Gertrude Tumpel-Gugerell: Elements for intervention on accounting issues

Speaking notes by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the colloquium “La juste valeur dans tous ses États”, organised by the Académie des Sciences et Techniques Comptables et Financières, Paris, 27 April 2010.

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Which are the issues related to the fair value for companies?

Fair value is an appropriate measurement for certain financial instruments, notably those that are held for trading (i.e. business model is to generate profits by buying/selling in the short term) and for which reliable market prices are readily available, as well as for derivatives. Indeed, given that many derivative contracts have a zero cost at inception, fair value accounting is crucial as it recognises the potential leveraged exposure on the balance sheet.

Fair value accounting mainly raises two issues: first, when to apply fair value measurement (conceptual considerations) and second, how to apply fair value measurement (operational challenges).

First, in our view fair value accounting does not provide decision-useful information to investors if the intention of an entity is to hold the assets until maturity or to settle the liabilities at their nominal amount at maturity. In these cases, recognising interim fair value changes simply heightens the volatility of the financial accounts, without providing actual “information content”. This is typically the case for the loan book of commercial banks.

Moreover, the ECB does not agree that an entity is required to record a gain when the fair value of its own debt falls due to a decrease in its creditworthiness. The rationale being that the entity could buy back the debt and realise the profit. However, in reality and especially in times of distress, an entity does not have readily available the extra cash to buy back their debt. The recognition of such misleading gains was particularly prevalent in the case of Lehman that used it to net against the mounting losses, which simply blurred the entity's actual performance. As referred to in the recent book “Too big to fail” by Andrew Sorkin: “It means that the day before you go bankrupt is the most profitable day in the history of your company, because you'll say all the debt was worthless. You get to call it revenue. And literally (…) pay bonuses off this.” I think we can all agree that there is something fundamentally wrong with this argument.

Second, with regard to its application, fair value accounting poses certain operational challenges, namely when markets become illiquid and reliable market prices are no longer available. What is the use of marking-to-market when there is no market? The relevance and reliability of fair values based on market prices require a functioning market where prices adequately reflect the underlying fundamentals of the financial instrument. When the market is significantly disrupted, the use of market values may be utterly meaningless. In these cases, appropriate valuation techniques coupled with adequate guidance on the application of these techniques are needed in order to arrive at a reasonable estimate of the price at which an orderly transaction would currently take place between market participants. An entity should have in place adequate models that have been tested for accuracy in case the market is severely disrupted. Moreover, in rare circumstances, if the market dynamics are such that an institution may be forced to change its respective business model (i.e. shifting from a “day trading” to a “buy and hold” business model), then it should be able to reclassify financial instruments at amortised cost. These are important lessons to be learnt from the financial crisis.
Hence the ECB is of the opinion that fair value measurement should only be required if it is consistent with the institution’s business model and the characteristics of the particular underlying asset or liability.

**Which would be the worst drawbacks, if any, deriving from applying fair value in the light of the events happened in the last two years? Which are the positive aspects?**

In my view, the financial crisis has clearly highlighted the heightened pro-cyclicality stemming from two mutually reinforcing channels in the accounting framework: fair value accounting and the current loan loss provisioning practices (impairment methodologies).

Fair value accounting – while certainly not being the “root cause” – served as an amplifier of stress in the financial system. Fair value measurement – by its nature – tends to introduce pro-cyclicality into the accounting framework. It requires the immediate reflection of market-related information in the financial accounts (thus providing a “snapshot” of the reporting entity’s economic condition). In doing so, all fluctuations in fair value (even if only temporary) are to be reflected, thereby increasing accounting volatility.

Downward swings in fair valuations of assets cause entities to sell these assets; these “fire sales” may themselves add to further downward pressure on respective market prices. As a result, further adjustments to the fair values of these assets become necessary, thereby perpetuating the “downward dynamics”.¹ These dynamics may in the end have adverse implications for the “real economy”, e.g. banks may further curb their lending to the economy.

In this context, the potential impact of fair value accounting on behaviour, asset price dynamics and subsequently on financial stability should not be underestimated.

Pre-crisis provisioning practices delayed the recognition of credit losses inherent in loans. Accounting rules require a specific trigger event, such as a default in payment to take place before allowing an entity to create provisions for credit losses. As a result, major write-offs usually accumulate during severe downturns when the inherent credit losses actually materialise, adding further stress to the financial system.

Hence, a more forward-looking provisioning methodology should be developed. This has also been a recommendation of the G20 Leaders. In this context, the ECB welcomes the recent IASB proposal for an expected cash flow approach. Despite some operational challenges that need to be resolved before its final adoption, this approach allows for a timelier recognition of expected credit losses, thereby contributing to mitigating pro-cyclicality. In this context, it should be noted that the Basel Committee has recently developed an approach which aims at reducing the complexity of the IASB’s approach. The ECB urges the IASB to work together with the Basel Committee with a view to developing a workable solution to a more forward-looking provisioning approach.

This is also a good example of where the objectives of high quality accounting and safeguarding financial stability complement each other.

On that note, let me finally underline that the ECB acknowledges the work of the IASB and welcomes the progress that has been achieved in the accounting framework. We look forward to continuing the intense dialogue with the IASB on the remaining phases of the financial instruments’ project, as well as other accounting areas that may be of importance from a regulatory perspective.

