



Pro-cyclical Impact of Fair Value Accounting In Current Inactive Markets

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.

Cure for the Problem: In order to prevent the pro-cyclical impact of fair value accounting, allow the use of fair value measures as follows:

- Don't look at recent sales transactions by distressed seller in an inactive market
- Allow banks to mark to a fair value measure based upon the projection of future cash flows.

The Financial Accounting Standards Board (FASB), an independent organization, sets and interprets accounting standards. The Securities Exchange Commission (SEC) is responsible for setting standards for the form and content of financial statements for publicly-held companies. The SEC can and often does influence the FASB's decisions on accounting rules. SEC needs to be convinced that there is indeed a pro-cyclical impact from existing fair value guidance, and it needs to encourage the FASB to issue additional clarifying guidance or allow for suspension of marking assets down to distressed sale values.