# *Fair value and the current crisis: Discussion of Huizinga and Laeven (H&L) and Laux and Leutz (L&L)*

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***The views expressed are the author's own and do not necessarily reflect those of the Bank of Italy***

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# The debate over fair value

**The prosecution:**

- "Mark-to-market rules must die so that banks will live. Avoiding the writedown of unrealized losses will give banks time to recover. Suspending fair value will prop the economy at no cost." (W. Brian & R. Stein, in Forbes, Feb. 09).

**The defense:**

- Don't kill the messenger. Accounting just reports the facts

**The "fact":**

- "Fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008." (SEC 2008, p. 4)

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# L&L (2009)

- Real question at this stage is: did FVA contribute to the deepening of the crisis (a contagion/ accelerator effect)? (point well clarified by L&L(2009a)).
- L&L(2009): answer is “no”: “… The claim that FVA exacerbated the crisis is largely unfounded”
- This is a strong position: “While accounting standards *may* result in some element of pro-cyclicality, we remain cautious of any attempt to address this issue through the standard-setting process.” (D. Tweedie, 2008)

# L&L (2009)

Is this "no" convincing? Three arguments:

1. "Fair value plays only a limited role for banks'income statement and regulatory capital ratios, except for a few banks with large trading positions" (p. 29)

2. FVA as applied by GAAP has "circuit breakers" (e.g. fire sale prices can be discarded)

3. FV assets as reported by banks are still optimistic (same finding in H&L(2009))

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# L&L (2009)

Concerning first argument (limited role of FV):

- Panetta, Angelini et al. (2009) argue that banks classified too many securities at FV through P&L. At some banks, share exceeded 50% of total assets, with peaks above 70%. Speculate that one reason was to boost profits

    - Treatment of hedges (detail)

- AFS reserves have turned negative in many cases

- AFS reserves have complicated effects on banks' supervisory capital under IFRS

# L&L (2009)

In addition:

- Consolidation and derecognition rules
- Treatment of goodwill (detail)

(Issues not related to FV as such but to FVA in general)

# L&L (2009)

Concerning  second argument (circuit breakers):

Circuit breakers were revised/added  by FASB and IASB as the crisis unfolded

- Clarifications about concept of “inactive market” (Sep.-Oct. 08, Apr.09)
- Several important reclassifications from HFT to L&R, HTM allowed (Citi, DB, UBS) (Oct.08, Apr. 09)
- Both GAAP&IFRS contain “impediments” to forward-looking (loan) loss provisioning, an important circuit breaker

# L&L (2009)

Concerning third argument (FV assets still overvalued):

True, but does it necessarily imply that FVA did not contribute to the crisis? We lack a credible counterfactual

Summing up: Analysis convincing, but conclusions could be tempered somewhat

# H&L (2009)

Three main results:

1. In 2008 banks' book values were overvalued (overestimated mkt values)

2. This is (partly) due to banks' discretion. In 2008 banks with large MBS exposures:

   a) kept loan loss prov. too low

   b) classified large share of MBS as HTM to artificially boost asset values

3. This discretion is a reason of concern

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# H&L (2009)

What about discretion **prior** to the onset of crisis?

FVA has brought about:

1. **Substantial discretionality** (L&L p. 4; H&L, p. 10-11)

2. **Substantial complexity**: "Jon Symonds … said the big problem was that almost nobody truly understood IAS 39. "We agree with him," says Tweedie."

   (www.the-financedirector.com)

- If banks used accounting discretion during the crisis, they likely used it before the crisis as well

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# H&L (2009)

Table 3, years 2001-2007:

$$\frac{\text{Market}}{\text{Book}} = \ldots \underset{(0.01)}{+0.05} \frac{\text{MBS AFS}}{\text{Total assets}} \underset{(0.05)}{+0.14} \frac{\text{HFT portfolio}}{\text{Total assets}}$$

- Suggests that in 2001-2007 banks classified excessive amounts of MBS at FV to boost share prices?
- Similarly, regressions in Table 5 suggest that in 2001-2007 banks with large share of MBS classified excessive amounts of MBS at FV to boost profits?

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# H&L (2009)

2. In 2008 banks with large MBS exposures:
   a) classified large share of MBS as HTM to artificially boost asset values
   b) kept loan loss prov. too low

Certainly reason for concern. However:

- (Re)classification as HTM was tolerated or explicitly allowed by policymakers & standard setters
- What about loss provisions **prior** to the onset of crisis?

