Fair value limited.

Contingent preference formation in international accounting standard setting

Daniel Mügge
Universiteit van Amsterdam, The Netherlands
d.k.muegge@uva.nl

Bart Stellinga
Scientific Council for Government Policy (WRR), The Netherlands
stellinga@wrr.nl

Abstract
Recent scholarship on international financial regulation has disaggregated state preferences and concentrated on preference formation among key actors, in particular regulators. Deducing preferences from standard economics understandings of financial market functioning, this work assumes that regulators face a trade-off between enhancing the competitiveness of domestic firms (laxer standards) and enhancing stability (tighter standards). While sensible for example in banking regulatory, this approach is at odds with the empirical record in international accounting standard setting: here, regulators' positions have been highly volatile and inconsistent over time.

As we argue in this paper, this finding does not invalidate the aim of using economic theory to deduce preference formation. Heterodox economic theorizing, drawing on Keynes and Minsky, suggests that tighter (that is, less flexible) accounting standards can be both a bane and a boon for financial stability, depending on overall market conditions. The pattern we find in 15 years of international accounting standard setting dovetails with this intuition: regulators' specific policy preferences are contingent on their assessment of market conditions at the time, leading them to heed banks' calls for a more flexible accounting regime at one point, only to tighten the reigns shortly thereafter – always in the name of financial stability.

This paper shows how economic theories that have gained currency in the wake of the recent financial crisis can be made fruitful for IPE theorizing. They allow us to model how a stable policy goal – financial stability – can lead to diverging policy preferences over time and hence portray regulatory politics in accounting standard setting much more realistically.

1 The authors extend their thanks to the organizers of the AGORA workshop in Brisbane in January 2011 for their hospitality and its participants for the valuable comments. We are also grateful for the feedback we received at the SGIR conference in Stockholm in September 2010, at the International Political Economy and Comparative Stratification club at the University of Amsterdam in November 2010, and at the COST-ESRN conference in Bielefeld in December 2010.

2 The views expressed in this paper are solely those of the authors and should in no way be associated with the WRR.
INTRODUCTION
Since the 1980s, cross-border standardization and international regulatory regimes have become key features of global financial governance. Many scholars recognize the importance of this trend, but they disagree on the motivation of key actors to endorse particular regulatory arrangements rather than others. What drives global regulatory politics: the interests of financial firms, concerns about financial stability, ideational dynamics, the inter-state distribution of power, or yet something else?
Although constructivist work has nuanced our understanding of how actors arrive at their particular preferences, most scholarship in the field assumes that we can identify sources of these preferences that rest outside of regulatory cooperation itself. If preferences are at least partially prior to such cooperation, understanding their sources better is a central task for students of global financial governance. As Jeffrey Frieden has argued for the study of politics in general, actor preferences can simply be assumed, inferred from observations (‘revealed preferences’) or – most usefully for modeling – deduced from theories covering preference formation itself.
More recently, David Lake has specified this view, claiming that the deduction of interests from economic theory is the defining innovation of open economy politics (OEP), the dominant approach in contemporary International Political Economy.
For global financial governance, David Singer’s work has been particularly helpful for theorizing national preferences, articulated by regulatory agencies, in international cooperation. In line with what is implicit in much other scholarship, Singer models the international politics of banking regulation as a compromise between two opposing policy goals: enhancing the competitiveness of national financial industries, which argues in favor of laxer standards, and financial stability, which requires more

---

6 Frieden, 1999.
7 Lake, 2006.
stringent standards. These motives rhyme with mainstream economic theory: capital reserves constitute a cost for banks, and those with lower costs have a competitive edge. At the same time, the bigger capital buffers are, the more likely it is that banks can withstand a deterioration of their loan portfolio or overall asset devaluation.

Regulators’ policy preferences are a function of this trade-off: they evade potentially deleterious regulatory competition by seeking international rule harmonization, which allows sustaining regulatory stringency required to safeguard financial stability.

As we show in this paper, even though the stability-competitiveness trade-off is crucial in explaining preference formation and hence governance arrangements in banking regulation, it is less helpful in other domains, including accounting standards – the case discussed in this paper in detail. Here, the policy preferences of regulators do not spring from an unchanging trade-off between stability and competitiveness. Instead, the relationship between stability and competitiveness itself changes over time. Depending on market circumstances and regulators’ expectations of the future, laxer rules can be both a boon and a bane for financial stability. Lax rules can facilitate the build-up of systemic risk, but they can also provide banks with crucial breathing space in times of distress. Whether regulators see lax or stringent rules as the route to market stability thus depends on collective assumptions about future market developments.

