Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting

OFFICE OF THE CHIEF ACCOUNTANT
DIVISION OF CORPORATION FINANCE

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

This is a report by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.
Executive Summary

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“EESA” or the “Act”) was signed into law.1 Section 133 of the Act mandates that the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) conduct, in consultation with the Board of Governors of the Federal Reserve System (“Federal Reserve”) and the Secretary of the Treasury, a study on mark-to-market accounting standards as provided by Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standards (“SFAS”) No. 157, Fair Value Measurements (“SFAS No. 157”).2

As discussed further in this study, SFAS No. 157 does not itself require mark-to-market or fair value accounting. Rather, other accounting standards in various ways require what is more broadly known as “fair value” accounting, of which mark-to-market accounting is a subset. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles (“GAAP”), and requires expanded disclosures about fair value measurements. However, to ensure that this study was responsive to the policy debate discussed below, for purposes of this study the SEC Staff (the “Staff”) considered the issue of fair value accounting in this larger context, including both mark-to-market accounting and SFAS No. 157.

The events leading up to the Congressional call for this study illustrated the need for identifying and understanding the linkages that exist between fair value accounting standards and the usefulness of information provided by financial institutions. In the months preceding passage of the Act, some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under SFAS No. 157, contributed to instability in our financial markets. According to these critics, fair value accounting did so by requiring what some believed were potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result of inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities. These voices pointed out the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions, highlighting that this correlation could lead to the failure of long-standing financial institutions if sufficient additional capital is unavailable to offset investment write-downs. Further, they believed the need to raise additional capital, the effect of failures, and the reporting of large write-downs would have broader negative impact on markets and prices, leading to further write-downs and financial instability.

Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public. These participants indicated that fair value information is vital in times of stress, and a suspension of this information would weaken investor confidence and result in further instability in the markets. These participants pointed to what they believe are the root causes of the crisis, namely poor lending decisions and inadequate risk management, combined with shortcomings in the current approach to supervision and regulation, rather than accounting. Suspending the use

1 Pub. L. No. 110-343, Division A.
2 See Section 133(a) of the Act.
of fair value accounting, these participants warned, would be akin to “shooting the messenger” and hiding from capital providers the true economic condition of a financial institution. These participants noted that they were aware of the arguments about the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions. However, they pointed out that adjustments to the calculation of regulatory capital, like those adjustments currently in place for “available-for-sale” (“AFS”) securities, can be made to reduce this correlation where appropriate.3

As the debate intensified in late September of 2008, SEC Staff and the FASB staff issued a joint press release clarifying the application of SFAS No. 157.4 This joint release clarified the measurement of fair value when an active market for a security does not exist. On October 10, 2008, the FASB issued FASB Staff Position (“FSP”) 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (“FSP FAS 157-3”), which further clarified the application of fair value measurements.

Currently, the debate over fair value measurements extends beyond national borders and is being considered internationally by the International Accounting Standards Board (the “IASB”), the standard-setting body for international financial reporting standards (“IFRS”), and other global market participants. To coordinate international efforts, and address issues such as fair value measurements that have arisen from the global economic crisis, the IASB and FASB (the “Boards”) created a global advisory group comprising regulators, preparers, auditors, and investors.

As a result of both domestic and international concern, it has become clear that a careful and thoughtful consideration of all competing viewpoints is necessary to determine what further action may be appropriate. The credibility and experience of parties on both sides of this debate demand careful attention to their points and counterpoints on the effects of fair value accounting on financial markets. Moreover, a broader understanding of the prevalence of fair value accounting relative to other measures of fair value that do not immediately impact a financial institution’s income or capital requirements is needed to narrow the issues to those most relevant to the debate.

For many years, accounting standards have required measurement of financial instruments on a financial institution’s balance sheet at fair value. In some cases, for example when securities are actively traded, changes in fair value are required to be recognized in the income statement. This is the specific meaning of “mark-to-market” accounting. However, in most other cases, such changes in fair value are generally reported in other comprehensive income (“OCI”) or equity, and these changes do not flow through to income unless an impairment has occurred.

3 AFS securities are measured at fair value on a financial institution’s balance sheet with changes in fair value generally reported in a balance sheet line called accumulated other comprehensive income, or equity. The Staff understands that changes in fair value reported in other comprehensive income or equity are generally excluded from regulatory capital ratios. On the other hand, consistent with safety and soundness objectives, losses on assets that are reflected in income and retained earnings in accordance with U.S. GAAP are generally recognized in regulatory capital.

It is also important, as noted above, to clearly demarcate the difference between the accounting standards that require measurement of financial instruments at fair value and SFAS No. 157, which only provides guidance on how to estimate fair value. This demarcation is important when considering the focus of this study as well as its recommendations.

