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The financial valuation crisis

The inherent limits to taming unstable markets

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Publication date

2018

Document Version

Other version

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Citation for published version (APA):

Stellinga, B. J. P. (2018). *The financial valuation crisis: The inherent limits to taming unstable markets*.

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3 The unstable core of global finance. Contingent valuation and governance of international accounting standards³

3.1 Introduction

As financial globalization gathered pace in the 1980s, a fundamental question emerged in the domain of accounting standard setting: should countries converge on a single set of standards, and if so: who should develop these? Apart from this harmonization issue, a crucial question was how standards should be reformed given the major changes to the global economy. This latter issue was particularly pertinent in the domain of accounting for financial instruments. As financial markets changed rapidly – with many banks becoming complex, global institutions focused more and more on trading activities – accounting standard setters and banking regulators alike considered that accounting standards needed a thorough reform. These two issues – harmonization and reform – became intertwined in the work of the International Accounting Standards Board (IASB), which has become the de facto global standard setter since the European Union embraced its standards at start of the new millennium.

This chapter examines two decades of political battles over the IASB's financial instrument accounting standards. The main issue at stake was the balance between the application of Fair Value Accounting (FVA), which shows assets and liabilities at their current market value, and Historical Cost Accounting (HCA), which shows them at their acquisition cost (André et al. 2009). Remarkably, ever since the issue had risen to prominence in the mid-1990s, policymakers have been unable to agree on a clear set of accounting rules in this area. Instead, accounting standard setting in this field has been a succession of temporary policy fixes. Every standard that was agreed over the past 20 years was immediately recognized as deficient and in need of replacement with a more durable solution. What explains this pattern?

This pattern seems at odds with two dominant IPE-approaches: material interest-based bargaining (e.g. Lall 2014) and expert governance guided by shared sets of ideas (e.g. Büthe and Mattli 2011) (see chapter 2, section 2). The differences between these approaches mask a common assumption: actors in global financial governance have clear policy goals and know with which

³ This chapter is a modified version of: Mügge, D.K. and Stellinga, B. (2015) 'The unstable core of global finance: contingent valuation and governance of accounting standard setting', *Regulation & Governance*, 9 (1): 47-62. It also uses parts of: Stellinga, B. (2014) 'Accounting standards', pp. 78-96, in: Mügge, D.K. (ed.) *Europe and the Governance of Global Finance*, Oxford: Oxford University Press.

regulatory policies to promote them. If goals and their policy implications are clear to the actors involved, why do standard setters fail to design a coherent standard and stick to it?

Against an emphasis on bargaining between stakeholders with clear policy preferences, for example banks, we show that politics in this domain has been driven primarily by banking regulators who did and do not have such clear preferences – in spite of almost two decades of intense debate. Against an emphasis on the power of ideas (the putative dominance of FVA), we show that the central feature of this case is not a straightforward trend towards the adoption of FVA (cf. Power 2010), but the persistent *failure* to agree for good how and when FVA should be applied to financial instruments. Banking regulators have been central actors in the development of these standards, but they have not been able to derive unambiguous accounting preferences from either their policy goals or a guiding policy paradigm. As a consequence, governance patterns in this field have been highly unstable. Although that does not invalidate the expertise- and bargaining-perspectives *in general*, it does suggest that the pattern studied here requires a different explanation.

The key to two decades of unstable governance lies in the interaction between accounting rules on the one hand and financial stability and bank profitability on the other. Depending on market circumstances and future expectations, FVA and HCA can either promote or undermine both policy goals. In reflexive markets, accounting standards *influence* the asset values they only seek to *measure*, for example by inviting procyclicality. In the terminology used in chapter 2: accounting standards are performative. When FVA or HCA is applied in practice, it spawns market developments that bolster the case for switching to its alternative. That makes governance unstable: regulators realize that the application of a rule set undermines its efficacy. Because this applies to every potential accounting ‘solution’, rules are continually adapted without the emergence of a standard that is seen as more than a temporary fix.

This decades-long inability to settle a fundamental question in finance strikes at the heart of financial governance. Banks follow accounting standards when they calculate profits and losses, which determine their viability as going concerns or potential collapse. Credit rating agencies use banks’ accounts to assess creditworthiness. Supervisors and investors depend on banks’ reports on the value of their assets and liabilities. Hence, the dynamics of accounting standard setting are not ‘an exceptional case’ among diverse regulatory domains in finance. Accounting standards are a key pillar of global financial governance, and banking regulation is no more stable than the asset valuations that feed it.

We demonstrate how the IASB clashed with banks, global banking regulators and financial authorities in the European Union (EU), the most important adopter of the IASB's standards. To become effective in the EU, the EU's Accounting and Regulatory Committee (ARC) has to endorse IFRS (Dewing and Russell 2004). Although the ARC accepts most standards without change, for rules concerning financial instruments – the key standard for financial stability – it modified standards or outright refused endorsement. Instead, it followed the line set out by the banking regulators and supervisors in the Basel Committee on Banking Supervision (BCBS). That puts regulators central in both our conceptual framework and the empirical analysis.

The empirical sections cover three key episodes. In the late 1990s, the standard setter's proposal for full fair value accounting was defeated, with a standard mixing FVA and HCA as a temporary solution (episode 1). Subsequent proposed fixes included revised rules for hedge accounting and a fair value option (episode 2, early 2000s) and amendments to reclassification rules (episode 3, since the onset of the financial crisis), but all of these were recognized as inadequate and temporary, even as they were introduced. Even ten years after the crisis, the EU still uses the standard that the IASB had originally issued as a 'temporary solution' (IAS 39), with a full switch to the new standard (IFRS 9) taking at least another five years. Despite all parties' proclaimed eagerness finally to solve the accounting impasse, key issues remain unresolved.

3.2 The rise of international accounting standards

The European debate on accounting has been focused on both harmonization and reform. As it became clear during the 1990s that the European Commission wanted to harmonize European standards by adopting international accounting standards, the debate on accounting reform centered on the work of the IASB. This section discusses this shift, describing developments that led to the European endorsement of IASB's standards in 2002. It shows that the EU embraced these standards primarily for pragmatic reasons: they were readily available and a viable alternative to US standards. The standards' content was initially of secondary concern, but quickly gained more prominence. This was especially the case for the standard for financial instruments (IAS 39), which became a key concern for banks and banking regulators when they realized that it would become mandatory for all the major European banks.

3.2.1 Developments stimulating accounting harmonization in the EU

The rise of IFRS is intrinsically linked with European efforts to harmonize their rules. The setting of accounting standards in the EU was for a long time a national affair, generally the preserve of

finance ministries or other public organizations (see Büthe and Mattli 2011: 89-94). The European Commission began its attempts to harmonize accounting rules for limited liability companies in the EU in the 1970s, leading to the issuance of the Fourth Council Directive in 1978 and the Seventh Council Directive in 1983. The Commission's goal was to ensure the 'equivalence' of EU companies' financial statements (Van Hulle 2004). The Fourth Council Directive defined the types of companies required to prepare annual accounts and their formats. The Seventh Council Directive introduced a separation between annual and consolidated accounts: a significant distinction as only the annual accounts of listed companies were used for tax purposes. It implied that accounting harmonization need not intervene into governments' taxation policies. Still, the development of these directives was a painstaking process, as member states saw little urgency in harmonization and had different accounting traditions (Botzem 2012: 39-41).

Accounting harmonization in Europe accelerated in the late 1980s due to changes in the global and European corporate and financial landscape. The expansion of European business abroad involved multinational firms seeking funds in global financial markets. Due to the removal of intra-European barriers (part of the Single European Market program of 1986/87), Europe saw a rush of cross-border mergers and take-overs. The ties between the large European companies that ventured on European and global markets and their traditional financiers (such as creditor banks) thereby weakened, meaning that globalizing firms increasingly had to look for funds elsewhere. Many multinational firms chose to tap into booming, deep, and liquid US financial markets by listing on US stock exchanges. Between 1990 and 1998, the number of European companies listed in the USA rose from 50 to 250 (Camfferman and Zeff 2007: 427). Many were high-profile companies; Daimler Benz, for example, listed on the New York Stock Exchange in 1993.

