DFSA
Dubai Financial Services Authority

Discussion Paper 1

Fair Value Accounting – Is it True and Fair?

8th February 2009

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This paper is the first in a series of discussion papers on policy issues confronting the global financial services industry. The series is designed to provoke discussion on topical issues confronting regulators and the activities and markets that they regulate.

Introduction:

The purpose of this paper is to foster and promote discussion on whether or not fair value accounting, in its present form, is appropriate in today's unique circumstances. Further, should application of fair value accounting be temporarily suspended and replaced with something more workable that reflects economic fundamentals?

The continuing financial market turmoil has produced unprecedented disruption and volatility in the world's financial and capital markets. Problems of dysfunctional markets become more pronounced every day.

Unfortunately, fair value has not been a dominant issue in the current financial market turmoil. Such matters as capital adequacy/solvency, consolidation and securitisation have occupied a higher place in discussions amongst global financial experts. But in many respects fair value accounting as we know it today has been the cause of problems with capital adequacy, solvency and credit availability. Fair value should not be dismissed as purely an "accountant's issue", but should be addressed and discussed by the world's regulators.

In many situations, current asset valuations are clearly not reflective of what would exist in an active market, enabling sound analysis and decisions. Further, as markets become increasingly illiquid due to thinning volumes and trades become fewer and more volatile, the markets themselves become increasingly unreliable as a realistic indicator of value.

In this current climate of turmoil, fair value accounting has received some attention and scrutiny, as seen with the recent changes to International Accounting Standard (IAS) 39 on reclassification of assets, as well as the International Accounting Standards Board's (IASB) guidance notes on fair value, which in turn were in response to recommendations

of the Financial Stability Forum and the US Securities and Exchange Commission's recent study on mark to market accounting.

One must ask however, under these extremely exceptional conditions, whether there really is a true "fair value" on which investors and users of financial statements can rely to assess accurately a firm's financial position?

Is the artificiality of current price discovery serving investors and other users of financial statements?

Is it inducing asset valuations that materially misstate a firm's true financial position?

The accounting standard setters, together with the accounting profession, support fair value accounting, commonly referred to as "mark to market".

While it is acknowledged that fair value accounting was not the cause of the collapse of capital markets with the increased turmoil and volatility, fair value accounting has not assisted in allowing markets to return to normality. Instead, it is highly pro-cyclical and has had an accelerative effect in driving markets down further. [Note: It is equally true is that in times of rising asset prices, fair value accounting has the opposite pro-cyclical effect.]

What is being put forward in this discussion paper should not be perceived as such a huge step when governments are proposing the establishment of "bad banks." These allow impaired assets to be transferred in at current values with the provision that they will not be revalued while dysfunctional markets continue or recent amendments to the standards to allow reclassification of assets.

At the very least, the discussion should examine fair value in detail and it is hoped it will at the very least "close off" one suspected element of the contagion that many have argued has undermined investor confidence in the current turmoil.

Is the "needle point" precision of fair value accounting too precise or would an improved disclosure paragraph in management's discussion and analysis on valuations be more helpful?

With so many corners of the financial markets dysfunctional or unstable, the discussion of such a proposal may assist regulators, who have been put under pressure primarily by financial institutions to take action, to consider this as an interim measure while the due process of the accounting standard setters is allowed to consider whether or not fair value accounting in its present form should be amended or modified so it can work in all market conditions.

Suggested Way Forward:

In the longer term, the accounting standard setting bodies need to revisit fair value and stress test it under all conditions, including the present situation.

The current implementation of fair value accounting for most financial instruments presupposes there is an active market that provides reliable pricing. Since this is clearly not the case at present, the following actions should be placed upon the agenda for discussion:

1. Whether or not to give regulators the option to allow a moratorium from fair value for financial and non financial assets until the markets return to normalcy;

2. What should be the criteria for applying such a moratorium? We suggest that these should have to be specified in advance, and that important components would be volumes and volatility in the relevant markets. There would also be criteria for judging when the moratorium would cease;

3. What should be the criteria for measuring fair value during the moratorium? (E.g. would a moving average of markets for say the last 180 days be more reflective of fair value or look at underlying economic value - cash flow.)

4. What should be the enhanced disclosure requirements in notes to financial statements where suspension of normal fair value accounting is allowed? (E.g. How should management's considerations and discussions in choosing the valuation it has and why this valuation is believed to be most representative of the true intrinsic value rather reflective of a dysfunctional market? (This is imperative to meet the anticipated arguments that this is a backward step. It is assumed that management will be required to make more disclosure in the notes to assist investors in making an informed decision.)

5. Whether any moratorium should be extended to all corporate entities and not just financial institutions such as banks, insurers, investment banks, funds etc.

6. Should a moratorium cover just financial assets and liabilities such as equities, investments, debt instruments, CDS etc., or be extended to any assets or liabilities that would be subject to fair value?

To make it abundantly clear, the purpose of the proposed moratorium, under discussion, is not to induce inconsistency or to create confusion in accounts, as has been argued recently, concerning the utility of fair value in these tumultuous times. The moratorium proposed for discussion will not be allowed to continue beyond the point that is absolutely necessary, as it may lend itself to abuse from financial institutions when normalcy returns. The discussion will seek to define when that point maybe reached.

As stated above, this paper is not advocating an avoidance of transparency. The discussion of a moratorium is to look at one possible way to stop the vicious cycle where erosion of capital affects solvency, which causes nervousness leading to liquidity problems (authorities begin talk of nationalisation) since capital raisings are extremely difficult, leading to further depressed values and bank closures.

