

# How to Overcome the *Fair Market Value* Crisis

**M**organ Stanley boss John Mack reckons we're at the "top of the ninth inning" of the subprime-induced credit crisis. His counterparts at Goldman Sachs and Lehman Brothers — Lloyd Blankfein and Richard Fuld — chose comparable analogies. They may be right. But it feels more like the intermission at the Rocky Horror Picture Show: opaque accounting rules governing Wall Street's disclosure of their hard-to-value asset values have left investors and the public in the dark about the true impact of the credit crisis on corporate balance sheets.

Despite financial firms writing down hundreds of billions of dollars in losses, disclosure has only marginally improved. Ironically, regulatory efforts to enhance pricing transparency may have compounded confusion and suspicion. Worse, these fair-market accounting practices may represent another disincentive for freeing up capital and restoring liquidity.

Investors will remain skeptical until they have the tools to confidently make their own determinations about assets that have been valued using management's sole discretion. Full disclosure would be the best way for this horror show to achieve that, but is probably unrealistic considering the confidentiality issues managements face.

Given that, how can we craft more transparency? If market participants cannot solve this conundrum, a solution will likely be imposed upon us that may have the unintended consequence of discouraging companies from purchasing headline-risk assets. It is inconceivable the market and its regulators will support the current level of accounting ambiguity much longer: accurate book values are too important to valuing corporations.

Accounting regulators never intended new rules to cause havoc in the credit markets. But the turmoil of the past year has thrown the spotlight on how Wall Street firms book hard-to-value assets like mortgages and CDOs on their balance sheets. Investors shouldn't be forced to trust management on valuation — they should be given enough details on these holdings to verify it themselves, argues hedge fund manager Carlos Mendez.



*Seeing isn't always believing — sometimes you need more proof*

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At a minimum, discretionary valuations should be accompanied by asset-type descriptions, portfolio concentrations and make-up, counterparty risk, valuation methodologies and key assumptions. Where the accounting guidelines permit valuation based on proprietary models, a look inside them would mark a pioneering step forward.

## Opening Pandora's Box

For years, the public has been comfortably relying on management's self-valued assessments of hard-to-price assets. That encompasses trillions of dollars in securities, derivatives and private transactions held by U.S. financial institutions.

That was the case before the Financial Accounting Standards Board introduced fair-market accounting rule 157 last September which simply quantified it for us more by introducing three buckets to put assets in: Level 1 represents assets whose prices can be easily observed; Level 2 uses observable inputs in

internal models; and Level 3 uses unobservable inputs in internal models.

Toss in some hard-to-decipher qualifiers for what can and cannot be in these buckets, and a downward-spiraling market, and you end up where we investors are today — suspicious of the system.

### Accountants vs. CFOs

The regulators did not intend to change how companies value assets; they simply wanted to offer the public visibility into valuation methodologies. Unfortunately, interpreting “market observable pricing” and determining what assets are comparable for pricing squares CFOs up against their accountants, especially for Level 3 investments.

Professional investors recognize that the lack of third-party verification for mark-to-model assets gives management a tremendous amount of latitude. Ratings agencies, though able to assess confidential, portfolio-level information, do not necessarily do so. Nor is the SEC performing portfolio reviews.

Keeping management in check has overwhelmingly been the function of the auditors — but their job is to verify the books, not to determine investment valuations. If anything, their need to eliminate any potential liability from misrepresentation makes them conservative.

AIG's battle with the bean counters is a case in point. In February the insurance giant announced that October and November losses on swaps would, at some \$4.9 billion, be about four times the size of previous estimates because its auditor decided the firm had initially used faulty accounting. AIG chief Martin Sullivan called KPMG's valuations “unfair market prices,” saying \$900 million was more realistic based on its “stress-test worst-case scenario” for unrealized losses.

Sullivan argues that realized losses should be booked when sold, rather than recorded as an unrealized loss, as required under FASB 157, even if the asset hasn't been sold and is intended to be held to maturity. Furthermore, he advocates that worst-case estimates be provided for the actual damage that may result from unrealized losses. FASB 157 also requires unrealized gains to be booked in the same way. So AIG may well swing from their worst performance ever to their best without doing a thing, just because market liquidity returns and pricing approaches something closer to the fundamental performance of the securities.

Morgan Stanley and Goldman Sachs have already used some internal accounting to boost their earnings. The SEC granted these institutions an exemption from complying with some of the accounting firm opinions for valuations which AIG was subject to. Morgan Stanley reported a \$4.24 billion bonanza of net unrealized gains on self-assessed Level 3 assets and liabilities in its first-quarter earnings — nearly twice the company's pre-tax income. Goldman's self-assessed gains for the same period equate to 96% of pretax income. Considering market liquidity and credit pricing significantly deteriorated that quarter, this leaves one to assume the gains came from either short positions or mark-to-model pricing revisions. But

we'll never know.

Sullivan's approach, which FASB board member Donald Young describes as “mark-to-management,” is problematic when investors have no idea how management divines its estimates. But of more concern is the opportunity afforded to management to manipulate earnings.

Responding to industry demands for immediate relief from mark-to-market accounting, the SEC Division of Corporate Finance, in a letter to CFOs in March, broadened the eligibility of Level 3 assets. The clarification gave CFOs the discretion to characterize “actual prices” as prices reflected in a normally operating marketplace versus “prices [as] the result of a forced liquidation or distress[ed] sale.” In effect, they gave CFOs more control of their valuation methodologies over their auditors in an illiquid marketplace. To paraphrase FASB's Young, it's a mark-to-management's-market valuation.

### Size Matters — Level 3 Black Hole

Wall Street firms have a significant and growing amount of hard-to-value holdings by any metric. For instance, Goldman Sachs' \$96 billion of Level 3 assets is almost as large as the GDP of the oil rich United Arab Emirates. Its Level 2 assets are six times the size.