US accounting standards (US Generally Accepted Accounting Principles [GAAP]) became the de facto global standards for multinational firms as foreign firms listed in the USA were required to adopt (or reconcile statements with) US GAAP (Camfferman and Zeff 2007: 311). This heightened the urgency of European accounting harmonization. Doing nothing was an unattractive option: it would likely mean that an ever-growing number of EU companies would shift to US GAAP, the content of which the EU could not influence.

The EU, however, was unable to develop its own set of rules (Dewing and Russell 2004; Véron et al. 2006; Posner 2010), because of disagreements among Member States and the EU lacked regulatory capacity to do so. Apart from the Commission, the most important EU fora for accounting matters were the Contact Committee (an advisory body composed of representatives

of member states) and the European Accounting Study Group (dubbed E5+2). Both were weak actors (Camfferman and Zeff 2007: 445-446).⁴ Developing a stronger institutional framework was not a feasible strategy for the Commission as member states and private actors alike remained wary of attempts to develop a separate set of EU standards (ibid.: 421). In the end, the Commission came to realize the minimal chances of EU-made accounting standards being recognized in the USA – where European standards were generally seen as deficient (Mügge 2007: 11).

Although the Commission tried to resolve some tensions in the directives in the early 1990s, it changed its course shortly thereafter: it began to see the International Accounting Standards (IASs) issued by the International Accounting Standards Committee (IASC) as the way forward to harmonize European accounting rules and counter growing US hegemony. In 1995, the Commission formulated its preference to permit or require EU listed companies to publish their statements according to IASs. This preference was thus largely pragmatic: it had little to do with the content of IASC's standards.

3.2.2 The IASC vis-à-vis the USA and the EU

The IASC was founded in 1973 by national accounting standards boards and operated until the birth of the International Accounting Standards Board (IASB) in 2001. Its goal was to “formulate and publish in the public interest, basic standards... and to promote their worldwide acceptance and observance” (Camfferman and Zeff 2007: 500). The IASC had little impact during its first two decades: its standards (IASs) were mainly used by developing countries on a voluntarily basis and it lacked enforcement power (Büthe and Mattli 2011: 69). Most developed countries (and specifically the USA) saw IASs as too flexible and of doubtful quality, arguing that they contained too many options and represented the lowest common denominator of global accounting practice (Camfferman and Zeff 2007; Zeff 2012).

During the 1970s and 1980s, the European Commission – which saw the issuance of directives as the path to EU-level accounting harmonization – paid little attention to the work of the IASC (Camfferman and Zeff 2007: 16-17). This changed in the late 1980s (Posner 2010). The EU now wanted the USA to acknowledge IASs as equivalent to US GAAP so European companies listed in the USA could use a non-US standard. The EU also wanted to prevent these standards from being fully modelled on US standards. The USA, on the other hand, stressed that international standards

⁴ The E5+2 forum consisted of accounting representatives from France, Germany, the Netherlands, the Nordic Federation, and the UK (E5) as well as representatives from the European Commission and the Federation of European Accountants (+2).

and standards setting procedures would have to improve before they were deemed equivalent to US GAAP.

The rise of IFRS involved negotiations between EU and USA agencies over the IASC's standard setting process (Camfferman and Zeff 2007; Posner 2010; Zeff 2012). The push for a new institutional framework was mainly due to pressure from the US Securities and Exchange Commission (SEC), as it had stated its recognition of IASs equivalency would depend on the quality of standards-setting procedures at the IASC. The EU favored a set-up based on the geographical representation of countries that had committed themselves to adopt the standards. The USA, in contrast, pushed for a governance framework involving independent experts, modelled on its own accounting framework (Zeff 2012: 819). The SEC expected that 'independent experts' selected based on their professional experience would almost by default come from accounting standards boards (or the big accountancy firms) that were inclined to the American view on accounting. The IASC sided with the USA as it feared for its own demise should the USA turn away and pursue international harmonization on its own terms (Camfferman and Zeff 2007: 443-446). The eventual outcome thus mirrored the SEC's wishes: a relatively independent standards-setting board – the IASB – replaced the IASC in 2001, without any prescribed geographical representation (ibid.: 15). The IASB inherited the International Accounting Standards (IASs) issued by IASC but would henceforth only issue International Financial Reporting Standards (IFRSs) that would eventually replace all IASs.

As the IASC strove for the recognition of its standards by national securities regulators (specifically the SEC), it sought cooperation with the International Organization of Securities Commissions (IOSCO). While the IASC had hoped for an IOSCO endorsement of its standards, the latter (mainly due to SEC pressure) stated that its endorsement would depend on their improvement. The IASC thus commenced on projects to improve IASs, first by eliminating the many options contained in them (1987-1993), then by developing a set of high quality 'core standards' (1993-1999) (Zeff 2012). Especially during this second phase, controversies about the standards' content emerged. Especially the standard for financial instruments became a cause for concern (more on this below), but not to the extent that the EU backtracked on its harmonization efforts: the push for harmonization was stronger than concerns about the standards' content.

The IASC completed work on its core standards in December 1998. While these standards leaned heavily on American accounting practices (Posner and Véron 2010: 404), they cannot be seen as just another version of US GAAP as differences remained significant (Leblond 2011). While the

IOSCO endorsed these standards in May 2000, this constituted a ‘hollow victory’ for the EU (and IASC). Following the demands the SEC had made earlier that year, IOSCO allowed national regulators to impose supplementary treatments on the statements of multinational companies complying with IASs (Zeff 2012: 822-823). Rather than a full endorsement implying the equivalence of US GAAP and IASs, the SEC could continue requiring companies to conform to or reconcile with US GAAP.

3.2.3 EU adoption of IAS/IFRS

European leaders decided to make IASs mandatory for the consolidated accounts of all European listed companies at the Lisbon Summit in 2000. This was formalized in EU Regulation No. 1606/2002 which required shifting to IASs by 2005. The harmonization of accounting standards was part of a general 1990s trend in the EU to centralize financial regulation (Posner 2009, 2010). Compared to the period before 1990, European governments and businesses had changed their positions on the desirability of a supranational strategy—a common framework was now seen as necessary to boost the European financial sector. The Financial Services Action Plan (FSAP) of March 2000 provided the legislation to integrate Europe’s national financial services industries (Posner 2009: 681). Part of this plan was to harmonize accounting rules. As many public and private stakeholders found EU decision-making procedures too cumbersome to keep up with financial market developments, the Lamfalussy process provided the institutional framework to speed up regulatory reforms at the EU level.

The years thereafter witnessed new dynamics in the global politics of accounting regulation (Posner 2010). Whereas the USA was by and large able to dictate developments in the 1990s (Simmons 2001), it now had to take a more cooperative stance (Posner 2010). The Enron and WorldCom scandals at the beginning of the millennium did much to challenge the aura of technical superiority around US GAAP (Zeff 2012). Significantly, in 2002 the US Congress asked the SEC to review FASB’s very detailed, ‘rules-based’ approach and to consider moving in IASB’s ‘principles-based’ direction. The EU’s adoption of IFRSs had bolstered the IASB’s bargaining position vis-à-vis the FASB. Without EU backing, it is inconceivable that the IASB would have emerged as an equal partner to FASB in the creation of a global accounting regime (Mügge 2007; Botzem 2012).

Still, the EU was hesitant to fully delegate rule-making authority to a private organization over which it had only limited influence. The adoption of IFRSs in the EU was therefore conditional (Botzem 2012: 43): the standards would have to be approved by several EU bodies following a comitology procedure before entering into force, implying that IASs/IFRSs would not

automatically become EU rules. The standards' content and their effects on the EU economy, occupying a secondary concern in the previous debates, were now getting more and more attention.

This endorsement procedure works as follows. After the IASB issues or modifies a standard, the European Financial Reporting Advisory Group (EFRAG) – a privately financed and managed organization staffed by accounting experts – advises the Commission on its compliance to European framework directives. The Standards Advice Review Group (SARG), staffed by representatives of national accounting standards boards, then reviews whether EFRAG's advice is balanced and objective. If both organizations give their approval, the Commission issues a draft endorsement regulation which is subsequently examined by the Accounting Regulatory Committee (ARC), staffed by national representatives. If ARC considers the regulation adequate, the European Council and European Parliament have three months to oppose the endorsement. If no objection is made, the regulation is approved and the standard enters into effect in the EU. Although the Commission can reject standards, postpone adoption, or in exceptional cases 'carve out' sections of standards, it cannot modify them by adding language.

