C.D. Howe Institute
Institut C.D. Howe

Celebrating/Nous célébrons 50 years/ans

*verbatim* April 17, 2008

# "On Fair Value"

Remarks by Nicholas Le Pan
C.D. Howe Institute, February 23, 2009

I am here to defend what some consider the indefensible. Nothing I say reflects the views of any organizations I am, have been, or will be associated with.

Fair value is the right concept, incredibly badly implemented by standard setters, preparers, market participants, regulators and policy makers. They did not recognize the difficulties and deal with them up front (despite being told to). They did not realize that upwards of 75 percent of fair values would be some form of mark-to-model or mark-to-proxies. Nor did they recognize the changes in business practices that would be necessary and advantageous in a fair value environment. If they had recognized that, now we could get on with the necessary fixes.

I also think that we should delay considerably any gleam in the zealot's eyes – and there are zealots out there – about going to full fair value for all financial assets and liabilities. We have to, and we can, get the bugs sorted out. Confidence in this measurement approach has to be increased. That was the view of the Basel Committee on Banking Supervision (BCBS) in 2001 when I drafted the first critical response to the International Accounting Standards Board (IASB). It is even more important in today's fragile financial environment.

It is crucial to understand that fair value is not just slavish mark-to-market. For assets and liabilities that do not have markets, such as loans or insurance contracts, it is often an organized, constrained, disclosed, more-consistent methodology to approximate what markets would likely pay for something. That can include discounted cash flow analysis with appropriate risk margin, and can be more forward looking than historical cost, which is what we need if we are to avoid messes like we are now in. Nothing says you have to use distress prices in a seized market. However you do have to disclose your method, and we need to do a better job at that.

Why is the principle right? Many people believe fair value is bad, and that full fair value is worse. Everything else is worse. Does anyone really think we should account for stuff solely on the basis of what it was bought for? Fair value critics do not have a viable alternative that meets the criteria of usefulness and relevance to investors and creditors.

It's a marketing kudo; who could want unfair value? No one seems to complain when fair values overshoot on the upside!

This is all about the age-old adage that comes from behavioral finance: "if you don't know who you are, markets are a very expensive place to find out." Fair value, in concept, is better than all the alternatives as a way of measuring 'who you are.' Sometimes the answers are harsh. They have to be interpreted with a lot of judgment, which they have not always been, in part because standard setters and preparers did not help explain the change in rules well or allow enough use of judgment.

Nick Le Pan is former Superintendent of Financial Institutions and is a Senior Fellow at the C.D. Howe Institute, where he co-chairs the Institute's Pensions Program Advisory Panel. This *verbatim* reflects Mr. Le Pan's comments during a debate with Dominic D'Alessandro, President and CEO of Manulife Financial Corporation, on fair value accounting issues, February 23, 2009, in Toronto.

INDEPENDENT • REASONED • RELEVANT

How can economic reality be measured other than by reference to markets? Of course, there are problems that have to be dealt with sensibly when markets do not exist or break down, but there is a basic philosophical issue here. If we don't measure things consistently close to what markets would pay, we invite problems. Some of the biggest problems of mixed attributes accounting are: arbitrage between entities who account for things differently; development of not well understood risk transfer; badly assessed risk concentrations; financial statements that risk not representing reality; and gamesmanship, like income smoothing.

The debate should be about the room for, constraints on and clear disclosure of reasonable judgment when mechanistic use of mark-to-market or mark-to-model would not reflect fair value.

Accounting has to be about useful score keeping; the widely accepted principle for accounting standards is whether it is useful to users in making economic decisions. A recent Securities & Exchange Committee study, mandated by the U.S. Congress, concluded based on comment letters and roundtables that investors want the comparability and relevance of fair value information.

Let's look at transparency, relevance, reliability, accountability, what caused the meltdown, and problems for businesses.

