AMERICAN BANKER

Fair Value: Few Fans, But Fewer Alternatives; Despite widespread frustration, changes don't seem likely

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March 24, 2008
Page 1, Volume 173, No. 56

Entire portions of the credit markets have evaporated in recent months, leaving legions of market professionals with plenty of time to find someone or something to blame.

Most of the usual suspects in the blame game - irresponsible borrowers, incompetent lenders, fee-crazed packagers, lazy investors, and invisible regulators, to name a few - have constituencies dedicated to throwing up formidable defenses against perceived sin. Rather than sit in a circle and point the finger at each other, the standard playbook in these situations is to blame things, not people.

It is with that understanding that the current debate over fair-value accounting comes into focus. It's not easy to defend an accounting model when the attackers are so plentiful, and the arguments so seductive. It's not our fault; it's the accounting, the illiquid markets, the pricing models, the unobservable inputs, the Level 3 instruments, the exit prices, and the wide bid/ask spreads.

But if it is true, as popularly suggested, that determining value for some securities in markets such as these is close to impossible, then the issue must be less about method and more about the dilemma of being forced to pick a number. That may explain why the debate over fair value is heavy on criticism but suspiciously light on solutions. With all the fair-value rhetoric flying about, there are precious few initiatives to change anything.

"There are conversations about fair value, but when someone asks for alternatives, there aren't many practical suggestions," said Russell Golden, the director of technical applications and implementation activities at the Financial Accounting Standards Board.

"The FASB is in constant dialogue with our constituents, including the Securities and Exchange Commission, and to this point no one has provided a formal request to reopen" consideration of its fair-value standard that became effective this year.

The pace of the board's agenda might charitably be described as deliberate; the absence of any such agenda item at this point is a solid indication that a change - if one were proposed - would not become a practical reality anytime soon.

The standards board isn't alone in being empowered to make a change, but the bank regulatory agencies are hardly more active. Accounting officials at the agencies are certainly aware of the criticism, but to this point are doing more listening than acting.

"Everyone is looking at all sorts of possibilities about how to provide some assistance in a very difficult situation, but we also recognize some of the downsides - principally the difficulties of how any change might be accomplished," said an accounting official at a bank regulatory agency who spoke on the condition of anonymity in order to speak with greater candor.

"Whether fair value did or didn't cause some of the problems, given the situation we're in now, if you change the accounting you have a very high probability of increasing the uncertainty instead of reducing it."

Though bank regulators have expressed some concerns about the application of fair value repeatedly over the past two decades, there is support for some of its general concepts. They also appreciate that it pushes market risk into the financial statements, where bank executives ignore it at their own peril - as many apparently did. Sources said there are currently no plans to adjust regulatory accounting or capital requirements in response to the criticism of fair value.

One reason the regulators may be hesitant to express their views openly is Capitol Hill's increasing interest in fair value.

In recent weeks, Rep. Barney Frank, D-Mass., the chairman of the House Financial Services Committee, Sen. Chris Dodd, D-Conn., his counterpart on the Senate Banking Committee, and Sen. Charles Schumer, D-N.Y., have all expressed some skepticism about fair-value accounting. Rep. Frank has said he intends to hold hearings on the matter.

At a Feb. 28 Senate hearing, Federal Reserve Board Chairman Ben Bernanke agreed with Sen. Schumer that mark-to-market accounting - sometimes used as a very rough synonym for fair value - was a problem. But he didn't get very far in offering a solution.

"I don't know how to fix it," said Mr. Bernanke. "I don't know what to do about it."

About the closest thing to a fix is the SEC's current plan to release information about fair-value accounting that would encourage companies to make additional disclosures in footnotes and discussion sections of their financial statements.

Any such direction would be informal and would not alter the fundamental model of the standard. And indeed, the value of the SEC's initiative is made more nebulous by the fact that the current measurement standard, FAS 157, already encourages companies to provide copious disclosure about the methods they use to value securities.

Though FAS 157 went into effect this year, and was adopted early by some large banking companies last year, the model itself is not new. In fact, 157 is only a guide to measuring fair value; a companion statement, FAS 159, gave public companies the option of choosing which securities they would value with the method.

"We think that 157 is an improvement because it reduces the diversity in how you would have arrived at a fair value, but it does not change when fair value was appropriate," said Mr. Golden.