This formal endorsement procedure became the most powerful tool, albeit a blunt one, for the EU to influence the standards setting process of the IASB. As a newly issued or modified standard would be scrutinized by European organizations, the IASB had an interest in ensuring the acceptability of its standards by EU organizations. As the IASB was keen to present itself as an independent standards setter uninfluenced by particularistic interests and had many other countries and organizations to consider (especially the SEC), it had to walk a tightrope between gaining the EU's acceptance and not appearing as a mere 'agent' of the Commission (Leblond 2011).

The EU faced a similar dilemma. It of course had an interest in ensuring standards that were acceptable within the EU, but also risked frustrating equivalence negotiations with the USA if it did not wholeheartedly implement IASB standards. In practice, this tension generally proved to be relatively unproblematic. The EU endorsed almost all standards without delay. As many listed companies were already familiar with international accounting practices (either US GAAP or IASs/IFRSs), most IASB standards were hardly controversial (Donnelly 2010: 227). But as we will see below, this was not the case for a particularly crucial issue: accounting for financial instruments.

3.3 Preference formation in global accounting standard setting

Given forceful intervention by public authorities, one would expect accounting standard setting in the area of financial instruments to exhibit parallels with other areas of global financial governance, for example standard setting for banks, securities markets and insurance (cf. Singer 2007). In these and other domains, stakeholders are argued to form policy preferences based either on their material interest or on a set of normative and technical beliefs. The distribution of relevant resources and the institutional setting then determine how individual preferences translate into policy output.

3.3.1 Expert governance

The case for technical rationality is strong in accounting standards: in 2002 the EU has outsourced standard design to the IASB, a private organization staffed by accounting experts (Camffermann and Zeff 2007). The countries using IFRS have had few levers to influence standard setting, and the IASB has become an exemplary case of transnational private governance (Botzem 2012; Büthe and Mattli 2011). This perspective emphasizes the institutions through which accounting standards are set; their specific substance, in contrast, is frequently of secondary concern. The rise of FVA as an accounting paradigm is explained by a functionalist logic: the rise of corporate restructuring in the 1980s increased the appeal of accounting techniques that reported the market value of assets and liabilities into which a company could be broken up (Barlev and Haddad 2003).

An emphasis on expert governance and epistemic communities leads us to expect relatively stable policy output. Policy changes incrementally, and rule output is mainly a function of public actors' willingness to delegate rule setting to experts who derive unambiguous accounting preferences from the dominant policy paradigm. The IASB has indeed shown a consistent preference for FVA in this area, but this preference has not generated stable and consistent policy output. Instead, we find a succession of temporary fixes and policy reversals. Another dynamic clearly is at play.

3.3.2 Bargaining perspectives

The main alternative approach sees regulation as captured by identifiable material interests, normally financial firms. Also here, policy preferences are considered relatively unproblematic. They are inferred either from the impact of harmonized rules on firms' competitiveness or from the domestic status quo (Oatley and Nabors 1998; cf. Simmons 2001). The defining hallmark of what we label the bargaining-approach is that the actors who actually make the difference to the observed policy outcomes have unambiguous preferences, such that the policy-dynamic is one of

powering, not puzzling, to use Hecló's terms (as cited in Hall 1993). So when internationally harmonized rules emerge, their substance follows from actors' relative bargaining power and prevailing domestic rules (Drezner 2007).

Applied to accounting standards, this approach has emphasized transatlantic rivalry (Mattli and Büthe 2005; Posner 2009; Büthe and Mattli 2011; Leblond 2011). Because it sees standard design by the IASB and the FASB as disconnected from political fights between their public sponsors (the EU and the USA, respectively), it studies the *success* of a particular rule detached from its specific *content*. Accounting standards setting becomes a coordination game comparable to the competition between, say, the BlueRay and HD DVD formats to succeed the DVD (Sunder 2002).

This scholarship captures very well the politics that have created the global dominance of IFRS and their incremental recognition in the USA. However, it provides less leverage on the actual content of these standards and the futile attempts to craft a lasting standard for financial instruments. Banks have been consistent and surprisingly unified across borders in their demand for accounting flexibility for financial instruments. But a durable accounting standard along those lines – as expected when emphasizing private interest bargaining – has not emerged. Concerned about financial stability, regulators successfully rebuffed both accounting standard setters, who consistently favored strict application of FVA, and banks, who preferred flexible accounting rules.

This emphasis on regulators stands prominent in the scholarship of Singer (2007; cf. Mügge 2010 in the European context), who has fused firms' interest in 'competitiveness' with regulators' concern for financial stability in a single framework. But in contrast to his findings for banking, securities and insurance, in our analysis the international politics of accounting for financial instruments are not primarily driven by bargaining between regulators with clear and incompatible preferences, even if international differences obviously exist (cf. Lagneau-Ymonet and Quack 2012). In the tug-of-war with the IASB, banking regulators, assembled in the BCBS, emerge as a relatively unified actor – but as one without a clear and consistent preference either for a specific accounting treatment for financial instruments or for allowing banks to choose one themselves. To understand these ambiguous preferences, we have to disentangle the link between accounting standards and financial stability.

3.4 Financial stability and ambiguous accounting preferences

In this chapter we distinguish between policy goals, policy preferences, and accounting preferences. Policy goals are the ends that actors want to attain by seeing a standard implemented

– for example financial stability for regulators, coherence and transparency for the IASB, or profitability for banks. Policy preferences are the specific standards that actors favor based on the expectation that they would promote these policy goals. Such a policy preference could be a very rigorous standard, for example, or one that gives financial institutions accounting flexibility. Accounting preferences, finally, are preferences for a particular accounting treatment, most importantly FVA or Historical Cost Accounting (HCA). Thus defined, a bank that consistently prefers flexibility in how it accounts for its financial instruments has a clear policy preference but no consistent accounting preference (which is why it favors flexibility).

We demonstrate that both regulators and firms are unable to form unambiguous accounting preferences. They cannot unequivocally answer the question: what should be the general rule for determining the value of financial assets and liabilities? That is true at any given moment, because stakeholders realize that the accounting treatment they prefer right then may not be the one they prefer at a later date. This ambiguity of preferences, in turn, leads to unstable governance over time, as one uneasy compromise is replaced with another.

This finding would hold *even if* we made the simplifying assumption that policy goals were fixed and unambiguous – financial stability for regulators, and profits for banks. Depending on market circumstances, FVA and HCA can buttress as well as undermine both policy goals. Banks favor the easy way out: a high degree of freedom to switch between accounting treatment at will. While they have a consistent policy preference – flexibility – the regulators do not: they oscillate between championing such flexibility and wanting to restrict it. The key to these ambiguous preferences lies in the contingency of valuation.

3.4.1 The contingency of financial valuation

Standards setters' inability to agree on an appropriate valuation technique derives from the contingency of value itself. Objects do not have a fixed, inherent value independent of our ability to measure it. Therefore, proponents of FVA argue, the current market value of any asset or liability is the best value-estimate we have, given that – if a market for that asset or liability exists – it integrates judgments of a wide variety of observers. Of course, the price investors are willing to pay for an asset is influenced by many external factors: interest rates, future expectations, investment alternatives, and so forth. The market valuation of financial instruments can therefore be extremely volatile (Mandelbrot and Hudson 2004). And if markets for an asset are illiquid, FVA

relies on models or estimates, introducing a highly subjective dimension into accounting (Enria et al. 2004: 8f, 46).⁵

On the macro-level, FVA can generate procyclicality (Laux and Leuz 2009; Magnan 2009; Novoa et al. 2009; Casabona and Shoaf 2010). Future assessments, as expressed in asset valuations, feed market behavior and can generate herding and self-fulfilling prophecies (Akerlof and Shiller 2009). For example, positive market sentiment can funnel credit into real estate and sustain an asset bubble that would otherwise collapse. Conversely, dropping prices can trigger asset sales, further depressing their value, triggering more sales, and so on. Such market reflexivity operates irrespective of accounting standards (cf. Minsky 2008 [1986]). But FVA translates changes in asset values into bank profits or losses and therefore incentivizes market participants to follow such self-reinforcing trends. FVA 'hardwires' market reflexivity into the financial system.

