Application of the Fair Value Principle to the Banks' Financial Statements

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INTRODUCTION

Market discipline has gained importance in step with the liberalisation and deregulation of the financial markets. To an increasing degree, the market penalises and rewards the decisions taken by the boards and managements of stock-exchange-listed companies. Several international organisations highlight the benefits to society of stronger market discipline, including the market's controlling role in ensuring financial stability. To optimise market discipline the market needs information. One source of information is the accounts of the companies in question, so it is important that they present as true and fair a view as possible.

In May this year, the Folketing (Parliament) adopted the Financial Business Act. The chapter of this act concerning financial reporting should be viewed in conjunction with the new Companies Accounts Act, also introduced in the spring of 2001, which is an exhaustive modernisation of the accounting regulations for non-financial enterprises. In future, annual financial statements are to have greater focus on the measurement and presentation of current values. For the financial enterprises, this increased focus on current values means that the fair value principle has been introduced as the new main valuation principle. The greater use of current values in the presentation of financial statements will support the market's opportunities to exercise control.

The use of the fair value principle as the principal rule in the new legislation for the financial sector will not enter into force until a committee under the Danish Financial Supervisory Authority has examined the consequences of introducing the new rules. Their deliberations will include assessment of how valuation is affected by the introduction of the fair value principle, and how to ensure a sound transition. Until then, the present valuation principles will still apply. Sound committee work is important, since the consequences should be considered fully before the fair value principle is introduced.

1 Crockett (2001).
In principle, Danmarks Nationalbank believes that the existing prudent accounting principle gives the financial institutions an incentive to pursue an appropriate valuation policy. The introduction of new rules must not reduce certainty that the institutions can fulfil their obligations, as also stated in the explanatory memorandum to the act.

The purpose of this article is to outline some of the problematic issues to be discussed prior to the application of the fair value principle. The article considers in particular the problems relating to determining the fair value of the banks' lending. The first part considers the valuation principles of financial enterprises. The legislative history is described and the fair value principle is compared with the current valuation rules. The second part focuses on the implications, including the benefits and drawbacks of applying the fair value principle. The new rules are expected to have a positive impact on the market's opportunities to exert control. The third part describes the international development concerning accounting valuation standards.

Even though the EU has drawn up a future strategy for the area of accounting, there is no clear picture of the international development in this area. If the international development continues to be subject to uncertainty, this will affect the process in Denmark. The explanatory memorandum to the Act thus states that the application of the fair value principle will not be introduced until "the development in international practice makes this appropriate".

**VALUATION PRINCIPLES**

**Legislative development in Denmark**

The Financial Business Act follows up on the recommendations of the report "The Financial Sector after the Year 2000" submitted in 1999 by a committee under the Ministry of Economic Affairs. The greater integration of the financial markets and the formation of financial conglomerates are the background to the new Act, which combines a number of uniform rules from the acts on individual sectors. The objective is to ensure equal treatment of uniform financial products, irrespective of their origin.

The chapter on accounting of the new Financial Business Act also includes actual legislative amendments. Although financial enterprises are not subject to the new Companies Accounts Act, the wording of the new Financial Business Act is almost identical to the parallel provisions of the new Companies Accounts Act. This is to ensure that the presentation of

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financial statements by financial and non-financial enterprises is based on the same principles and the same set of concepts. In both the new Companies Accounts Act and the chapter on accounting reference is made to the international development in the field of financial statements, including reference to the fact that the internationalisation of financial markets to an increasing degree requires accounting regulations which ensure transparency and comparability of financial statements presented at an international level.

The new accounting rules in theory reflect a shift away from transaction-based towards value-based financial reporting. Transaction-based financial reporting is subject to the principles of realised transactions and valuation on the basis of historical cost price. In value-based financial reporting there is more emphasis on current and correct valuation of assets and liabilities, while a transaction does not necessarily have to take place for a value adjustment to be carried to the profit and loss account.

The amendment of the valuation principle in the Financial Business Act is due to the fact that the current main principle already provides for so many exemptions that it could be misleading to retain it. Moreover, the development in international accounting principles indicates that more and more assets and liabilities are to be valued at fair value, since it is assumed that this will lead to more transparent and comparable financial statements.

**True and fair view**
The main requirement of any financial statement is that it gives a true and fair view of the institution's balance sheet, financial position and result. The true and fair view is an abstract requirement to ensure that the submitted financial statements are relevant and clear to the reader. The true and fair view is supported by a number of more specific fundamental assumptions, including requirements that transactions, events and value adjustments are included when they occur, irrespective of time of payment (the accrual principle).