While this emphasis on expectations and historical contingency sits uneasily with mainstream economic theory, it chimes in well with many heterodox economists’ understanding of financial market functioning. The credit crisis that started in 2007 has reignited interest in the work of John Maynard Keynes, Hyman Minsky and

---

9 The trade-off between financial stability and pandering to financial industry interests pervades the political economy literature on financial regulation. See e.g. Underhill, 1995, Underhill, 1997.
10 Mainstream economic theory is understood here as neoclassical economics, in which actors are presumed to have unambiguous preferences.
12 Building on the early work of Tiebout (1956) on regulatory competition (cf. Esty and Geradin, 2001), such behavior has been usefully theorized as co-opetition (McCahtery and Geradin, 2004), which fuses regulatory competition and cooperation. On regulatory competition in international financial services regulation, cf. Jackson and Pan, 2001, Trachtman, 2001.
Benoit Mandelbrot. They all emphasize that financial markets have no natural anchor (the equilibrium point in neoclassical economics), but that they are driven by market participants’ expectations. Soros has helpfully labeled this feature ‘reflexivity’. As we argue, where mainstream economics is unable to account for regulators’ stances towards accounting standard setting, heterodox economics that heeds market reflexivity succeeds. It makes comprehensible the seemingly contradictory stances that regulators take over times and their varying levels of support for financial industry positions. In this way, our argument meets the recent call by Helleiner and Pagliari for ‘more cyclical theories of private influence [on financial rules]’. Contingency and market expectations, which themselves are cyclical in nature, are key to our argument.

Empirically, this paper concentrates on the rise of fair-value accounting (FVA) as the most important trend in world-wide accounting over the past decades. The project of weaving FVA into every thread of accounting has been pursued by the International Accounting Standards Board (IASB) in particular. The Financial Accounting Standards Board (FASB), responsible for setting US standards, has put similar emphasis on FVA. However, given that the FASB is firmly embedded in domestic American politics while the IASB has assumed a quasi-global role, the latter lends itself much better to an analysis of international regulatory politics than the former.

13 Key works are Keynes, 1964 [1936], Minsky, 2008 [1986]; Mandelbrot’s thinking on finance is summarized in Mandelbrot and Hudson, 2004. For other recent applications, see e.g. the special issue of the International Journal of Political Economy entitled ‘Keynes, Minsky, and Analyses of the Financial Crisis’ (2010) and Mirowski, 2010.
16 Fair value accounting shows assets and liabilities at their current market value on the balance sheet rather than at historical cost, that is, at acquisition cost (André et al 2009: 4). The fair value of an instrument is generally defined as ‘the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction’. The practice of fair valuing assets and liabilities involves periodic revaluations of these instruments with reference to shifting market prices.
The IASB efforts to promote FVA ran into political trouble in the late 1990s, again in the early 2000s and yet again one year into the credit crisis. Each time, conflict was ignited by disagreements over the application of FVA to financial instruments – the linchpin for struggles over FVA in general. Even though the standard covering these instruments is only one among several dozen, convoluted political fights about accounting for financial instruments turned into the moment of truth for the FVA-project as a whole. As we demonstrate in this paper, plugging heterodox economic theory into our understanding of the politics of accounting standards explains both the positions regulators have taken at particular moments and the dynamics of these fights over time. Ever since the IASB published a provisional standard in the late 1990s, accounting standard setting for financial instruments has been in limbo, with one temporary fix following the other. International agreement on how financial instruments should be treated in firms’ is as remote now as it was when the IASB started its work. Infusing heterodox economics into IPE accounts of international regulatory politics explains why.

In this way, the contribution of this paper goes beyond the political economy of accounting standard setting. It shows how what Lake has called the key strength of the OEP-approach – the use of economic theory to model actor preferences – need not be restricted to neoclassical economics. In finance and financial regulation in particular, OEP can be combined with theories of financial markets which, in contrast to their neoclassical brethren, have been vindicated by the global financial crisis. In this sense, we see our case as an important, and hitherto rare, illustration of how disparate traditions in political economy can be fruitfully combined.\textsuperscript{18}

This paper proceeds as follows: it first shows how scholarship on international financial governance has failed to address fully how the specific content of financial rules may matter to the governance dynamics surrounding them. After surveying political economy treatments of international accounting standard setting, we outline the theoretical basis of our argument, showing what a heterodox understanding of financial market functioning implies both for policy preferences meant to serve the competitiveness of financial firms and, in particular, financial stability.

\textsuperscript{18} Cf. Phillips and Weaver, 2011.
The empirical section treats the key episodes of political contestation over the work of the IASB since it has risen to prominence in the mid-1990s to show how our argument explains the otherwise puzzling stances regulators have taken. The first episode of conflict revolves around the Joint Working Group of Standard Setters, which between 1997 and 2001 unsuccessfully promoted full fair value accounting for banks. Then, between 2002 and 2005, the IASB and EU authorities were at loggerheads over the International Accounting Standard (IAS) 39, again intended to impose FVA on banks. And finally, between 2008 and 2009, standard setters and EU authorities once more clashed over the way forward with FVA under crisis conditions.

