CRA Insights: Credit Crisis

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Supporters of the mark-to-market disclosure rules argue that FAS 157, Fair Value Measurements, has helped bring more transparency to financial institutions' disclosures of the effect of volatile credit markets. However, critics argue that in today's credit environment mark-to-market accounting may force the valuation of these assets based on distressed or fire-sale prices, rather than value in a normal functioning market. This article reviews the arguments of both fair value accounting supporters and its critics, and provides an overview of the recently released SEC and FASB clarification on fair value implementation.

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Mark to... Market or Reality?

What is fair value accounting

Fair value accounting, also known as mark-to-market accounting, is a method to report the balance sheet value of a company's assets and liabilities. The concept of fair value has been around for many years, as the Financial Accounting Standards Board (FASB) required companies to present certain assets and liabilities at their fair values. However, until recently, the term "fair value" lacked a consistent usage in accounting. The FASB rectified this by issuing Financial Accounting Standard No. 157, Fair Value Measurements (FAS 157), in September 2006. FAS 157 requires companies to measure the fair value of assets and liabilities at what they could be sold or settled at, a value known as the exit price.

FAS 157 also instituted a fair value hierarchy that requires fair value assets and liabilities to be grouped into one of three levels based on the inputs used in determining the fair value. Level 1 assets or liabilities are priced based upon quoted prices for identical items in active, liquid markets. Level 2 assets or liabilities are priced based upon observable information for similar items in active or illiquid markets. Finally, level 3 assets or liabilities are priced based upon unobservable information when markets do not exist or are illiquid.

Although FAS 157 did not become effective for most companies until this year, many of the large financial institutions on Wall Street chose to adopt this standard in late 2006 and early 2007, just as the current credit crisis was beginning to unfold. The financial disclosures of the firms that early-adopted have reported the changes in the fair value of their asset and liability portfolios over the past seven quarters. Many of these assets and liabilities were related to mortgage-backed securities. While markets were liquid, many of these securities were valued based on observable prices, i.e., as level 1 assets and liabilities, whereas today they are mostly classified as level 3 securities, reflecting changes in liquidity and the absence of observable market prices.

Did fair value accounting help worsen the credit crisis

The credit crisis was initially triggered by declines in the housing prices in the United States. Housing prices have fallen approximately 20 percent since peaking in July 2006, as measured by the S&P Case-Shiller index. Since the start of the credit crisis last year, over $500 billion in write-downs and losses related to mortgage-backed securities have been recognized by banks and other financial institutions. During the peak of the crisis in September and early October this year, stock markets suffered from extreme volatility and declines and credit markets worldwide seized up. Spreads on inter-bank lending rates reached historic highs. Governments and central banks in the US and Europe feared a "systemic" collapse of the financial system, and took unprecedented monetary steps to pump liquidity into the system and arrest market declines.

The current financial and economic crisis has led to the largest financial sector rescue effort by the US government since the Great Depression of the 1930s. The federal government has taken control of Fannie Mae and Freddie Mac, and has loaned funds of as much as $120 billion to rescue the insurance company AIG, in which it also took a large equity position. After much debate in Congress on a bailout plan to unfreeze credit markets, the Emergency Economic Stabilization Act (EESA) was signed into law on October 3, 2008. It authorizes the US government to spend as much as $700 billion to buy illiquid mortgage assets from banks. The government also announced that it would inject about $250 billion of the above funds directly into major banks in return for preferred stock stakes. These developments have reignited a debate that started with the early adoption of FAS 157 last year: did FAS 157 worsen the credit crisis or even cause it?

Fair value critics and their positions

Critics of fair value accounting contend that strict application of the mark-to-market accounting rules has forced banks to take billions of dollars of unnecessary write downs. The newly passed EESA includes a provision authorizing the SEC to ease the mark-to-market accounting rules. The provision reflects the belief of lawmakers that an easement of the rules will slow or reverse mortgage-related losses and stop the fire sale of assets by banks, thus reducing the overall cost of the bailout plan. The American Bankers Association, an industry group, also supports easement of the rules by the SEC, saying that it "will help auditors more accurately price assets that are difficult to value under current conditions."

In addition, individuals who have held high-profile positions in Washington have expressed their concerns over mark-to-market accounting's role in the credit crisis. William Isaac, a former chairman of the FDIC, wrote (in an article titled "We need to get it right") that "A bad idea became highly destructive when the SEC decided to continue fair value accounting after the market for mortgage securities evaporated last year. In the absence of a market, the SEC forced banks to mark these assets to an arbitrary index. Mortgage securities were marked to a fraction of their true economic value, which destroyed $500 billion of capital in our financial system. Since banks lend about $10 for each dollar of capital, the SEC's rule diminished bank lending capacity by $5 trillion…" Robert Rubin, a former US Treasury Secretary and now a senior advisor to Citigroup, called on accounting regulators to suspend the fair value rules because he believed that the rules worsened the banking system crisis.

