

Chapter 9: Executive Summary

Fair Value Accounting: Policy Issues Raised by the Credit Crunch

Stephen Ryan

Background

The practical applicability of fair value accounting has been tested by the severely illiquid and otherwise disorderly markets for mortgage-backed securities and other such positions during the ongoing credit crunch. This fact has led various parties to raise three main potential criticisms of fair value accounting. First, unrealized losses recognized under fair value accounting may reverse over time. Second, market illiquidity may render fair values difficult to measure, yielding overstated or unreliable reported losses. Third, firms reporting unrealized losses under fair value accounting may yield adverse feedback effects that cause further deterioration of market prices and increase the overall risk of the financial system (“systemic risk”). These parties typically advocate one of two alternatives: either abandoning fair value accounting and returning to some form of amortized cost accounting or, less extreme, altering fair value accounting requirements to reduce the amount of firms’ reported losses. While each of the potential criticisms of fair value accounting contains some truth, all of these criticisms are overstated and do not acknowledge the far more severe limitations of the advocated alternative accounting measurement approaches.

The Issues

Like any other accounting system, fair value accounting has its limitations, both conceptual and practical. The relevant questions for policymakers to ask are:

1. Does fair value accounting provide more useful information to market participants than the alternative accounting measurement approaches (generally some form of amortized cost accounting)?
2. Can the FASB improve FAS 157’s guidance regarding fair value measurement to cope better with illiquid or otherwise disorderly markets?

The answer to the first question is yes, because the alternative approaches invariably suppress the timely reporting of some or all unrealized gains and losses and thereby reduce firms’ incentives for voluntary disclosure. Such suppression of critical information would prolong the price and resources allocation adjustment processes that are necessary to put the current crisis behind us.

The answer to the second question once again is yes; the FASB can provide additional guidance about when market illiquidity is so great that firms may estimate fair values using internal models instead of observable but low quality market information, and also about how to estimate illiquidity risk premia.

A Telling Historical Analogy: The Thrift Crisis

The thrift crisis began when interest rates rose during the first oil crisis/recession in 1973-1975, causing thrifts' fixed-rate mortgage assets to experience large economic losses that were not recognized under amortized cost accounting. Because these economic losses were unrecognized, bank regulators and other economic policymakers allowed the crisis to fester for a decade and a half—effectively encouraging thrifts to invest in risky assets, exploit deposit insurance, and in some cases even commit fraud in the meantime, activities that significantly worsened the ultimate cost of the crisis—until the crisis was effectively addressed through the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991. These acts required troubled thrifts to be shut down with their assets sold through the Resolution Trust Corporation, and prohibited regulatory forbearance and various other direct actions. Similarly direct policymaking is needed now, and it must not be deterred by throwing an accounting cloak over very real and sizeable problems.

Policy Recommendations

1. Policymakers should support existing fair value accounting requirements and their extension to all financial instruments.
2. The FASB should provide additional guidance about
 - a. when market illiquidity is so great that firms may estimate fair values using internal models instead of observable but low quality market information, and about
 - b. how to measure illiquidity risk premia.
3. The FASB and SEC should require firms to make additional mandatory disclosures and strongly encourage them to make additional voluntary disclosures about their unrealized fair value gains and losses, and how these losses have resulted from market illiquidity.

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