FINANCIAL STABILITY CONSIDERATIONS RELATED TO TRENDS IN ACCOUNTING STANDARDS

The following excerpt is from Chapter III of the September 2005 Global Financial Stability Report. *Footnote numbers have not been modified and therefore do not begin at 1. In addition, the references have been included without being modified.*

Our series on risk transfer in the previous issues of the GFSR highlighted how accounting standards (and regulations) may significantly influence investment and risk management behavior, as well as asset allocation among key institutional investors, such as pension funds and insurance companies. As part of this chapter's theme of global asset allocation, this module steps back from detailed issues associated with recent or proposed accounting reforms to ask how accounting standards, particularly as applied to pension funds and insurers, may influence financial stability. Without a doubt, these are complicated issues, and the major standards setters (the U.S. Financial Accounting Standards Board and the International Accounting Standards Board) are working to improve accounting principles in order to enhance the comparability and transparency of accounts, which deserves strong support. Indeed, many of the recently considered and proposed accounting standards are aimed at moving toward a broadly applicable best practice for measurement, and away from long-standing measurement methods that arguably contributed to or masked some of the recent problems experienced by pension funds and insurance companies. However, there has been very little commentary or analysis that broadly assesses the impact of these proposals on the larger issue of financial stability. This module presents a balanced review of the relevant policy issues, and raises questions related to financial stability that policymakers may consider as accounting standards are being reviewed.

Risk Transfer

In recent years, financial stability is generally viewed by authorities as having improved, in large part through more proactive risk management activities by banks and the related transfer and dispersion of risks from banks to diverse nonbanking institutions, which often have longer-term liability structures, and therefore may be more appropriate holders of such risks. As a result, systemically important banks are broadly recognized today as more financially stable and resilient. Banks are also currently viewed as leaders with regard to risk management practices, encouraged in part by regulatory and supervisory developments (e.g., risk-based capital requirements). This has encouraged the spread of various risk management practices from banks to nonbanking institutions.

The risk management techniques increasingly being adopted in other sectors are often designed to control exposures to credit and market risks in an environment where asset prices and liquidity may change rapidly. While relevant to certain parts of their business and activities, such short-term risk tools may not be as relevant to all parts of the activities of insurers and pension funds as they are for commercial and investment banks. As such, this module asks whether certain risk management and related financial reporting

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standards typically applied to such banks are equally appropriate for all nonbanking sectors, particularly pension funds and insurers.[47] Clearly, numerous cross-sector benefits have emerged. However, the possible impact on financial stability may remain open, unless policymakers and standard setters consider fully the potential influence of such standards on the investment and risk management behavior of nonbanks.

Accounting Affects Behavior

There is widespread agreement that accounting, financial reporting, and other issues of measurement influence the behavior of market participants (i.e., managers, creditors, shareholders, and other stakeholders). In addition, researchers have analyzed and assessed different channels by which accounting standards influence a firm's management and various stakeholders' behavior.[48]

It is also important to acknowledge a few practical considerations relevant to this discussion. First, markets may sometimes be imperfect, at least in the short run, and thus may not always reflect fundamental values or operate in a frictionless manner. As such, markets are frequently influenced by outside factors, such as accounting standards, that can contribute to procyclical behavior caused by a feedback mechanism from short-term price movements. In part, such market behavior may relate to the fact that many markets do not exhibit the depth and liquidity assumed in "perfect" markets, and therefore only in the longer term do markets "correctly" reflect fundamental values. Finally, and most important, many assets classes, and even more so balance sheet liabilities, lack a reasonably transparent and observable market price. Of course, this is an important impediment to any standards setter given the task of measuring financial performance. This is particularly true for many of the long-term liabilities (and related embedded options) on the balance sheets of pensions and insurers. Indeed, the inability to reliably measure and report liability values may represent the greatest source of "accounting volatility" as standards setters seek to develop measurement and valuation approaches.[49]

As discussed in the first module of this chapter, pension funds and life insurance companies are each a very important and significant investor class, with pension funds the largest investor group in many countries. The liability structures of pension funds and insurance companies have historically allowed them to play a supportive role in financial stability by maintaining a longer-term investment horizon and an asset allocation strategy rarely influenced by short-term market fluctuations. Indeed, from a financial stability perspective, the "acyclical" investment behavior of pension funds and (to a lesser extent) insurance companies has represented a relatively stable and steady source of investment capital.[50]

[47]Some bank regulations and risk management practices are considered to have undesirable operational characteristics. For example, Clerc, Drumetz, and Jaudoin (2002) discuss how bank capital requirements, regulations, and risk management models have procyclical properties that must be moderated by proactive bank supervision.