Although not mandated for study by the Act, the Staff believes that it is important to recognize what many believe to be the larger problem in the financial crisis that led to the financial distress at financial institutions other than banks, including The Bear Stearns Companies, Inc. (“Bear Stearns”), Lehman Brothers Holdings Inc. (“Lehman”), and Merrill Lynch & Co., Inc. (“Merrill Lynch”). Rather than a crisis precipitated by fair value accounting, the crisis was a “run on the bank” at certain institutions, manifesting itself in counterparties reducing or eliminating the various credit and other risk exposures they had to each firm. This was, in part, the result of the massive de-leveraging of balance sheets by market participants and reduced appetite for risk as margin calls increased, putting enormous pressure on asset prices and creating a “self-reinforcing downward spiral of higher haircuts, forced sales, lower prices, higher volatility, and still lower prices.” The trust and confidence that counterparties require in one another in order to lend, trade, or engage in similar risk-based transactions evaporated to varying degrees for each firm very quickly. What would have been more than sufficient in previous stressful periods was insufficient in more extreme times.

A. The Organization of this Study

As mandated by the Act, this study addresses six key issues in separate sections. Issues were studied using a combination of techniques, which are described in each of the respective sections. Where practicable under the time constraints of this study, data was analyzed empirically and obtained from a broad-based population that included a cross-section of financial institutions.

For issues that did not lend themselves to empirical analysis, alternative methods were undertaken, including Staff research of public records, analysis of public comment letters received regarding this study, and the hosting of three public roundtables to obtain a wide range of views and perspectives from all parties. Careful attention was given to maximize the opportunities for both proponents and opponents of fair value measurements to be heard.

This study is organized into seven sections, beginning with an introductory section that outlines in greater detail the mandate for this study under the Act and background information intended to provide readers with a common base of knowledge. Each of the remaining six sections addresses one of the issues mandated for study. The following highlights each of these six sections.

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5 Testimony of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, before the Committee on Banking, Housing and Urban Affairs of the United States Senate on Actions by the Federal Reserve Bank of New York in Response to Liquidity Pressures in Financial Markets (April 3, 2008).
1. **Effects of Fair Value Accounting Standards on Financial Institutions’ Balance Sheets**

This section explores the effects of fair value accounting standards on financial institutions’ balance sheets. In the debate concerning fair value accounting, some assert that accounting standards that require fair value accounting may inappropriately affect the balance sheets of financial institutions. This section studies those concerns by analyzing a sample of fifty financial institutions that were selected from a broad-based population of financial institutions in our markets.

The effects of fair value accounting standards on each financial institution was studied to gauge the prevalence of assets measured at fair value on the balance sheet and the subset of those assets that are also marked-to-market through the income statement. This study also evaluated, among other items, the level within SFAS No. 157’s fair value hierarchy in which assets fell. Information was analyzed by type of financial institution to draw out common characteristics and dissimilarities that may exist within each industry type.

From the sample of financial institutions studied in this section of the study, the Staff observed that fair value measurements were used to measure a minority of the assets (45%) and liabilities (15%) included in financial institutions’ balance sheets. The percentage of assets for which changes in fair value affected income was significantly less (25%), reflecting the mark-to-market requirements for trading and derivative investments. However, for those same financial institutions, the Staff observed that fair value measurements did significantly affect financial institutions’ reported income.

2. **Impact of Fair Value Accounting on Bank Failures in 2008**

This section analyzes possible linkages between fair value accounting and bank failures occurring during 2008. Some have asserted that fair value accounting contributed to the failure of one, or more, financial institutions during 2008.

For purposes of studying this issue, banks were grouped based on asset size. Within each group, this study evaluated banks’ use of fair value measurements over time by analyzing data over a period of three years. The Staff also analyzed the key drivers of regulatory capital to evaluate the impact of fair value measurements on capital adequacy relative to other factors, such as incurred losses on loans.

The Staff observes that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.

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6 SFAS No. 157’s fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets (Level 1) and the lowest priority to unobservable inputs (Level 3).
3. **Impact of Fair Value Accounting on the Quality of Financial Information Available to Investors**

This section describes investors’ views related to the usefulness of fair value accounting. Proponents of fair value accounting assert the importance of such concepts to the transparency of financial information provided to investors. To evaluate those assertions, the Staff considered how fair value accounting and fair value measurements are used by investors.

The Staff considered a broad spectrum of investor perspectives, including those focused on both debt and equity analysis. The sources of information included Staff research of published investor views, analysis of comment letters received by the Commission on this topic, and consideration of the views expressed during a series of three roundtables hosted by the Commission. In addition, the Staff surveyed academic research on the topic and the conclusions of two recent federal advisory committees that addressed fair value accounting as part of their respective mandates.