THE POLITICAL ECONOMY OF FINANCIAL REGULATION

We see the preferences of policymakers who are directly involved in financial regulation as important data to understand better the development of financial market rules. In this sense, our argument stands in the tradition of scholarship that traces the evolution of such rules instead of using large-n data sets to determine the causal drivers behind rule changes.19 As we will demonstrate below, the focus on preferences formation is particularly relevant because in the case we study these preferences are highly contingent on external conditions, which significantly complicates modeling them for the purpose of quantitative analysis.

Earlier qualitative comparative work in financial governance concentrated on variation in between-country and over time variation in financial sector profiles, national economic institutions and the reactions of both public and private actors to increasing economic openness or technological change.20 These scholars addressed a common question: what has been the key driver behind financial deregulation or market-oriented re-regulation? The thick descriptions of policy processes contained in this scholarship obliterated the need for elaborate theories that explained actors’ professed preferences. Instead, the observations of these preferences could be used directly, with over-time changes in actors’ preferences, political resources and

19 The field of large-n studies is enormous. Prominent international comparative work includes Quinn, 1997, Abiad and Mody, 2003; key across-state comparison concentrating on the USA is Kroszner and Strahan, 1999. On the differing approaches, see Gerring, 2007: 37ff.
institutions as aggregators of preferences accounting for policy changes. Policy preferences themselves warranted no problematization as financial firms, investors, regulators and finance ministries – the key actors in most accounts – faced no obstacles in identifying their overarching goals and tying these to specific policy preferences.

Post-1970s financial deregulation spawned enormous growth in private sector cross-border financial transactions, and hence incentives to coordinate regulation internationally. This coordination became a second, related focus of scholarly attention. Kapstein emphasized the epistemic dynamics in the 1988 Basel negotiations, but much consecutive work concentrated on the distributive dimensions of international regulatory agreements.\(^{21}\) Attempts in the European Union to forge a single market for financial services were analyzed in a similar vein, with emphases on competitive concerns of national financial industries or the latters’ embeddedness in national ‘varieties of capitalism’, as they later became to be called, as sources of national preferences.\(^{22}\) The political constellation thus fit Moravcsik’s liberal intergovernmentalism in which alternative depictions of domestic policy processes could be inserted into bargaining models.\(^{23}\)

More recent scholarship has refined our understanding of both the international and domestic bargaining processes. On the international level, the dependent variable of most studies has been the international harmonization or otherwise of financial standards. They have commonly pointed to two drivers of such harmonization. As discussed above, agreement on common rules across an integrated market with fragmented jurisdiction (nation states in a globalized economy) can prevent regulatory races to the bottom, which might be inimical to other policy goals.\(^{24}\) More specifically, international harmonization may be desirable when unilateral imposition of preferred rules on domestic markets creates significant negative externalities. As Simmons as argued, the presence or absence of such externalities has been key to explaining whether the USA has cared about other countries’ adoption of US

\(^{23}\) Moravcsik, 1997, drawing in this respect on Putnam, 1988. For a more recent application of great power diplomacy to regulatory politics, see Drezner, 2007.
standards, and if so, whether it has found it necessary to impose them through international agreements rather than being able to rely on voluntary third-party adoption.\textsuperscript{25}

The second common driver is the boost to effective cross-border market integration that results from standard harmonization. As Mattli and Büthe argue, the politics of such harmonization combine distributive and welfare-enhancing logics.\textsuperscript{26} Still, both globally and within the European Union, where cross-border standard harmonization has progressed farthest, the easing of international transactions remains a key incentive to agree common rules.\textsuperscript{27}

Which standards emerge victorious from such international coordination? For financial rules, Simmons convincingly argued that US regulatory preferences have long been a natural center of gravity because of the exorbitant size of US capital markets.\textsuperscript{28} By denying market access to countries unwilling to follow the regulatory lead of the USA, it could effectively set international standards if it so desired. The unification of financial markets in the European Union and the relative resurgence of London as a financial center have allowed the EU to challenge US leadership at least in some regulatory domains.\textsuperscript{29} If the relative distribution of power thus explains whose rules prevail, their substance depends on the adjustment costs that new rules impose on the parties to the regulatory agreement. With adjustment costs lowest when the status quo is maintained, international regulatory politics effectively becomes a tug-of-war between the attempts of powerful jurisdictions to universalize their domestic standards. Substance is not theorized per se, but measured relative to prevailing national rules.\textsuperscript{30}

One way in which substance itself has entered contemporary theorizing of international financial regulation is through the relative stringency or laxity of rules.\textsuperscript{31}

