Accounting at the G20 London Summit
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Accounting at the G20 London summit: Watering down or walking the talk?

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It doesn't happen very often that technical matters like accounting standards make it into the final declaration of a G20 summit, agreed by the heads of government of the world's leading nations. Nevertheless, yesterday it happened (PDF). After deliberating for two days in the City of London about the appropriate means to cure the most severe worldwide financial crisis since 1929, the leaders of the G20 stated in their declaration on strengthening the financial system

> We have agreed that the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons…. We also welcome the FSF recommendation on procyclicality that address accounting issues. We have agreed that accounting standard setters should take action by the end of 2009 to … (for more see PDF)

Why did something so mundane make it to the agenda of world politics? While it is certainly the merit of Nicolas Sarkozy's populist threat to walk demonstratively out of the summit that made bloggers and newspaper writers wonder whether accounting standards could save the G20, the reasons for the G20 leaders dealing with "fair value" and "dynamic provision" are certainly more complex. Some, likeDavid Zaring, also wonder whether the G20 summit produced more than just rhetoric.

Certainly the declaration of the summit, as all declarations of this kind, encompasses a significant dose of political grandstanding which different political leaders will use to satisfy their domestic electorates, as highlighted in the Ft.com. Nevertheless, behind the usual rhetoric there is a level of detail that gives reason to believe that a substantial revision of the content and governance of banking and accounting standard setting might be conceivable in the near future.

To understand the current political attention to banking and accounting standards one has to dig into the causes of the current crises. As Martin Hellwig of the Max Planck Institute for Research on Collective Goods, points out in his analysis of the subprime-mortgage financial crisis (PDF), Basel capital adequacy and fair value accounting standards together with a malfunctioning of the market for over-the-counter derivatives and other securitized financial products were significant factors for the spreading of the sub-prime mortgage crisis from the US across the world financial system.

An accounting history of the crisis

The crisis had first-order and second-order causes. The first-order causes are located in macroeconomic developments such as huge imbalances in world trade, abundant liquidity and continuously low interest rates, as well as excessive maturity transformation in mortgage securitization in the US. The mortgage crisis rapidly

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translated into downward pressures on securities prices. The second-order causes, in turn, led to a self-enforcing downward spiral which spread systemic risk from mortgages to other parts of the financial system and from the US across the globe.

One of these secondary causes was fair value accounting which had been introduced to US banking as a reaction to the Savings and Loans crisis in the 1980s. At that time, fair value accounting was thought of as a remedy to cure the overestimation of banks assets accounted for at historical costs but devalued in a changing environment. In the current crisis, however, fair value had exactly the opposite effect. As banks incurred losses from mortgages, they had to write off their assets at rapidly declining market prices.

As the crisis unfolded, there was often no market price any more, as markets simply stopped functioning. Accounting rules forced banks to write off their assets, and as they did so, capital adequacy standards required that they either take additional capital in, or retrench their overall lending. As more banks had to write off assets they entered a vicious cycle of failure which was reinforced by the fact that banks worldwide had been economizing on equity capital since the 1990s and therefore did not have sufficient capital buffers to soften the effects of the crisis.

Martin Hellwig concludes that it was not too little regulation or too little supervision that went wrong. Instead, he states that

> the regulation we currently have may actually have exacerbated the crisis

Since the publication of Hellwig's study, the need for reforms to prevent unintended and undesirable pro-cyclical effects of prudential banking regulation and fair value accounting standards has been broadly recognized in academic and public debates.

A plethora of studies and reports converging on the need for reform

Over the last 13 months, a remarkable number of analytical reports and policy recommendations have been published which tackle problems of and remedies for the financial crisis from various perspectives. It seems worthwhile to rapidly browse through them to see what their conclusions are for future accounting and prudential regulation, without any claim for completeness. Interested readers might wish to make up their own views using the following resources:

- US President's Working Group on Financial Markets (PDF), March 2008
- G20 Washington Action Plan (PDF), November 15, 2008
- The Group of Thirty Report (PDF), January 15, 2009
- De Larosière Report EU (PDF), February 25, 2009
- Progress Report on Washington Action Plan, UK Chair of G20 (PDF), March 14, 2009
- Turner Review Financial Services Agency UK (PDF), March 18, 2009
- G20 Working Group 1 – Final Report (PDF), March 25, 2009
- Report Financial Stability Forum (PDF), April 2, 2009
- G20 London Summit Declaration (PDF), April 2, 2009

In March 2008, when the secondary effects of the subprime mortgage crisis were still unfolding, the US President's Working Group on Financial markets stated that (PDF)

> Authorities should encourage FASB (the American accounting standard setter) to evaluate the role of accounting standards in the current market turmoil.

The Washington Action Plan, agreed by the G20 during their summit in November 15, 2008 (PDF) suggested that global accounting standard-setting bodies should enhance guidance for the evaluation of securities in illiquid

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markets, advance their work to address weaknesses in accounting and enhance the disclosure of complex financial instruments. In addition, financial standard setters were asked to strengthen capital requirements for banks credit and securitization activities.

