BANCO DE ESPAÑA

Fair Value Accounting

Conference on “Procyclicality in the financial system”

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Outline

- The information in financial statements must be relevant, reliable and comparable in order to promote greater market discipline, confidence and, all in all, a better allocation of resources that internalise the information present in financial markets

- **Cost-based accounting has been inadequate in providing a true and fair view of companies** (e.g. financial derivatives)

- **Fair value is the best accounting standard** for providing final users of financial statements with relevant, reliable and comparable information

- **But** as the current crisis in the international financial system has highlighted **fair value has its own limitations**

Is it possible to improve fair value?

Limitations of fair value (1)

- Subjectivity
  - In many cases estimating fair value involves the use of **valuation methods**: valuation will be affected by the **judgement** of those who have to developed a model
  - **Model risk**
  - Moral hazard problems: **cherry-picking specific parameters** or assumptions
- Volatility
  - **Markets conditions are taken into account in a specific time**: P&L accounts would be excessively influenced by these potentially very temporary market conditions
  - **Transmission of these greater volatility to capital**
- Excessive emphasis on the short term
  - As a result of greater volatility the use of fair value might create **perverse incentives in banks' management decisions: too much emphasis to the short term**

Limitations of fair value (2)

- **The crisis in the international financial system has highlighted these and other related shortcomings of fair value**

- When markets dried up, many financial institutions have been obliged to resort more to market-to-model valuations. **The problems have been more relevant regarding complex products developed in recent years under the originate-to-distribute banking model**

  - **Quantitative limitations:**
    - *Valuation models have not properly captured the characteristics of the most complex products. Even more, models were design under benign economic conditions*
  - **Qualitative limitations:**
    - *Governance problems: systems have not been appropriately designed to verify and test the valuations made*
  - **Lack of transparency:**
    - *The information reported to the market does not appear to have been sufficient*

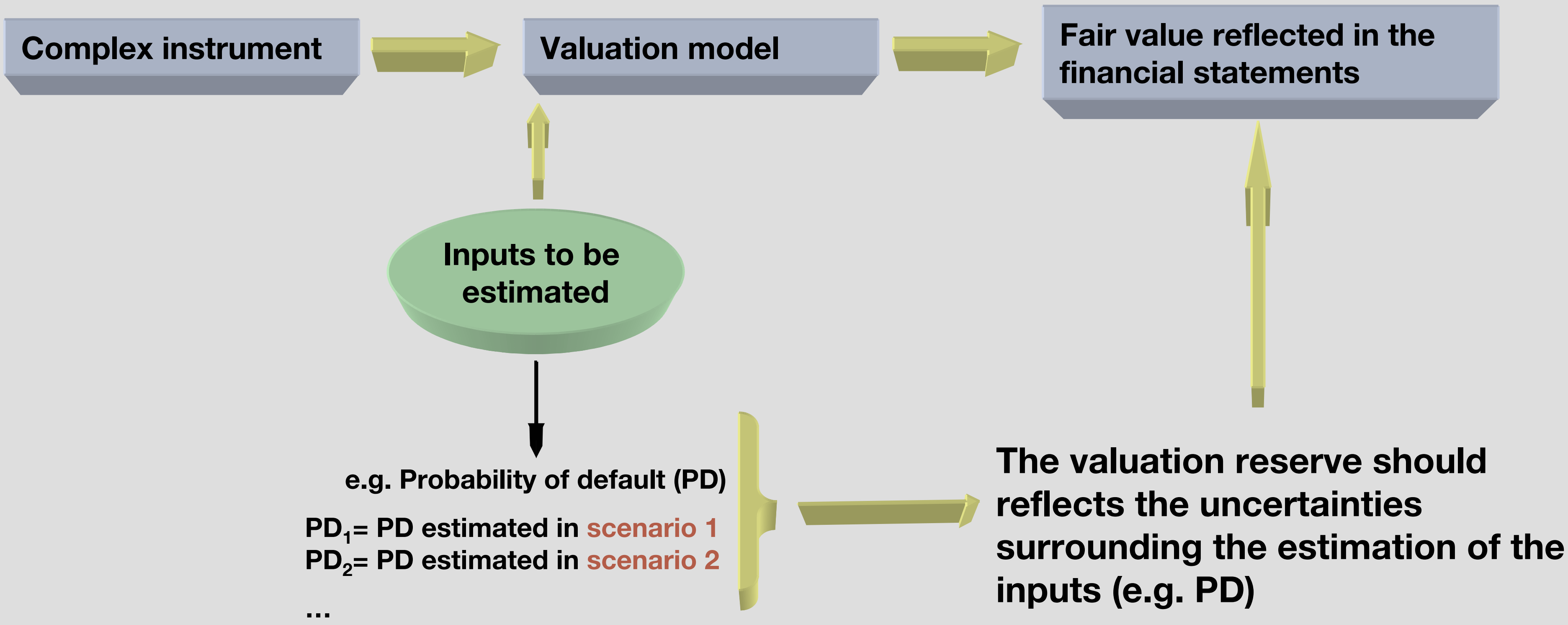
Limitations of fair value (3)

- All these limitations in the design of the fair value, as well as shortcomings in its implementation have affected management and investment decisions …
- … **particularly exacerbating the procyclical behaviour of financial markets, because fair value have introduced incentives to increase leverage and mispricing risks**
  - Procyclicality is an intrinsic characteristic of financial markets, but beyond a certain point it generates highly adverse effects on long-term growth prospects: “excessive procyclicality”
  - But surprisingly there has been very little debate until recently about the procyclical implications of accounting rules
- Nevertheless, and answering the question I have formulated in the first slide, **it is not only possible to improve fair value, but necessary**
- **I will suggest two specific mechanisms and some general principles for the review of fair value**

