MARK-TO-MARKET ACCOUNTING AND THE LOSS FIGURES PRODUCED BY LARGE AND COMPLEX BANKING GROUPS

This box outlines the accounting and valuation concepts behind the recent figures disclosed by euro area LCBGs. Contrary to certain media reports the majority of these figures reflect valuation changes on securities held rather than impairments reflecting outright credit losses. In any event, there are inherent difficulties in comparisons across institutions due to differences in the methods and assumptions used to value these exposures.

The impact of the sub-prime crisis can be seen in the figures disclosed by banks in their financial statements in two main ways: valuation changes on various assets and increases in credit impairments. Most of the figures recorded in banks’ accounts are valuation changes and relate to securities whose value has been adversely affected by the sub-prime turbulence. Under International Financial Reporting Standards (IFRS), euro area banks value these securities depending on the accounting category in which they were included at the time of recognition, namely: fair-value through profit or loss, available for sale (AFS) or held to maturity (HTM). According to reports from the LCBGs themselves, most sub-prime-related securities are accounted for under the first two categories. Those securities that were classified as “held for trading purposes”, and thus included in the fair-value through profit or loss category, must be valued at market prices, if such prices are available, or through a valuation technique, if they are not. The resulting changes are reflected directly in the profit and loss account of the holding entity.

For securities included under AFS, the decline in value that does not constitute an impairment of the asset is reflected in changes in equity (in a special AFS reserve) and the loss is not taken through the profit and loss account until the asset is sold. Banks generally have considerable discretion regarding whether AFS assets are impaired, which may be one of the reasons why there was not a material increase in impairments in the third quarter of 2007.
In addition, where banks have marked to market their own issued liabilities, deterioration in their credit risk standing will have a positive effect and lead to an increase in equity as it reflects a lower value of this obligation.

Furthermore, the way in which banks calculate mark-to-market valuation changes and whether these valuation changes are comparable across banks have attracted increased attention in the current period. Before the turmoil, under IFRS, banks disclosed limited information concerning the amount and type of assets that were marked to model. This situation in the euro area is in contrast to the United States where new Generally Accepted Accounting Principles (GAAP) require certain disclosures concerning the portion of assets in a portfolio that are purely marked to model.¹ Large US financial institutions began to disclose these details during the course of 2007. In the meantime, however, most euro area LCBGs have also voluntarily revealed the scale of their actual exposures to holdings of sub-prime-related assets – including CDOs – in response to market developments and to considerations from their auditors.

¹ Under US GAAP accounting standards (SFAS 157), US financial institutions are required to classify these assets under a three-level hierarchy that gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In Level 2 reporting entities classify assets for which the only available inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.