

CSFI

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Marking to model... Is it the root of the CDO problem? Does it have a future? A round-table discussion with John Hitchins (PwC), Richard Thorpe (FSA), Michael Thomas (Alliance & Leicester), Gavin Francis (IASB) and Jennifer Hughes (Financial Times) held Monday, June 2, 2008 at Innholders' Hall, 30 College Street, London EC4R 2RH, from 12:30-2:15pm

What was billed by the CSFI as an “arcane” issue attracted a standing-room only roundtable. Hardly surprising given the role that “fair value” valuation of structured finance products intended to be held to maturity have had in the financial crisis. The lack of readily observable market prices in non-liquid markets has led to firms using techniques such as models to determine valuations. The first speaker said fair value – the lynchpin of mark-to-market – was still the most sensible way of measuring assets held over the short term. The issue was whether it was useful for assets held to maturity. One problem was that participants had unrealistic expectations of getting a single price for a single instrument that was not traded.

The key was to look at the assumptions made, especially when the time horizon varies between institutions – what is a problem for a cash-strapped house will not be a problem for Barclays. It was important that the much-needed standardisation came from industry and not regulators who would lay down prescriptions learned from the last crisis. The best place to address these valuation issues is not a single number in the accounts but with more forward-looking views in the operating and financial review (OFR). One member was worried this would push accountants from a deterministic task – what is the right number? – towards a probabilistic one.

The second speaker said the Financial Service Authority’s concern was market confidence and there were signs fair value was producing some odd implications, such a 70% default rate. The market needs guidance on assumptions and issues such as impairment of assets. Indeed the Committee of European Securities Regulators is working on that. The Financial Stability Forum has suggested a group of banks agree a common valuation methodology.

The third speaker said there was nothing intrinsically impenetrable about a model – the problem came with trying to calibrate a market price using historical data or proxy indices. Prices can sometimes focus on a forced sale, which lead to trenches of debt being valued less than the underlying assets. An analogy was taking a Lucien Freud to a car boot sale 30 minutes before closing, being offered £50 and believing one had been wiped out. That is plainly not the case if you can afford to wait to realise the cash. It was therefore better to look at the expected cash flow from an asset. Accountants in the audience were sceptical and one asked what the verification process would be. Another said it was illogical to use cash flows to establish a price for something on the balance sheet.

The fourth speaker took a step back saying a general purpose financial statement served a different purpose for accountants versus regulators. Currently there is a market problem, based on poor lending, which itself was based on poor understanding. Fair value is not perfect but there is no real alternative, particularly for structured products. What fair value does is to bring some level of transparency of the position a company is in. Investors should not be shielded from that. Yes, getting fair value without a liquid market is difficult but the speaker believed it was the best way to reach an assessment, disclose uncertainties and leave investors to form a view.

The fifth speaker agreed there was not one simple single number. Fair value supported by disclosure was the best option– but better disclosure than at present. There have already been signs of that, with UK banks disclosing more than they need to because investors want more information. She cited the example of AIG reporting a writedown of \$11bn but forecasting an expected loss over time of \$900m. The fourth speaker agreed that disclosing both numbers served a useful purpose. They set a benchmark and the only alternative to fair value is not to recognise any numbers.

One member with memories of previous crashes such as the secondary UK banking crisis and the Latin American debt default said the real target should be to prevent a downward spiral. Markets needed pragmatic solutions to get trades moving and he feared that pure adherence to accounting standards would do the exact opposite. In the LatAm crisis half the banks involved would have gone bust – and the market knew it, cutting their share prices below their net asset value. At the worst of the crisis bonds were worth five cents in the dollar. But because banks lent the money to allow countries to repay their interest in the end no one lost any money as Latin America bounced back. In the secondary banking crisis, the banks agreed to launch the lifeboat after they became aware that failure to help would bring down one of their number. In today's situation the value of US property will come back so why force banks to write down the assets and then raise cash to offset that?

The fourth speaker said the problem was a shift from mark-to-market to mark-to-model that had not been anticipated. When no one can come up with a definite number it is simply best to disclose as much as possible. The fifth speaker echoed that saying one reason for volatility in the share price of US broker/dealers in the third quarter of 2007 was uncertainty which assets would be marked-to-model. The fourth speaker said a move from principles-based to rules-based regulation was inevitable. The organiser of the roundtable said the circuit breaker function should be provided by regulators not accountants, Accountancy is just another piece of evidence. Investors are not stupid. They have coped with pensions deficits and Vodafone's shift from record loss to record profit because of accounting treatment of Mannesman. Investors have an idea of fair value.