

FASB, IASB and SEC Should Address the Pro-Cyclical Impact of Fair Value Accounting in Inactive Markets

MBA RECOMMENDS

FASB should eliminate the requirement for use of a “liquidity risk factor” in determining discount rates used to model future cash flows. It is “circular” and leads to marking assets to distressed sale values. The SEC should encourage FASB to suspend the use of liquidity risk factor when markets are illiquid or inactive.

BACKGROUND

In September 2006, the Financial Accounting Standards Board (FASB) issued FAS 157, Fair Value Measurements (FAS 157). 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; and
- 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. Even using discounted cash flows to calculate an intrinsic value calls for use of a discount rate that reflects the illiquidity of the current markets. These mark-downs to distressed sale prices adversely impact 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.

During the fourth quarter of 2008 and the first and second quarters of 2009, FASB issued several staff positions in an attempt to provide further clarity to preparers of financial statements as to how to measure fair values in an inactive market. These staff position papers did in fact clarify what a preparer should look for in identifying an inactive market and a distressed transaction. However, FASB still stuck with the definition of fair value as an “exit price” — the price that the asset could be sold for at the measurement date. It requires that the preparer continue to take into account liquidity risk premium. Therefore, these staff position papers did not solve the root 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 \$0.95 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 something close \$0.50 on the dollar (presumably the difference between the inherent value and the \$0.50 value represents the liquidity discount). 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 something close 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.

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