

PRESS RELEASE

## Fair value accounting intensifies the crisis – study warns of need for quick reform

SAL. OPPENHEIM PRESENTS A STUDY IN COOPERATION WITH PROF. BERNHARD PELLENS ON THE EFFECTS OF FAIR VALUE ACCOUNTING DURING THE FINANCIAL CRISIS

- *IFRS fair value accounting did not cause the financial crisis but have fuelled it and intensified its impact*
- *Accounting in accordance with IFRS causes sharply increasing earnings volatility for stocks in banks, and insurance and property companies*
- *Pro-cyclical effect of supervisory law intensifies the crisis*
- *IFRS reform: More flexible application of fair values for illiquid assets and market failure; suspension of fair value accounting for financial liabilities*
- *Higher and anti-cyclical capital requirements for banks*
- *More anti-cyclical investment strategy:*
- *Analysis should be based on cash flows and total change in net assets (for financial stocks)*

FRANKFURT, 23 SEPTEMBER 2008

Current application of the IFRS standards on fair value accounting was not in fact the cause of the current financial crisis and economic slowdown, but was a factor in its occurrence and intensified its impact, due in part to a lack of understanding by market participants. This is the basic message of a joint study conducted by Sal. Oppenheim jr. & Cie. and Prof. Dr. Bernhard Pellens, chair of International Accounting at the Ruhr University in Bochum (and member of the Executive Board of the German Accounting Standards Committee - *Deutsche Rechnungslegungs Standards Committee* (DRSC)). The authors of this study are calling for comprehensive reforms including a more flexible definition and a reduction in the application of fair value measurements for assets that are little traded, as well as higher capital requirements for banks, with anti-cyclical effects.

The starting point of the current crisis was the dynamic economic upswing of the past few years, supported in part by a lax US Fed policy. The application of fair value

*page 1 of 4*

# SAL. OPPENHEIM

Private bankers since 1789

measurements during the upswing resulted in financial instruments and real estate, in particular, being valued higher whether or not they were realised, as well as considerable increases in profit and equity.

## IFRS FAIR VALUE ACCOUNTING PROMOTES DANGEROUS DOWNWARD SPIRAL

This development is reversing in the current financial market crisis. The write-ups of the past few years stand in contrast to the current substantial write-downs. This is a typical feature of IFRS fair value accounting, as Prof. Pellen explains: “With volatile market prices of assets, this results in companies recording considerably stronger fluctuation in results and equity compared to accounting in accordance with the German Commercial Code (HGB).” This effect is more pronounced if the reported fair values are determined on the basis of non-realised price changes on markets with little liquidity. “While positive market development significantly increased the banks’ leeway in lending and risk tolerance, this has now suddenly been dramatically reduced,” says Prof. Pellens. This causes a dangerous downward spiral to be set in motion, as a reduction in outstanding loans (deleveraging) and decreasing risk-bearing capacity result in drastic measurement adjustments and distress sales, which in turn lead to a number of other consequences.

Dr. Wolfgang Sawazki, Head of Research at Sal. Oppenheim jr. & Cie., feels that the financial market crisis will not be over for quite some time: “We are currently in the middle of a financial crisis, which has resulted in impairment losses reported by financial institutions in the region of 500 billion dollars.” These losses were only partially offset by newly raised equity in the banking sector of currently around 350 billion dollars. At this point, a pro-cyclical supervisory law would intensify the problems. “As a bank’s lending opportunities are based on the amount of equity, in accordance with supervisory provisions, these write-downs also restrict the bank’s lending scope,” explains Dr. Sawazki. This ultimately limits the company’s investments and consumer propensity to buy, which in turn threatens to result in a drastic economic cooldown. “As a result, we see an increase in exaggerations and significantly more volatile equity markets,” adds Dr. Sawazki.

There were two periods in the past six years in which bank shares fell by more than 40%. “In the previous 30 years, in which fair value accounting played a lesser role, this happened only once,” explains Dr. Ralf Zimmermann, equity strategist at Sal. Oppenheim. These unintended effects of IFRS fair value accounting in combination with pro-cyclical supervisory law appear to be taken into insufficient account in the learning process by the supervisory authorities, and also by the other market players such as shareholders or trade unions.

