Fair-value Accounting Implications *for* Liquidity Risk Management

Applying fair-value accounting *across the board without careful thought to the impact on volatility of reported earnings and book capital could inadvertently cause instability.*

by David M. Rowe

The first article in this series appeared one year ago, in the October 2007 issue of *The RMA Journal*, at the same time as the near collapse of Northern Rock Bank in the U.K. Since then we have lived in interesting times. And few bankers would dispute that the Chinese saying "May you live in interesting times" is indeed a curse.

Despite the hardships of the past year, these events offer food for thought concerning the evolution of banking, bank supervision, and liquidity risk. In particular, this article considers the growing application of fair-value accounting and its impact on bank liquidity risk management, both individually and collectively.

Most analysts agree that the growing application of fair-value accounting to banks' activities has improved pricing discipline, made loan pricing more risk sensitive, and minimized opportunities to arbitrage banks versus the bond market. As described in an earlier article in this series,[1] this has been a 25-year transition from an originate-and-hold to an originate-and-distribute business model. As bank loans became more liquid and as securitization became a core operational strategy for most banks of significant size, pricing loans consistent with the market-determined cost of credit was essential.

While improved credit allocation is a net positive result of greater fair-value accounting, this series also has argued that fair value is not a complete measure of bank performance.[2] First, while mark-to-market values are based on all available public information, much of a bank's long-term value lies in confidential, nonpublic information. This difference plays an especially significant role in times of crisis, when market decisions are driven predominately by fear—especially fear of the unknown.

The experience of significant asset write-downs and the reported losses over the past year should get us thinking about the potential dangers of applying mark-to-market accounting across the board. Most analysts agree that markets probably have overreacted in their markdowns of structured assets. This overreaction is quite understandable given the lack of transparency around the underlying collateral and uncertainty about how the complex structuring will play out over time. Nevertheless, it probably overstates the impact of subprime mortgage defaults on the ultimate recovery value of these assets.

Overreaction or not, the write-downs also have triggered significant knock-on effects. Much of the sudden paralysis in the interbank lending market was due to concern over which bank might be next to record sudden asset write-downs and accounting losses. One traditional role for historical cost accounting has been to mask some of the short-term shifts in market value. This produces an accounting balance sheet that attempts to show a longer-term, through-the-cycle perspective on asset values rather than an immediate fair-value representation.

Of course, this approach has problems of its own. It failed to reflect the balance sheet impact of interest rate increases on fixed-rate loans as interest rates ballooned in the late 1970s. This allowed many savings and loan associations to mask the severe damage these rate increases were inflicting on long-term viability until their circumstances became truly dire. At the time, there were few effective tools, such as interest rate swaps, to allow effective hedging of the maturity mismatch between assets and liabilities. With such tools readily available today, one argument for broader application of fair-value accounting is that it sharpens the incentive for effective asset/liability risk management. A look at the (partial) balance sheet of U.S.-chartered commercial banks, however, offers reason to proceed with caution.

As shown in the table, almost half of U.S.-chartered commercial bank liabilities are in the form of either checkable or small time and savings deposits, while over three-quarters of their credit extensions are in the form of loans. It seems clear that if the full loan book were marked to market based on prevailing interest rates, it would be more volatile than the large base of short-term and fairly rate-insensitive deposits. The short maturity of these deposits effectively guarantees their relative stability.[3]

A potentially more serious impact arises not from general interest rate movements but from increased credit spreads in an economic downturn. Such increases correspond to the depressed value of corporation bonds during a recession and, with full mark-to-market accounting, would have to be reflected in lower loan asset values. In a full mark-to-market regime, this fall in total asset value would flow directly through P&L and into a decline in the book value of capital.

As we have been reminded repeatedly in the past year, banking is a business built on confidence. When that confidence is shaken by negative events, market reaction can significantly magnify the damage caused by the initial events themselves. Erosion of normal funding sources is the most common manifestation of this vicious cycle. Do we really want to force all short-term cyclical fluctuations in the valuation of credit-risky assets through officially published bank P&L statements? Are we confident that not just sophisticated market professionals but the public at large will assess these cyclical impacts on earnings from a sensible long-term perspective?

Table 1

U.S.-Chartered Commercial Banks' Balance Sheet (Partial)*
Q1 2008 (in billions)

Total loans	6,116	77%
Treasury, GSE, municipal, corporate, and foreign bonds	1,761	22%
Corporate equities and mutual fund shares	59	1%
Total bank credit	7,936	
Checkable plus small time and savings deposits	4,697	49%
Large time deposits and corporate bonds	1,185	12%
Other liabilities	3,710	39%
Total liabilities	9,592	

*Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States.

In today's world of 24-hour news and instant global communication, self-reinforcing waves of optimism and pessimism can spread with alarming speed. Applying fair-value accounting across the board without careful thought to the impact on volatility of reported earnings and book capital could cause the system to stumble inadvertently into an unstable situation. One can imagine a scenario in which the cyclical erosion in capital ratios triggers the prompt corrective-action elements of FDICIA. This, in turn, could trigger deposit disintermediation and force banks to borrow or raise capital in the most inopportune environment, where the market's perception of the banks' risk is artificially inflated. The role of the Federal Reserve as the lender of last resort could very plausibly come under unexpected stress in such a scenario.

Fair-value accounting offers many benefits in the form of more rational pricing of credit risk, but we need to beware of unintended consequences. Perhaps in the cold light of the morning after the subprime mortgage crisis, the current ugly duckling we call a mixed-attribute accounting model will look more like a beautiful swan than we ever imagined. ❖

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Notes

1. Rowe, David, and Day, Thomas, "Credit Risk Management's 25-Year Transformation," *The RMA Journal*, October 2007, pp. 40-46.

2. Rowe, David, and Day, Thomas, "Accounting Rules, Risk-based Pricing, and Reporting Arbitrage," *The RMA Journal*, December 2007-January 2008, pp. 56-61.

3. This is ironic, to a degree. As my former colleague Tom Day is fond of saying, one of a bank's biggest "assets" is its ability to maintain a stable base of attractively priced retail deposit liabilities. Indeed, the attractiveness of these deposits increases as rates rise.