The Staff’s research on this issue reflects that, based on these sources, investors generally support measurements at fair value as providing the most transparent financial reporting of an investment, thereby facilitating better investment decision-making and more efficient capital allocation amongst firms. While investors generally expressed support for existing fair value requirements, many also indicated the need for improvements to the application of existing standards. Improvements to the impairment requirements, application in practice of SFAS No. 157 (particularly in times of financial stress), fair value measurement of liabilities, and improvements to the related presentation and disclosure requirements of fair value measures were cited as areas warranting improvement.

4. **Process Used by the FASB in Developing Accounting Standards**

This section outlines the independent accounting standard-setting process in the U.S. A key aspect of this study mandates consideration of the viability and feasibility of modifications to accounting standards that require fair value accounting. To properly understand the viability and feasibility of such modifications, a complete understanding of how accounting standards are developed and promulgated is important.

The Staff’s analysis of the FASB’s processes used to develop accounting standards reaffirms that an independent accounting standard-setter is best positioned to develop neutral and unbiased accounting guidance. The Staff believes that while the FASB’s process works well for this purpose, there are several steps that could be taken to enhance the existing procedures. These recommendations include steps that could enhance the timeliness and transparency of the process. For example, to be responsive to the need to timely identify and address challenges encountered in the application of standards in practice, key participants in the capital markets need to communicate and understand these challenges as they arise. To facilitate the more timely identification and resolution of issues, the Staff believes that it is advisable to move quickly to implement the recommendation of the SEC Advisory Committee on Improvements to Financial Reporting (“CIFiR”) related to the creation of a financial reporting forum (“FRF”).
5. Alternatives to Fair Value Accounting Standards

This section examines the potential alternatives to fair value measurements. During the recent debate leading to the mandate for this study, some have considered the feasibility of suspending SFAS No. 157. This section first addresses the specific consequences of suspending the guidance in SFAS No. 157, which would not itself change fair value accounting requirements, but rather remove the currently operative guidance for implementation. This section also discusses whether it would be prudent to modify the guidance on fair value measurements that currently exists.

This section also examines consideration of a suspension of fair value accounting itself, including the positives and negatives of available alternatives, such as historical cost-based measures. Valuable insights and thoughts for this section were obtained through review of academic research, comment letters received on this study, and also from the perspectives of participants at the three public roundtables hosted by the Commission.

Through its study of this issue, the Staff found that suspending SFAS No. 157 itself would only lead to a reversion of practice, resulting in inconsistent and sometimes conflicting guidance on fair value measurements. As to alternatives to fair value accounting, while such alternative measurement bases exist, each alternative exhibits strengths and weaknesses, as well as implementation issues. Considering evidence regarding the usefulness of fair value information to investors, the suspension of fair value accounting to return to historical cost-based measures would likely increase investor uncertainty. However, given the significant challenges encountered in practice related to implementing existing standards, additional actions to improve the application and understanding of fair value requirements are advisable. Such additional measures to improve the application should include addressing the need for additional guidance for determining fair value in inactive markets (including examining the impact of illiquidity), assessing whether the incorporation of credit risk in fair value measurement of liabilities provides useful information to investors, and enhancing existing presentation and disclosure requirements.

One of the most significant concerns expressed regarding existing fair value standards is the current state of accounting for impairments. Currently there are multiple different models applied in practice for determining when to record an impairment for investments in securities. Additionally, existing impairment guidelines for securities are not consistent with the reporting guidelines for impairment charges for other non-securitized investments (e.g., direct investments in loans). Accordingly, investors are provided information that is not recognized, calculated, or reported on a comparable basis. Further, under existing presentation requirements, investors are often not provided sufficient information to fully assess whether declines in value are related to changes in liquidity or whether declines relate to probable credit losses. In addition, subsequent increases in value generally are not reflected in income until the security is sold. The Staff believes that the existing impairment standards should be readdressed with the goal of improving the utility of information available to investors.
6. Advisability and Feasibility of Modifications to Fair Value Accounting Standards

This final section summarizes steps taken and underway to improve upon current accounting requirements. This section also provides recommendations on the advisability and feasibility of modifications to existing accounting standards and related financial reporting requirements, which are discussed below.

B. Recommendations

The recommendations, and the observations leading to the related recommendations, are described in detail in the final section of this study. For ease of reference, the following table provides an executive summary of the recommendations based upon the observations of this study. To facilitate an understanding for how each recommendation was developed, each recommendation below is associated with relevant observations that indicated a need for action or improvement.