While HCA may temper market volatility, it generates its own problems. HCA records assets and liabilities at acquisition prices and does not update banks' books to reflect current market conditions (Barlev and Haddad 2003: 386). In an economic downturn banks may start amassing 'non-performing' loans hidden from market participants and financial supervisors; creditors doubt the banks' viability, stifling lending to businesses and thus prompting the further build-up of economic vulnerability and risk. The 1980s US Savings and Loans crisis and the Japanese economic stagnation in the 1990s are examples of hidden losses aggravating financial and economic problems (Enria et al. 2004: 10-11; on Japan, see Hoshi and Kashyap 2004: 15ff).

Derivatives have exacerbated the problems of HCA (European Central Bank [ECB] 2004; Enria et al. 2004). Even simple derivatives such as options entail contingent liabilities that fluctuate with market conditions. Given that the original cost of a derivative can be a fraction of the ultimate liability, the market value of banks' assets and liabilities can diverge widely from reported positions (ECB 2004: 70). HCA becomes a poor guide to the health of a bank.

3.4.2 Stable goals, ambiguous preferences

There is no consistent, let alone universally agreed, valuation technique that is appropriate for financial instruments. When FVA is applied to a bank's whole balance sheet, including its liabilities, counter-intuitive situations arise: a bank in trouble, whose own traded debt falls in market value, would be allowed to record its liabilities at a discount and, in an extreme scenario, post a profit

⁵ For example, in the year before its implosion, Lehman Brothers had more than 80 percent of its fair value-assets valued in this way (Magnan 2009: 206).

(ECB 2001: 3). Applying FVA only to assets also creates problems as the match between assets and liabilities that defines the banks' risk management becomes undone (BCBS 2000: 14). Nor is valuing only tradable assets at FVA a viable option. Banks and insurance companies use derivatives to hedge risks. Hedges that make sense from a risk-management perspective would be invalidated if the hedged instruments were treated differently than the hedge itself (Enria et al. 2004: 6).

With no obviously appropriate accounting regime for financial instruments, from the perspective of banks the impact of accounting rules on competitiveness moves to the fore. *Ceteris paribus*, banks should favor FVA in times of market upswing to record rising asset values as profits. In market downswings – as during the credit crisis – FVA may force financial institutions to mark down the value of assets, even if they still generate returns and are to be held until maturity (Enria et al. 2004: 3). Then banks will prefer a switch to HCA. As a result of these dynamics, banks' have no consistent *accounting* preference (for either FVA or HCA), but they do have a consistent *policy* preference: the flexibility to switch between accounting treatments depending on market circumstances and assets' function in the portfolio (for example hedging). Of course, because of their concern with competitiveness, banks anticipate the impact of a rule change relative to their peers, and based on that, scholars have found banks to support divergent specific policies over time (Perry and Nölke 2006; Botzem 2012; Lagneau-Ymonet and Quack 2012). At the level we discuss, however, these are differences of emphasis: the common position that banks share, with very few exceptions, is that they should retain a modicum of flexibility in the application of accounting treatments.

Regulators face a more complicated dilemma. As up-to-date information on banks' financial positions is indispensable for market supervision, public authorities have strong incentives to support FVA. At the same time, in the name of financial stability, they have high stakes in the viability of financial institutions. Regulators cannot support standards that risk pushing large banks over the brink. In times of distress, regulators will adopt the view-point of banks: regardless of inconsistencies, desirable standards are those that forestall pernicious losses.

Accounting standard setting is unstable because standards do not only provide a snapshot of corporate activity but drive that activity itself. In short, they are performative. FVA can increase systemic risk by amplifying changes in asset values, spawning calls for HCA as a corrective. In contrast, HCA can lead banks to understate their liabilities and losses, with FVA as the obvious remedy. Banks can adapt their business models opportunistically to changes in accounting rules, undoing their intended effects. Herein lies the dilemma of accounting standard setting: regulators

realize that the negative consequences of any approach applied will eventually bolster the case for switching to its alternative. Instead of long-term alterations between HCA and FVA, regulators fail to embrace either approach fully. Regulators frequently sanction flexible standards but at the same time dread the scope for abuse they offer banks and regularly try to re-impose stringency, only to fail to settle for any specific accounting treatment that should replace flexibility for good. Like banks, regulators have no unambiguous accounting preference. They also, however, have no unambiguous policy preference, because they fear that flexible standards invite instability. With no solution to this dilemma, accounting standards for financial instruments offer no solid fundament for global financial governance. Instead, they remain temporary fixes to an intractable problem and invalidate the apparent solidity of other rules that build on them, whether they concern bank capital buffers, derivatives trading or credit ratings.

The link between financial stability and the viability of banks has important implications for the relationship between regulators and the financial sector. Regulators may argue for rules that bolster bank profits not because they are ‘captured’, but because these rules promote (short-term) financial stability. Depending on market circumstances, financial stability and bank competitiveness can imply similar as well as opposing policy preferences. In essence, regulators have two hearts beating in their chests: as guardians of banks’ conduct, they cherish bank’s openness about their financial positions. As guardians of banks’ survival, they may dread that same transparency (see Table 3.1).

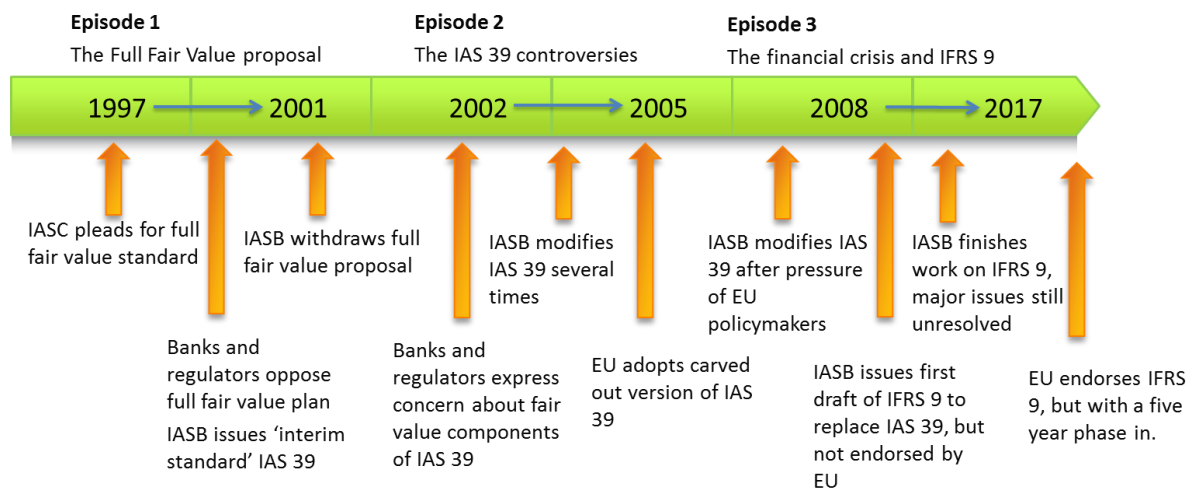
Table 3.1 Overview of policy goals, policy preferences, and accounting preferences

	Standards setters	Financial firms	Regulators
<i>Policy goal</i>	Market efficiency through transparency	Competitiveness (boosting profits)	Financial stability
<i>Policy preference</i>	Unambiguous: stringent standard	Unambiguous: flexible standard	Ambiguous: stringent standard, fearing abuse and long-term instability; flexible standard fearing short-term instability
<i>Accounting preference</i>	Unambiguous: FVA	Ambiguous: FVA in market upswing, HCA in downswing	Ambiguous: neither FVA nor HCA, fearing abuse and procyclicality; mixed measurement standards only as temporary solutions because of inconsistencies

3.4.3 Unstable governance in accounting for financial instruments

The following sections reveal this dynamic in real-world accounting standard setting. The main conflicts over fair value accounting took place in three episodes (see figure 3.1 and table 3.2 for an overview). They were not driven by a clash of stakeholders with clear accounting preferences. Instead, each time it was ambiguity on this point that let stakeholders revisit extant policy arrangements. Concerned about their viability, regulators repeatedly sided with banks. But they ignored bank preferences when these could be separated from stability-issues.

Figure 3.1 Timeline of policy dynamics



In each episode, stakeholders haggled over appropriate standard design, but the successive rule modifications did not amount to simple bargaining: as we show in the detailed accounts, modifications did not stem from changing power balances in any tangible sense, but from regulators' ambiguous policy preferences as each temporary fix (inevitably, we argue) triggered further modifications once its inadequacy materialized. Regulators' ambiguous preferences have also trumped the IASB's putative rule-setting power: in the most controversial area of accounting standard setting, it has failed to get its way up to this day.