"A lot of the writedowns and impairments would have been required absent the existence of 157. What the standard does is provide discipline so that companies are valuing securities using the same methodology."

The writedowns reported by large banking companies in the third and fourth quarter of 2007 - and possibly more for the current quarter - are at the center of the debate over fair-value accounting. Though some of the valuation adjustments have come from the leveraged lending book of the dealer banks, most of the pain has been inflicted by securities backed by residential mortgages, including collateralized debt obligations.

The argument against fair value is a compelling one: volatile markets make securities valuation difficult and undermine investors' confidence, forcing companies to mark down values, leading to greater illiquidity and further markdowns. The more the markdowns impair capital, the greater the loss of investor confidence, and the faster the churn of the self-reinforcing cycle.

"Clearly there are business decisions that are being influenced by the accounting, and companies are having to account for things at fair values that are not based on deep, broad markets," said Dennis Beresford, a former FASB chairman who now chairs Fannie Mae's audit committee and teaches at the University of Georgia.

"The liquidity of the market is such that a lot of prices are probably not what most people would feel are fair and appropriate in normal circumstances. But that's still what the market price is."

Fair-value adherents aren't entirely unsympathetic to banks' concerns about cratering value, but argue as a general matter that inconvenient markets don't trump valuation principles.

"Let's not hide from the truth by misreporting what the true valuation of our bank is," said Darrell Duffie, a finance professor at Stanford University's Graduate School of Business.

"If I were an investor I would be much more spooked if I knew that everyone's accounting didn't reflect reality, but was just some cost accounting of what the assets were once worth."

The problem invites an interesting philosophical exploration about the nature of value, and particularly whether there is a difference between the perception of value and value itself. Companies argue, convincingly, that the economic or inherent value of some out-of-favor securities is far greater than their market value. From some perspectives, that's a simple argument to make: A primary reason for most investment is because one party holds a different conception of value than another. Universal harmony about value would remove a fundamental reason for trading.

Equally legitimately, some observers ask if illiquid markets are really valuing some securities at all.

"We have heard from bankers that they can get a quote from a broker, but if you ask in more detail about the quote, the broker basically says, 'If I were to buy, this is how much I would pay - but I am not interested in buying,' " said the regulatory accounting official.

The problem, critics say, is that there is frequently a distinction between price, value, and a quote, and fair-value accounting is prone to conflating the three.

Where the argument loses some currency, however, is in many of the Level 3 assets, which is the lowest level of the fair-value hierarchy.

For these instruments, there are no observable inputs, forcing the company to determine value through models stuffed with macroeconomic data - not securities-market pricing.

In its 10-K filed last month, Citigroup Inc. disclosed $29.3 billion of super senior CDOs, largely backed by residential mortgage securities, that it said were Level 3 securities.

Its valuation model uses "estimated housing price changes, unemployment rates, interest rates, and borrower attributes such as age, credit scores, documentation status, loan-to-value (LTV) ratios, and debt-to-income (DTI) ratios," the company said. Also, "the methodology takes into account estimates of the impact of geographic concentration of mortgages, estimated impact of reported fraud in the origination of subprime mortgages and the application of discount rates for each level of exposure, the fair value of which is being estimated. The primary drivers that will impact the super senior valuations are housing prices, interest and unemployment rates as well as the discount rates used to present value projected cash flows."

In short, broker quotes don't have much influence on the value of these securities. The problem was the underwriting of the loans, the packaging and collateralization of the securities, and the decision to hold them as investments.

"I would like to see people back away from talking about fair value as being the problem and focus on the fundamental problems: lack of market discipline, lending practices dealing with subprime, and compensation out of kilter with risk and reward," said Georgene B. Palacky, the director of the financial reporting policy group of the CFA Institute, which represents investors' interests. Complaints about fair value are "a lot of noise about something that isn't really the problem. It is a distracting argument from really solving the problems."

Prof. Beresford said much of the criticism of fair value stems from a more fundamental misunderstanding about financial statements and how they should be used. In general, he sees far too much faith and reliance in numbers that by rule are required to be specific, but in principle are more just educated suggestions.

"These are not facts etched in stone, but estimates that are subject to a lot of Kentucky windage," he said.