\textsuperscript{26} Mattli and Büthe, 2003.
\textsuperscript{27} Egan, 2001.
\textsuperscript{28} Simmons, 2001.
\textsuperscript{29} Posner, 2009.
\textsuperscript{30} The relative measure in this case are the costs arising from a switchover to alternative regimes.
\textsuperscript{31} Notably Singer, 2004, Singer, 2007. In his model of international regulatory politics, Drezner also 'normalizes' disparate regulatory measures into a 'unidimensional measure of regulatory stringency'. Drezner, 2007: 52.
In the international politics of banking regulation, the key variable is the level of capital reserves that banks have to keep as a buffer against losses. Keeping such capital reserves constitutes a cost for banks as it constrains their lending capacity. Hence, relatively lower capital reserve requirements constitute a competitive advantage. At the same time, bank losses on their asset portfolio tend to accumulate in economic downturns, meaning that periodically banks’ capital base needs to withstand particular stress. Higher buffers make banks themselves more resilient and increase the mutual trust of counterparties in distressed capital markets. Beyond the focus on relative stringency, the specific content of financial rules has mostly remained outside the purview of IPE scholarship on international financial governance.

This omission was justified in light of assumed homogeneity of actors’ preferences regardless of their provenance. Banks around the world would see their competitive position boosted by relatively low capital reserve requirements, just as such low requirements would endanger financial stability in Japan as much as in Germany. Put differently, a focus on regulatory content appeared to hold little inferential value-added for understanding better patterns of international governance. Private and public objectives were neatly aligned with unambiguous policy preferences – an assumption that does not hold at all for accounting standards, as we will show below. Regardless of how actors’ preferences are formed, whose preferences matter in international financial governance? And hence, on which actors should we focus our analysis? As a quick survey of the literature directly suggests, the answers vary widely between different issue-areas. Some policy domains are governed by international organizations such as the International Monetary Fund (IMF) that act as agents of national governments. Depending on the presumed level of IMF autonomy, the appropriate actors to study are national governments as principals or (policymakers within) the Fund itself. The emergence of the Basel Accord and its successors is mostly analyzed as a mix of intergovernmental politics, national or transnationally

32 For recent overviews, see Porter, 2005, Germain, 2010.
organized financial industry interests, and cognitive dynamics within the Basel Committee itself. 34 Depending on the specific perspective taken, national governments, central bankers assembled in the G10, national lobbying associations or transnational advocacy bodies such as the Institute of International Finance or the Group of Thirty move into view. 35 Transgovernmental regulatory networks can facilitate both the diffusion of ideas and specific standards with government coercion or formal agreement. 36 Credit ratings agencies have themselves been analyzed as a form of standard setters. 37 Accounting standard setting, discussed in more detail below, has been studied both as a contest between the European Union and the USA and as a prime example of private authority in international affairs. 38 What emerges from this wide array of actors at the center of analyses is that which actors should be studied depends both on the case at hand and the question to be answered. In many domains the authority is dispersed over a variety of levels or links in a chain of delegation. Without any hard claims about the ultimate source of authority in any given domain, we pragmatically argue that the most useful locus for analysis is that in which the relevant variation originates – whether that concerns industry preferences or belief systems that change over time or national preferences that vary across countries. In line with Singer’s approach to banking regulation, this consideration underpins our focus on bank regulators as the actors who have to marry the dual public policy objectives of financial stability and bank competitiveness, and who, through the balance they strike between the two, have important influence on the eventual rule outcome.

**The established view on rise of FVA**

Much recent political science scholarship on the international politics of accounting standards has concentrated on the competition between public actors in influencing the direction of global standard setting. 39 In this view, transatlantic rivalry stands central in the politics of international accounting and the success of FVA, certainly in

---

Europe, is seen as epiphenomenal to the rise of International Financial Reporting Standards, the successors to IAS, as produced by the IASB. These approaches treat global accounting standard harmonization itself as a trend that is sustained by increasing cross-border financial integration, irrespective of the specific content of the standards that are being promulgated. For example, Chua and Taylor attribute the prominence of IFRS to the legitimacy of the IASB as a standard setting body, which happens to champion FVA.

While this work is helpful for understanding the trend towards international and global harmonization of standards, it has less to say about the content of these standards, particularly because standard setting has been outsourced to private bodies (the IASB and the FASB) while the political fights unfold between their public sponsors (the EU and the USA, respectively). Hence, what FVA does to or means for the economy at large is mostly ignored. Standard setting is effectively seen as a coordination game, making accounting rules not much different than, say, the BlueRay format as the successor of the DVD, over which a hard struggle has been fought against the HD DVD.

