

Letter to the Editor: Fair Value's Impact Will Only Grow

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To the Editor:

A major component of the writedowns being reported by numerous financial institutions is based on fair-value accounting assumptions. The recent series of articles in *American Banker* ["Fair Value: Bumpy Road from Theory to Practice," Dec. 28; "Fair Value: Simple Idea, Complex Path," Dec. 31; and "[In Fair-Value Debate, Trust Is Wild Card](#)," Jan. 2] was an excellent introduction to this very complex topic. Fair-value accounting impacts all financial institutions, and my organization, the American Association of Bank Directors, encourages every board member to read these articles.

Anyone who reads FAS 157 (145 pages) issued in September 2006 and FAS 159 (54 pages) issued in February 2007 will likely be as frustrated as many bank audit committee members with these newest additions to the growing number of accounting pronouncements. These new accounting standards are very complex, and their impact on reported financial results is apparently not yet well understood by investors.

The objective of this letter is to highlight several important issues related to the application of fair value and express hope that the proposed new Call Report schedule (RC-Q Fair Value), which is to be introduced as of March 31, will provide consistent disclosure.

In simple terms, there are three levels of assets and liabilities subject to fair value.

Level 1 valuations are based on quoted prices in active markets for identical assets or liabilities obtained from sources independent of the financial institution.

Level 2 valuations are based on observable inputs in inactive markets for similar assets or liabilities.

Level 3 valuations are based on "mark-to-model" — unobservable inputs based on the financial institution's own assumptions about the assumptions that other market participants would use in pricing the asset or liability.

These Level 3 values are a "best guess" and, accordingly, very likely to be either too high or too low. The resulting changes in future estimates of value will have a recurring noncash impact on reported earnings. The result will be increased volatility of reported earnings related to "mark-to-model" assumptions rather than actual transactions.

Another consequence of fair value when applied to liabilities such as debt issued by a financial institution is the reporting of a "gain" if the fair value of the institution's debt declines in value as a consequence of the institution's deteriorating financial condition. In other words, poor performance by an institution could create a "gain," and a future improvement in performance could create a "loss" on the fair value of its own debt.

No matter what your opinion of its merits, fair value will have a growing impact on the financial statements of all financial institutions. The AABD strongly encourages board members of all financial institutions to gain a better understanding of the limitations and implications of fair-value concepts.

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