[48]For example, Plantin, Sapra, and Shin (2005) develop a model to demonstrate that accounting changes influence the actions of market participants. Hill and others (2005) and the Geneva Association (2004) highlight how changes in accounting standards could affect risk management practices in insurance companies.

[49]The measurement difficulties may represent the greatest obstacle to fair or market value principles, particularly longer-term assets and (even more so) liabilities. As such, in discussions with the standards setters, it was discussed that full fair value accounting standards (including reporting all value changes in the earnings statement) may be best applied to those assets and liabilities with a shorter remaining life (e.g., 5 or 10 years), in order to reflect the more pending and measurable financial requirements.

[50]A recent example of this acyclical behavior was evident in the structured credit markets of April and May. Market participants widely commented on how insurers (especially) and pension funds during this volatile period did not sell into downward price swings, and frequently referred to their "non–mark-to-market behavior," compared with the trading or "mark-to-market" behavior of hedge funds or investment banks.

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The desire by the standards setters to increase the "accuracy" of financial reports has promoted the broader use of mark-to-market valuations for all companies, including their pension funds. However, fair value approaches require the existence of active and liquid markets, or some reasonable proxy, that can readily provide observed "value-in-exchange" prices. Moreover, to be implemented effectively, fair value approaches should require the same for liabilities. By comparison, "value-in-use" prices, which are meant to reflect the asset value to that particular business or purpose, are derived from projected future cash flows or the hedging value of a firm's assets and liabilities. As such, both approaches present measurement challenges.

An important consideration is whether fair value accounting may shorten the decision horizons of market participants, both users and preparers of accounts. Recent studies, and discussions with company executives and investors, suggest that shifting to fair value accounting, with frequent adjustments to earnings, may reinforce incentives to engage in short-term, procyclical activities.[51] Furthermore, many corporate officers have noted the rising tension between company sponsors and their defined benefit pension funds, as sponsors seek to manage down the potential earnings volatility from their pension funds. As such, pursuant to a full implementation of fair value accounting (i.e., whereby all valuation changes are reported through the earnings statement) companies with large pension funds may have greater incentives to procyclically sell assets during market downturns to limit valuation effects, and thereby exacerbate market swings. In other words, when the decision horizon is shortened, the recent experience or anticipation of price movements will affect a firm's decisions, which in turn may inject further volatility into markets and prices. Indeed, this may be more likely for longer duration assets and more illiquid asset classes and markets (e.g., structured credit, or smaller domestic or developing markets), which has particular relevance for pensions and insurers.[52]

To be clear, pension funds and hedge funds are not expected to pursue similar trading strategies because of accounting policy, nor does volatility alone equal financial instability. However, extreme volatility or liquidity "black holes" can create disorderly markets and lead to financial instability.[53] As such, this module asks whether the financial stability gains in recent periods, due in large part to the dispersion of risks and the diversity of investor behavior in a variety of markets, may be reduced, and procyclical behavior increased, by such accounting or financial reporting policies.

Fair value accounting is certainly a useful measure and representation of financial activities under many circumstances, and is appropriate and desirable for a variety of uses. For example, management and regulatory accounting should include all relevant and reliable market valuations for risk management and other purposes, and would clearly benefit from market or fair value measures. Fair value measures can also serve as an instrument of discipline for financial interme-

[51]Burkhardt and Strausz (2004) present a model outlining how fair value accounting may provide incentives for increased procyclical behavior. They also show that there may be incentives for an intermediary to sell its higher quality assets, leaving lower quality assets on its books.

[52]Plantin, Sapra, and Shin (2005) demonstrate that, influenced by accounting treatment, managers may sell assets following price swings or market shocks that they would otherwise have retained, particularly longer-duration assets. Moreover, they also highlight conditions under which such actions may amplify the effects of market shocks. See also Hann, Heflin, and Subramanyam (2004).

