative
- Nature of any recourse provisions enabling seller to recover payments from third parties
- Existence of Collateral

FASB Chairman Bob Herz's Thoughts on Fair Value

On September 18, 2008, FASB Chairman Bob Herz gave a speech at a structured finance forum in New York titled "Lessons Learned, Relearned, and Relearned Again from the Credit Crisis – Accounting and Beyond." The full speech is available on the FASB website. We present excerpts from that speech in Exhibit 4.

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Exhibit 4. Excerpt from September 18, 2008 Speech Given by FASB Chairman Bob Herz

There are clearly issues with fair value, particularly in illiquid markets, but that doesn't mean it shouldn't be reported, supplemented by useful disclosures. Over the course of the past year, some have periodically complained that its use understates the "true value" of securities in illiquid markets thereby overstating the extent of the "true" losses. For example, last October they argued that a security with a fair value of say $80 was really worth $95, and in December when the fair value of that security had fallen to $60 they argued it was really worth $70, in March that the fair value of $40 should really be $55, and so on all the way down until, for example, the security was sold for say $25 in July.

Unfortunately, so far these assertions have proven Pollyannaish with the values of the securities in question falling fairly steadily over the course of the last year and with some of the institutions making these assertions amongst those that have failed and/or had to be rescued by the Treasury and the Fed.

To be sure, there is no question that implementing fair value in illiquid markets can be challenging and difficult and there are important questions to be asked. Does it lead, reflect, or lag reality? Are there genuine concerns over procyclicality? These are important questions and issues; but I would ask, what is the alternative? Not to try to be truthful about the current value of your assets, to use original cost or some other smoothed value that ignores current market conditions? Yet, in some cases, that is what some people have asked us to do—suspend the bad news for a while…until things get better. That is what Japan tried to do rather unsuccessfully for over a decade.

Investors have been clear: they want to see the current fair values of a company's financial assets. They believe it is the appropriate method of accounting for such items, and they generally applaud the added transparency provided by the new disclosures under FAS 157 (and indeed would like some additional disclosures like ranges and sensitivities).

Why is this so? Well, think about your own finances. If you were looking to get a loan, what values would the bank put on your assets, such as your house or your investments? Would it be cost? Would it be some smoothed value that was higher than their current value in a sale? I doubt it. And when you get your monthly brokerage statement in down markets, does it substitute some smoothed values for the current market values? And when you suffer a decline in your net worth, even on an unrealized basis, you might be prompted to take some "procyclical" actions like spending less, or even selling some assets to raise cash. But, in tough times, surely we don't want people spending less, that will only help precipitate a recession. What we need is people spending more. So why don't we just pass a law requiring broker-dealers to send out monthly statements to their retail customers that show nicely rising values, thereby engendering consumer confidence, spurring more spending and helping us avoid a recession. Sound like I am exaggerating and even getting ridiculous? Perhaps. But how far is that from some of the arguments made by certain leaders of the business community and politicians over the past year?

The harsh reality is that we can't just suspend or modify the financial reporting when there is bad news. That's not to say that fair value is the universal panacea. There are difficult issues, particularly in illiquid markets.

Source: FASB.

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