

The SEC Should Address the Pro-cyclical Impact of Fair Value Accounting

MBA RECOMMENDS

In the short-term, the requirement for use of a “liquidity risk factor” in determining discount rates used to model future cash flows needs to be eliminated. It is “circular” and leads to marking to distressed sale values. Also, the list of factors that are indicative of an “inactive market” needs to expand beyond the present interpretations which include only: 1) Were there multiple buyers bidding? and/or 2) Was the sale exposed to the market for the customary time? FASB should provide additional guidance that expands the list of “symptoms” of an inactive market to include 1) significant widening of “bid-ask” spreads, 2) significant reduction from the normal number of transactions in a market, and 3) trades occurring primarily by sellers who are financially troubled. In the longer term, FASB and the SEC should consider a strategic reevaluation of the entire fair value project.

BACKGROUND

In September 2006, the Financial Accounting Standards Board (FASB) issued FAS 157, *Fair Value Measurements* (FAS 157).¹ In FAS 157, fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” FAS 157 defines a “hierarchy” for fair value measurements:

- **Level 1 inputs** are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date...
- **Level 2 inputs** are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly...
- **Level 3 inputs** are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available...

Under the FAS 157 hierarchy, Level 1 inputs are preferable to Level 2 inputs that are preferable to Level 3 inputs. Most non-government credit instruments are priced using Level 2 inputs.

As a result of the current global economic crisis, credit markets have “seized up.” Few trades occur for credit instruments that are not backed by the government. Those trades that do occur are generally sales by financially distressed sellers into an illiquid market at “fire sale” prices. FAS 157 requires that all enterprises owning a security sold in such sales that have elected fair value accounting mark their holdings of those securities to such fire sale prices. This adversely impacts the risk-based capital and earnings of otherwise healthy financial institutions. It could result in more banks moving from “well-capitalized” to lower categories, resulting in those additional banks reducing their new lending to consumers, homeowners and small businesses as the banks struggle to improve their risk-based capital ratings.

On September 30, 2008, the Securities and Exchange Commission and FASB issued a joint press release that attempted to provide more guidance for measuring fair value in an inactive market environment — generally allowing more frequent use of Level 3 inputs in an inactive market. Subsequently, on October 10, 2008, the FASB issued a staff position paper that added an example of use of cash flow analysis in an inactive market. The example in the staff position requires the use of a “liquidity risk

1. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, September 2006.

factor” in coming up with a discount rate in the cash flow model. This gets a resulting value not too different from using the most recent trade by a distressed seller in an illiquid market. As a result, little has changed to correct the problem.

EXAMPLE OF PRO-CYCLICAL IMPACT

The following example highlights the pro-cyclical impact of fair value accounting:

- **Assume:** The market for private-label (non-Ginnie, Fannie or Freddie) mortgage-backed securities (MBS) is inactive. The only sales getting done are sales by a handful of troubled institutions that must sell to meet collateral calls or to meet risk-based capital requirements. Those sales are closing at prices far below the “intrinsic” value of the securities (defined as the projection of future cash flows if one were to retain the security).
- **Scenario:** Troubled Bank ABC files its quarterly Call Report with the OCC. Its capital ratings fell during the quarter from “well capitalized” to the low end of “adequately capitalized.” It realizes that in order to avoid regulatory prompt corrective action it needs to put into effect a plan to restore its capital levels. It decides to sell some of its private label Alt A MBSs into the market. This will enable Bank ABC to move a portion of its assets from assets requiring a great deal of risk-based capital to be held to categories like cash or U.S. Treasury securities that require little, if any, capital.
- In auctioning the securities, Bank ABC receives only one bid at \$0.50 on the dollar. Bank ABC has projected the cash flows from the securities being auctioned and believes that the future cash flows from the securities would indicate an intrinsic value of \$.95 on the dollar. Bank ABC’s capital and regulatory situation is such that it feels compelled to accept the “low ball” bid.
- **Results in the Marketplace:** If Bank ABC’s sale is the only recent sale during the period of that security, ALL banks holding that security or similar securities would be forced to mark their holdings down to \$0.50 on the dollar. This would artificially reduce risk-based

capital for all banks holding the asset. It could result in more banks moving from “well-capitalized” to lower categories, resulting in those additional banks reducing their new lending to consumers, homeowners and small businesses as the banks struggle to improve their risk-based capital ratings. Some of those banks may sell some of their assets into the inactive market place, maybe at \$0.40 on the dollar this time. This would again require all banks owning that security or similar securities to write down their holdings to \$0.40 on the dollar in a cycle that continues to spiral downward.

SHORT-TERM ACTION NEEDED

FASB, an independent organization, sets and interprets accounting standards. The SEC is responsible for setting standards for the form and content of financial statements for publicly-held companies. Most mid- to large-sized financial institutions are SEC registrants, and are subject to the jurisdiction of the SEC. Likewise, the SEC can and often does influence the FASB’s decisions on accounting rules. The SEC can and should use its authority to suspend the use of fire sale prices in fair value accounting and influence the FASB to do so for all enterprises not under the direct jurisdiction of the SEC. The requirement for use of a “liquidity risk factor” in determining discount rates used to model future cash flows needs to be eliminated. It is “circular” and leads to marking to distressed sale values.

Also in the short term, the list of factors that are indicative of an “inactive market” needs to expand beyond the present interpretations which include only: 1) Were there multiple buyers bidding? and/or 2) Was the sale exposed to the market for the customary time? FASB should provide additional guidance that expands the list of “symptoms” of an inactive market to include 1) significant widening of “bid-ask” spreads, 2) significant reduction from the normal number of transactions in a market, and 3) trades occurring primarily by sellers who are financially troubled.

LONG-TERM SOLUTION

MBA believes the long-term solution is for the FASB and the SEC to consider a strategic re-evaluation of the entire fair value accounting project.