[53]Liquidity black holes are extreme situations where selling activity increases the incentives or pressures for other market participants to sell into declining markets (i.e., a one-sided market develops), and the process becomes self-reinforcing. See Morris and Shin (2004); and Plantin, Sapra, and Shin (2005) for a more detailed analysis.

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diaries, where senior executives in the past may have been slow to face the reality of persistently lower asset prices or inappropriate risk management systems. Valuation of assets and liabilities closer to market values would also make more explicit the amount of intertemporal risk sharing provided by life insurers. Risk sharing over time is a result of mismatches between an insurer's assets and liabilities, and is therefore linked to one of the key concerns expressed about fair value accounting: namely, the fact that reported earnings would likely become more volatile as values of assets and liabilities behave differently. To the extent that the higher earnings volatility stems from an asset and liability mismatch, it is in large part a real risk and is the result of risk sharing over time provided by the insurer. Fair value accounting will likely make this intertemporal risk sharing more explicit and apparent, and would reveal its costs more clearly. This type of risk sharing would therefore likely be priced by the market more appropriately.[54]

Financial reports are used differently by different parties, and an accounting framework that mandates a single approach for valuing assets and liabilities may not reflect the economic fundamentals or reality for all stakeholders, including regulators. These differing requirements may depend on whether the user is assessing the credit quality (e.g., estimating the probability of default) or the long-run value (e.g., equity price) of a firm.[55] For example, certain public bodies, such as the U.S. Pension Benefit Guaranty Corporation or the U.K. Pension Protection Fund, may require current market valuations (including liquidation or run-off values) in forming their regulatory or prudential assessments. By comparison, equity investors may focus more on the value of assets in the business, including as held against certain pension or insurance liabilities, as they evaluate the longer-term performance of a firm.[56] In this latter case, separating the short-term or transitory effects from the more permanent changes in value may be very difficult in a full fair value system. In such a situation, fair value accounting principles may induce a much greater focus on short-term (e.g., quarterly) earnings management, and thus produce more active rebalancing or trading of the investment portfolios of pension funds and insurers in the financial markets.

Efforts by Accounting Standards Setters

Standards setters, such as the FASB and the IASB, are currently considering a variety of accounting and reporting standards with the goal of reflecting economic reality, maintaining or enhancing comparability and use, and improving the transparency of the financial affairs of the business. They are guided by principles such as relevance and reliability, and utilize tools such as measurement, disclosure, and presentation to accurately reflect a company's underlying fundamentals. Policymakers and regulators have also sought to ensure that changes in international accounting standards work to enhance transparency and improve the understanding and comparability of accounts, and thereby pro-

[54]See Häusler (2003).

[55]Hann, Heflin, and Subramanyam (2004) discuss the different information requirements of creditors compared with equity investors. They present evidence that, under certain market conditions, the increased earnings volatility in fair value reporting may make it more difficult for investors to separate transitory from permanent changes in a company's earnings potential.

[56]The importance of financial reporting and the disclosure of relevant information for financial stability is emphasized in Michael (2004). Allen and Gale (1998) discuss some of the literature on the impact of stakeholder perceptions of bank asset valuations, and develop a model of bank runs induced by changes in perceived bank asset values. Bank industry groups have long called for an accounting and financial reporting framework that allows for a variety of valuation methodologies for measuring balance sheets and reporting performance (e.g., Joint Working Group of Banking Associations, 1999).

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mote efficient cross-border investment and company access to capital.[57] These are clearly appropriate and necessary goals and conditions for the functioning of financial markets.

The current "mixed attributes" model of accounting and financial reporting has attempted to recognize different investment periods, where some assets are valued at market prices and others are carried at historical cost (e.g., "hold-to-maturity" versus "assets available for sale," and trading assets). The banking industry illustrates requirements for using different reporting frameworks even within a single institution—a practice that can be accommodated with the "mixed attributes" model. Bank earnings often stem from a variety of activities. Trading activities by banks are driven largely by the buying and selling of securities, where assessments of rapidly changing relative values are critical. Fair value accounting seems an appropriate framework in this case, since it mirrors the information and decision process of the business activity. By comparison, banks often hold loans to maturity. Under these circumstances, historical or amortized cost accounting may be appropriate where the value of the loan depends more on credit quality and the cost of servicing the loan.[58]

