

Marking to What Market?

Transparency in Financial Accounting

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About Market Transparency

- OTC markets do not have consistent reporting requirements. Exchanges do. CDS & CDO's are traded OTC.
- All evidence for efficiency of “free” markets comes from structured exchanges with full disclosure => no guarantee of efficiency without transparency.
- If transparency enforced, most problems are manifest and heavy regulation not needed.

Transparency and Fair Value

- FASB/IASB intended fair value/mark to market to enhance transparency.
- To do so, it must mark assets and liabilities to the right markets.
- We shall see that the current version of FV/MtM in fact uses the wrong markets, ignoring two important options that inhere to a going concern.

Making Sense of Fair Value

- FV/MtM is supposed to account for going concerns. Does it really?
- MtM uses spot prices, valuing assets for immediate sale.
- Marking liabilities to market uses asset spot prices, discounting for credit risk.
- We shall see that neither is appropriate for a going concern.

Going Concern Options: Assets

- A firm in liquidation must value assets for immediate sale.
- A going concern has the option to defer sale or simply to wait around for contractual cash flows.
- Call this option the “liquidity penalty”.
- Is it non-zero? Yes, or we would not have futures markets. But small when markets are behaving well.

Going Concern: Liabilities

- A firm in liquidation can negotiate reduced values for its obligations or renege altogether.
- A going concern expects to fulfill its obligations and hence does not have this option, the “credit penalty”, a share of the insolvency put.
- The credit penalty, an asset of the owners, not the firm, has no place on the firm’s balance sheet, standard accounting notwithstanding.

So What is Fair Value?

- FV/MTM mandates current market values, or surrogates, for assets.
- It mandates valuing liabilities at the market values of the countervailing assets, net of the credit penalty.
- These are liquidation values.
- Conclusion: *Fair Value is Liquidation Accounting imposed on Going Concerns!*

More Mischief in Fair Value

- A credit downgrade reduces liability values.
- Changes in asset and liability values are taken through income, so downgrade = income surge.
- In Q1 2008, Radian Group, a financial guarantor, took a credit *downgrade*. This turned a \$215M loss to a \$195M *profit*.

Remedies

- See Chasteen and Ransom , OK State, *Accounting Horizons*, July 2007.
 - Value liabilities risk free.
 - Risk-free value less proceeds = credit penalty.
 - Changes in risk-free rate go through income.
 - Credit penalty and changes go direct to equity.
- Charge against equity reflects ownership of insolvency put. Solves *known* liability problem. Also resolves repurchase puzzle.
- See also Heckman, *NAAJ*, Jan. 2004

General Approach: Assets

- Assets for liquidation trade in the spot market.
- Going concern assets trade in the futures market, if any.
- Going concern valuation should estimate the liquidity penalty, guided by futures prices, where available, and add it back to the spot values.

General Approach: Liabilities

- Liabilities for liquidation follow asset prices.
- Going concern liabilities essentially trade in the surety market, if there is one.
- Going concern valuation should estimate the credit penalty, guided by surety prices where available, and add it back to the asset value.
- In dynamic terms, *decreasing* asset values tend to cause the default option to *increase*. True equity can disappear very quickly.

Why is this important?

- Imposing liquidation accounting on a going concern is misleading and dishonest.
- It can mask insolvency or signal false insolvencies, depending on the situation.
- It frustrates the goal of transparency and threatens the stability of financial markets.
- Insurers compete in the capital markets with firms that use debt. The playing field should be level.

Whose problem is it?

- This is the age of Google. Professions are no longer in silos. Problems are shared with the user community.
- Accountants are new at valuation. Those who make a living valuing assets and liabilities should have a say. This includes actuaries.
- Statutory accounting is no longer a safe haven. Head in sand = exposed posterior. Actuaries' good name is at stake.

Dude, where's my pension?

- Pension actuaries have availed themselves of accounting rules to discount liabilities at rates bordering on pure fantasy. Underfunding could become a calamity.
- The public will not distinguish among specialties if “actuary” becomes a dirty word.
- Not all P/C actuaries work for insurers. Many sign reserves for self insurers under GAAP. Should not they have appropriate guidance?

What Can Actuaries Do?

- Going concern asset/liability valuation calls on actuarial/financial skills and pose unsolved problems.
- We need a fusion of actuarial and financial approaches.
- Problems must be solved systematically and universally. Fixing insurance accounting while leaving debt accounting hanging is not acceptable.
- Work toward transparent, logical regulation.