CREDIT CRUNCH 2 - Fair value – ICAEW Financial Services Faculty event.

Presentation delivered by Tim Bush Director, Hermes Focus Asset Management Limited speaking at the ICAEW on Wednesday June 11 2008.

Mortgages originated in off-balance sheet structures set-up by investment banks, then came back into the wider banking system on balance sheet as MBS (Mortgage Backed Securities) or CDOs (Collateralised Debt Obligations), where they were held for trading (stock broking banks, such as UBS, RBS or Bear Stearns) or held as treasury assets (any bank, such as Bradford and Bingley, Alliance and Leicester, and again UBS).

IAS 39 is the standard that accounts for these things (called by IAS 39 "financial instruments") but which are still at heart, mortgage cash flows.

For mortgage loans held on normal loan books, boards and auditors would have to **authenticate** the carrying value of the loans, by reference to **prime data** (by that I mean authenticate **fundamental quality:** existence, lack of fraud, lack of arrears).

Unfortunately the accounting approach with IAS 39, is not to refer to and account for the quality of the underlying loans making up the MBS or CDOs but is concerned with the fair value of the **"financial instruments**" on the basis of "mark to market" (or to a fair value model in the absence of a market based on **probable** defaults and hence **probable** rates of fraud).

Unlike Company Law accounting rules - which IFRS superceded - there is no net realisable value (i.e. fundamental cash flow) sense check, the IAS 39 criteria is at least **one step removed**: being either what the market thought the **"instrument**" value was (at 4:30 on New Year's Eve, on the inherently limited basis of what was known on New Year's Eve), or what the model thinks that the value ought to be.

Unfortunately because IAS 39 accounting **stops at an abstraction**, a "price" (with no overriding check in IAS 39 to what - if anything - is underpinning it). IAS 39 accounting is not actually a sign of authenticity or even business/accounting reliability. Markets can trade junk, and junk prices will contain an increasingly speculative element. Indeed the whole thing traded may fall over. As it has.

Coincidentally, *reliability* was specifically excluded as an accounting attribute in the IASB/FASB Conceptual framework, it was replaced by "*verifiability*", but hold that word up to the window, and all that is saying, is verify the price in the market as at 31 December, off a Bloomberg screen, and the accounting complies.

IASB/FASB has also eliminated substance over form as an accounting attribute. Again, this has been relevant in the credit crunch, as in substance CDO's/MBS are interests in pools of mortgages, and merely worth **the cashflows from the mortgages adjusted for the levels of subordination built into the structures**. But, under IAS 39, form prevails, these things are **not accounted for and audited by looking to the** substance of **the transactions**, instead, the accounting relies on the markets' perception of value of **the "financial instrument",** itself something in the abstract. The accounting shows it as one asset, priced net. The underlying substance is somewhat different to that. Indeed some CDO structures are now being disintegrated to the underlying loans (e.g. BarCap's).

If the market, or the model has got things wrong, then the public accounting may have been not only over inflating assets, but the bank is booking non-existent profits. Unlike the Companies Act model that IFRS superceded, IAS 39 requires the booking of fair value gains as profits up front, where these things are being held as trading stock, however, the "profit" is at that stage is merely **at best** an unrealised holding gain, ephemeral, or fictitious.

IAS 39 simply does not allow for the fact that inherent value (that supported by the quality of cash flows) and prices may disconnect. This happens in the upswing of bubbles, where markets may defy gravity, and speculation not valuation drives price setting in markets. Indeed, Ponzi schemes work by dragging more and more people in, though there is no asset backing what is being sold. **IAS 39 seems to have allowed Ponzi type activity to be accounted for, and legitimised via auditing, at the heart of the banking system**, on the basis that the price of the last transaction **is** the fair value for the public accounting of banks' assets.

US sub-prime was Ponzi-like, no firm covenant - what were called mortgages in many states actually had no recourse to the borrower (merely the property) - poor origination, yet banks' profits were peaking in Q1 2007, despite evidence of mortgage arrears and fraud months before, which on an empirical basis would have suggested provisioning was needed in 2006. Not as late as Q1 2008 which has been the outcome with IAS 39.

However, what banks were including in their 2006 and 2007 balance sheets, in some cases fair values greater than the entire capital of the bank, were actually market fair values of pools of mortgage assets, without even waiting for the co-terminus audit of the underlying assets (some are probably still not audited).

IAS 39 is requiring a mode of accounting and audit that is little different to the estate agent valuing a property by merely driving by, relying on the price of the house next door, but who may find a lower value if he actually was required to observe from the inside whether the house had subsidence.

The problems with fair value **as it is being applied by IAS 39** include:

> a lack of **synchronisation** between what markets have at a year end to price, with what is really going on **at that time**.

> a lack of substance, no **authentication of the quality** of the mortgage books.

> reliance by auditors on market values, propped up by credit ratings, both things being an abstraction. Credit ratings are not audits, credit ratings are projecting future default rates, indeed **credit ratings rely on audits**, but IAS 39 has the accounting and the audit relying on the market price, even though the market price is relying on the credit rating. Chicken-Egg-Chicken.

> allowing for the booking of unauthenticated, unrealised "instrument" "gains" as "profit", and affecting incentives, with banks then paying bonuses on the back of these.

> IFRS does not even allow for adjusting post balance sheet events, to get more appropriate

31 December numbers, even when things have clearly gone pear shaped in January and February, and 31 December numbers were plainly ridiculous. e.g. RBS/UBS Rights issues. French auditors of Sec Gen, needing to override IFRS.

With Enron, derivatives were priced, but the whole thing fell over shortly afterwards, IAS 39 was at the heart of it, just like this time. It is the template for creation and innovation – and it **had regulatory sanction**

As a footnote, don't be fooled by the line that "accounting for financial instruments" is difficult. Cashflows are not that difficult to account for, and if they are contingent, leave them out of valuations. It is the weaknesses in IAS 39 that both creates difficulty **and** has given licence for many of these things to proliferate in the first place. It was the template for sweet wrappers without being able to see whether anything lay beneath it.

Look at the coincident timing of the introduction of IAS 39 in Europe and the proliferation of structured credit products.

The limitations of the standard, which unfortunately has force of law, seems to have given directors a false comfort from accounting "compliance", if they even knew that these things were there, and ties the hands of auditors who would otherwise do a sense check beneath the abstract pricing test of the "financial instrument", i.e. they would have to open the black box, and look at it in the raw, and take a view, not a price from a Bloomberg screen.

Under IAS 39, assets in excess of the capital of some banks, have been slowly decaying for an extended period of time, with market values not responding negatively, but the cash flows drying up nevertheless. The price of convergence to a **known to be faulty standard**.

END

Not for distribution prior to 11th June.

The views expressed in this paper are those of the speaker and do not necessarily represent those of the Financial Services Faculty and the Institute of Chartered Accountants in England and Wales, or Hermes.