

# Chapter 7

## Accounting Standards in the U.S. Banking Industry during the Financial Crisis

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### ABSTRACT

*The global financial crisis became evident when U.S. house prices fell related to the subprime mortgage-backed securities crisis. In the years preceding the financial crisis of 2008, there was a real estate bubble that pushed U.S. real estate prices to high levels, and at the same time financial institutions were holding large amounts of subprime mortgage-backed securities. Fair value accounting (FVA) and its link to the recent global financial crisis has been a focus of discussion and interest for accounting researchers, financial analyst and policy makers. During the financial crisis, a large percentage of assets in the balance sheets of banks were calculated using fair value. The main concern was that those assets were calculated using mark-to-model accounting (Goh, Ng, & Yong 2009). There are still contradictory conclusions on the implications of fair value accounting and the global financial crisis (Laux & Leuz, 2009). The main objective of this chapter is to provide a better understanding of the global financial crisis and of the mechanisms of fair value accounting.*

### INTRODUCTION

The global financial crisis became evident when U.S. house prices fell related to the subprime mortgage-backed securities crisis. In the years preceding the financial crisis of 2008, there was a real estate bubble that pushed real estate prices to high levels, and at the same time financial institutions were holding large amounts of subprime mortgage-backed securities. An estimated

subprime debt of \$500 billion was linked to \$140 trillion in global assets (Wallison, 2008). The bubble burst when house prices fell, generating large losses on mortgage-backed securities. Fair value accounting (FVA) and its link to the recent global financial crisis has been a focus of discussion and interest for accounting researchers, financial analysts and policy makers. During the financial crisis, a large percentage of assets in the balance sheets of banks were calculated using fair

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value. The main concern was that those assets were calculated using mark-to-model accounting (Goh, Ng, & Yong, 2009). This kind of behavior was a concern because the calculation of fair values during a period of economic distress may have not been the most efficient way to estimate the real value of assets.

A common problem was that financial institutions were not holding loans that they originated because of the widespread use of securitization. Securitization occurs when the loan originator sells loans and debt obligations to investors, so the loan originator may be biased towards lowering its underwriting standards, therefore increasing the risk of default. Underwriting is the process to determine the probability of the borrower to pay back the loan. During the financial crisis, a large percentage of mortgage loans, often interest-only mortgages (Financial Crisis Inquiry Commission, 2011), were granted to buyers or investors using relaxed standards that, under stricter standards, would have not been approved. These types of accounting practices increased the risk of default. Wallinson (2008) mentions a list of guilty parties such as loan originator with low underwriting standards, ineffective credit risk models provided by credit rating agencies, high risk borrowers taking loans that they cannot afford, and ineffective supervision by regulatory entities.

## **CONTRADICTIONARY RESULTS ON THE EFFECTS OF FAIR VALUE ACCOUNTING**

There are still contradictory conclusions about the role of fair value accounting and its link to the global financial crisis. Some research studies claim that fair value accounting generated and worsened the financial crisis (Wallinson, 2008; Plantin, Sapra & Shin, 2008). Wallinson (2008) contends that fair value accounting was the main reason for a sharp loss of the value of assets of financial institutions and at the same time a sharp

increase in the volatility of their corresponding value, therefore accounting regulations have to be updated in order to avoid these accounting distortions. He noted that a financial institution may look healthy or unhealthy from an accounting point of view only depending on the method used to value its assets. So, depending on the method, a financial institution may be reporting losses, therefore hurting investors and stockholders. Fair value regulations were not industry specific with the original intention that it can help the comparison of companies across industries, but this created a problem because the same type of regulation was applied to different firms operating in different industries. Depending on the nature of the specific industry, some companies will follow a business model where they hold assets to maturity, and some others will operate under a different business model where they actively trade assets with the purpose of reselling in the short term. In addition to that, it is also difficult to compare firms within the same industry given the fact that not every company within the same industry values the same percentage of assets at fair value, and in addition to that depending upon if observable market prices are available, companies within the same industry may be using different fair value methods to appraise the value of their corresponding assets. Wallinson (2008) also questions the use of market values on assets that companies are not planning to sell; therefore he entertains the idea of developing a nonmarket valuation model for these kinds of assets. After all, fair value regulations were designed under the assumption of normal market conditions, so he also entertains the idea of developing fair value regulations for markets that are not operating under normal conditions.

In addition, researchers have found other problems with fair value accounting. For example, FVA may not have been appropriate for assets with a long maturity date. Further, fair value accounting calculations may have been affected by liquidity problems (Laux & Leuz, 2009). Moreover, valu-

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