Table 3.2 Overview of actors' positions in different episodes

	Standards setters	Financial firms	Regulators
<i>Episode I: The Full Fair Value Proposal (1997-2001)</i>	Strict application of FVA to all financial instruments	Mixed model with flexible classification rules	Retain mixed model in the short run
<i>Episode II: The IAS 39 controversies (2002-2005)</i>	Strict hedge accounting rules Unrestricted but irrevocable use of 'fair value option'	Flexible hedge accounting rules Flexible use of 'fair value option'	Flexible hedge accounting rules to facilitate risk management; not too flexible to allow earnings management Restricted use of 'fair value option'
<i>Episode III: The Financial Crisis and IFRS 9 (2008-2017)</i>	IAS 39: Reclassification not allowed IFRS 9: HCA only in specific circumstances; loan loss provisioning rules should not invite income management; hedge accounting more principles-based but with limited management discretion	IAS 39: Reclassification allowed IFRS 9: classification depending on business model; loan loss provisioning rules should not increase regulatory burden; hedge accounting should be flexible and aligned with risk management strategies	IAS 39: Reclassification allowed to ensure firms' survival IFRS 9: classification rules should not lead to FVA expansion; decisions supported by clearly documented risk management strategies; loan loss provisioning rules should be countercyclical; hedge accounting should be aligned with risk management strategies but management discretion should be limited

3.5 The Full Fair Value proposal (1997-2001)

Georgiou and Jack (2011) chronicle the use of mixed models in accounting, which blend different valuation methods. HCA dominated from the Great Depression until the 1970s, even if market-based valuation methods were also used. Since then, FVA has been on the rise (cf. Barlev and Haddad 2003; Power 2010). Although 'fair value' has remained disputed and been given different meanings over time (Power 2010), it generally came to denote "the amount for which an asset

could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" (André et al. 2009: 4) – the market (exit) value, or an estimation thereof.

Turning to financial instruments (cf. Botzem 2012), the expansion of banks' trading activities (the 'trading book') relative to loans (the 'banking book') since the 1980s caught the attention of both standard setters and banking regulators (Lagneau-Ymonet and Quack 2012). The rise of tradable assets on banks' balance sheets was deemed to demand more market-based valuation methods to maintain the relevance of accounting figures. Derivatives in turn blurred the line between traded and non-traded assets as one and the same derivative could function both as a frequently traded investment and as a long-term 'hedge' – in effect an insurance against financial risks. Both standard setters and banking supervisors realized that these developments necessitated a clear and consistent standard for financial instruments.

The International Accounting Standards Committee (IASC, the predecessor of the IASB) began work on standards for financial instruments in the early 1990s (Hernández Hernández 2003: 73). The project gained momentum in 1995 when the International Organization of Securities Commissions (IOSCO) announced that its recognition of International Accounting Standards (IAS) in 1998 would depend on the existence of financial instrument standards (Walton 2004: 13).⁶ Realizing that reaching consensus would be difficult, the IASC pursued a two-step strategy (Hague 2004: 13). It issued IAS 39 in 1998 as an interim standard to meet IOSCO's deadline (Whittington 2005: 138), modeled on the corresponding US Statement of Financial Accounting Standard (SFAS) 133 (Shin 2004: 14; cf. Camfferman and Zeff 2007). Simultaneously, it set up the Joint Working Group of Standard Setters (JWGSS) with experts from 13 countries to develop a suitable long-term standard.

The core principle was laid out in a 1997 IASC Discussion Paper: *all* financial instruments should be measured at fair value (full fair value accounting, or FFVA) (IASC and Canadian Institute of Chartered Accountants 1997). Hence, the 2000 JWGSS draft standard proposed abandoning IAS 39 in favor of FFVA. Fair value, the JWGSS (2000) argued, was the most relevant measurement for financial instruments, as it reflects the market's assessment of the effects of (changes in) current economic conditions on financial instruments. Changed fair values of financial instruments should

⁶ International Accounting Standards were issued by the IASC. The IASB (the successor) inherited the old standards (IAS) but itself only issues standards called International Financial Reporting Standards (IFRS), which should eventually replace all IAS.

immediately be recognized as profits or losses, restricting management's freedom to obscure firms' financial positions (JWGSS: 150-151).

FFVA differed from the IAS 39 'mixed model' (Hernández Hernández 2003: 82), in which only instruments held for trading were measured at fair value, while those intended to be held until maturity were measured at historic cost (BCBS 2000: 2). The JWGSS (2000: 161) dismissed this model:

Existing mixed cost-fair value accounting for financial instruments is not sustainable in the longer term, and cannot provide a satisfactory basis for financial accounting, because it is based on mixing elements of two incompatible measurement systems for financial instruments.

Depending on categorization, similar assets would appear in balance sheets with different values – anathema to the coherence and transparency favored by standards setters (Hernández Hernández 2003: 80).

Banks preferred the mixed model, which allowed them to categorize assets following their own business models and interests, over FFVA. Their industry associations set up the Joint Working Group of Banking Associations (JWGBA), composed of the banking associations of the USA, Australia, Canada, Japan and the EU. In a 1998 letter to the IASC/JWGSS it rejected FFVA (cf. JWGSS 1999: §2.1). Instead, it argued, "the mixed measurement system provides the optimal means of reporting financial performance" (JWGBA 1999: 2). Fair value accounting might be suitable for a bank's trading activities, but not for traditional credit intermediation, as the fair value of long-term loans would fall victim to short-term market volatility.

The banks' main concern was not an intellectual inadequacy of FVA for traditional banking activities, but its implications for their income statements. Banks argued that the volatility FFVA would introduce would undermine public confidence and limit their ability to perform credit intermediation. In short, banks did not favor one or the other methodology per se, but an accounting system that could flexibly respond to their own business model.

Regulators and supervisors shared banks' volatility concerns. The BCBS (2001: §1.4) argued that the time was not ripe for FFVA. While FVA might be appropriate for trading activities, too many difficulties remained with the fair value measurement of banking book instruments (ibid.: §3.1). Moreover, as accounting practices influence business decisions, the wider micro- and macro-economic effects of new rules would have to be thoroughly assessed (ibid.: §3.9) – a clear recognition that accounting standards not only measure but also shape bank performance. From

a supervisory vantage point, the European Central Bank (ECB 2001: 3) rejected application of FVA to the banking book because it would induce imprudent bank behavior.

At the same time, regulators acknowledged the flaws of mixed measurement models, not least through complex hedge accounting provisions – the eventual Achilles' heel of the mixed model. Hence a move towards FFVA in the long run was not to be excluded *a priori* (BCBS 2001: §4.2). The BCBS (2001: §1.5) argued that such a move might improve reporting if four preconditions were met: 1) conceptual and practical issues of fair value are resolved; 2) active markets develop for major aspects of banking book positions; 3) bank risk management evolves to rely on fair value measurements; and 4) a broad range of financial statement users, including depositors and other creditors, see fair value as the best measure for primary financial statements. For the time being, however, regulators simply urged standards setters to address problems as they arose – in other words, to muddle through.

In its feedback summary, the IASB (2002) concluded that most preparers opposed FFVA – so much so that it temporarily abandoned the project. Regulators had acknowledged that FFVA might promote financial stability through transparent bank accounts. But they avoided a clear decision on FVA, pointing to unsuitable market conditions. In the end both banks and regulators towed the same line, but the latter had their own motivations from the very beginning. While banks rejected FFVA because of its interference with business practices, regulators worried about micro- and macro-stability issues. Without a clear accounting preference, regulators supported an incoherent mixed measurement approach. IAS 39 became the reference point for subsequent debate.

3.6 The IAS 39 controversies (2002-2005)

When the European Commission announced in 2002 its intention to mandate IAS for EU-listed companies, IAS 39 turned from an object of theoretical debate into a source of real urgency for European stakeholders. The mixed-measurement model of IAS 39 soon generated its own problems through its treatment of derivatives. The two ways to address these – hedge accounting and the voluntary use of FVA – became the new focal point of clashes between the IASB, regulators and banks. The central issue remained unchanged: could regulators and banks even articulate an unambiguous preference for how a particular financial instrument should be valued? If the answer was 'No' – as it indeed turned out – the rest of the regulatory edifice would continue to rest on quicksand.