A report by the Group of Thirty (PDF), under the leadership of Paul A. Volcker, issued two month later, criticised the too-rigid application of fair value accounting rules and pointed to an underlying tension between the business purposes of financial institutions – particularly the intermediation of credit and liquidity risk – and the interest of investors and creditors to have the best current information on the immediate market value of assets and liabilities. While the report maintained that mark-to-market accounting is the preferred method for trading activities, it suggested that

> Fair value accounting principles and standards should be re-evaluated with a view to developing more realistic guidelines for dealing with less-liquid instruments and distressed markets.

The high-level group of financial supervisors in the EU, chaired by Jacques de Larosière, went far further in reviewing the weaknesses of a mark-to-market principle as applied to the financial system. The authors of this report (PDF) not only highlighted that

> It is particularly important that banks can retain the possibility to keep assets, accounted for amortised cost at historical or original fair value (corrected, of course, for future impairments), over a long period in the banking book. …. Regarding the issue of pro-cyclicality, as a matter of principle, the accounting system should be neutral and not allowed to change business models – which it has been doing in the by past by "incentivising" banks to act short term.

In order to reduce pro-cyclical effects, the Larosière report also suggested that prudential regulation should be revised so that banks can create counter-cyclical capital buffers. In their assessment of risk "through the cycle" banks should follow the method of "dynamic provisioning" introduced by the Bank of Spain in 2000. Furthermore, the report broached the issue of the so-far relatively encapsulated world of highly technical private standard setting in which, as studies by Sebastian Botzem and Carlos Ramirez show, representatives of the world's largest accounting firms play a leading role:

> It should be the role of the International Accounting Standard Board (IASB) to foster the emergence of a consensus as to where and how the mark-to-market principle should apply – and where it should not. The IASB must, to this end, open itself up more to the views of the regulatory, supervisory and business communities. This should be coupled with developing a far more responsive, open, accountable and balanced governance structure. If such a consensus does not emerge, it should be the role of the international community to set limits to the application of the mark-to-market principle.

Counter-cyclical approaches for reforms of prudential financial and accounting regulation also figured very high on the agenda of the Turner review (PDF) of theUK Financial Services Authority, published in March 2009. The report recommended a combination of "through the cycle" risk estimates (instead of "point-in-time" estimates), the creation of counter-cyclical capital buffers and transparent reporting of counter-cyclical buffers in published accounts as "economic cycle reserve". Again, the Spanish experience with "dynamic provisioning" featured as a positive benchmark for future financial and accounting regulation:

The so-called statistical or dynamic provisioning is, as the Governor of the Bank of Spain explained in a speech at the Federal Reserve Bank of Chicago, a solvency provision for financial institutions which dynamically captures

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their capital provisions for expected losses over the business cycle. Thanks to the mechanism of the statistical provision, the burden of credit risk on the profits of banking institutions is better-spread over the cycle. In terms of accounting, these provisions are considered value adjustments and will be deducted from the book value of the credit items that produce it in the published accounts.

Prospects for reform in the G20 group: Watering down or Walking the Talk?

It is a well-known fact that big politics works along its own dynamics. The more global a summit is, the higher the likelihood for dilution of policy recommendation. How do the results then compare to the problem analysis and policy recommendations that were available from the above reports prior to the summit? While an overall evaluation would lead too far here (for a more comprehensive debate see voxeu.org), a reading of the final declaration on prudential regulation and accounting standards (PDF) raises hopes that concrete steps will follow in the next months:

> Prudential regulatory standards should be strengthened. Buffers above regulatory minima should be increased and the quality of capital should be enhanced. Guidelines for harmonisation of the definition of capital should be produced by end of 2009.
>
> The FSB, BCBS, and CFGS, working with accounting standards setters, should take forward, with a deadline of end 2009, implementation of the recommendations published today to mitigate procyclicality, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate.
>
> We will amend our regulatory systems to ensure authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadow banks, and private pools of capital to limit the build up of systemic risk.

At the same time, the G20 declarations about the direction of a necessary reform of accounting standards for the financial sector remain somewhat vague in comparison to the level of sophistication of some of the reports reviewed above. Particularly, it seems disputable whether the suggestions made for improvement of standards to overcome counter-cyclical effects can be achieved “while reaffirming the framework of fair value accounting”, as stated in the final declaration.

The Report of the Financial Stability Forum (FSF) on Addressing Pro-cyclicality in the Financial System (PDF), published on the day of the summit, though, strikes a more radical tone: The FSF recommends that standard setters give due consideration to alternative approaches to recognising and measuring loan losses that incorporate a broader range of available credit information, including a fair value model, an expected loss model and dynamic provisioning.

Given that the G20 decided to re-establish the FSF with enhanced capacity and broadened mandate as a Financial Stability Board (FSB), effective as of April 2 2009, the organisation has the potential to overcome the reservations that representatives of the FASB and IASB have articulated so far towards a substantial reconsideration of fair value accounting.

But that is another story to be dealt with in my next post.

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