Institution-specific Value

Comments by David Andrews, Fitch Ratings, on a paper presented by Ken Peasnell

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In his presentation, "Institution-specific Value", Professor Peasnell has added considerably to the case for fair value accounting. It may possibly be assumed by some of those present that I as an analyst in a rating agency would not share his enthusiasm for this fairly new concept. This is not the case. I have just been involved as co-author in the publication of a paper titled "IFRS and Their Implications for Bank Analysis and Analytical Spreadsheets". This starts as follows: "Fitch Ratings welcomes the introduction of IFRS for a large number of banks in 2005, even though the agency realises that this complicates life for financial analysts, especially in the short term."

Needless to say, the introduction of IFRS has not, however, led to wholesale adoption of fair value accounting, and in particular not for banks. As Professor Peasnell surmises, IAS 39 did come as a shock to the banking community in many countries, but, as he also concludes, "the application of fair value accounting to financial instruments presents a huge opportunity to advance the quality of financial reporting by financial institutions".

Professor Peasnell's allusion in his paper to the CCA (Current Cost Accounting) controversy of the 1970s is interesting. Others have drawn an analogy with fair value accounting, predicting that it too will eventually go the way of the dodo. As the Professor says, however, there has been a massive, fairly recent, increase in the use of innovative financial instruments, which, although they carry the seeds of potential systemic risk, have until now usually lurked off balance sheet. Fair value accounting

is part (but not all) of the key to disclosure of this overhang. I certainly consider it a much more resilient species than CCA: as Professor Peasnell says, the need for CCA vanished when Western governments finally got inflation under control. Nothing short of a worldwide financial meltdown seems likely to put a brake on (even less, bring an end to) financial innovation. Also, fair value accounting appears to have a much more solid base in theoretical economics than CCA ever did. I remember the CCA valuation of, for example, bank lending as being almost entirely based on the whim of banks' managements.

Returning to the paper, I particularly like Professor Peasnell's characterization of hedge accounting as "essentially a 'fix' to avoid mismatch problems in historical cost accounting". As he says, "The fix involves not recognizing gains and losses on different sides of a hedge until some future date when they can be brought into alignment". He is also probably correct in stating that the problem posed by the institution-specific application of fair value accounting is more manageable for financial institutions. But, until we do achieve full fair value accounting on both sides of the balance sheet, difficulties will remain.

Another major bone of contention that Professor Peasnell identifies is the fair value accounting of liabilities. Apart from the measurement difficulties, which he deals with in detail, this certainly poses problems for regulators and, by association, rating agencies. It is entirely sensible for the fair value of banks' liabilities to drop after a ratings downgrade. The snag, however, is that this leads to an increase in equity, which does not possess any solidity in a sudden-collapse "scenario". Thus, in an emergency dissolution of the bank in question this extra equity would prove to be

non-existent. The compromise we have arrived at is to show as a liability on our spreadsheet the amount the bank is contractually obliged to pay but to record any deduction (or addition) made in order to report the liability at fair value as a credit (i.e. a negative) balance in “Other Liabilities” rather than in “Equity”. As part of our so-called “soft factor” analysis, i.e. that reported outside our analytical spreadsheet, we discuss in the narrative of our rating report just how much reliance may be placed on this quasi-equity in the analysis of the loss-absorbing capital we consider to be available to protect third-party creditors.

Professor Peasnell makes the point that, if both financial assets and liabilities are fair valued, then any increase in equity resulting from the fair valuation of liabilities will be countered by the loss resulting from the opposite fair valuation of assets. As he says, “However, if financial assets were also fair valued, then the vanishing liabilities of a credit-impaired enterprise would presumably be accompanied by vanishing assets; otherwise it is difficult to see how credit impairment can be deemed to have taken place.” Unfortunately, however, this is not what is happening at present: most banking assets continue to be held at historic cost less what are still effectively loan loss reserves, and we do not have great faith in the ability of these to achieve a convincing fair value for bank lending.

Nevertheless, I agree with Professor Peasnell that: “The economic effects of macro hedging that has the goal of generating profit by taking specified risks subject to value at risk management controls will be properly reflected in income only if both the financial liabilities and the hedging assets are marked to market; any resultant gains

and losses on the net position will reflect the risk-return trade-off the entity has made."

