Is it fair to blame fair value accounting for the financial crisis?
Robert C Pozen, Harvard Business Review, November 2009

Marking to market is the practice of revaluing an asset periodically according to the price it would fetch if were sold in the market. Marking to market is a key component of fair value accounting.

Some have argued that during the financial crisis, marking to market pushed many banks towards insolvency. This forced them to sell assets at distressed prices, which then caused values to fall even further.

Others have argued that fair value accounting cannot be blamed for the problems faced by banks. It only communicated the effects of bad decisions such as giving subprime loans. Keeping such loans on the books at their original prices would have been running away from reality. Indeed, if banks had not marked their bonds to market, investors would have been very uncertain about asset values and hence reluctant to capitalize troubled institutions.

Myth 1: Historical cost accounting has no connection to market value.
Even under historical accounting, current market values are factored into financial statements. Under US accounting rules, if any asset is permanently impaired, it must be marked down to its current value on the balance sheet and the resulting loss recorded on the income statement. The only difference is that in historical cost accounting, the decrease in market value can be reported more slowly and in larger lumps than in case of fair value accounting.

Myth 2: Most assets of financial institutions are marked to market.
In late 2008, only 31% of bank assets were marked to market. Most loans and bonds were "held to maturity" and hence subject to historical accounting. Moreover, debt securities in the category, "available for sale" were marked to market each quarter but the gains or losses were reflected under "Other comprehensive income". As a result, neither the net income nor the regulatory capital were affected.

Myth 3: Assets must be valued at current market prices even if the market for them is illiquid
When the debt markets froze during the fall of 2008, the US FASB clarified that companies did not have to use prices from forced or distressed sales transactions to value illiquid assets. Banks were given the flexibility to value their securities using their own models. As a result, banks could significantly

reduce the size of the write downs they took on assets in the first quarter of 2009.

Recommendations for realistic reporting

It may now be clear that historical cost and fair value accounting are much closer to each other than people think. But the two methods of accounting may have significant differences in a given context. While banks would like to present their assets in the best possible light, investors would be interested in understanding the potential exposures.

Recommendation 1: Enhance the credibility of marking to model.

Mark to model allows banks to project an optimistic picture of their financial condition. Banks should provide a list of the assets for which mark to model is applicable and summarize their key characteristics. Banks should also disclose in detail the assumptions underlying the model.

Recommendation 2: Delink accounting and capital requirements

Fair value accounting has been blamed for driving banks to the brink of insolvency by eroding their capital base. Banks feel that fair value accounting forces an artificial reduction in asset values that are likely to rebound once the crisis is over. Investors may however have doubts about a recovery in asset prices. The right way to reconcile the two perspectives is requiring banks to use fair value accounting but not insisting on reduction of regulatory capital.

Recommendation 3: Calculate EPS in both ways

Due to fair value accounting, earnings might fluctuate from quarter to quarter. Such volatility might depress the bank's stock price. The way to deal with this problem is to ask banks to report EPS with and without fair value accounting. This way, the investors would understand better what portion of the bank's net income has come from operating earnings and what portion from movements in security prices.

Concluding notes

There is no single best way to value the assets of banks. For some assets, measurement may be better done through fair value accounting and for others through a historical cost approach. Regulators should delink financial reporting from capital requirements. Fair value accounting did not cause the financial crisis but misperceptions about accounting standards may have aggravated the crisis.