When assessing the fair value principle and the present valuation principles, it should be borne in mind that valuations are influenced by subjective assessments.

**The current valuation principles**
The valuation of the financial institutions' assets and liabilities is governed by the prudent accounting principle. This has two implications for...
financial enterprises. In one sense, as a general rule, gains may not be included before they are realised, while losses must be included as soon as they are likely. Secondly, the prudent accounting principle is interpreted in the sense that in practice, within the framework of the Act, the financial enterprises adopt a prudent approach to the valuation of assets and liabilities. The application of the prudent accounting principle varies among the individual financial institutions.

Moreover, valuation according to the current rules is influenced by the fact that varying valuation principles are applied to individual balance-sheet items. The current valuation principle is based on historical costs, i.e. the asset is valued on the basis of the acquisition price.

Listed securities must be valued at the officially listed prices as of the close of the financial year. Listed securities are thus stated at market value, which is an exception from the historical cost principle and the prudent accounting principle. On the other hand, unlisted securities are primarily valued at acquisition price. Should their market value decrease, unlisted securities must be written down, but they may not be written up beyond the acquisition price.

Lending is valued at nominal value, which corresponds to the debt less provisions (outstanding debt). Write-offs (losses) and write-downs (provisions) are made on lending after close perusal of the individual outstanding claims. The provisions must be necessary and adequate to cover the expected losses.

The current valuation rules thus entail that both realised and unrealised asset value depreciation is deducted in the profit and loss account, while on a smaller scale unrealised value increases can be carried to the profit and loss account.

The prudent accounting principle has been criticised for being conducive to the creation of "hidden reserves". This means that within the framework of the Act, the financial enterprise builds a buffer between the valuation in the financial statements and the "true" value. Together with the fact that the financial enterprises do not apply the prudent accounting principle on a uniform scale, this makes it difficult for readers of the financial statements to assess how prudent the various financial enterprises actually are. The prudent accounting principle can thus contribute to reducing the reliability of the financial statements, and thereby their value as the relevant basis for decision by readers of the financial statements.

The "hidden reserve" which is built up under the prudent accounting principle, can, on the other hand, contribute to equalising results across

1 Cf. Danish Commercial Banks and Savings Banks Act, Section 32, subsection 1, no. 3.
favourable and less favourable periods, and thereby to dampening stockholders' demand for dividends in periods when results are favourable. A buffer of this type can help to safeguard financial stability.

The fair value principle
According to the Financial Business Act the valuation principle will be changed to fair value, measured as "the market value of the asset or liability in a well-functioning market. If the asset or liability is not traded on a well-functioning market, a recognised method is used to calculate the fair value of the asset or liability in question". The ongoing value adjustment of assets and liabilities must be included in the profit and loss account. Equity capital will be continuously affected by the fluctuations in the value of the assets and liabilities.

As already stated, the fair value principle is already applied by the financial enterprises with regard to certain items, e.g. the listed securities portfolios. A significant proportion of the balance sheet of credit institutions, e.g. lending and deposits, is not traded in well-functioning markets. The fair value of assets and liabilities which are not traded in well-functioning markets can in theory be estimated using recognised calculation methods. Fair value is an estimate of the proceeds from transfer of an asset to a buyer on market terms. In the case of a liability, the set-off value of the liability on market terms must be estimated.

The new Financial Business Act does not apply the existing prudent accounting principle. The goal is for the future value-based financial statements to reflect to a greater degree the actual financial situation of the financial enterprises, so that "hidden reserves" are avoided.

IMPLICATIONS OF THE FAIR VALUE PRINCIPLE

Introducing the fair value principle as the main rule in the new Financial Business Act is a step towards improving opportunities for the market to function as a control mechanism. The Bank for International Settlements (BIS) among others has pointed out that more can be done to improve market discipline, primarily by providing the market with better information. However, it is also emphasised that a certain amount of prudence or conservatism applied to valuation can act as a natural stabiliser to prevent the financial institutions from contributing to the fluctuations in the economy.

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1 In accordance with information from the Danish Financial Supervisory Authority Denmark is among the countries which have made most progress in consideration of application of fair values to the accounts of life assurance companies.