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¹ It should be mentioned that the same dynamics may apply in a boom, albeit in the opposite direction, resulting in increasingly “optimistic valuations” and thereby fuelling additional lending.
As regards the convergence between the American implementation and the IFRS rules, which is your general view? More precisely, on which technical/conceptual points Europe will not give up?

One of the key lessons to be learnt from this crisis is the need for international accounting convergence. Towards this aim, G20 Leaders have urged accounting standard setters to develop a single set of high-quality accounting standards.

A global set of accounting standards is desirable from the perspective of both investors and regulators since it improves the comparability and transparency on a global basis. This contributes towards sounder investment decisions and thus to a more efficient allocation of resources as well as overall functioning of capital markets. Moreover, the financial crisis clearly revealed the shortcomings of different accounting rules on both sides of the Atlantic, as differences in rules contributed towards a lower degree of confidence in financial reporting.

For all these reasons, the ECB welcomes the ongoing efforts of the accounting standard setters to achieve fully compatible, high-quality accounting standards in a direct response to the G20 request. However, we are concerned to hear that the FASB and the IASB are still far from reaching a consensus on key accounting concepts, such as the classification and measurement of financial instruments. The IASB has confirmed a "mixed measurement model" that measures financial instruments both at amortised cost and fair value. In contrast, the US standard setter, the FASB, is determined to move towards a "full fair value model", claiming that only fair value provides decision-useful information to investors.

I have already mentioned in my intervention how the financial crisis has blatantly revealed the flaws with this measurement and how in certain circumstances, namely when markets are dislocated, applying full fair value accounting to the financial statements of the banking sector raises financial stability concerns and does not provide decision-useful information to investors.

Just to re-emphasise, the ECB strongly opposes a full fair value approach. In this context, convergence should not come at the expense of high-quality accounting standards.

Finally, with regard to recent assertions made by the IASB and FASB that convergence is on track, I would like to highlight that we are not so optimistic. In this regard, putting in place a reconciliation mechanism that simply discloses figures at amortised cost and fair value for each item on the balance sheet would certainly not achieve the aim of convergence.

As regards governance, which improvements do you envisage in relation to the elaboration of accounting rules?

First, I would like to stress that the ECB fully supports the concept of “independent accounting standard setting”. In their April 2009 DECLARATION ON STRENGTHENING THE FINANCIAL SYSTEM, when identifying the main areas of concern in the accounting area, the Leaders of the G20 never challenged this concept.

Second, the ECB very much welcomes the recent efforts of the IASB with a view to enhancing their public accountability. We appreciate the open dialogue between the IASB and various stakeholders, including prudential supervisors, on various accounting issues.

Having said that, the ECB would still like to see accounting standard setters take better account of financial stability implications when revising existing or creating new accounting standards, as for instance indicated by the IASB on the occasion of setting up the “enhanced technical dialogue” with prudential supervisors in 2009. One concrete and important area where the IASB can prove that it takes duly into account financial stability implications would be the on-going discussions on introducing more forward-looking provisioning.
In this sense, the ECB looks forward to continuing the close dialogue with the IASB on the accounting projects that lie ahead.

More generally, please indicate two essential measures for financial regulation in the current debate.

The ECB firmly believes that momentum should be maintained with regard to the global regulatory reform agenda. We need to ensure we put in place a regulatory framework that will enhance the resilience and stability of the global financial system. Under the aegis of the G20, the international community has agreed on a comprehensive set of measures that reflect a substantive revamp of the regulatory framework. Going forward, I would mention three key priority areas.

First, the global community should commit to implementing the so-called Basel III proposals on capital and liquidity issued in December of last year. The ECB supports these proposals which are designed to put banks in the position to better withstand the effects of future crises. At the same time, it is crucial to carefully assess the macro-economic impact of the measures. In this context, the outcome of the quantitative impact assessment that is currently being conducted needs to be awaited before taking any final decisions. Inappropriate calibration of the measures may impact on the provision of credit to the real economy. This is particularly relevant for the EU financial system which is more bank-dependent and where the substitutability between market finance and bank finance is more limited when compared to, for example, the US. The main challenge consists in ensuring a more resilient and stable financial system that neither compromises economic recovery nor unduly impinges on financial innovation.

Second, we need to ensure that we effectively capture all systemically important financial institutions, products, markets and infrastructures within the scope of regulation. One of the lessons from the crisis was the need to make the shadow banking sector more transparent. This becomes more urgent as we tighten the regulatory net for the banking sector. Otherwise we may simply shift risks to unregulated or more loosely regulated entities.

In this respect let me mention the OTC derivative markets. These markets should be subject to greater transparency by promoting the reporting of non-centralised trades to trade repositories. Additionally, we should promote the clearing of eligible OTC derivatives transactions through central counterparties, which should be themselves subject to high prudential and operational standards.

Finally, we need to effectively address the risks posed by systemically important financial institutions. In particular, we need to define a regulatory framework addressing the risks posed by large and complex financial institutions, and to discuss possible measures aimed to ensure a smooth winding-up of ailing systemically important financial institutions. It is crucial that a consistent framework is agreed at international level to avoid conflicting national regimes applied to multinational institutions and regulatory arbitrage. In this context, I strongly support the current work being carried out by the Financial Stability Board and the Basel Committee.