# H&L (2009)

Key issue: Under both GAAP and IFRS, impairment losses must be actually incurred or be expected in the near future to be provisioned ➔Prudential reserves eliminated

- Objective of norm: reduce managers' discretionality, enhance transparency of accounts
- Problem: risk accumulates during expansions, but materializes in downturns (Borio et al. (2001))
- Outcome of norm: reduced income smoothing, stronger expansion of lending/assets in booms and contraction in downturns

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# L&L (2009), H&L (2009)

- Last March, FASB&IASB boards jointly announced intention to further explore Spanish dynamic provisioning model (FASB 2009)

- Critical issue, at the joint between accounting and regulation. Solution requires agreement between supervisors and accountants:
  - Broaden the accounting concept of expected losses, acknowledging that they increase in good times
  - Let regulators handle the problem via value adjustments which do not affect the P&L statement (Panetta, Angelini et al.(2009))

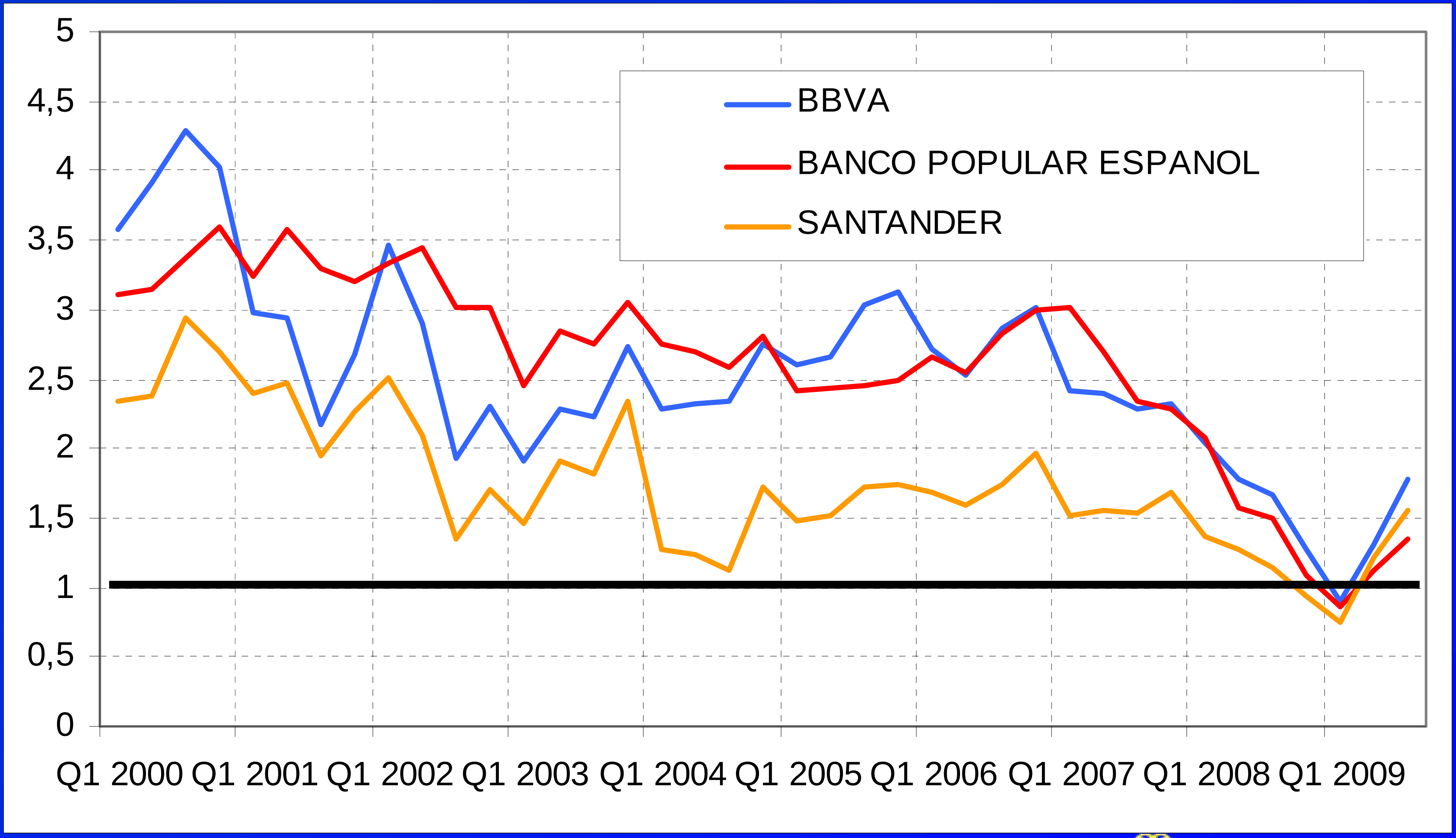
# L&L (2009), H&L (2009)

Policy conclusions:

- L&L (2009) do not advocate extension of FV accounting
- H&L(2009) conclude that FV should be extended to ALL assets

# L&L (2009), H&L (2009)

Market/book of key Spanish banks

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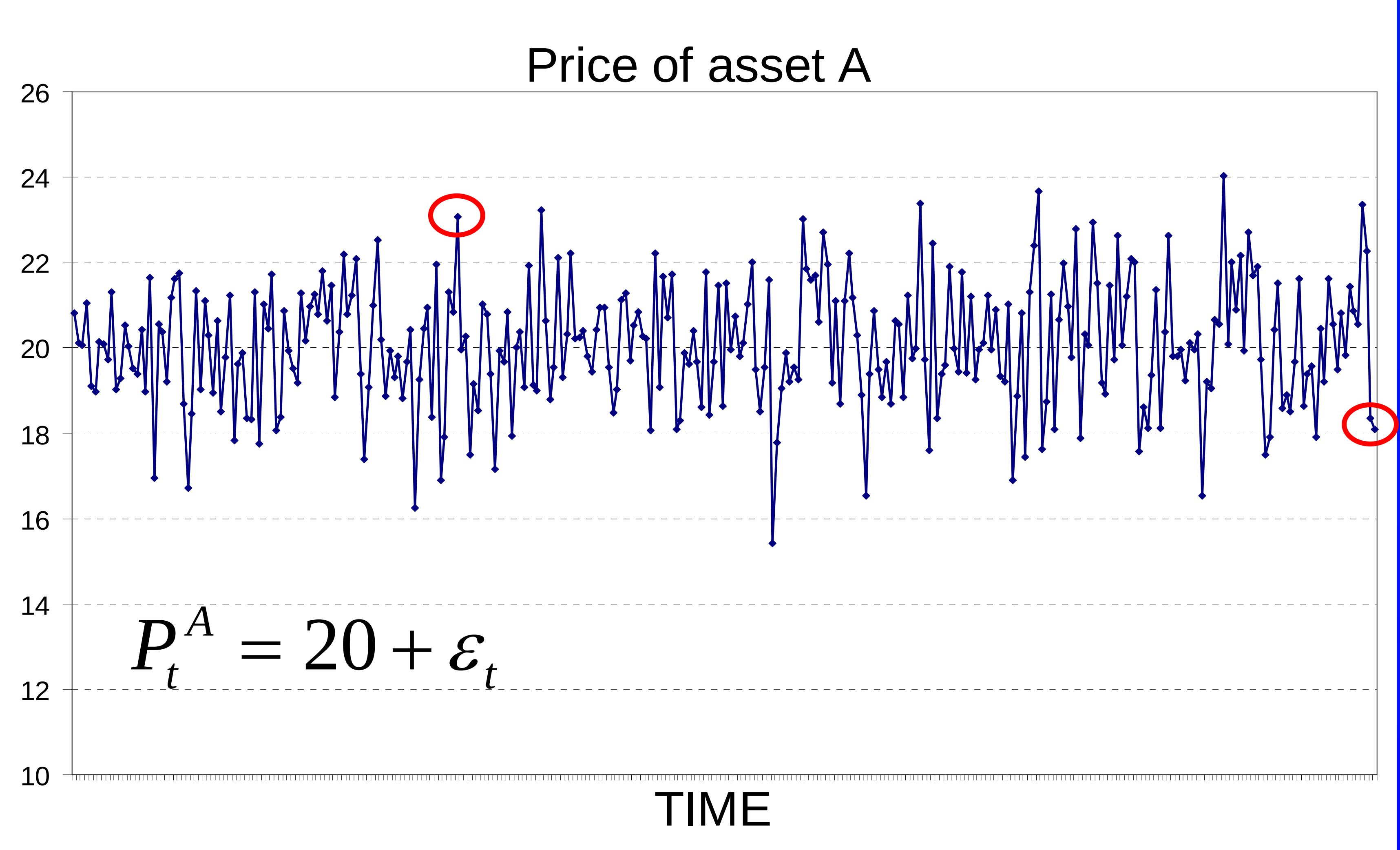
# Historical cost vs. Fair value