Scholarship that hones in on the rise of FVA itself points to a conflict between different stakeholders in accounting systems, most importantly preparers and users, and the way in which their political leverage and interests have changed over the past decades. Different approaches to accounting serve different purposes and hence different stakeholders. With the rise of shareholder value as a guiding concept in corporate strategy since the 1980s, investors have allegedly become eager to assess the opportunity costs incurred by leaving a corporation whole instead of selling its constituent parts. If the net present value of projected future cash flow is less than the market value of a company’s net assets, leaving it intact equates incurring a loss.

More generally, the growth of financial securitization has lessened the utility of accounting techniques that fail to keep track of the market values of the assets and

41 Chua and Taylor, 2008.
43 Rayman, 2006.
44 Lazonick and O'Sullivan, 2000, Froud, Johal, Leaver, and Williams, 2006.
liabilities into which a company could be broken up.\textsuperscript{45} In the mainstream view on accounting that underlies these arguments,

organizations are sets of implicit and explicit contracts \textsuperscript{[\ldots]}.
These parties have different preferences \textsuperscript{[\ldots]}, which gives rise to conflicts of interests and thus to contracting and monitoring problems. Accounting information can address these problems.\textsuperscript{46}

Barth \textit{et al.} have demonstrated that outside users of accounting information prefer FVA over historical cost accounting (HCA) in the presentation of corporations’ economic results.\textsuperscript{47}

The critical pendant to this view sees the rise of fair value accounting as evidence of a growing dominance of financial channels of accumulation over profits directly derived from industrial production (financialization as understood for example by Krippner).\textsuperscript{48} Arnold formulates it as a question:

\begin{quote}
Does the domination of finance over industrial capital explain the move towards fair value accounting and the abandonment of the income measurement model in favor of a balance sheet valuation approach to financial accounting?\textsuperscript{49}
\end{quote}

The work of Perry and Nölke suggests such a conclusion.\textsuperscript{50} According to Nölke, FVA is essential for financialization.\textsuperscript{51} As financial assets have become more profitable than production assets in recent decades, investors support FVA so that shifting balance sheet values are recognized and recorded as profits.

In spite of other theoretical differences, both the mainstream view on the rise of FVA and its critical version agree that with the introduction of FVA, accounting rules are amended at the behest of the users of accounts – whether conceptualized as investors or (financial) capitalists. While these actors’ preferences are plausible, it remains unclear how they translate them into tangible policy change. Big accounting firms, the financial industry, large multinational non-financials and a select group of

\begin{footnotes}
46 Leuz, Pfaff, and Hopwood, 2004: xxv.
47 Barth, Beaver, and Landsman, 2001.
48 Krippner, 2005.
49 Arnold, 2009: 806.
51 Nölke, 2009.
\end{footnotes}
public actors populate the relevant policy communities. In contrast, the constituency the aforementioned approaches put central is hardly visible in policy debates and formalized deliberation. More importantly, even when the role of interest groups such as banks and insurance companies is taken into account, actors’ interests are largely taken as given and static unless disturbed by exogenous shocks. How can this view be squared with the frequently shifting positions of both public and private actors over accounting rules?

**THE CONTINGENCY OF VALUATIONS AND THE POLITICS OF ACCOUNTING**

We argue that the politics of accounting standard setting cannot be understood without acknowledging the inherent limitations of accounting, in particular for financial assets. These limits of different accounting methods, and the practical ramifications of their implementation, are what leads public stakeholders to shift their policy preferences over time and give the concomitant arguments for one or the other methodology different weights. Large banks may at one moment favour particular aspects of FVA, only to reject them later, just as public authorities oscillate between calls for rigorous application of FVA on the one hand and watered down rules that allow banks to withstand losses on the other.

**The contingency of value**

Most accounting scholars recognize that things do not have one quantifiable value, which could, given proper measurement instruments, be identified objectively. Hence, so the argument of the proponents of FVA, 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 indeed exists – this valuation integrates the independent assessments of a wide variety of observers. That is what makes the value ‘fair’, even if it is not ‘correct’ or fundamentally fixed. Standards setters have consistently taken this view. As for example Keynes and Minsky have pointed out and as the credit crisis has demonstrated forcefully, market valuation of assets, and financial assets and derivatives in particular, can be extremely volatile. Current assessments feed market

---

52 Perry and Nölke, 2005.
behaviour and can generate (temporarily) self-fulfilling prophecies, herd behaviour, etc.\textsuperscript{54}

Neither of the two valuation methods that has traditionally been available has good answers to this problem. Historic cost accounting fails to update banks’ books to reflect their current market position. Traditionally, this has mostly been a problem on the asset-side of the balance sheet. An economic downturn may mean that banks are unlikely to recover the money they have lent out. Bad debts start amassing that let creditors doubt the ultimate viability of banks, thereby stifle lending to businesses and foster the build-up of risk in the financial system that remain hidden not only from the view of other market participants, but also financial supervisors.