1) First transparency: In 46 AD, Plutarch had it right when he spoke of transparency and fairness, ''when the candles are out all women are fair.'' This can apply to all men too. Economic decision makers need to be able to rank 'fairness' of enterprises, over time and between competing enterprises. We do not want to be operating with the candles out. Fair value is the only principle that consistently goes to that aim across the plethora of different financial instruments. We cannot have confidence in entities and markets unless we have transparency. ''Trust me'' does not cut it. Accounting not based on market reality where markets exist, and not based on market approximations where they do not, can easily be ''trust me'' accounting. Lack of confidence costs firms and the economy. I think that we need more, not less, confidence in markets now. Any moves to suspend fair value would threaten confidence. It may have been acceptable, thirty years ago, to have smoothed measures in all financial institutions' accounting as the bedrock of financial stability. Many aspects of the economy and financial system supported that approach: less competition, less market penetration, less sophisticated globalized capital pools and capital movements, less demand for transparency, willingness of financial institutions (FIs) and authorities to get together to solve big problems behind the scenes, and so on. Those days cannot come back, markets will not accept them.

2) Fair values are likely to be the most relevant to investors, with a focus on: what is this worth today? Not: what does someone say it will be worth tomorrow? Not: what was it worth when we bought it? Increasingly, managements value firms, assess risk, and base compensation on market or market-based measures. That has gone too far in some cases. We need to allow reasonable judgment for illiquidity, and for pricing problems when markets do not exist. Investors and creditors should have measures of performance that are closer to how managements actually run these firms. Remember accounting is about assessing stewardship and accountability. Asking what markets think something is worth, or how markets would likely assess value is the best way I can think of to make that assessment. It is not likely to be well done if the accounting model essentially asks what management says something is worth or likely to be worth.

3) We have a reliability problem – which has led to unintended consequences of fair value accounting. This is serious. We tried to force-fit certain things into a model for liquid tradable instruments. It is why we should not go to full fair value anytime soon. However, this does not that mean we should throw out the concept. We should allow judgment and approximations, backed by transparency. We need to make sure that there are standards for the models being used in the mark-to-model part . Maybe auditors and audit regulators have to up their game. That is what the recent guidance from the IASB and the U.S. Federal Accounting Standards Board is finally doing, albeit in bits. Issuing guidance and new rules pushed by politicians in the middle of a crisis is not the way to build confidence in financial reporting, which what we need.

4) Fair value accounting is not the major cause of the financial meltdown. The major cause was leverage, opacity, inadequate risk management, real credit losses, liquidity drying up as counterparty credit risk rose, risk concentrations, and actions and inactions of the authorities in some countries, although not in Canada. Fair value helps recognize problems, not hide them. We do not want a lost decade because we didn't recognize problems and deal with them.

5) Impacts on business: When it comes to impacts on business, fair value is like Buckley's, it tastes bad but is good for you. One impact on business is the development of a better understanding of where risk and reward are coming from. This is a good thing – balance sheets matter. Tracking changes in value of assets and liabilities is a good thing from this perspective. Fair value accounting promotes that mindset. Consistent comparisons over time and across entities promote better performance.

The negative impact on business is about two things: fear of accounting not matching the business model and the fear of volatility. Financial institutions, whose business is about intermediating across maturities and between the liquid and illiquid, worry that fair value cannot reflect that. I am not so sure. I still think it is worth knowing the best answer for evaluating an enterprise and its management to the question of what would someone pay for this today? Getting confidence up is essential so that approximations can work well when there are no active markets and leave enough room for judgement, not manipulation. That is why I do not favour going to full fair value soon.

I appreciate the business concern regarding volatility. Some of the volatility is real and accounting is recognizing reality. Since a lot of this volatility was a surprise to markets, counterparties, firms themselves and investors, it has imposed a cost. Surprises and uncertainty of outcomes are a lot more troublesome than volatility. They mean that firms have not been able to take all the measures they would like to manage in the fair value world. The impacts on business were not well understood by standard setters or by preparers. This is one of the irresponsible implications of the fast extension of fair value and inadequate guidance form standard setters. The impacts and imperfections were not well understood by markets, analysts, rating agencies and so on. As we move forward, including in insurance accounting where the Canadian model is a good one and a good base for fair value, we have an opportunity to do better.

## Conclusion

''If you do not know who you are, markets are a very expensive place to find out.'' Fair value, in concept, is better than all the alternatives as a way of measuring who you are. Let's not operate with the candles out.

Thank you.