3.6.1 Hedge accounting

Unsurprisingly, the main conflict between standards setters, banks and public regulators concentrated on accounting for derivatives (Shin 2004: xiv). IAS 39 held that all financial instruments should be on the balance sheet and that

fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives.... In accordance with this principle, almost all derivatives falling within the scope of IAS 39 are measured at fair value (Hague 2004: 22).

Previous European accounting practices had not required all derivatives to be on the balance sheet, let alone to be measured at fair value (BCBS 2000: 2). Volatility in banks' financial positions through fluctuations in derivatives values was again a major concern. Banks had managed such volatility through 'hedge accounting', in which value-changes of derivatives could be offset by recognizing fluctuations in 'linked' instruments that would otherwise have been measured at historic cost. Now, the IASB limited 'special accounting' to clearly defined circumstances lest banks could manipulate income by hiding gains and losses too easily (Hague 2004: 25f).

Banks protested, arguing that these provisions did not correspond to long-standing practice (e.g., European Banking Federation 2002: 2). Again they were backed by the BCBS, which feared that the new rules would discourage prudential risk management strategies (BCBS 2002: 5). At the same time, it remained wary of overly flexible standards. Hedging strategies, it argued, should be clearly identifiable, measurable, effective and documented for hedge accounting to be appropriate. In short, the BCBS wanted banks to enjoy flexibility while making sure that this flexibility was not abused – an intractable dilemma.

Big banks lobbied the IASB – both individually and through the European Banking Federation (EBF) – but to no avail (Parker 2004b). The European Financial Services Round Table (EFR), a trade association of mostly continental banks and insurers, appealed to the European Commission: “the current proposals do not reflect economic reality, create artificial and undue volatility on earnings and equity and would lead to misinterpretation of financial statements” (EFR 2004: 1-2). Threatening not to endorse IAS 39 unaltered, the Commission set a deadline for a solution (Parker 2004a).

In the end, France, Italy, Spain and Belgium opposed full endorsement of IAS 39; six other member states (including Germany) remained undecided (Dombey 2004). The European Financial Reporting Advisory Group (EFRAG) also withheld full endorsement (Walton 2004: 6). With the 2005 implementation deadline looming, the Commission resolved to endorse IAS 39, but with the

controversial sections on hedge accounting ‘carved out’. This amended version again dodged a clear decision in favor or against FVA for financial instruments, and both the European Commission (2004) and the ECB (2006: 24) stressed that it was only a temporary solution (to an already temporary standard).

3.6.2 The Fair Value Option

On hedge accounting, regulators sided with banks, fearing for financial stability if one accounting methodology was applied too stringently. But on the other key issue – the so-called Fair Value Option (FVO) – they ignored bankers’ demands as competitiveness issues could be disentangled from stability concerns. The FVO had been introduced into an amended version of IAS 39 in December 2003 (Whittington 2005: 139). It allowed the measurement of *any* financial asset or liability at fair value *if* that instrument was designated in the FVO category the first time it appeared on a bank’s balance sheet. This would allow offsetting fluctuations without complex hedge accounting. Interestingly, while in the hedge accounting debate IASB worried about giving banks too much accounting discretion, the initial FVO proposal gave banks just that – though the option was irrevocable and prohibited reclassification. The IASB’s support for FVA trumped the danger of institutions measuring similar instruments differently and accounts becoming less comparable.

Banking regulators and the ECB remained skeptical (cf. ECB 2006). The BCBS acknowledged that the FVO might resolve mixed measurement problems in IAS 39 but feared that banks might record profits when their creditworthiness deteriorated (BCBS 2002). For financial instruments without reliable fair values, “this option may permit companies to manage earnings in ways that would not easily be detected by financial statement users” (ibid.: 2). And institutional investors might pressure banks to extend fair-valuing assets opportunistically, reintroducing concerns about income volatility and financial stability (Enria et al. 2004: 40-41).

Bowing to regulators’ pressure, the IASB proposed a more restrictive rule in March 2004 (Croft 2004). The industry response was overwhelmingly negative. The EBF (2004) championed the FVO for eliminating basic flaws in IAS 39; the London Investment Banking Association (2004) portrayed an unrestricted FVO a “key cornerstone” of IAS 39. Political stalemate ensued and the issue remained unsolved when IAS 39 was endorsed in late 2004. So the original FVO provisions were also ‘carved out’, much to the chagrin of banks (Buck and Parker 2004).

The question was finally resolved in line with supervisors’ demands the following year (ECB 2006). The FVO could be used to eliminate or significantly reduce an “accounting mismatch” (European

Commission 2005). Alternatively, financial institutions had to document that instruments were managed with a specific risk or investment strategy and to support FVO application with adequate disclosure (ibid.). The FVO was not going to be the free-for-all that banks had hoped for.

The controversies around hedge accounting and the FVO show unstable governance in action. The failure to adopt FFVA necessitated fixes to address the shortcomings of a mixed measurement model. On hedge accounting, banks and standard setters pleaded for flexibility and stringency, respectively. Regulators tried to combine both – a contradiction in terms. The fair value option, devised to circumvent the flaws of hedge accounting, generated its own problems, as regulators feared that its flexible use could undermine financial stability. As in the first episode, the question how one should determine the value of a financial instrument remained unanswered. And before long, the (new) temporary fix spawned its own problems and further reforms.

3.7 The financial crisis and IFRS 9 (2008-2017)

The ‘solution’ found through IAS 39 modification calmed nerves, largely because propitious economic conditions until mid-2007 prevented any real problems. Political debates refocused on the issue of IFRS-US GAAP convergence. In September 2002, the IASB and FASB had reached the so-called Norwalk Agreement where the two parties committed to make US GAAP and IFRSs fully compatible and to coordinate future changes (Posner 2010: 646). In this convergence process, accounting standards reform had been more or less a two-way street: sometimes the FASB followed IASB, at times vice-versa (Leblond 2011: 454). In 2007 the SEC acknowledged IFRSs (although not the EU version of IFRSs) as equivalent to US GAAP. The EU followed suit and decided in 2008 that US GAAP (and Japanese GAAP) were equivalent to IFRSs.

But with the credit crisis, accounting for financial instruments reappeared on the political agenda. The IASB modified IAS 39 once more and began work on a new standard (IFRS 9) to replace it. Both moves revealed the dilemmas faced by stakeholders.

3.7.1 Ad hoc amendment of IAS 39

As the credit crunch evolved into a full-blown crisis, banks complained that FVA forced them to translate falling asset prices into losses even when they had no intention of selling the assets concerned (cf. American Bankers Association 2008; Financial Stability Forum 2009, 5; Securities and Exchange Commission 2008). Wary of FVA’s systemic effects, both banks and regulators revisited their original positions. But regulators found it difficult to argue for flexible rules to

dampen market turmoil *and* for stringency to avoid future abuse by banks – especially as banks’ ability to hide risk had exacerbated systemic vulnerabilities to begin with.

EU member states advocated asset reclassification into categories that did not require market-based valuations to give banks ‘breathing space’. The EU effectively threatened the IASB: ‘either you change the rules, or we will’, arguing that European banks were being disadvantaged by the IASB rules as reclassification in “rare circumstances” was allowed in the USA (André et al. 2009). The pressure on the IASB was so intense that, without due process, it amended IAS 39 in October 2008, suspending market-based valuations for many assets. This modification exposed the difficult position of public authorities. Many observers balked at banks who suddenly claimed that troubled assets were long-term investments even though they had happily marked them to market values when prices had been rising (André et al. 2009: 22). On top, deferred loss recognition was problematic from a prudential perspective, as hiding losses can aggravate economic crises (Enria et al. 2004: 10-11).

That said, the danger of imploding credit intermediaries was even greater, and banks were seen to need freedom to choose ‘appropriate’ valuation techniques for their assets. But the BCBS’ (2009c) demand that “[c]lassification and reclassification practices should not be used with the view to circumvent accounting requirements in order to achieve a particular result” rang hollow. It was precisely the need to achieve ‘particular results’ – the survival of banks – that required ad hoc IAS 39 modification. Analyzing 100 large financial firms, the Committee of European Securities Regulators (CESR) found 61 to have used the option to reclassify assets, allowing 28 billion euros in losses to go unrecognized in 2008 alone, enough to bankrupt several large European banks (CESR 2009: 6f).