Improving fair value: valuation reserves (1)

- Institutions could set aside **valuation reserves for those more complex structured products that are market-to-model**

- Valuation reserves would **recognise the uncertainty associated with the calculations of fair value under specific circumstances**

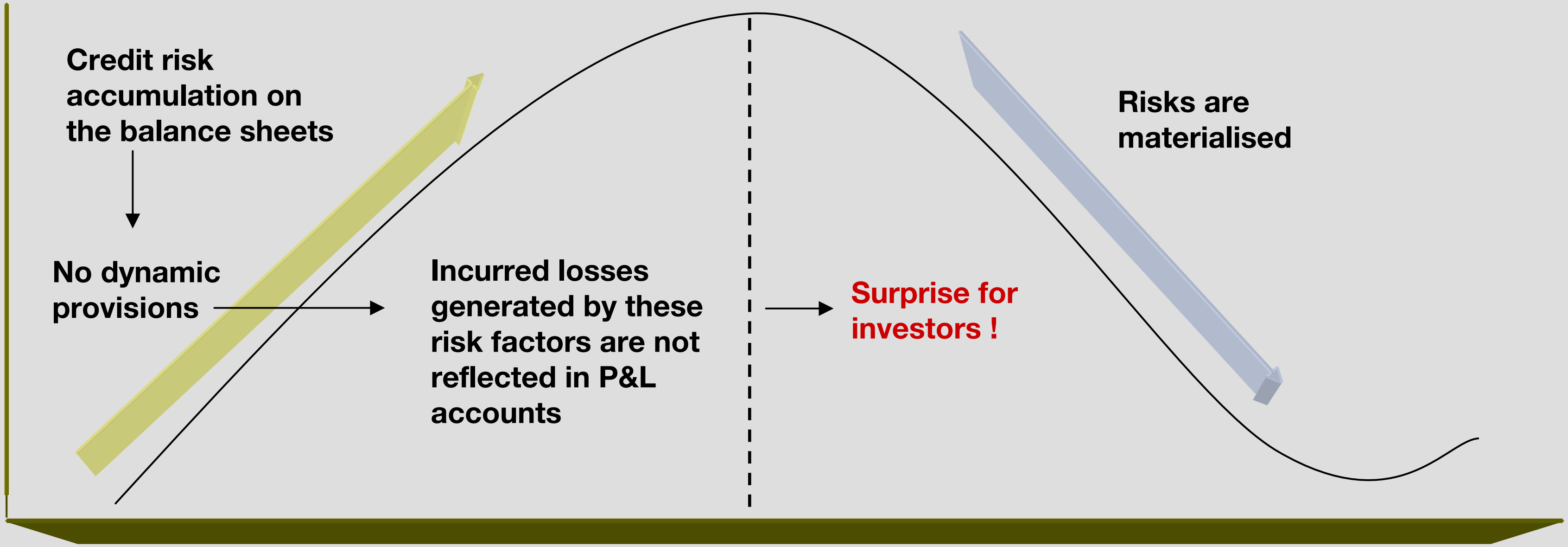


Improving fair value: valuation reserves (2)

- **Valuation reserves should satisfy certain conditions:**
  - **Objective**
  - **Transparent**
  - **Symmetrical**
    - *These reserves have to function both in the good times of the cycle and when the economic conditions turn adverse*
  - **Act at all times**
    - *Is during good times when agents act with excessive optimism*

Improving fair value: dynamic provisions (1)

- **Correct valuation of loans should include** specific losses but also **the factors of risk that can not be specified at the level of individual loans, but that have generate losses that the institution is aware it has incurred**
  - **It is not reasonable that investors should be surprised in the future by what is already known it is going to happen**
  - Both supervisory experience and economic literature show that the **risks that are materialised after a period of rapid credit growth have been built up during the expansionary phase** of the cycle



Improving fair value: dynamic provisions (2)

- For all these reasons **dynamic provisions should be considered as an approximation to the fair value of banks' loan portfolios**

  – They mitigate the fact that, at good times of the economic cycle, risks are build up but are only disclose with a delay in the P&L account of the financial institutions,

  – … in other words, dynamic provisions **offer a truer and fairer view of financial institutions**

  – Moreover, and importantly, they **contribute to reduce the procyclicality of accounting rules**, and more general, the procyclical behaviour of financial market participants

- Dynamic provisions, as valuation reserves, **should be objective and transparent**

Improving fair value: general principles

- **Search for better valuations**
  - Quantitative aspects of valuations models
  - More realistic view of the risks and benefits of the activity throughout the cycle
- **Minimise the procyclical impact induced by fair value**
  - Valuation reserves and dynamic provisions are two examples
- **Governance**
  - Qualitative aspects when implementing fair value are relevant (models should be tested by independent units etc.)
- **Transparency**
  - Investors need to have proper information (volume of exposures valued at fair value, valuation method and inputs etc.)

Conclusion

- **Fair value is the best accounting standard** for providing final users of financial statements with relevant, reliable and comparable information

- **But it is necessary to improve it**

  – **To strengthen the relevance, reliability and comparability of information …**

  – **To make it compatible with best practices in risk management**

  – **To minimise the "excessive procyclicality"** induced by accounting standards

- **Objective and transparent valuation reserves and dynamic provisions can contribute to this process of improvement of fair value**

Thank you for your attention