Lehman's Level 3 assets are 2.5 times the size of its tangible common equity, or 1.7 times including hybrid securities and subordinated debt. With investment bank gross leverage ratios in excess of 30 times, even small percentages in the value of assets suddenly matter a lot. At 30 times, a 2% mark down of asset values destroys more than half the equity.

Thus far, mark-to-market losses have forced U.S. and European banks to raise well over \$200 billion in stock, preferred stock and hybrid securities to maintain their capitalization ratios at well-capitalized regulatory thresholds. The IMF estimates total losses on loan-based assets at \$945 billion — essentially, banks could have another \$500 billion to come, thus would need to raise an additional \$320 billion in tier 1 capital. Given the sizeable losses and coordinated capital raises thus far, it's apparent companies have been raising capital before reporting unrealized losses. As FASB 157 stands today, management can obscure holdings and misdirect scrutiny while architecting the difficult task of deleveraging their balance sheets over time. Citigroup's \$4.5 billion stock sale two weeks after reporting a second straight quarterly loss and after its executives said they wouldn't need more, might just be a precursor to more losses.

### Riddle Me This

The SEC has asked management to better describe hard-to-value assets. Specifically, for example, they have asked for information about their valuation and basis, the models they use, descriptions of material declines or increases in fair values and disclosure of the underlying assets. Little has happened yet: first-quarter reports are more enlightening than in the past, but still deficient in painting a complete picture.

Goldman Sachs' latest 10-Q quarterly report devoted three pages to Level 3 assets, which jumped 50% from the end of last

year. The most revealing of its disclosures covered measurement techniques, but these were described in short two- to three-sentence bullet points, all with market-based orientations. The firm did reveal that it transferred \$14 billion of assorted mortgage assets from Level 2 to Level 3, although gave no indication of any change in value. The question is: how are they self-priced? Basically, Goldman's message is: trust us.

Granularity to decipher the make-up and associated risk of the portfolios is not required. Subsequently, disclosure around derivative transactions such as Citigroup's recent sale of \$12 billion of leveraged loans to Apollo, Blackstone and Texas Pacific are difficult to follow from an accounting perspective. In that transaction, Citigroup is financing much of the purchase and guaranteeing the first 20% of losses. From a risk transfer perspective, it can be argued nothing changed since Citigroup remains on the hook for the majority of the most likely losses. That was certainly FitchRatings' take on the deal. But will an investor be able to recognize that there is now a \$2.4 billion derivative obligation for any losses to the same loans it reported selling on the upcoming 10-Q? The transaction effectively converts Level 1 or 2 exposure — leveraged loans — to Level 3 exposure — mark-to-model derivatives.

### **We're All Big Boys and Girls**

Whatever the investment valuations reported by management, professional investors just want to be able to compute prices themselves on hard-to-value assets. To support this analysis, we should consider developing a more detailed reporting schema for describing company asset types, portfolio parameters, model assumptions and counterparty information. As a first step, one could replicate the basic information needed by a typical subprime mortgage trader without disclosing the exact investments.

These would include external inputs: not just fundamentals such as benchmark mortgage rates and home price appreciation assumptions, but other macro real estate metrics such as foreclosure and liquidation timelines and future interest-rates assumptions.

Companies should also make loan-level information more accessible by disaggregating assets by FICO credit scores, loan-to-value, documentation levels, second liens, loan vintages and unpaid balances, debt-to-income ratios, occupancy, loan purpose and affordability features, IO, prepay penalties, capital structure, and time to first reset. An effective initiative would be a breakdown of borrowers and properties geographically: market participants commonly use punitive levels such as California home-price appreciation or foreclosure scenarios for all mortgage assets.

And more specifics on portfolios would be key. First-quarter reports break out high-level investment categories such as

securities compared with loans or rating breakdowns by vintage and sector. Additional information might include average holding sizes and structural attributes such as the over-collateralization structure compared with shifting interest.

Apply these metrics to analyze Countrywide Financial's on-balance-sheet mortgage residuals, whole loans and servicing rights portfolios as of year-end, and the company's total liabilities exceeded its assets on a mark-to-market basis. That supports the market's belief that the mortgage lender was facing bankruptcy when it was bought by Bank of America in January. Perhaps it wasn't. But public filings never disclosed enough information to decisively come to that conclusion oneself, nor

to decipher whether management envisioned a different outcome.

Undoubtedly, disclosing these metrics would offer a level of transparency into management's assumption of business conditions that would not always bolster market confidence. But it would enable investors and companies to shift the focus away from unavailable mar-

ket prices and self-generated valuations for hard-to-value assets to true risk measurement.

### **Reporting on the Untradable**

Enabling management to make rational decisions around value and pricing for hard-to-value assets of whatever description while requiring detailed portfolio and valuation methodology disclosures is the balanced approach the market is seeking. Much of the information is already available, as recently demonstrated by Ambac. For first-quarter earnings, the monoline released its valuation models, gave a 77-page presentation and allotted three hours to explain it all on a conference call. Our reliance on management to assess non-market ready assets for book value needs to transition from blind trust to verification of a publicly available valuation methodology.

Furthermore, for assets that are self-priced, we should remove their changes in value from the income statement. Write-downs and write-ups on opaque assets should not reflect income volatility. It is delusional to assume the ability to self-generate profits and losses does not introduce a conflict of interest for management deciding valuations assumptions.

Lastly, investors should be explicitly notified that no one except the company is assessing the risk on the balance sheet. False reliance on auditors and ratings agencies should be dispelled.

So, whether or not you agree with Mack's 9th-inning analogy, the time has come for companies to provide investors the tools to be able to make up their own minds. ▼

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