The Unfair Fair Value

What could be wrong with using fair value to measure financial instruments? After all, if it's fair it must be right - to accept any other answer is like arguing against motherhood and apple pie. But like many other things, being labeled something doesn't make it so. . In worshiping at the altar of comparability we have sacrificed relevance. Fair value's unintended consequences have contributed to the current market distress and lack of investor confidence that has made the situation worse.

Summary Of Problems With Fair Value And Recommendations For Improvement

The more significant problems with fair value include:

- **Securities must be marked to depressed sale prices even if an investor has no current intention of selling**
- **Financial statements are less relevant and reliable**
- **Portfolios can't be managed for fear of tainting the portfolio**
- **Large paper losses by companies cause equity investors to lose confidence**
- **Assets designated level 3 in the fair value hierarchy are viewed with suspicion.**
- **Security market declines become pro-cyclical**
- **Capital may need to be raised in an unfavorable capital market**

Our recommendations to solve these problems include:

- **Ban exit pricing when there is no intention to exit**
- **Allow investors to change intent without tainting the portfolio**
- **Record unrealized losses in other comprehensive income without a charge to equity**
- **Expand the fair value hierarchy**

Problems With Fair Value Accounting

Securities must be marked to depressed sale prices even if an investor has no current intention of selling.

Securities must be valued at the most recent selling prices even when a company has no intention of, nor need to sell at those prices. Due to extremely illiquid market conditions, market quotes have been overly cautious. Using observable exit prices for all securities that trade, even in a distressed market, results in many securities unnecessarily valued at near fire sale prices.

For many instruments, banks determine whether a security has impairment by analyzing the rights to the cash flows from the instrument, assessing the ability of the counterparty to meet its obligations based on an assessment of the future market environment when

the obligations are due and then discounting those cash flows. However, this may yield a very different value than the one the bank would get from a broker in the current illiquid markets.

In some cases the spreads are very wide -- 50% or more. Is the "fair" impairment to record the 20% that the bank expects to incur over its intended hold period or the 70% derived from a price obtained from a "source" in a more senior level of the hierarchy. While that 70% write-down may accurately reflect the exit price in today's market, it does not reliably measure the loss the bank will incur on the security.

Financial statements are less relevant and reliable

Financial statement security values are now biased toward liquidation values rather than meaningful fair values based on management's intent towards realization of these assets. This has been a result of an over zealous drive toward comparability.

The fair value criteria of "orderly transaction" and "distressed sale" have been interpreted in a manner such that a market is deemed orderly unless the sale can be proven to be a forced sale. There is no middle ground. This creates an issue with the reliability of the value measurement, as well as its relevance.

The relevance of paper losses based on overly cautious broker quotes is questionable since incremental loss recorded in period of write-down will not be realized, but will turn around as the security pays down or is sold at a later date. In future periods artificial gains are created and recorded in operating income. While charges taken based on reduced expected cash flows reflects a fair measurement of the loss due to the failure of the securities to perform in the bank's management strategy, the artificial incremental write-downs and gains are not relevant to measuring that performance.

Portfolios can't be managed for fear of tainting the portfolio.

With a few exceptions, very strict "tainting" rules prohibit all sales of securities held to maturity and all sales of available for sale (AFS) securities which have a loss. While this is effective in preventing abuses in some cases, it effectively ties management's hands in managing the portfolio over its expected duration.

Large paper losses by companies cause equity investors to lose confidence
Sudden large paper losses that result from unusual market pricing cause many investors and shareholders to quickly lose confidence in a company or its financial statements. Many do not appreciate the difference between credit-driven losses in security holdings (genuine impairment issues) from temporary market depression in security prices, which will not be realized if the securities are held to recovery or beyond.

Assets designated level 3 in the fair value hierarchy are viewed with suspicion.

Level 3 fair value designations are being viewed in the marketplace as a sign of poor credit quality. Companies do not want to report more than a minimal percentage of their assets as Level 3 and certainly do want to have more than their peers. Since there are only three defined levels of fair value under FAS 157, the Level 3 designation is too broad. Using one's own estimate of value other than an available low-ball broker quote results in a Level 3 designation.

Security market declines become pro-cyclical.

The impact from fair value accounting treatment has accelerated the pressure for some companies to sell certain securities at declining prices that, in turn, increase the pressure to sell. Many interim declines in debt security prices are not due to credit issues and would likely be recovered if held. Accounting requirements to write-down securities to observable prices encourages some companies to sell sooner than they otherwise would further depressing prices in an illiquid market.

Capital may need to be raised in an unfavorable capital market.

A company now faces the prospect that it may need to raise capital on short notice due to large paper losses from a rapid downward spiral of securities even though a company still has the ability to hold until recovery. If a company's liquidity needs do not require it to sell temporarily depressed securities, its capital position shouldn't be penalized as if it would. Using observable exit prices for all of a company's securities sweeps in the fire sale or temporarily stressed prices accepted by a few sellers. This in turn unduly negatively affects capital if the company's intent is to hold for the foreseeable future.

Recommendations To Improve Fair Value Accounting

Ban exit pricing when there is no intention to exit

We recommend the requirement to use exit prices should be amended. Exit prices should not be the required basis for measuring assets when sale does not reflect the strategy of the company and when near-term exit is not intended. In the absence of market-related pricing information in an orderly marketplace, a company should be able to rely on internally developed pricing models to account for credit risk and interest rates.

Further, we propose that fair values not be required to use broker quotes if they are not reflective of actual bid offers in an active market. Broker quotes may be indicative of market appetite for limited quantities of a security or class or securities or may contain an unusually high premium for liquidity.

Allow investors to change intent without tainting the portfolio

Sales of available for sale and held to maturity securities more than 30 days after the balance sheet date should be allowed without calling into question management's intent and ability to hold the remainder of portfolio to recovery or maturity.

As the liquidity issues have hit the market this past year, many banks have adjusted their interest rate management outlook for the duration and yields of their portfolios of deposits and securities. In some cases, this change in outlook, while not changing the business strategy, would normally indicate some of the securities should be sold. In some cases, the interest rate management strategy indicates securities which currently have unrealized losses meet the criteria for sale. In addition as the crisis developed some companies may have wanted to reduce their exposure to certain securities or asset classes. However, under the "tainting" rules, investors are prevented from selling securities because doing so would jeopardize the accounting for the rest of the portfolio.

Record unrealized losses in other comprehensive income without a charge to equity

The AFS unrealized mark-to-market adjustment for securities whose price is under temporary distress but whose price recovery is expected should no longer be recorded in equity but only recorded in an other comprehensive income category that is not posted to equity. The higher capital requirement to cover such mark-to-market OCI is unreasonably severe if a company intends to carry such securities for the foreseeable future when prices would be expected to recover. Replacement capital is expensive. The resultant higher cost of capital is unnecessarily hurting the economy at the wrong time. We continue to believe that full and transparent disclosure of securities portfolios and the valuation methods thereof should not be reduced, even if the way in which the mark is recorded would be changed.

Our suggestions above focus on the mark-to-market recorded in equity and the current limitations on sales under FAS 115. If these suggestions are adopted the distinction between held to maturity and available for sale may no longer be needed.

Expand the fair value hierarchy

We recommend having more than three levels in the fair value hierarchy. The current scope of the Level 3 category combines assets for which internal estimates provide the fair values with assets whose trading is restricted; this encompasses too wide a variety of situations. If investors are going to interpret the lowest level as risky or akin to highly speculative, more levels would enable a definition of the lowest level that better matches that interpretation. In addition, investors should be able to use a lower hierarchy level if they believe it produces a more relevant price.