Despite the efforts of standards setters to improve accounting and financial reporting standards, financial officers and other market participants frequently highlight how new or proposed standards may influence their decision making. Some accounting conventions (e.g., hedge accounting) may cause listed companies to forgo economically beneficial decisions to avoid increased earnings volatility and potentially adverse investor reactions, even if the increased reported volatility does not reflect the firm's underlying business or risk profile.[59] The standards setters are aware and sensitive to these issues and concerns. Indeed, at present, a potentially very important joint FASB and IASB project is under way, called "Financial Performance Reporting by Business Enterprises." In short, the project seeks to preserve the measurement benefits of using market or fair values wherever possible, while addressing concerns about transitory or nonrecurring volatilities through a variety of presentation frameworks. For example, one possibility is that short-term, transitory value effects may be reported "below the line," and as such be included in a "comprehensive income" figure for the period, but more easily separated for an analysis of longer-term value effects on a firm and (possibly) certain widely used earnings figures (i.e., net income, earnings per share, etc.). While this may represent an attractive way forward, it does not reconcile the difficulty of objectively measuring all balance sheet items, particularly liabilities, which may eliminate any reasonable concerns with fair value standards.

Preserving Financial Stability Gains

An important financial stability consideration is the depth of markets and the related diversity of investors, targeting a healthy mix of investors with a variety of investment behaviors, often related to liability and liquidity structures. However, as discussed above, different accounting and financial reporting standards that have historically facilitated such diversity are being reviewed. An important question is whether, in light of evolving

[57]Bies (2004) and Large (2004) are two recent examples of central bank policymakers recognizing the important influence accounting has on investors, creditors, and other market participants, and offering potential guidelines for accounting standards to promote efficient capital allocation and sound banking standards. In addition, the desire to improve transparency and promote comparability recently led the Securities and Exchange Commission (SEC) staff to recommend continued efforts to facilitate the implementation of fair value accounting (see SEC, 2005).

[58]This banking example was adapted from Bies (2004).

[59]See Weinberg (2003).

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accounting standards for pension funds and insurers, we may reduce the diversity of investment behavior, particularly as it relates to their long-term, stable investment behavior. In other words, would full implementation of fair value accounting lead to more procyclical market behavior among these large and important investors?

Our market surveillance produces an uncertain answer to these questions, at least in the near term. On the one hand, risk managers of insurance companies and pension funds repeatedly describe such accounting changes as increasing their need to more actively trade their investment portfolio to avoid accounting volatility. However, particularly for pension funds, such increased market activity would represent a significant change from their historical behavior. Indeed, their traditionally patient investment behavior, stemming in part from their longer-term liability structure, has enhanced financial stability. As such, if accounting changes cause these large and important investors to become more proactive and short-term focused, financial stability may also suffer.

There is strong support among company treasurers, financial officers, and regulators for designing financial accounting and reporting frameworks for shareholders and other stakeholders (i.e., external reports) that reflect the economic reality of an enterprise as a going concern in a full and transparent manner. Moreover, much of the "accounting volatility" that industry participants highlight, particularly as it concerns the potential influence on pension funds and insurers, would either not exist or, alternatively, would correctly reflect asset-liability mismatches, if liabilities could be reliably measured and reported in the accounts. However, liability measures are broadly viewed as more problematic than asset values, so standards setters continue to struggle with a variety of "mixed" measurement frameworks. Therefore, in an imperfect world, policymakers need to consider whether proposed accounting reforms may not diminish the diversity of investment behavior and the long-term orientation of important institutional investors, which has typically enhanced financial stability.

Standards setters are currently considering a variety of accounting and reporting standards with the goal of better reflecting economic reality, maintaining or enhancing comparability and use, and improving the transparency of the financial affairs of the business. These are very desirable and appropriate goals, and important progress and improvements have been made in recent years related to these efforts. However, as standards setters and other policymakers reassess accounting and reporting standards, they should consider the broader financial stability issues, and the benefits from risk dispersion and investor diversity. As in other areas, we need to consider the consistency of various policies with the intended goals, as well as trying to understand the consequent flows of risk and behavioral effects related to such policies and standards.

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