Despite the IAS 39 amendment, banks remained unsatisfied. Two weeks later, the European Banking Federation asked for possibilities to transfer instruments out of the FVO-category and to amend the impairment rules for instruments classified in the ‘Available for Sale’ (AFS) category (EBF 2008: 1-2).⁷ In episode II, banks had favored the FVO while regulators worried about its abuse. In response, the EBF (2004) had emphasized the prohibition on reclassification as “a safeguard against possible abuses” (EBF 2004: 1). But once markets were under stress, the EBF concluded

⁷ Although the IAS 39 amendment allowed for the reclassification of instruments out of the AFS category, this only applied to instruments that met the requirements of loans and receivables. Banks still faced future losses on AFS instruments and lobbied against the obligation to use FVA to calculate them. Effectively, they were arguing for historic cost treatment of losses on instruments that did not meet the requirements of loans and receivables (KPMG 2009: 19).

that “the FVO is in many cases no longer effective at eliminating or reducing the accounting mismatch which it was intended to address” (EBF 2008: 2). Changed market circumstances altered banks’ perspective on FVO rules, and the European Commission (2008c) asked the IASB to amend IAS 39 on precisely those issues the EBF found problematic. However, this time round the EC could not point to a competitive disadvantage vis-à-vis the USA for justification, as the modifications it desired were in tension with US rules (Cheung and Morley 2008: 52). The IASB could easily ignore these demands and instead argued that an entirely new standard for financial instruments was required.

The IASB’s second move was to begin developing a standard to replace IAS 39 (IASB 2008: IN4). In the long run, it argued, a single measurement method would reduce complexity, and fair value was the most appropriate one (ibid.: IN5). In advocating FFVA, the IASB returned its position of a decade earlier. Banks predictably opposed the move (British Bankers Association 2008; International Banking Federation 2008). But the crisis had also changed regulators’ perspective: even in the long run, any move to FFVA was out of the question (BCBS 2008; Committee of European Banking Supervisors 2008b). The IASB promised a new standard by the end of 2009, to be developed in three steps that would each replace a key part of IAS 39: measurement and classification; impairment methodology; and hedge accounting.

3.7.2 IFRS 9 step 1: Classification and measurement

The proposals for classification and measurement reopened the FVA-HCA debate: which instruments should be measured according to which methodology, and who should decide when banks could switch between them? In July 2009, the IASB (2009b) gave in to outside pressure and announced that

the Board decided that measuring all financial assets and financial liabilities at fair value is not the most appropriate approach to improving the financial reporting for financial instruments (IASB 2009b: BC13).

Still, the draft proposal departed from IAS 39 in having two instead of four accounting categories and hence less room for maneuver. An instrument’s characteristics would be the main criterion for classification, and subsequent reclassification would not be allowed (IASB 2009b).

The BCBS (2009c: 1) had transformed from a cautious champion of FVA into a skeptic, warning that “[t]he new two-category approach for financial instruments should not result in an expansion of fair value accounting”. A bank’s “business model” should be central to classification but also be clearly documented. Reclassification should only be allowed if “events [...] clearly led to a change

in business model” (ibid.: 2). In its final draft of the first stage, issued in November 2009, the IASB basically followed this line (see IASB 2009c: §§ B 5.9-5.11).

But the EU refused to adopt IFRS 9. The European Commission still wondered whether new rules would expand fair value accounting unduly (European Commission 2009; Sanderson et al. 2009: 19). Observers highlighted other reasons for not endorsing IFRS 9: many instruments transferred to historic cost categories in the ad hoc IAS 39 modification return to the fair value category in IFRS 9. The flexibility of the modified IAS 39 disappeared, and many Continental banks had accumulated significant but hitherto undeclared losses (Tait and Sanderson 2009).

3.7.3 IFRS 9 step 2: Impairment methodology

Meanwhile, the IASB had started work on the second phase of IFRS 9 development, impairment methodology: how should banks provision for losses on loans measured at historic cost? Under the IAS 39 ‘incurred loss approach’, firms had to wait for losses to materialize. Regulators blamed this model for requiring insufficient buffers and inducing procyclicality (BCBS 2009c: 2). The IASB responded in November 2009 with the ‘expected loss approach’ (IASB 2009a), a U-turn from the system used thus far (Sanderson 2010). The loan value was to be recalculated periodically, discounting for expected losses, in order to recognize losses earlier and dampen procyclical effects. Crucially, the IASB allowed banks to use their risk models to calculate expected losses. But the IASB simultaneously feared this would give banks the flexibility to ‘cook the books’. They therefore pleaded for the use of so-called ‘point-in-time (PIT) models’, that mainly rely on publicly available information (IASB 2009a).

For banking regulators, the proposal was a mixed blessing. They supported the switch to the expected loss approach. Yet they feared that reliance on PIT-models, with their emphasis on current market circumstances, would lead to worse forms of procyclicality (BCBS 2010b; Wood and Clark 2010). Banking regulators favored a more ‘through-the-cycle (TTC) approach’, under which banks build up buffers based on historical data and assumptions about the economic cycle. On the other hand, they also acknowledged that the TTC-approach would give banks too much discretion:

[If] expected loss is calculated by reference to judgements about future possible losses informed by past experiences or by formulae which link provisions to broad indicators or likely future credit problems [...] some investors might have concerns whether these judgments [...] are based on fact and are transparently understandable (Turner 2010a: 3-4).

So, regulators favored the TTC-models as the lesser of two evils. In spite of the ensuing “regulatory burden” of the TTC-approach, banking associations supported the regulators’ line (EBF 2010; Institute of International Finance 2010).

Unsurprisingly, the IASB feared the implicit flexibility of a TTC-approach would give banks too much freedom to manage income. IASB head Sir David Tweedie retorted that regulators wanted accounting to do their job: “We are not going to show banks making profits when they are making losses (...). We’ll make clear the profit and then it’s up to the regulator to say, this bit can’t be handed out, this bit has to be retained. That’s not the job of accounting.” (Quoted in Sanderson and Jones 2010). So, the IASB returned to the drawing board to amend the ‘expected loss approach’, again having to square the circle of mixing stringency with discretion.

In 2014, the IASB issued a final version of the expected loss approach (IASB 2014b), constituting an uneasy compromise between a PIT-approach and a TTC-approach (Novotny-Farkas 2015). While banking regulators were happy about the reduction of the rules’ potential procyclical effects, the proposal has nonetheless become a cause for concern. Banks and their regulators fear that the new proposal will lead to substantially higher provisioning requirements for a significant amount of EU banks. As provisions are deducted from income, and any shortfall in provisions deducted from capital, policymakers worry that the standard will harm bank recovery in the short-run, even if it might make banks more robust in the longer run (EBA 2016). The EC has thus recently proposed a transitional arrangement of up to five years after IFRS 9 enters into force (in 2018), to ensure a limited impact on capital figures (EC 2016b: 264-5; see also chapter 6 for a more extensive discussion of loan-loss provisioning).

3.7.4 IFRS 9 step 3: Hedge accounting

Finally, the IASB issued an exposure draft on hedge accounting in December 2010 (IASB 2010). The new rules accommodated demands of banks and regulators to be more congruent with firms’ risk management strategies (Ernst & Young 2011). But they only covered relatively simple hedging strategies. The treatment of macro hedges, the most contentious issue for financial firms, was simply postponed.

Banking representatives welcomed new rules but demanded they be “entirely faithful to the risk management objective” (EBF 2011a: 1) and that “[s]ome flexibility in designating hedging relationships is needed to adequately reflect underlying risk management activities” (Institute of International Finance 2011: 4). Regulators supported better alignment of rules with firms’ risk management strategies, but they warned against excessive flexibility on hedge accounting: “it is

important to include appropriate safeguards to maintain rigor in accounting application, to prevent the link between hedging activities and their reflection in the financial statements being used improperly, for example, to manage earnings or to inappropriately defer loss recognition” (BCBS 2011: 4). Yet again, regulators championed rules in line with banks’ risk management strategies but feared their abuse.