The rise of derivatives has exacerbated this problem. Many derivatives, even simple products such as options and futures, entail contingent liabilities, in which the amounts owed vary in line with market conditions. Given that the original cost of issuing the derivative can be a fraction of the ultimate liability incurred, they augment the potential for banks’ real assets and liabilities to diverge widely from their reported positions. Historic cost accounting clearly is a poor guide to a bank’s affairs.

FVA generates its own problems. On a micro-level it can be argued that fair value accounting relies on the existence of deep and liquid markets in order to establish reliable values. For many financial instruments, such markets do not always exist. Banks and supervisors have to rely on models or estimates to gauge values, introducing a highly subjective dimension into accounting and causing uncertainty as to the reliability of the estimated value. On a macro-level, FVA can introduce more pro-cyclicality in the financial system. Dropping market prices may trigger sales on particular instruments, further depressing their value, triggering more sales, etc. This is especially acute when FVA involves recognizing changing values directly into the profit and loss account.

**Bank competitiveness and contingent policy preferences**

What do these shortcomings of accounting standards mean for bank competitiveness? In line with arguments about the relationship between bank competitiveness and capital reserve requirements, those rules are understood as

\textsuperscript{54} Akerlof and Shiller, 2009.
increasing competitiveness that, ceteris paribus, boost banks’ profits. For accounting standards, this remains a relevant concern as European banks, covered by IASB rules, compete with American firms, which throughout the period studied here have been required to use FASB standards.

As a consequence of this asset values’ contingency, bank incentives to favor either FVA or HCA at any given moment depend on other factors. Ceteris paribus, banks can be expected to favor FVA in times of market upswing, as it allows them to record rising asset values as profits. Also, as market participants, banks have an interest in understanding the market positions of their counterparties. At the same time, rigorous FVA application has clear downsides. Most obviously, in market downswings, as during the credit crisis, financial institutions may be forced to mark-to-market the falling values of assets which they may not even want to sell and the cash-flow position of which remains solid.  

Furthermore, if FVA is applied to the whole balance sheet of a bank, including its liabilities, counterintuitive situations arise: a bank in trouble, which would see its own traded debt fall in market value, would be allowed to record its own liabilities at a discount and, in an extreme scenario, post a profit as a consequence. Real liabilities would be understated. Applying FVA only to assets also creates problems, as the matching between assets and liabilities that defines the banks’ risk management becomes undone, particularly with respect to untradeable assets such as loans, which banks intend to hold until maturity. Finally, only valuing tradable assets at FVA also is no viable option. Banks and insurance companies regularly use derivatives to hedge risks in their portfolios. What may make sense from a risk-management perspective would be invalidated, however, if the hedged instruments were treated differently than the hedge itself. In short, there exists no consistent, let alone universally agreed, valuation technique that is appropriate for financial institutions.

As the empirical analysis below will show, banks have as a consequence called for divergent accounting treatments throughout the economic cycle. Their ultimate preference, however, has been an accounting regime that gives them discretion in

---

55 This argument was particularly common with respect to senior-tranches of collateralized debt obligations, which were downgraded and hence revalued during the crisis even though the underlying payments were still coming in.
classifying assets in line with both their function in the portfolio (for example hedging) and market conditions. That flexibility can be used both to dampen the impact of market fluctuations on banks’ balance sheets and to hide losses until it is too late to correct them.

**Financial stability and contingent policy preferences**

Public authorities deal with a similar set of problems. International Financial Reporting Standards are in the first instance designed by the IASB. To become effective for example in the European Union, they have to be endorsed by the EU’s Accounting and Regulatory Committee (ARC), which brings together member state representatives. In most instances, the ARC endorses IASB standards without any changes. As outlined below, standards concerning financial instruments have been the key exception. By modifying standards on its own or simply refusing endorsement, the ARC has exercised its power in defiance of the IASB’s putative private authority. ARC committee members have followed the line set out by banking regulators and supervisors, who are responsible for safeguarding financial stability. This makes regulators, charged with spelling out policy preferences in light of overall policy goals (financial stability without competitive disadvantages for domestic firms), the key actors both for modeling and the empirical analysis set out below. How does the contingency of assets’ market valuations translate into policy positions?

