The Impact of Fair Value Accounting for Uncertainty in Risk During the Crisis

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Ashton Kutcher: Fair Value Accounting’s Newest Foe

fasb 157 alone dnt cause the crash however it drove the banks down at a pace that was so fast we couldn't recover. Greed caused the crash

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Fair value accounting and the crisis

• FVA has been blamed to have exacerbated the financial crisis
  - Excessive leverage in booms
  - Excessive write-downs in busts, leading to downward spirals, i.e., declines in asset values lead to write-downs, which in turn leads to fire sales and then further declines and write-downs
  - Contagion: Fire sales become relevant “marks” for other banks

• Did FVA accounting contribute to the current crisis?
  - Popular claim and conventional wisdom
  - Specific evidence of the problems is rarely provided
Challenge of identifying FVA as a culprit

• Market prices are used in many places, not just in FVA
  – Collateral & margin requirements, Value at Risk techniques
  – It is easy to confuse problems from the use of market values in these arrangements with the use of market values in accounting

• Large losses obviously cause problems for banks
  – But did FVA exacerbate the problems?
  – Would these problems have not occurred otherwise?

• What is the alternative?
  – Would HCA have been better?
    ▪ Impairments under HCA are similar to write-downs under FVA
  – Would the market have reacted differently if banks had not reported losses?
When can we blame FVA?

- Losses occur
- FVA reports losses
- Actions are taken

Actions would have taken place regardless
Procyclicality

• There are many sources of procyclicality for highly leveraged financial institutions:
  – Market-value-based bank management (VaR)
  – Haircuts and margin requirements (collateralized borrowing and repurchase agreements)
  – Collateralization requirements (based on ratings)

• Due to these arrangements, banks are forced to raise capital or sell assets in a financial crisis

• But these reactions are not a matter or result of FVA
Procyclicality of FVA
So what does it take?

• We need to identify and be explicit about the link through which FVA caused problems
  − Capital regulation
  − Contracts (e.g., debt covenants, compensation contracts)
  − Accounting fixation by investors, rating agencies and bank managers

• FVA as stipulated by GAAP includes various circuit breakers
  − They can mitigate the potential problems of FVA
  − Did they work?