*page 2 of 4*

# SAL. OPPENHEIM

Private bankers since 1789

## REVISION OF IFRS ACCOUNTING NECESSARY

From the study's authors' point of view, this has direct consequences for investors, banks, banking supervisors and the accounting standard setter, in order to reduce the risks of financial and economic crises in the future. Accounting should continue to be based on fair values since it remains the most convincingly method of representing the economic situation. "However, if the markets are not functioning and thus no reliable market prices exist, then cash flow-based valuation models should be used," says Prof. Pellens. In case of market failure, clear rules must be set out for a potential reclassification from the trading book to "held to maturity" or "market to model" valuation. Moreover, the International Accounting Standards Board (IASB) should urgently restructure the way results are reported, and thus also the concept of profit and loss accounting (performance reporting) and fair value accounting of financial liabilities which is extremely misrepresentational in times of crisis. "As much sense as IFRS fair value accounting makes in the balance sheet, for industrials, the net profit reported for the period should only comprise realised income and expenses since there are a large number of consequences linked to this, such as dividends and wage demands," stresses Prof. Pellens.

Moreover, all ways of recognising off-balance sheet vehicles must be critically reviewed. "We cannot have major assets and liabilities such as for ABS financing and leasing absent from the balance sheet," warns Prof. Pellens. Furthermore, it is the standard setter's duty to offer assistance in the future so that market participants can learn to deal with and interpret IFRS fair value accounting.

## BANKS MUST INCREASE THEIR RISK CAPITAL

The study's authors remind the supervisory authority to raise capital requirements due to the illiquidity of assets in case of market failure and increased volatility. Moreover, a fundamental concept must be developed for an anti-cyclical build-up of reserves and reversals. Profits in trading books should only be included in equity on a pro-rata basis ("prudential filter"). It goes hand in hand with this to say that losses in value in use (risk-adjusted cash flow considerations) in failed markets should be limited. In addition, risk awareness at banks should be improved by including all risks in the balance sheet and introducing a retention for securitisations. "The banks are forced to raise their risk capital. It should be made possible for them to increase and decrease capital on an anti-cyclical basis," explains Dr. Sawazki. Banks would have to refinance themselves according to deadlines and gear staff compensation systems to performance over several years. The result of current developments will be a reduction in the banks' return on equity in the future, in the course of increasing regulation.

*page 3 of 4*

# SAL. OPPENHEIM

Private bankers since 1789

## HISTORICAL VALUATION METHODS ABANDONED

For investors, IFRS fair value accounting means that overstatements on the equities and securities markets are increasing, valuations are being revised downwards and that historically developed measurement methods are no longer used. From the investor's point of view, this requires anti-cyclical tactical asset allocation based on increased risk capital as well as enhanced analysis instruments. "The focus should be more clearly on normalised profits and cash flow factors," advises Dr. Sawazki. Investors should increasingly analyse all asset changes in financials – including equity impacts, which are not visible in the income statement. "Looking at profit reported is insufficient," explains Dr. Sawazki. As such, further considerable write-downs are to be expected for bank, and real estate and insurance stocks in the next few months.

In their conclusion to the study, the authors assume that the financial crisis will enter a new phase during the coming months. "The crisis has reached its peak but the pain is growing," fears Dr. Sawazki. Due to the subprime crisis, there is no flexibility left in the capital base of some institutions to intercept, for one, the further write-downs on the problematic assets and, for another, the foreseeable risks of the global economic slowdown and the increasing loan defaults. The latest dramatic escalation – bank bankruptcies and liquidation of financial service providers – initially brought with it the threat of further forced selling, which could put a strain on asset prices across the board and cause more write-downs. However, in light of the worsening of the crisis around the world, concentrated stabilisation efforts by governments and central banks are essential, as is regulatory intervention by the supervisory authorities and standard setters. In particular, the US Treasury's planned USD 700 billion rescue campaign is likely to gradually help to stabilise the lending markets. "The effects of the crisis will hugely increase the consolidation pressure in the banking environment," says Dr. Sawazki. The crisis also highlights the benefit of equity-financed business models.

approx. 9,000 characters

## CONTACT

Sal. Oppenheim jr. & Cie. KGaA

Press and PR

Dirk von Manikowsky

Tel. +49 221 145-1955

E-mail: [presse@oppenheim.de](mailto:presse@oppenheim.de)

*page 4 of 4*