To the degree that accurate information about market participants’ financial position is indispensable for financial market functioning, public authorities have strong incentives to support FVA. At the same time, in the name of financial stability, they have big stakes in the viability of banks and other financial institutions as going

---

57 Regulatory and supervisory responsibilities are carved up in different ways around the world. The Basel Committee for Banking Supervision has a misleading title, as it is involved in regulation (setting standards) rather than only supervision (monitoring their implementation). To avoid cumbersome language, and because rule setting is the key activity that counts here, this paper will henceforth use the label ‘regulators’ for those entities that are either directly involved in or de facto shape the design of the relevant financial rules. This may include regulators proper, but also central bankers or financial ministry officials. For the purpose of our analysis, they share the contingent preferences that let them argue in favor of flexibility at one point, only to call for more stringency the next.
58 On the ambiguous role of transparency in international financial and monetary governance, see Best, 2005.
Regulators cannot afford to endorse standards that can endanger financial stability by pushing key financial institutions over the brink. Hence, in times of distress, they have incentives to adopt the banks’ view: desirable standards are those that forestall pernicious losses, regardless of whether they are consistent. The link between financial stability and the viability of banks has important consequences for the relationship between regulators and the financial industry. The former have a strong incentive to support the latter in order to serve their own policy goals – stability. Regulators who visibly cared about the well-being of their own firms are often accused of having fallen prey to regulatory capture. While we acknowledge the disproportional influence firms, and financial firms in particular, can exercise over public policy, regulators do have incentives to argue the banks’ case which goes beyond such capture.

Regulators have to advocate discretion for banks, which is inimical to their original preference for transparency and rigorous application of a single set of standards to aid market functioning. With respect to policy preferences (bank discretion versus rigorous application of one set of standards), regulators thus have two hearts beating in their breast: as guardians of banks’ proper conduct, they cherish bank openness about their financial positions. As guardians of banks’ survival, they may dread that same transparency (see table 1). The contingency of valuations that we put central in this paper implies that there is no escape from this problem, except perhaps by a radical overhaul of the financial system. Even if a pure FVA regime were the point of departure, endemic bouts of market euphoria and the ensuing downturns would endanger financial stability and hence spawn calls for more flexible accounting rules. In this sense, the problems

---

59 Banking regulators may also fear that FVA push banks away from their traditional activities (borrow short and lend long), especially when fair value accounting is applied to bank loans. The fair value of bank loans is calculated as the net present value of these loans, which depends on current interest rates. Small fluctuations in these interest rates can cause great shifts in the value of the loans, especially when the loan is long term. Banks dislike such exposure to income fluctuations, and may turn their attention away from long term assets or shorten the average maturity of a loan.

60 Stigler, 1971.


62 An example of a drastic proposal that may effectively address the problem at the heart of accounting standards is forbidding banks to incur debt (including customer deposits), turning them into mutual funds instead. Kotlikoff, 2010.
dogging accounting standard setting are similar to those that keep financial crises from recurring irrespective of efforts to prevent them. Without objective measures to determine whether assets are over- or undervalued, it is impossible to know whether another boom or bust is in the offing. This paper demonstrates how this logic plays out in real-world accounting standard setting.

Table 1: Overview of policy goals, preferences, and accounting regimes

<table>
<thead>
<tr>
<th>Standard setters</th>
<th>Financial firms</th>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Policy goal</strong></td>
<td>Market efficiency through transparency</td>
<td>Competitiveness (boosting profits)</td>
</tr>
<tr>
<td><strong>Policy preference</strong></td>
<td>Consistent: rigorous application of single set of standards</td>
<td>Consistent: discretion in application of FVA or HCA</td>
</tr>
<tr>
<td><strong>Preferred accounting regime</strong></td>
<td>Consistent: FVA</td>
<td>Contingent upon market conditions FVA in market upswing, HCA in downswing</td>
</tr>
</tbody>
</table>

ACCOUNTING POLITICS BEYOND REGULATORY CAPTURE

The main conflicts over FVA as proposed by the IASB fall into three episodes, recounted below. These episodes show that what drove conflicts, and what kept them going, was not a clash between stakeholders with clear preferences for one or the other accounting system. It was precisely the ambiguity on this point that time and again let stakeholders revisit extant policy arrangements. At times, regulators sided with the financial industry out of a concern for the viability of banks in particular. But it would be wrong to mistake such alliances for regulatory capture. Where banks’ preferences could be detached from their own stability and survival, regulators had no qualms rejecting them.

**Episode I: The Full Fair Value proposal (1997-2001)**

The International Accounting Standards Committee (IASC, the predecessor of the IASB) started working on the development of an adequate standard for financial instruments in the 1990s. Its project gained momentum in 1995 when the

---

International Organization of Securities Commissions (IOSCO) announced that its official recognition of International Accounting Standards (IAS) as of 1998 was conditional on the existence of such a standard.\textsuperscript{64} The IASC realized that reaching consensus on such a standard would be difficult, so it opted for a two-step approach. The first step was to issue IAS 39 in 1998 as an interim standard in order to meet the IOSCO deadline. This standard was heavily modeled on the US Statement of Financial Accounting Standard (SFAS) 133. Simultaneously, the Joint Working Group of Standard Setters (JWGSS) was set up, in which national accounting experts were to develop a standard that would be more suitable for the long term than IAS 39 was.\textsuperscript{65} The principle that would, in the opinion of the IASC, preferably underlie such a standard was put forward in a 1997 IASC Discussion Paper, which held that all financial instruments be measured at fair value (full fair value accounting, or FFVA).