Professor Peasnell refers in his paper to the phenomenon of "securitization", which in recent years banks have liberally exploited in order, among other more commendable things, to pull the wool over the eyes of investors, regulators, auditors and rating agencies. He suggests that securitized assets should leave the sponsor bank's balance sheet at "exit" price, which is to all intents and purposes a fair value. However, I consider that fair valuation should be extended to cover the recording in the sponsoring bank's books of the credit risk it retains in a securitization in the shape of a remaining stake in any so-called "first loss piece". A beneficial consequence of IFRS is the requirement that banks should consolidate their securitizations, thereby forcing them to recognize this risk.

Professor Peasnell refers to banks' long-established reliance on the comfort blanket of various kinds of hidden reserves. Even the US banks with their longer tradition of "full disclosure" have on occasions in effect resorted to this. One of the principal purposes of such reserves is to smooth out "volatility". A fear expressed by banks in anticipation of IFRS was that, since rating agencies do not like volatility and volatility is an inevitable consequence of IFRS, their ratings would be lowered. However, in its analysis of banks Fitch imposes a measure of recurring, core, operating profit. This takes care of much of the profit volatility likely to arise, enabling analysts to adjust for non-core operating items identified from IFRS' fuller disclosure. Remaining volatility may be largely attributable to any fair-valued derivatives that are hedging assets or

liabilities accounted for at amortised value. Any such volatility is a spur to analysts to investigate the purpose and execution of banks' hedging policy and procedures.

Fitch Ratings also has a long-standing concept of core, loss-absorbing capital for banks, which complements IFRS. It excludes much of the volatility in reported equity, which originates in the net revaluation of "available for sale" investments and loans, fixed asset revaluations and the foreign currency translation reserve. IFRS' great boon is more information, and to downgrade a bank effectively on the grounds that it was too generous in its provision of data would be crass in the extreme.

I should perhaps explain here that despite the widespread view held in the banking sector and among financial journalists, we do not measure capital in terms of the Basel Committee's Tier 1, Tier 2 and Total Capital. Rather we have a concept of "loss-absorbing capital". This consists of two elements. The first is CORE CAPITAL. This is common equity plus loss-absorbing minorities, less goodwill, deferred tax assets/receivables and deferred acquisition costs (i.e. "DAC", an accounting practice in insurance business intended to delay recognition of the costs of acquiring new business). The second element is ELIGIBLE CAPITAL. In our 27th July 2005 Criteria Report, "*Bank Hybrid and Preferred Securities: Evaluating Their Role in Capital Analysis*" Fitch introduced the concept of qualifying loss-absorbing capital, which we refer to as "eligible capital". Hybrid debt is eligible for inclusion in this measure of a bank's capital base up to a limit of 25% of that base, but with the proviso that cumulative hybrids should be discounted to 80% of their nominal value. In addition, "Class A" hybrids (defined as non-cumulative instruments with no step-up or call features) may account for a further 10% of total eligible capital, so that, in

aggregate, Class A plus other eligible hybrids may account for 35% of eligible capital. The rest of eligible capital is core capital, which I have already explained.

Fitch also has a concept of "comprehensive income", which differs from the current IFRS net income concept. It excludes movements in cash flow hedges but includes all the other movements in the so-called "Statement of Recognised Income and Expense" (SORIE), i.e. changes in the value of AFS investments, currency translation differences and other gains/losses not included in published net income and the movement in the balance sheet account, "Revaluation Reserves". Fitch excludes amounts recorded in the SORIE and revaluations otherwise taken directly to equity from eligible capital – except for changes in actuarial pension fund obligations, which are taken into account and usually constitute a deduction from eligible capital.

I realize that we may be accused of contradicting ourselves in so far as, having welcomed the introduction of IFRS, we then take steps ourselves to smooth out much of the resulting "volatility". Some of this would go if full fair value accounting were adopted; the rest is grist to our analytical mill. For example, as Professor Peasnell says, "traditional hedge accounting rules allowed such gains and losses (i.e. unmatched gains and losses on different sides of a hedge) to be hidden." Now we can at least see some of these and ask management for explanations.

I also realize that I have not yet done justice to Professor Peasnell's concept of institution-specific value. As he says, a large proportion of financial assets and liabilities is now dealt in in some form of market and this should establish a fair value. At present the greatest lack of any market valuation pertains to bank lending. To deal

with this IFRS use the concept of “impairment”, which differs from the previously established procedure of loan loss provisioning. Unfortunately, the new concept involves just as much subjectivity as the old, and we, as a rating agency, are not normally privy to all the information the banks have to hand when making the necessary calculations. However, there are occasions when a bad credit has borrowed from a wide range of banks, and we can compare the varying levels of risk reserve set up by them and thereby reach our own view of fair value. Nevertheless, I consider that the day when we can obtain institution-specific fair values for individual banks’ lending is still a long way off.