



LETTER OF COMMENT NO. 1

Testimony of

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### Reform of "Fair Value" Accounting

Mr. Chairman, Ranking Member Bachus, and members of the Subcommittee, thank you for the opportunity to present testimony on the immediate need to reform "fair value" accounting, which has made and continues to make the financial crisis worse than it needs to be. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago. I am a director of three financial services companies.

#### Reform of the "Fair Value" Accounting Theory is Needed Immediately

"Fair value," also called "mark to market," is an accounting theory. We need to understand as a fundamental point that it is a theory, not a fact. It is a theory which has had enormously damaging real world unintended results.

"The mark to market mechanism is pernicious," Gene Ludwig, Comptroller of the Currency under President Clinton, has stated. *Fair value accounting is "a major cause of the world-wide financial crisis,"* Bill Isaac, the Chairman of the FDIC during the 1980s financial crisis and a distinguished witness today, has observed. He has added that the application of fair value accounting on top of the other problems of the 1980s would have been disastrous.

"Bank investments should be considered in the light of inherent soundness...and should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth." This was the conclusion of

the Federal Reserve in 1938, as it put an end to the former mark to market practices of the day, which had helped drive the banking system down, then as now. (There are no new ideas in finance.)

What does “intrinsic value” mean? Fundamentally, it means the principal and interest that you are going to collect. If you are not going to collect it, it should of course be written off. But should you write it off when you are going to collect it, because a panicked market has put a panicked price on it? That way, which is the fair value way, creates a downward spiral in which everybody except short-sellers and vulture buyers loses.

A FASB defense of its fair value accounting theory, which has cycled into becoming the dominant accounting fashion only during the last couple of decades, claims that “Fair value *reflects* losses that have been incurred, it does not *cause* losses.” But in a big financial bust, with a self-reinforcing downward spiral of panic and illiquidity, this is manifestly untrue: accounting has real world effects. These include freezing funding markets, heightening uncertainty, triggering defaults on debt covenants, and changing customer and regulatory behavior. This all creates further uncertainty, which further lowers asset prices, which triggers accounting losses...and so on down.

The perverse effects of fair value accounting in a market panic are why almost all banking regulators oppose it. It is too easy for them to think of distressed situations which the banking system would not have survived if it had had to mark to market at the time.

### Accounting is Always a Theory

Apologists for FASB and fair value accounting say they are only insisting on “the facts” of market prices, although they of course admit that in many cases there is no active market or no market at all, and that panicked conditions can result in fire sale prices that will be judged by later observers as irrational. Nonetheless, they say, we must not hide from “the facts.”

But accounting is always a matter of theory. It never is and never can be simply facts. It is and can only be certain facts as treated according to some theory. Within the theory, it generates the projections, estimates and guesses needed to calculate what the theory defines as its results—for example, the defined concepts of “profit” and “capital.” As the Institute of Chartered Accountants of England and Wales so rightly observes:

“Financial reporting attempts to measure inherently abstract and debatable concepts such as income and net assets, and it has particular features that make it to some extent inevitably subjective.”

Thus accounting theories are debated over years and decades without the ability of one side or the other to prove it is right.

What kind of a theory is fair value accounting when applied to debt instruments? It is an OK theory in a stable period when prices of debt instruments are equilibrium-seeking. But in a period of disequilibrium and discontinuity, like a panic, it adds to the disequilibrium and makes the problems worse.

Debt instruments (unlike equities or houses) have a principal to be repaid at maturity and interest payments until then. Consider the principal and interest that is indeed going to be paid. What is the right accounting representation of these future cash flows in today's balance sheet? This is the same question as asking what discount rate should be applied to them, and how that should affect the defined concepts of profit and capital. To discount the cash flows by the exaggerated illiquidity premiums of a panicked market, and by doing so to exaggerate losses and erase capital, is both theoretically unsound and feeds the panic.

Many observers therefore say we should "suspend" fair value accounting. This seems to me to give it too much credit. I say it should not be suspended, but reformed.

The way to do this is to produce balance sheets and income statements as before the fair value days, that is, based on the principal and interest you are going to collect. This should define profit and capital. Then add a separate fair value balance sheet, completely "marked to market," using whatever market prices there are or estimates of what they might be if there were markets trading. This would give the proponents of fair value accounting all the information they desire, while not driving the financial system into the perverse downward spiral.

#### HR 1349

The FASB has been very slow and reluctant--even when confronted with the financial crisis-- to fix what seem to be the obvious problems with fair value accounting theory. Therefore a new oversight board to govern accounting rulemaking seems like a good idea to me. With its proposed membership, I believe this new board would provide a more balanced forum to address the problems I have discussed.

But such a board needs to be promptly created, get in business, and act quickly.

Thank you again for the opportunity to share these views.