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

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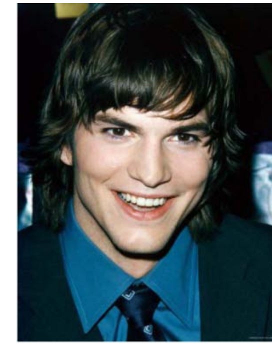
Ashton Kutcher: Fair Value Accounting's Newest Foe



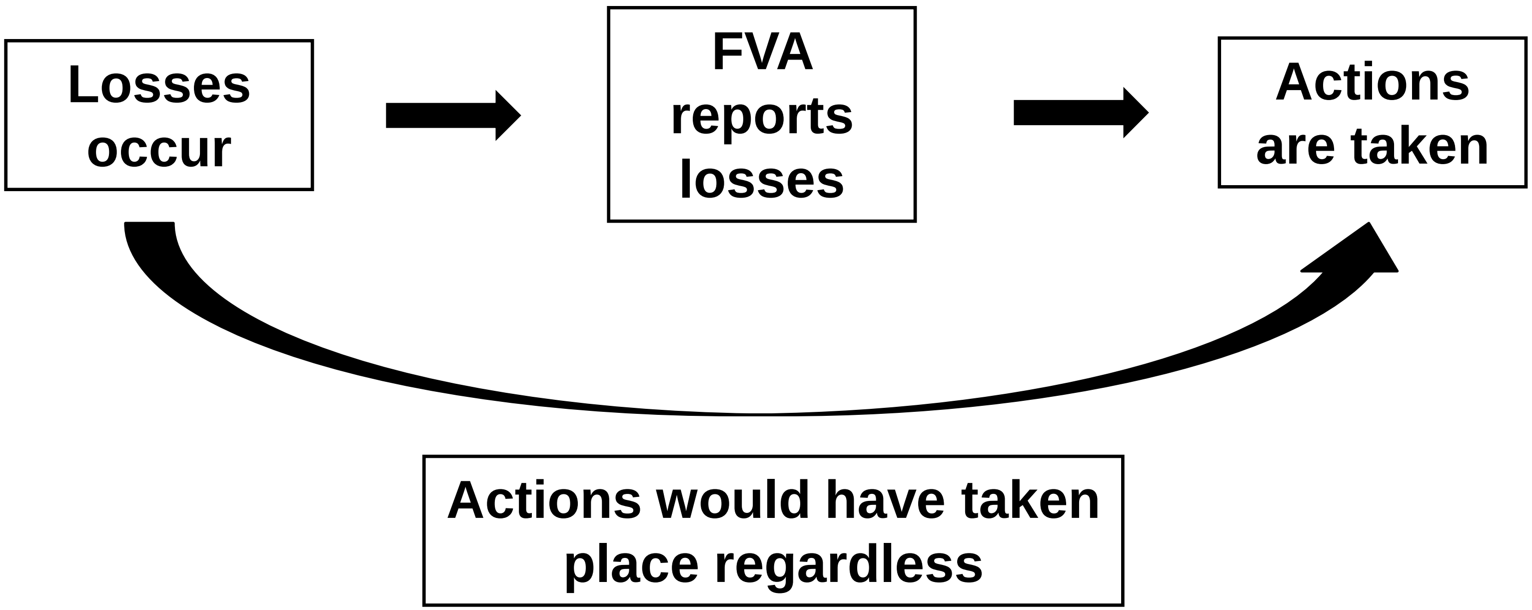
Fair value accounting and the crisis

- 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 arrangement 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?

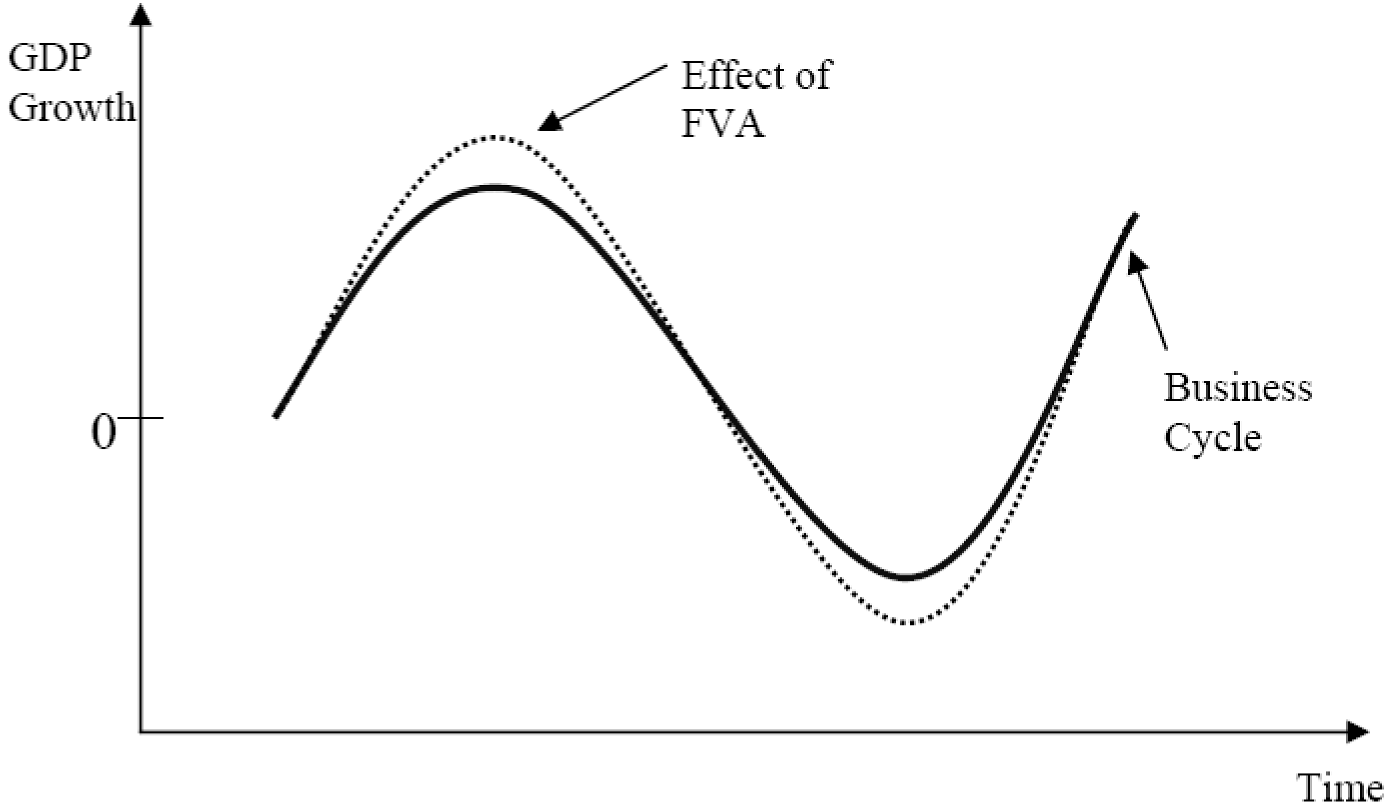
When can we blame FVA?



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?

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