2 Crockett (2001b).
In the following certain circumstances which the introduction of the fair value principle would change are outlined. This list is not exhaustive, and several of the factors stated are generally well-known, as they were part of the process to draft the new legislation.

**The fair value principle and loan portfolios**

At the present time, there are neither national nor international rules for how lending is to be included in the financial statements at fair value. Before the fair value principle is implemented in Denmark, the committee described above must clarify how the credit institutions’ lending will be valued, compared to the current practice. Assessment of the consequences of applying the fair value principle to lending is of interest since the loan portfolio is a significant item of the financial institutions' balance sheet, and is not subject to market trading.

Today, lending by financial institutions is included in the financial statements at nominal value. Losses considered to be final are written off directly to the nominal value of the lending. Should close inspection of a debtor’s ability and willingness to service the loan show that all or part of the loan is not expected to be repaid, a loan loss provision is made and the nominal value of the loan is written down. If collateral has been pledged for a loan against which a provision is made, the expected value of the collateral is set off against the provision. The provisions made by Danish financial institutions are governed by the prudent accounting principle.

Since there is no practical experience from measuring the fair value of lending, the implications of transition to fair value measurement can be assessed on the basis of the assumptions and methods which are currently expected to form the valuation basis. The fair value of a loan portfolio must reflect the potential proceeds from the portfolio on transfer to another lender on market terms. Calculation of the present value of the loan portfolio is emphasised as a possible estimation of fair value.

The present value method provides good opportunities for the financial institutions to calculate the fair values on a portfolio basis, which is in accordance with the institutions’ other risk management methods. When calculating the present value of the loan portfolio, the loan's expected future cash flows are rediscouned at a risk-adjusted interest rate. This risk-adjusted interest rate is called the discount factor. Determination of the discount factor is affected by a large number of differ-

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1. The concepts of provisions and write-downs are used interchangeably.
2. The risk adjustment can also be of the expected future payment flows.
ent factors, which can be generally classified as: current market interest rates, institution-specific assumptions and credit risks. Current market interest rates will determine the risk-free interest rate which is e.g. affected by the development on the financial markets. Institution-specific assumptions can e.g. be affected by the institution’s strategy and risk-management methods. A number of factors affect the estimation of the credit risk, such as the current cyclical position, political decisions, geographical and sectoral development trends, and the financial institution’s opportunities to diversify its risk. The credit risk is difficult to estimate precisely, just as it will vary among the individual credit institutions. Determining the discount factor will be complicated, and the valuation cannot be immediately verified in market prices, which can make the valuation less transparent.

When the fair value principle is applied provisions will be replaced by direct write-ups and write-downs of the value of the loan portfolio, rather than being booked to a separate account – the corrective account – as is the case today. In principle, the two methods involved can over a period in theory lead to the same accounting result.

As stated, a key purpose of the fair value principle is to avoid “hidden reserves”. However, the present values would have to be calculated on the basis of a weighting of the factors included in the discount factor. It can thus be argued that readers of financial statements can find it difficult to assess the principles on which the financial enterprise’s valuation is based. In principle, it is the same problem as for the prudent accounting principle.

When financial statements are presented on the basis of the fair value principle, the value of the loan portfolio will have to be written up or down as soon as market or cyclical fluctuations take place, so that current values are presented in the annual financial statements. According to the current valuation principle, provisions are not made until the market or cyclical fluctuations have affected the financial position of the individual borrower, so that losses are expected. Against this background it can be argued that with the fair value principle the change in credit risk is recognised earlier than in the case of the current principle. Valuation based on the fair value principle is thus more forward-looking. The philosophy behind this argument is outlined in Box 1.

Fair value principle in a cyclical context
Experience shows that the financial sector has been better at diversifying across sectors than over time. The financial institutions thus to a high

\[^1\] Jackson and Lodge (2000).
degree focus on achieving diversification by spreading the credit risk over a number of sectors. However, previous periods have shown that the credit risk is highly dependent on risks related to the cyclical development, cf. Box 2.

The seeds of the bad times are sown when excessive risks are taken in upturn periods. In the good times, the financial sector must build reserves to counter future downturns. However, several empirical studies have shown that the financial sector finds it difficult to adhere to this wisdom\(^1\). Development in Denmark also indicates a close correlation be-

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Several international analyses have illustrated the relation between financial stability and economic growth. It is pointed out that lower economic growth can diminish borrowers’ ability to repay their debt. However, this relation is not one-sided, since through its behaviour the financial sector can be said to amplify the economic development\(^1\). As an example, the financial sector continues to extend credit on apparently favourable terms in cases where credit granting is based on higher values of underlying collateral. However, ongoing credit granting in itself can help to support rising collateral values, and thereby keep the level artificially inflated. As a consequence, the fluctuations in economic growth are amplified, which in turn can influence financial stability, as the sector is affected more severely when the downturn actually comes.