The IASB finished the hedge accounting framework in 2014, but as mentioned this did not include the most contentious issue: macro hedge accounting. This issue had led to the IAS 39 carve out (see Episode 2) that at the time of writing (April 2018) is still unresolved. The problem is that it is difficult to establish a clear link between the derivative used to hedge, and the portfolio that is being hedged. Banks say this is inherent to the strategy, but the accounting standard setter fears abuse. Once again, the IASB worries about overly flexible rules, banks demand sufficient discretionary space, and banking regulators cannot formulate a clear policy preference.

Unsurprisingly, the IASB Discussion Paper on this topic (issued in 2014) proved very controversial. The proposal suggested that hedged portfolios (loans or deposits) would have to be revalued in line with fair value accounting to ascertain whether the hedging strategy was effective (IASB 2014a). Banks opposed it for fear of being a full fair value plan in disguise: “[it] will change the classification and measurement of the entire banking book, by measuring it at fair value for interest rate risk. It would directly conflict with the banking book business model to originate and hold to collect cash flows” (EBF 2014: 2).

Banking regulators also worried about this aspect (cf. EBA 2014; ECB 2014). The ECB (2014: 2) warned that “the resulting increase in profit or loss volatility could increase procyclicality and thus might be detrimental to financial stability”. They also once again highlighted the dilemma of mixing flexibility with stringency. A BCBS-statement on this matter is worth quoting at length:

The model should allow banking transactions to be portrayed in a robust and consistent manner in line with their economic substance. However, it is essential that appropriate discipline surrounds the use of the macro hedging accounting model. Therefore, the [BCBS] believes that it is very important to elaborate additional eligibility criteria to avoid cherry-picking of hedge accounting models and the creation of opportunities to manage profit or loss. The current IAS 39 includes provisions which may have been designed with an overly strong emphasis on “anti-abuse rules” [..]. Against that background, it is important that any future macro hedging accounting model strikes an appropriate balance between discipline and flexibility (BCBS 2014: 2).

Unable to find a suitable way out of the impasse, the IASB again postponed the issue of macro hedge accounting. It now plans to issue a second discussion paper in 2019.

3.7.5 Consequences for accounting harmonization

The IASB's original plan to complete IFRS 9 in 2010 had proven too optimistic. It finished work in 2014, but only because it excluded one of the most contentious issues. Moreover, controversy still surrounds the issues, with the EC (2016) announcing a phase-in period rather than an immediate implementation. The tension between banks' need for flexibility to maintain financial stability and its potential for abuse, which may undermine that same stability, remains unresolved. If regulators repeatedly found themselves on the same side of regulatory issues as banks, it was – more than anything else – due to their inability to formulate unambiguous preferences for or against the stringent or flexible application of FVA to financial instruments.

The controversies over financial instrument accounting have had broad effects. It triggered widespread discontent with the IASB's governance structure. EU member states, the European Parliament, and the Commission blamed the IASB for being unresponsive to (the EU's) financial stability concerns and demanded increased influence. The IASB responded by speeding up the planned constitution review (2008-2011), which resulted in the creation of a monitoring board in early 2009 to strengthen its links to public regulators. Apart from one Commission representative, this board was comprised of the IOSCO emerging markets committee, the IOSCO technical committee, the Japanese FSA, the SEC, and the BCBS. It participates in the trustee nomination and approval process, has oversight responsibilities for trustees, and refers accounting issues to trustees and the IASB chair. As Posner (2010) points out, the creation of the monitoring board fits the overall pattern since the 1990s in which "IASB's relative autonomy [...] has been on the decline [...]. The creation of the Monitoring Board [...] is merely the latest and most visible manifestation of this trend" (ibid: 648).

More importantly, the crisis affected the convergence project between the IASB and FASB: under EU pressure, the IASB backed away from prioritizing convergence with US GAAP. The standards setters had signed a memorandum of understanding in 2006 to reiterate their commitment to convergence and, under G20 pressure, had pledged in 2009 to intensify their efforts (Zeff 2012). But the financial instrument standards controversy unveiled their reluctance to coordinate their work: under EU pressure, the IASB released a 'mixed measurement' standard, while the FASB initially released a 'full fair value' standard with no role for HCA (which it later withdrew). The boards announced that their plan for complete convergence by 2011 would not be reached. The Commission stated that the quality of IASB standards was more important than convergence, while the IASB stated in 2012 that it would no longer prioritize convergence (Arons 2012).

The USA likewise backed away from formal commitments to introduce IFRSs any time soon. That the IASB had given in to EU demands to modify IAS 39 without due process provoked serious questions in the USA about the credibility of the IASB as a viable standards setter, feeding domestic resistance against the adoption of IFRSs (Zeff 2012: 830). Still, in the heat of the crisis the FASB itself had, under pressure of banks and regulators, modified aspects of its financial instrument standard to give banks more breathing space. In both the EU and the USA, the issue of how to balance FVA and HCA proved highly controversial – and ultimately remains unresolved (André et al. 2009).

3.8 Conclusion

In two decades of international accounting standard setting we find a succession of short-term fixes that is owed to ambiguous policy and accounting preferences of regulators. This pattern prevails at the time of writing as the core accounting problems remain unresolved. With accounting rules as the fundament of global financial governance more generally, the intractable valuation problems have meant that the regulatory edifice remains unstable.

This chapter contrasted these findings with what we would expect following two key approaches in the study of global financial governance: the interest-based bargaining approach and the expert politics approach. In both of them, dominant actors are assumed to have clear and unambiguous preferences regarding the nature of the rules that are likely to further their policy goals. International accounting standard setting for financial instruments does not fit either category: regulators have failed to articulate an unambiguous preference for or against FVA. Although the IASB consistently propagated an increased use of FVA, both banks and regulators changed their mind on key issues as economic circumstances and hence the impact of accounting standards on bank balance sheets changed.

In accounting standards, the contingency of preferences goes further. Cognizant of the variable impact of standards on capital, banks have effectively championed liberty to switch between accounting rules. Regulators have frequently supported this stance in the name of financial stability. At the same time, financial scandals and crises have justified their fear that flexibility can and will be abused to hide mounting losses and ultimately spawn instability. This makes the governance of accounting standard setting unstable: because any approach to accounting for financial instruments that may fix short-term problems can be abused and aggravate market instability, the (anticipated) effects of any one regime have simultaneously sown the seeds for opposition against it.

Ultimately, this dynamic rooted in the reflexivity of financial markets, in which future expectations, which are translated into valuations, shape the future they seek to describe. Given the key importance of accounting standards for other regulatory domains such as banking rules or assessments by credit rating agencies, this dynamic permeates global financial governance more broadly. To be sure, regulators have tried to devise alternative, domain-specific accounting-rules in several instances, and they have experimented with prudential filters.⁸ For example, in the calculation of capital adequacy, the denominator (total assets) is calculated using risk-weighting formulas that are specified in the Basel Accord, not IFRS accounting rules themselves. But the profits and losses of financial institutions, which may push them into bankruptcy, are calculated according to IFRS (or US GAAP, its US counterpart), such that accounting rules for financial instruments do have direct implications for financial stability. Indeed, if they did not, it would have made little sense for banking regulators to get involved in standard setting as much as we have shown them to have done over the past two decades.

Turning to real-world financial governance itself, these findings imply that an enduring accounting standard for financial instruments is elusive. With financial instability as old as money itself (cf. Graeber 2011; Kindleberger 1978; Reinhart and Rogoff 2009), codified rules cannot fully replace judgment based on experience as a guide for policymakers. This suggests that an apparent ‘lack of progress’ in global financial governance is not solely owed to its global nature, but more importantly to the inherent limits of governing reflexive financial markets. In chapter 7, I will elaborate on these policy implications. The next chapter assesses whether regulatory dilemmas similar to those discussed here also hamper post-crisis reforms of credit rating agency regulation.

⁸ Prudential filters are intended to limit the impact of value-changes of particular financial instruments on the value of banks’ equity as it is used for prudential purposes. In other words, for the calculation of bank’s capital for prudential purposes, accounting rules are not followed across the board (see CEBS 2006; Matherat 2008). However, these filters loosen the link between accounting standards and capital adequacy calculations only to a limited extent, as not all regulators apply them and they only apply to certain accounting categories (Matherat 2008: 58). Given that reclassification rules were modified during the crisis to dampen financial turmoil, these prudential filters were clearly not sufficient to break the link between accounting rules and financial stability.