Research: Is fair value really fair?

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As the United States continues its struggle to emerge from the worst economic crisis since the Great Depression, a practice known as fair-value accounting has been taking heat. Critics—mostly banking associations—say it worsened the recession's impact on banks, restricting their ability to lend money. Congress, prodded by banking industry lobbyists, has held hearings on the subject and pressured the Financial Accounting Standards Board, which responded swiftly with changes. And the debate has continued in both mainstream business publications and academic journals.

But ongoing research by three faculty members in the Accountancy Department in the University of Notre Dame's Mendoza College of Business, indicates fair value is getting a bum rap from those in banking circles who may be using the controversy to loosen some of the regulatory controls that were put in place during the past three decades.

"They're blaming the messenger," says Brad Badertscher, assistant professor of accountancy, who conducted the research with two colleagues, Assistant Professor Jeffrey Burks and Professor Peter Easton. "Mortgages were oversold, and banks made bad loans. It's not the fault of fair value—it's economics."

Fair-value accounting, also known as mark-to-market accounting, has been an evolving part of Generally Accepted Accounting Practices in the United States for more than half a century. It requires banks to report assets at current market value versus the historical value, or original purchase price. These regulations were tightened to protect investors and depositors following the savings and loan crises of the 1980s and 1990s, and again after the Enron/WorldCom debacles several years ago.

How does that relate to the current recession? Banks are required to maintain a certain amount of “regulatory capital” to lend. The minimum required is 6 percent, although the number for most banks falls in the 10-12 percent range, including almost all of those in the researchers’ sample of 150 bank holding companies, whose 2004-2008 filings were examined. The banking industry claims that with the economy collapsing—and particularly with real estate values falling—fair-value accounting forced them to write down the value of many of their assets. This, in turn, reduced their regulatory capital, giving them less to lend and forcing them to tighten loan requirements.This makes it much more difficult for consumers to borrow money and exacerbates the impact of the recession on the entire economy.

Not so, say the researchers. “We looked at the portion of the banks’ portfolios that consists of securities—stocks and bonds—that they hold as investments,” says Burks. “Most of the problem investments were mortgage-backed securities. Many homeowners stopped paying, so the securities tied to those mortgages plummeted in value. However, because of the way regulatory capital rules are written, most of the write-downs that banks were taking actually had no effect on their regulatory capital.”

In fact, note the researchers, most bank assets are not fair valued, and those that are have little effect on regulatory capital if the bank intends to hold them instead of sell them at low prices.

“This was not understood by most politicians or the public,” says Burks. “Our research found that the effect of fair-value accounting was negligible. Banks simply had a lot of charge-offs for bad loans.”

“Our findings suggest that Congress was rash in demanding rule changes," adds Easton. "This should give pause to advocates of even more government involvement in accounting standard setting."

But the pressure for rule changes remains unabated, in large measure because bankers would like to further scale back these regulations, so the debate—and the research—will continue.

Stay tuned.

Provided by University of Notre Dame

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