

March 11, 2009

From: rc whalen (chris@rcwhalen.com)
To: Financial Crisis Advisory Group (FCAG)
Re: FCAG Written Submissions from Constituents

The Financial Crisis Advisory Group (FCAG) is seeking written input from constituents in the form of responses to the following set of questions, to assist the FCAG in discussing accounting and reporting matters related to the financial crisis and making recommendations thereon to the IASB and the FASB:

From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

A: If you view the imposition of the fair-value accounting (“FVA”) as a reaction to the growing opacity and inefficiency in OTC cash and derivative markets, among other issues, then clearly FVA has been useful in identifying the areas of concern in much the same way that a severe stress test simulation seeks to make business model anomalies more visible. That said, the way to fix the OTC markets is by addressing retrograde market structure directly, not indirectly via accounting rules. Unless the Congress and the regulators are pushing for minimums of market openness and fairness, simply changing accounting rules to focus on the illiquid nature of complex structured assets was and is insufficient to address the concern.

If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

A: I do not believe that “through the cycle” loan loss estimates should be driven by accounting rules rather than safety and soundness criteria. The history of the past five years, when the SEC and some parts of the accounting industry slavishly adhered to a set of optimistic notions about what constitutes “appropriate” loss reserves for banks, has been shown to be a disaster for investors and safety & soundness as a public policy goal. Had regulators been allowed to compel certain banks to boost provisions earlier in the cycle, managing the cost of bank resolutions would be far more easily managed.

The visible skew in realized losses, in some cases causing banks to reports negative defaults for quarters at a time, was a glaring red flag to all rational observers that above-normal loss rates were impending. But, again, because only accounting experts were primarily involved in the FVA discussion, nobody pointed out the obvious skew in the macro credit environment. Thus when FVA was implemented, the proverbial rubber

band was released and we went from below-normal loss rates to above-normal loss rates in four quarters. Now that is market efficiency! More, the business model implications of FVA for banks suggests that most financial institutions are now compelled to maintain higher levels of tangible common equity (“TCE”).¹

The fact that markets have focused on TCE, which like EBITDA is not a defined accounting term, illustrates the folly of trying to define and thereby constrain the preferences of investors and analysts via accounting rules. Using TCE and Credit Default Swaps as valuation indicators, the market concludes that all large banks are insolvent. This is not just a matter of being “pro-cyclical” as is fashionable to say in economist circles, but rather of multiplying the already distorted, “market efficiency” perspective on value provided by FVA into a short sellers bonanza. No, the Chicago School is wrong dear friends, price is not equal to value.

Financial analytics is a constantly evolving art/science and the IASB and FASB face a tremendous challenge making rules that are sufficiently flexible to reflect this market reality. If you make every financial firm on the planet operate under the same rules as a broker-dealer for market risk positions, then capital levels must rise and leverage ratios for all types of financial disintermediation must fall. Everything will be held to maturity, securitization will become exclusively a government activity and the US economy will stagnate. FVA implies a net reduction in credit to the global economy that is causing and will continue to cause a global political firestorm. I salute the IASB and the FASB for being willing to sacrifice your organization and your careers for such a noble principle!

Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitizations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

Yes, agree completely. The accounting industry was an enabler for the off-balance sheet regulatory arbitrage that caused the subprime crisis. There is no such thing as a “good sale.” Accordingly, both accounting and regulatory regimes must be aligned to recognize the continuing control over and risk from off-balance sheet items. This risk may not be so large as to entirely discourage the use of off-balance sheet financing, but the cost of this risk must be explicitly stated and priced. Given higher capital ratios and lower leverage, it may be very difficult for private issuers to compete with GSEs.

Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model.

¹ As of today’s date, we have collected several dozen different ways to calculate TCE. The market standard seems to be total equity less all intangibles, a far harsher measure of capital than regulatory standards.

Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

No one accounting regime is “right.” Multiple perspectives are best. I would like to see both historic and FVA accounting stated in parallel. I think we need to have a discussion as to when a shift in FVA should hit income and/or assets and liabilities. Q: How can we validate swings with time? With respect to banks and financials especially, the change from historic to FVA has been so disruptive that any further changes may be counterproductive. We need to be cognizant of not just accounting goals and rules, but also business reporting, investor relations, legal and business issues in order to assess this question.

What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

I am not sure that “due process” necessarily ensures a better result. The current predicament was the result of an extensive consultative process going back more than a decade, yet the FVA was announced at the top of a bubble of historic proportions. Maybe there was too much deliberation!? Had the FVA rule be adopted in 2005 instead of 2007, a great deal of heartache might have been avoided.

Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organizations? If so, which issues and why, and which organizations?

In general, both agencies ought to formally request guidance from the SEC and the Congress on the market structure issues highlighted above. For example, should all SIVs be “on balance sheet” and if so under what terms? Is the SIV entity consolidated or is only the “net” exposure shown? How should accounting recognize the operational risks embedded in each SIV? To what extent has the breakdown of the agency model for securitization voided the concept entirely? More generally, what changes to market structure should the IASB and FASB champion so that rules like FVA actually become workable? In other words, does FVA require a certain minimum degree of market efficiency? Does the accounting profession as one need to proclaim that they cannot do the job of auditing in a reasonable way without transparent, liquid and public markets that meet minimum standards?

Is there any other input that you'd like to convey to the FCAG

See below:

- Comments to AEI/PRMIA Conference: Bust, Bankruptcy, Bailouts: What Should We Do Now? <http://www.rcwhalen.com/pdf/bust.pdf>
- [Yield to Commission: Is an OTC Market Model to Blame for Growing Systemic Risk? *The Journal of Structured Finance* Summer 2008](#)
- ['Does Fair Value Accounting + Credit Default Swaps = Global Deflation?'](#),
[January 23, 2009](#)

Best,

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