Don't Blame the Messenger … or Ignore the Message

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The message? Highly leveraged institutions gambling heavily on risky, low-transparency securities are simply asking for trouble. To avoid future financial crises, subprime mortgages need to move to moderately leveraged institutions – pension plans, 401(k) plans, mutual funds, sovereign funds, endowments, insurance companies and investment vehicles with conservative balance sheets like Berkshire Hathaway. Investment banks, and perhaps even banks, do not belong in this business. Ignoring this message will place us in peril again, someday.

The messenger? Honest balance sheets prepared under "fair value" accounting, which record financial assets at what they would obtain in an orderly market transaction (their "fair values"). Fair value methods are used for many assets on U.S. balance sheets (the SEC allows write-downs, but prohibits write-ups, for non-financial assets). The most recent U.S. accounting standard applying fair value methods to financial assets is Statement Number 157, issued in 2007 by the Financial Accounting Standards Board (FASB), and known as FAS 157. This standard first became applicable this fiscal year, just in time for the subprime meltdown, but it refines and extends fair value methods used for many financial assets since FAS 115 was passed in 1993. The U.S. historically has prided itself on the depth and efficiency of its financial markets, so what would seem more sensible than recording financial assets at fair values?

Why is the messenger being blamed? Fair value accounting is said by its critics to trigger a liquidity death spiral. Suppose a fall in value of mortgage backed securities (MBS) is recorded as a reduction in asset values in an investment bank's accounts. This triggers a violation of contractual or regulatory leverage constraints, which are based on balance sheet numbers. The investment bank cannot raise additional equity capital because its MBS risk exposure is complex, lacking in transparency, and costly to determine, so it must sell assets to reduce leverage. Other institutions hold similar bets on MBS, try to sell at the same time, and liquidity evaporates. The few transactions that occur are at below fundamental value. These prices establish a new and lower fair value benchmark, causing a further round of industry-wide balance sheet write-downs, hence further attempts to sell, further declines in prices, and so on. The death spiral, the argument goes, can only be halted by suspending or permanently restricting fair value accounting, thereby recording many securities at cost, not market value.

While it is clear that liquidity evaporated in many credit markets as early as August 2007, I am not convinced that a liquidity death spiral was responsible for the collapse in MBS prices. Nor am I convinced that suspending or restricting fair value accounting would be a good idea even if it was. That would send a signal that the real culprit – leverage – will be allowed to escape not only today, but tomorrow as well. I address each of these points in turn.

Two fundamental factors underlay the collapse in MBS prices. First, a substantial reduction in expected cash flows occurred when default rates increased and credit quality plummeted. Second, uncertainty ballooned. Securitizing mortgages separates the owners of claims to mortgage cash flows from the loan originator's information about the mortgagee. Repackaging mortgages into tranches then adds complexity and costs (including legal costs) to estimating a tranche's value. This resulted in low transparency, even to the institutions holding the MBS, to potential buyers of their MBS, and especially to their stockholders. More than a year since escalating MBS default rates became widespread knowledge, there still is considerable uncertainty about where the losses ultimately will lie, and legal wrangling seems likely to compound the uncertainty for years. Substantial losses in fundamental value therefore occurred for two reasons: sharply reduced cash flow expectations and sharply increased discount rates.

Illiquidity in the MBS market cannot explain why financial institutions were unable to issue sufficient new equity to restore their balance sheets. The extent to which they resorted to asset sales – allegedly below fundamental value – suggests potential investors were not convinced their assets in fact were under-priced. The market might well have correctly priced an extraordinary level of expected default rates, transactions costs, risk and adverse selection into MBS prices.

It is worth noting that claims of assets being offloaded below fair value came from the same managers who borrowed heavily to invest in them, and who had incentives to shift blame for their decisions to FAS 157.

It is hard to see FAS 157 as the culprit because it does not require valuation at market price if there is no orderly market. The standard certainly gives highest priority to reliable market prices when available, but explicitly permits the use of other estimates when they are not. "Mark to model" accounting is a well known and commonly used alternative to transaction prices. The SEC and FASB recently issued interpretative guidance on FAS 157, noting that prices can be unreliable in thin markets, even if there are price quotes, and reaffirming alternative valuation methods in such circumstances.

