

## Disclose the fair value of complex securities

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Banks and other financial institutions are lobbying against fair-value accounting for their asset holdings. They claim many of their assets are not impaired, that they intend to hold them to maturity anyway and that recent transaction prices reflect distressed sales into an illiquid market, not what the assets are actually worth. Legislatures and regulators support these arguments, preferring to conceal depressed asset prices rather than deal with the consequences of insolvent banks.

This is not the way forward. While regulators and legislators are keen to find simple solutions to complex problems, allowing financial institutions to ignore market transactions is a bad idea.

A bank typically argues that a mortgage loan for which it continues to receive regular monthly payments is not impaired and does not need to be written down. A potential purchaser of the loan, however, is unlikely to value it at its origination value. The purchaser calculates a loan-to-value ratio using the current, much lower value of the house. After calculating the likelihood of default, the potential buyer works out a price balancing the risk of default and amount that might be lost – a price well below the carrying value on the bank's books.

The bank is likely to ignore this offered price, or trades of similar assets, with the claim that unusual market conditions, not a decline in the value of the assets, causes a lack of buyers at the origination price. Its real motive, however, is to avoid recognising a loss. Yet, by keeping assets at their origination value, the bank creates the curious possibility that its traders could buy an identical loan more cheaply and so carry two identical securities in the same not-for-sale account at vastly different prices.

Financial assets, even complex pools of assets, trade continuously in markets. Markets function best when companies disclose valid information about the values of their assets and future cash flows. If companies choose not to disclose their best estimates of the fair values of their assets, market participants will make their own judgments about future cash flows and subtract a risk premium for non-disclosure. Good accounting should reduce such dead-weight losses.

This already happens in another financial sector. Mutual funds in the US now use models, rather than the last traded price, to provide estimates of the fair values of their assets that trade in overseas markets. The models forecast the prices at which these overseas assets would have traded at the close of the US market, based on the closing prices of similar assets in the US market. In this way, the funds ensure that their shareholders do not trade at biased net asset values calculated from stale prices. Banks can similarly use models to update the prices that would be paid for various assets. Trading desks in financial institutions have models that allow them to predict prices to within 5 per cent of what would be offered for even their complex asset pools.

Obtaining fair-value estimates for complex pools of asset-backed securities, of course, is not trivial. But these days it is possible for a bank's analysts to use recent market transaction prices as reference points and then adjust for the unique characteristics of the assets they actually hold, such as the specific local housing prices underlying their mortgage assets.

For fair-value estimates made by internal bank analysts to be credible, they need to be independently validated by external auditors. Many certified auditors, however, have little training or experience in the models used to calculate fair-value estimates. In this case, auditing firms can use outside experts, much as they do today with actuaries and lawyers who provide an independent attestation to other complex estimates disclosed in a company's financial statements. The higher cost of using independent experts is part of the price of originating and investing in complex, infrequently traded financial instruments.

Legislators and regulators fear that marking banks' assets down to fair-value estimates will trigger automatic actions as capital ratios deteriorate. But using accounting rules to mislead regulators with inaccurate information is a poor policy. If capital calculations are based on inaccurate values of assets, the ratios are already lower than they appear. Banks should provide regulators with the best information about their assets and liabilities and, separately, allow them the flexibility and discretion to adjust capital adequacy ratios based on the economic situation. Regulators can lower capital ratios during downturns and raise them during good economic times.

No system of disclosing the fair value of complex securities is perfect. Models can be misused or misinterpreted. But reasonable and auditable methods exist today to incorporate the information in the most recent market prices. Investors, creditors, boards and regulators need not base decisions on biased values of a company's financial assets and liabilities.

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