The financial sector’s procyclicality was already pointed out by Keynes in the 1930s, and in most recent literature\(^2\) is explained by “disaster myopia” and “cognitive dissonance”. Both explanations focus on psychological conditions.

Disaster myopia entails that the financial sector systematically underestimates the risk of a catastrophe. Memories are not long enough to remember the problems faced in previous times, so that this experience is not adequately incorporated in credit granting. In the case of cognitive dissonance a strategy is maintained despite new information to undermine it. Dissonance will be rejected, either by refuting the new information, or by influencing prevailing opinion to support the previous strategy. The problems are not recognised in time, for fear of unpleasant consequences in the short term.

As a consequence of the impact of the psychological factors the financial sector’s behaviour does not indicate sufficient foresight. Provisions are thus not made until the problems have materialised, and not when the risks are greatest, i.e. when the boom peaks. On the other hand, credit granting is restrained when the problems are apparent in a recession. However, in this situation the risks have diminished, in view of the greater probability that things are starting to pick up again.

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\(^1\) Borio, Furfine and Lowe (2001).
\(^2\) Beattie et al. (1995).
\(^3\) Guttentag and Herring (1986).

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between growth in lending, GDP growth and loss and provision ratios, cf. Chart 1. In periods of high economic growth, credit expansion is strong. On the other hand, the financial institutions do not make the necessary provisions until an economic slowdown has actually set in. There are several reasons for this, including legislation, which does not generally permit income smoothing.

Much will depend on whether the fair value principle can encourage the financial institutions to focus more on longer horizons in connection with the valuation of assets and liabilities. The application of the fair value principle and the discounting back of all future payment flows pertaining to a loan can thus help to put more focus on the development over time, rather than exclusively on the diversification among sectors.
Volatility
When the fair value principle is applied, financial statements can be expected to show greater fluctuation than balance-sheet items valued at historical cost and according to the prudent accounting principle. International analyses thus indicate that the fair value principle can lead to greater volatility in the banks’ earnings and equity capital. A precondition for this greater volatility having the appropriate impact on the market is that readers of financial statements can interpret the more volatile valuations. If this is not the case, the fair value principle can reduce transparency and thereby the market’s opportunities to discipline the financial enterprises.

Further reporting requirements such as the publication of sensitivity tests for individual items of the financial statements can contribute to clarification. The fair values stated in the financial statements should thus be supplemented with information to illustrate the sensitivity of the balance sheet to unforeseen fluctuations. During a possible transition period between the current accounting rules and the fair value principle readers of financial statements might be prepared for this via the introduction of notes to the financial statements with details of fair values.

1 Banque de France (2001).
Capital adequacy and the fair value principle

When the fair value principle is applied, the valuation of assets and liabilities will be continuously affected by the current market and cyclical situation, besides a number of other conditions. These current valuation fluctuations can result in ongoing fluctuations in equity capital too.

Greater fluctuations in equity capital can present difficulties for the financial enterprises as a consequence of the capital adequacy rules to which they are subject. Under the current capital adequacy rules, in principle the unexpected losses are covered by capital reserves, while provisions cover the losses which are expected. Since financial stability must be protected, greater fluctuations in capital adequacy are not desirable. The explanatory memorandum to the Act also states that the application of the new valuation principle must not reduce certainty that the credit institutions can fulfil their obligations, and it should also be considered whether the change makes it necessary to adapt the capital requirements of the credit institutions.

Capital adequacy rules are also subject to change⁠. In January 2001, the Basel Committee published its second consultation paper on new capital adequacy rules for the banks. The purpose of the proposed rules is to improve continuity between the capital adequacy rules and the real risks assumed by the banks. This strengthens the correlation between the methods the banks use to actually manage and hedge their risks, and the capital adequacy rules to which they are subject.

The overall effect on the banks’ behaviour of the new accounting rules and capital adequacy rules is not clear at the present time, and should be subject to thorough analysis.