Financial institutions might not even have made enough use of fair value. A bizarre accounting and regulatory loophole allows unrealized losses on securities classified as "available for sale" to be shown separately on the balance sheet and excluded from calculating Tier 1 "core" capital ratios. Freddie Mac's most recent balance sheet shows assets of $879 billion, liabilities of $866 billion and equity of only $13 billion. To most people this looks like 98.5% debt finance (76:1 leverage). But for Tier 1 ratio calculations, Freddie was allowed to add back $21 billion of fair value losses to its equity base, making the leverage ratio 26:1.

Suppose for a moment the liquidity-induced death spiral argument was true, and that fair value accounting did spawn fundamentally undervalued balance sheets. This still would not be a problem if the securities weren't held in highly leveraged institutions. Without a binding leverage constraint, there would be no need to dump assets in a fire sale. Any illiquidity in the MBS market would be due to correlated selling by leveraged institutions seeking to restore their balance sheets, not by honest accounting. Don't blame the fair value accounting messenger: blame the strategic cocktail of risk, opacity and high leverage. Suspending fair value accounting would only send the wrong signal, that the same risky strategy will be bailed out in future.

Nevertheless, spurred on by the managers of financial institutions who got us into this mess, Congress has authorized the SEC to selectively suspend the application of fair value accounting for any institution or security class. The SEC already had jurisdiction over accounting rules for public companies generally, but its new authority allows it to pick and choose who has to comply with them, and when. This authority is contained in Section 132 of H. R. 1424, the Emergency Economic Stabilization Act of 2008. Worse, Section 133 directs the Commission to study the application of fair valuation to financial institutions generally, and report to Congress within 90 days. It puts political pressure on the Commission to rein in fair value accounting on a permanent basis. This already has occurred in Europe, where government involvement in financial reporting rules is viewed as normal. The European Union has strong-armed the International Accounting standards Board into allowing European banks to reclassify some securities as long-term investments recorded at cost, not market – and presumably amortized at discount rates that pretend that no increase in uncertainty has occurred.

Abandoning fair value accounting is equivalent to ignoring market prices. Even if there were black holes of illiquidity in the MBS market, the blame surely would lie with the institutions.

It is a market whose structure they essentially created. Is the problem the market for MBS, or the strategies of its major players? If a clown is playing a Stradivarius, do you blame the violin for the noise?

High leverage makes long term debt act like short term debt whenever asset values decline substantially and this is honestly recorded in the accounts. At every balance date, fair value accounting can trigger leverage restrictions and assign repayment and liquidation rights to long term lenders. That is fair value's strength, not its weakness: it protects lenders against substantial declines. Perhaps Wall Street managers were too busy banking their bonuses during the 15 years since FAS 115 to adjust their strategies. Maybe they forgot their earlier support for fair value when FAS 115 was introduced, ironically in response to the S&L crisis in the 1980s.

Now the risks in their strategies have come home to roost, Wall Street is lobbying to suspend fair valuation. No such argument was mounted during good times, when the spreads from risky investment were multiplied by high leverage to generate high book profits and high bonuses. Ironically, prior to 1993 investment securities were booked at the lower of original cost and current market value. Wall Street managers now want the *higher* of cost or market. They want to enjoy asset write-ups during a boom, but to be insulated from the downside.

Wall Street is not lobbying for fair value to be suspended in the books of their corporate clients. How could lenders price new loans or exercise their rights under existing loans if they don't know whether the client's assets have declined in value?

Nor is Wall Street lobbying for an end to FAS 159, which allows them to book gains when their credit risk rises and the fair value of their own debts falls. Merrill Lynch, Morgan Stanley, Goldman Sachs and Citigroup all wrote letters lobbying the FASB to pass this rule, and most have taken advantage of it.

The current panic among investors is fueled by a lack of transparency and trust in what they are being told. Few seem confident they know where the toxic assets lie in the system, and what they are worth. So the appropriate response is to *reduce* transparency? To replace estimates of fair values with obsolete historical costs? This is what Japanese banks got away with for almost a decade. It encouraged them to invest unwisely and thereby inhibit economic recovery.

Washington loves the "blame game," and financial institutions in desperate need of bailout have supplied an ideal candidate: the accounting profession. After all, accountants are unpleasant and narrow-minded people, perhaps even below dentists in cocktail party popularity, and definitely ignorant of high finance and economics. Or are they? Maybe they got it right this time. Maybe financial institution managers are simply trying to avoid responsibility to their shareholders and to the public for their own folly. The focus should be on the message, not the messenger.

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