This paper does not put forward a final solution but is interested to reinvigorate the discussion on whether an interim measure such as a moratorium may assist in the present crisis.

In the longer term, the accounting standard setting bodies need to revisit fair value and stress test it under all conditions, including those in the present situation.

WHAT IS FAIR VALUE ACCOUNTING?

When financial markets are active, prices traded on them reflect consensus between buyers and sellers about the future cash flows of financial instruments, and on the degree of uncertainty surrounding them. Under these circumstances, fair value coincides with market prices.

International Financial Reporting Standards (IFRS) generally defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between two knowledgeable, willing parties in an arm's length transaction". When financial markets are active, prices traded on them reflect consensus between buyers and sellers about the future cash flows of financial instruments, and on the degree of uncertainty surrounding them. Under these circumstances, fair value coincides with market prices.

Fair value is used mostly to measure financial assets and liabilities however, it can be used for other assets and liabilities.

Fair value assumes active markets are efficient and rational prices are readily available.

WHAT ARE THE MAIN ISSUES WITH FAIR VALUE ACCOUNTING?

> By marking to market in good times allows management to increase their risk taking and financial vulnerabilities tend to build up in the system. These are not properly costed. However, when markets drop, these financial vulnerabilities surface which causes management to change its strategy and again fair value amplifies the cycle.

Fair value brings about a downward spiral of values whenever the markets are illiquid or when actively traded markets are no longer rational. This is because mark to market takes into consideration market conditions at a specific time and therefore, the income statement is significantly affected by large fluctuations in the markets.

Further, fair value appears to exacerbate pro-cyclical behaviour of financial markets. Marking to market in good times allows management to increase their risk taking and

financial vulnerabilities tend to build up in the system. It also creates volatility from one quarter to the next. These are not properly costed. However, when markets drop, these financial vulnerabilities surface which causes management to change its strategy and again fair value amplifies the cycle.

In the current illiquid markets, using fair value accounting can severely affect banks in the following ways:

- Capital is artificially eroded even in cases where solid fundamental credit performance is unchanged;
- The lending capability of a bank is reduced; and
- The accounting drives economic outcomes, including reduced availability of consumer and small business credit and a negative impact on the health of individual institutions while not reflecting economic reality.

SPECIFIC PROBLEMS

We have moved to the next phase where even active markets appear dysfunctional forcing holders of equities to report significant losses which only bringing more pressure to the system.

Recording losses that are based on a market's perception of value (fair value) often results

in recognising losses that exceed credit losses or recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms.

The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

Now even active markets appear dysfunctional which forces holders of equities to report significant losses which only brings more pressure on the system. This phenomenon has not been considered in recent studies on fair value accounting where markets now dictate only one price as the outcome.

Example: An entity acquired a long-term asset. As part of that acquisition it obtained a long-term loan with a variable interest rate. The loan agreement required that the entity to enter into an Interest Rate Swap (IRS) agreement to convert the variable rate to a fixed rate. Under IAS 39, the IRS had to be fair valued resulting in significant loss due the recent market turmoil which ultimately had to be booked to the income statement and balance sheet. If the original loan agreement had been taken out at a fixed rate then this adjustment under IAS 39 would not been applicable.

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THE VICIOUS CYCLE

Forced liquidations or distressed sales do not represent a sound basis for valuing similar assets and do not provide relevant, reliable, useful information to the users of financial statements.

In a time of falling market prices, mark to market requires financial institutions to take large impairment reductions which depletes their capital. These financial institutions then have poor options that quite often resort to distress selling of assets in an effort to contract their balance sheets in order to maintain minimum capital adequacy ratios. This systemic selling, in turn, drives prices down even more, creating a vicious cycle which ultimately leads to talk of nationalism and exacerbates the unavailability of credit and shareholders questioning whether their holdings are worthless.

Forced liquidations or distressed sales do not represent a sound basis for valuing similar assets and do not provide relevant, reliable, useful information to the users of financial statements.

Conclusion:

What a moratorium will do is stop fair value feeding the vicious cycle without eliminating relevant information to the investor by means of its disclosure. This will allow time for the markets to return to normality and for international accounting standard setting bodies to consider what needs to be done.

The DFSA is the independent financial services regulator for the DIFC

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Unprecedented times call for unprecedented actions.

Of course, suspending fair value will not prevent risk-taking financial institutions from failing. For example, the credit worthiness of an investment (i.e. Mortgage Back Security (MBS)) is still a result of the ability of the borrower to repay the loan as and when it falls due. However, as long as the borrower continues to pay, why should the MBS be marked down because the accounting standard demands it?

In the short-term, given the urgency of the situation, prudential regulators need to have the ability to seize the initiative, act swiftly and temporarily suspend/modify fair value accounting.

The discussion will address if a moratorium will break the vicious cycle. If it does that it will allow time for the markets to return to normality and for international standard setting bodies to consider what needs to be done.

While it may be argued that fair value has not caused failures to date, do we want accounting standards to be cited as the cause of financial institutions' failures?

Paul Koster

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Dubai Financial Services Authority

The Dubai Financial Services Authority (DFSA) is the independent regulator of financial and ancillary services conducted through the Dubai International Financial Centre (DIFC), a purpose-built financial free-zone in Dubai. The DFSA's regulatory mandate covers asset management, banking and credit services, securities, collective investment funds,

custody and trust services, commodities futures trading, Islamic finance, insurance, an international equities exchange and an international commodities derivatives exchange.