Many more critics of fair value accounting have expressed similar views in recent weeks. Here is a sample:

- Anne Canfield, executive vice president of the Consumer Mortgage Coalition (in comments sent to the SEC): "It makes no sense to unnecessarily cripple institutions that could otherwise weather this storm of financial uncertainty by being forced to continue to mark down their assets to unrealistic fire sale prices."

- Alex Pollack, resident fellow at American Enterprise Institute (in comments sent to the SEC): "The fair value theory has particularly perverse results when applied in the midst of a market panic, when markets are neither liquid, active or orderly. What is the meaning of a 'market price' when there is no market? Of course you can make estimates by projecting cash flows and applying a discount rate. But which discount rate? The fair value theory forces the huge uncertainty premium or panic discount of distressed markets into the profit and capital calculations of entities whose contracted-for cash flows may all be realized."

- Brian Wesbury, Chief Economist, and Robert Stein, Senior Economist, of First Trust (in a commentary titled "Mark-to-Market Mayhem"): "It is true that the root of this crisis is bad mortgage loans, but probably 70% of the real crisis that we face today is caused by mark-to-market accounting in an illiquid market."

Fair value supporters and their positions

FAS 157 defenders argue that asset valuations performed for mark-to-market accounting reflect true economic reality. Auditing and financial analyst industry groups, in particular, have defended the need for fair value reporting. Their view is that modifying or suspending mark-to-market accounting would deprive investors of critical financial information regarding economic reality.

The Center for Audit Quality (CAQ), an accounting industry group whose governing board includes the Big 4 accounting firms, joined with the CFA Institute and The Council of Institutional Investors to issue a statement to Congress opposing changes to mark-to-market accounting methods. It noted that "Suspending fair value accounting during these challenging economic times would deprive investors of critical financial information when it is needed most…it would not help solve our economic difficulties." In a separate letter to Congress, the CAQ further stated: "[P]roposals advocating suspension of mark-to-market (or fair value) accounting are not in the best interest of investors or the capital markets and should be rejected... It is important to underscore that mark-to-market accounting has contributed positively to revelations about the severity of the economic crisis facing our country's credit markets and certain institutions, but it did not create the economic crisis."

David Zion, a widely-followed accounting analyst at Credit Suisse, wrote that accounting is not the problem, "it is reflecting an economic reality that asset values are falling... the real problem was overexposure to certain assets, poor risk management, misunderstood mispriced risks, and lots of leverage." Diane Garnick, an investment strategist at Invesco and an early contributor to the development of mark-to-market accounting rules for derivatives, was quoted in Bloomberg as saying: "Suspending the mark-to-market prices is the most irresponsible thing to do. Accounting does not make corporate earnings or balance sheets more volatile. Accounting just increases the transparency of volatility in earnings."

Clarification by the SEC and the FASB

In response to calls for relaxation of the mark-to-market accounting rules, the SEC and the FASB issued a joint statement on September 30, 2008 clarifying how to implement the fair value accounting rules. The FASB followed with the issuance of an FASB Staff Position (FSP) No. 157-3 dated October 10, 2008, titled "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." The FSP noted the following:

- In situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date.
- Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value.
- Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset.
- In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.

A result of implementing FSP 157-3 would likely be a shift in the classification of fair value assets and liabilities from level 2 to level 3.

Conclusion

Although the financial sector rescue plan has been passed into law, what remains to be seen is how it will impact today's economic climate. There is no question that the financial world has changed dramatically as a result of the government rescue efforts.

While critics of FAS 157 argue that mark-to-market accounting rules have forced companies to report asset values at fire sale prices, anecdotal evidence from recent bank mergers does not point to fire-sale pricing from mark-to-market accounting and further research is needed to examine this argument. Many recent acquisitions in the banking industry seem to have been completed at prices that were even lower than the mark-to-market values indicated on the acquired companies' balance sheets. For example, Wachovia agreed in September 2008 to be purchased by Wells Fargo for approximately $15 billion. Wachovia's reported book value as of June 30, 2008 was $75.1 billion, while its tangible book value (excluding goodwill) was $38.1 billion. These values based on mark-to-market accounting for Wachovia's investments substantially exceeded the reported sales price.

Recent academic research on fair value accounting has focused mainly on investors' use of the disclosures. The current debate on mark-to-market accounting shows that more research is needed on the relationship between fair value and liquidity. Professors Franklin Allen and Elena Carletti note in an academic journal article that "When liquidity plays an important role as in financial crises, asset prices may reflect the amount of liquidity available rather than the asset's future earning power. Using market prices to assess financial institutions' solvency in such circumstances is not desirable." The debate on fair value accounting shows that there is clearly a need for more research and data on the economic effects of mark-to-market accounting.

Credit Crisis Task Force

The full magnitude and impact of the current economic crisis are not yet known. But undoubtedly, the effects on both financial institutions and global business will be profound and lasting. To provide insight into the complex issues raised by the current crisis, CRA has formed a multi-disciplinary Credit Crisis Task Force. We have the expertise to help you both understand the issues and advise you on how best to address them.

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