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<thead>
<tr>
<th>Recommendation #1</th>
<th>Observations</th>
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<tbody>
<tr>
<td>SFAS No. 157 should be improved, but not suspended.</td>
<td>• The guidance in SFAS No. 157 does not determine when fair value should be applied. SFAS No. 157 only provides a common definition of fair value and a common framework for its application.</td>
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<td>• Suspending SFAS No. 157 itself would only revert practice to inconsistent and sometimes conflicting guidance on fair value measurements.</td>
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<td>• Other recommendations address necessary improvements to existing standards.</td>
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<table>
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<tr>
<th>Recommendation #2</th>
<th>Observations</th>
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<td>Existing fair value and mark-to-market requirements should not be suspended.</td>
<td>• Fair value and mark-to-market accounting has been in place for years and abruptly removing it would erode investor confidence in financial statements.</td>
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<td>• Fair value and mark-to-market accounting do not appear to be the “cause” of bank and other financial institution failures.</td>
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<td></td>
<td>• Mark-to-market accounting is generally limited to investments held for trading purposes and for certain derivative instruments; for many financial institutions, these represent a minority of their total investment portfolio.</td>
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Over 90% of investments marked-to-market are valued based on observable inputs, such as market quotes obtained from active markets.

Investors generally agree that fair value accounting provides meaningful and transparent financial information, though improvements are desirable.

**Recommendation #3**

*While the Staff does not recommend a suspension of existing fair value standards, additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both Level 2 and Level 3 estimates).*

**Observations**

- Fair value requirements should be improved through development of application and best practices guidance for determining fair value in illiquid or inactive markets. This includes consideration of additional guidance regarding:
  - How to determine when markets become inactive
  - How to determine if a transaction or group of transactions is forced or distressed
  - How and when illiquidity should be considered in the valuation of an asset or liability, including whether additional disclosure is warranted
  - How the impact of a change in credit risk on the value of an asset or liability should be estimated
  - When observable market information should be supplemented with and / or reliance placed on unobservable information in the form of management estimates
  - How to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity

- Existing disclosure and presentation requirements related to the effect of fair value in the financial statements should be enhanced.
- FASB should assess whether the incorporation of changes in credit risk in the measurement of liabilities provides useful information to investors, including whether sufficient transparency is provided.
- Educational efforts to reinforce the need for management judgment in the determination of fair value estimates are needed.
- FASB should consider implementing changes to its Valuation Resource Group.
**Recommendation #4**  
*The accounting for financial asset impairments should be readdressed.*

**Observations**
- U.S. GAAP does not provide a uniform model for assessing impairments.
- The prominence of the measure “OCI,” where certain impairments are disclosed, could be enhanced by requiring its display on the income statement.
- For many financial institutions, financial assets marked-to-market through the income statement represent a minority of their investment portfolio.
- A large portion of financial institutions’ investment portfolios consist of AFS securities or loans, subject to challenging judgments related to impairment, which determines when such losses are reported in the income statement.
- Current impairment standards generally preclude income recognition when securities prices recover until investments are sold.

**Recommendation #5**  
*Implement further guidance to foster the use of sound judgment.*

**Observations**
- SFAS No. 157 is an objectives-based accounting standard that relies on sound, reasoned judgment in its application.
- Sound judgment is a platform from which to foster the neutral and unbiased measures of fair value desired by investors.
- Requests have been made for the Commission and the Public Company Accounting Oversight Board (“PCAOB”) to emphasize their support for sound judgment in the application of accounting and auditing standards.

**Recommendation #6**  
*Accounting standards should continue to be established to meet the needs of investors.*

**Observations**
- Investors, and most others, agree that financial reporting’s primary purpose is to meet the information needs of investors.
- Most appear to agree that fair value measurements provide useful information to investors, meeting their information needs.
- Beyond meeting the information needs of investors, general-purpose financial reporting has secondary uses that may be of additional
utility to others, such as for prudential oversight.

- General-purpose financial reporting should not be revised to meet the needs of other parties if doing so would compromise the needs of investors.

### Recommendation #7

**Additional formal measures to address the operation of existing accounting standards in practice should be established.**

### Observations

- While the existing FASB process works well, steps could be taken to enhance the process.
- After adoption of new accounting standards, unforeseen implementation issues often may arise.
- An independent accounting standard-setter is best equipped to address broadly effective implementation issues that arise from the adoption of a new accounting standard.
- Independent accounting standard-setters are well served by the input received from a broad spectrum of constituents.
- Critical to the success of an independent accounting standard-setter is its timely responsiveness to the information needs of investors.

### Recommendation #8

**Address the need to simplify the accounting for investments in financial assets.**

### Observations

- The prominence of OCI could be enhanced by requiring its display on the income statement.
- Many investors feel that clear disclosure of the inputs and judgments made when preparing a fair value measurement is useful.
- While a move to require fair value measurement for all financial instruments would likely reduce the operational complexity of U.S. GAAP, the use of fair value measurements should not be significantly expanded until obstacles related to such reporting are further addressed.