INTERNATIONAL DEVELOPMENT TRENDS

The EU has adopted the joint accounting strategy² for the purpose of ensuring uniform presentation of financial statements by the European stock-exchange-listed companies, so as to increase comparability. As part of this accounting strategy, in time the accounting standards of the International Accounting Standards Board³ will be implemented. In the longer term, the objective of the International Accounting Standards Boards is for all financial assets and liabilities to be subject to valuation based on the fair value principle.

¹ For amplification, see Hyldahl (2001).
³ The International Accounting Standards Board was formed on the restructuring of the International Accounting Standards Committee.
As a follow-up to this strategy, in May 2001 the EU Council of Ministers and the European Parliament approved a directive intended to modernise the EU accounting directives, so as to implement the fair value principle. The objective is for the three directives' concerned to make it possible for the fair value principle to be applied to certain financial assets and liabilities.

In 1997, an international working group (Joint Working Group of Standard Setters) was set up to prepare a draft new standard to prescribe full application of the fair value principle to the valuation of financial assets and liabilities. The Joint Working Group of Standard Setters submitted the first "Draft Standard and Basis for Conclusions – Financial Instruments and Similar Items" for open consultation in December 2000. A number of international organisations, such as the Basel Committee and committees under the European Commission, are currently preparing consultative responses to the submitted drafts. The Basel Committee has previously expressed its reservations concerning the full utilisation of the fair value principle.

Dynamic provisions in relation to the fair value principle

The authorities of several countries are aware of the financial sector's strong dependence on the economy's development, including the sector's periodic procyclicality. Some countries have considered whether legislation should be amended to reduce procyclical influence and behaviour. The method used is dynamic provisions, cf. Box 3. The principle is that the financial institutions are required to increase provisions in the good times, based on experience from the economy's development in the past.

In principle the fair value principle and dynamic provisions can have equivalent influence on the financial statements and help to ensure a longer valuation horizon. In the case of dynamic provisions this takes place by building up a reserve to draw on in less favourable times. The fair value principle entails adjustment directly to the profit and loss account, and thereby via the base capital in the final analysis. The principal difference between the two valuation methods, however, is that the fair value principle...

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2. The members were accounts experts from Australia, Canada, France, Germany, Japan, New Zealand, the UK, USA, the Nordic countries and IASC.
3. The Joint Working Group of Standard Setters is a working group under the International Accounting Standards Board.
value method is forward-looking, while in practice dynamic provisions have been more retrospective.

Even though the two methods have no significant differences and in principle can serve the same purpose of contributing to greater stability, this still shows that there is no clear international development trend.

CONCLUDING REMARKS

The adoption of the Financial Business Act marked the start of a process whereby the consequences of the fair value principle are to be further analysed and debated before the principle can be applied as the main rule to the financial statements of financial enterprises. Full analysis and exhaustive committee work are very important to ensure a full overview of the consequences of the fair value principle before its implementa-

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1 Further reference is made to Hyldahl (2001) concerning the new capital adequacy rules.

2 It is possible that provisions can be made on groups of uniform minor loans on the basis of statistical calculations of debtor risk (statistical provisions) if these are necessary and adequate provisions to cover the exposure risks.
tion. In this respect it is also important to observe the international development.

The new principle will be a step towards providing the market with more up-to-date information on risk development in the financial enterprises. At least from a theoretical viewpoint, the fair value principle can help to improve market control, and thereby induce the boards and managements of financial enterprises to make decisions which can strengthen financial stability.

However, a number of the circumstances concerning the introduction of the fair value principle cast doubt on the qualities of the principle, and should be subject to thorough analysis. There is broad-based agreement that the fair value principle will lead to greater fluctuations in the accounting items compiled. This greater volatility can be unfortunate in cases where value measurements are estimates, and thereby subject to some uncertainty, especially if the market is characterised by herd behaviour. Very short-term thinking by the financial institutions - with insufficient account taken of the development throughout an entire business cycle, in order to fulfil their own and the market's requirements of immediate returns - can thus have a negative impact on financial stability. Moreover, further analysis will be particularly important in the current situation where the capital adequacy rules are also subject to revision, and where interplay and interaction between the new regulation methods are an indisputable fact.

On the introduction of the fair value principle it will be important that the financial institutions have an incentive to make appropriate long-term arrangements. For as long as its practical utilisation fulfils the intentions of the Financial Business Act, which emphasise that amending the valuation principle must not reduce certainty that the institutions can fulfil their obligations, progress will be made in safeguarding financial stability.
LITERATURE


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