$$P_t^A = 20 + \varepsilon_t$$

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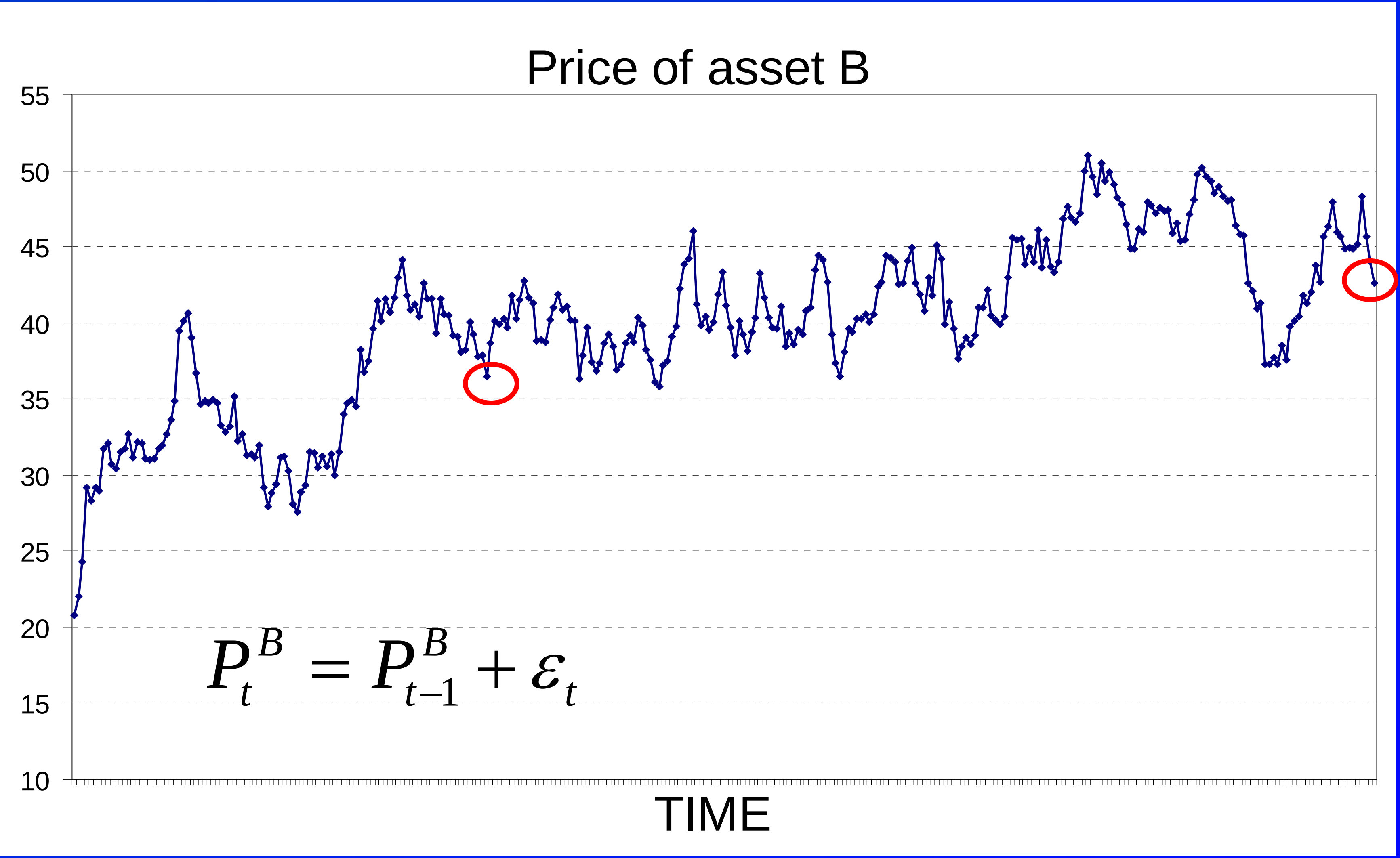
# Historical cost vs. Fair value



# Historical cost vs. Fair value

Bottom line:

- Estimating a phenomenon based on one observation is never good statistical practice

➔ Historical cost <u>never</u> seems to be a proper method to record value; HCA strictly dominated by some form of FV

# Historical cost vs. Fair value

- Current market price need not always be the proper method to record value either

- As most assets prices display intermediate behaviors between A and B above,  optimal estimator could  appropriately weighted time series of market prices (Kalman filter?)

# Treatment of goodwill (back)

(Panetta, Angelini et al. (2009))

- HCA: buyer amortizes goodwill
- FVA: goodwill is indefinite lifetime asset, but subject to annual impairment test, with losses affecting the P&L account

- In good times pro-cyclical M&A contribute to expansion of balance sheets
- In bad times impairment testing causes losses on goodwill to emerge, further depressing profits

# Hedge accounting (back)

Hedge is "highly effective"?

- Yes → both the derivative and the hedged item (only part hedged) valued at FV
- No → hedged item:
  - entirely valued at amortized cost
  - entirely valued at FV

    → strong incentive to resort to estimates and to excessively expand share of instruments at FV

# L&L (2009), H&L (2009)

Share price of large Italian bank which did not resort to govt aid