In the draft standard the JWGSS issued in 2000, it indeed proposed abandoning IAS 39 in favor of a FFVA model. The JWGSS argued that fair value was the most relevant measurement attribute for financial instruments and that generally sufficiently reliable estimates of their fair value would be obtainable.\textsuperscript{66} This model would provide a richer basis for the analysis of financial statements and would facilitate its predictive as well as its stewardship purposes.\textsuperscript{67} This was deemed to be the case because ‘[f]air value reflects the market’s assessment of the effects on financial instruments of current economic conditions, and changes in fair value reflect the effects of changes in those economic conditions when they take place.’\textsuperscript{68} Changes in the fair value of financial instruments should immediately be recognized

\textsuperscript{64} Walton, 2004: 13. 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 eventually should replace all IAS.

\textsuperscript{65} The JWGSS, in which the IASC participated, comprised accounting representatives from 13 countries (the USA, the UK, Canada, Australia, Germany, France, Japan, New Zealand and five Nordic countries).

\textsuperscript{66} Joint Working Group of Standards Setters, 2000: §1.7.

\textsuperscript{67} Ibid.: §1.28.

\textsuperscript{68} Ibid.: §1.8a.
as profits or losses, ensuring that management’s freedom to hide changes in firms’ financial position should be severely restricted.69

This FFVA model was different from the so called ‘mixed model’ that had hitherto been common practice in the financial sector. In this model, only financial instruments held for trading purposes were measured at fair value while those intended to be held to maturity were measured at historical cost. This model, which was also underlying IAS 39, was deemed inadequate by the JWGSS:

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.70

Depending on asset categorization by banks, similar assets would appear in balance sheets with different value – anathema to the kind of transparency favored by the standard setters. Unsurprisingly, banks opposed the idea of FFVA and preferred the mixed model, which gave them the leeway to categorize assets in line with their own business models and interests. The JWGSS had been well aware of this opposition, and during its work it consulted with banking representatives and even issued a separate paper on issues relating to banks.71 To make a strong fist, however, banking associations set up a parallel working group that issued papers spelling out the banking industry position. This Joint Working Group of Banking Associations (JWGBA) comprised the banking associations of the USA, Australia, Canada, Japan and the EU. In 1998 it sent a letter to the IASC/JWGSS stating that the latter’s desire to move to FFVA was not backed by compelling evidence of user or preparer support and did not adequately deal with the objections raised to it.72

In October 1999, the JWGBA issued a paper claiming that ‘the mixed measurement system provides the optimal means of reporting financial performance’ – a

69 Ibid.: §1.5b.
70 Ibid.: §138a.
72 Ibid.: §2.1.
contestable claim, as outlined above. Contrary to the JWGSS line of argument, the JWGBA claimed that established accounting practices already met the needs of users of banks’ financial statements. Banks practiced two fundamentally different activities: traditional banking activities (credit intermediation) and trading activities. While fair value accounting might be suitable for the latter, it was not for the former, so the JWGBA claimed. Fair value measurement of long term loans was seen as inadequate as it overemphasized short-term market volatility that did not correspond to the underlying economic rationale of these instruments.

That said, it was clear from the outset that the main concern of the banking community was not the perceived intellectual inadequacy of fair value accounting for traditional banking activities, but rather the implications of such accounting for banks’ income statements. Banks argued that the volatility that FFVA would introduce into their financial positions would undermine public confidence and adversely affect banks’ ability to perform credit intermediation. In short, banks were not in favour of one or the other methodology per se; they were in favour of an accounting system that corresponded to their own business model at any given time, effectively letting valuation of assets depend what was most opportune from a business standpoint. In the end, application of competing measurement instruments would be contingent on overall market conditions.

Banking regulators and prudential supervisors shared banks’ professed concern about excessive volatility as a result of FFVA. The Basel Committee on Banking Supervision (BCBS), for instance, expressed its concern about the JWGSS proposal and argued that the time was not ripe for the prescription of FFVA. According to the BCBS, while FVA was clearly appropriate for trading activities, there were still too many practical difficulties with fair value measurement of banking book instruments. The BCBS also expressed unease about the significant volatility that could be introduced into bank accounts. Moreover, as accounting practices influence business decisions, the wider micro- and macro-economic effects of a new

73 Joint Working Group of Banking Associations, 1999: 2.
74 Basel Committee on Banking Supervision, 2001: §1.4.
75 Ibid.: §3.1.
76 Ibid.: §3.8.
accounting framework would have to be assessed before introducing such a new framework. At the same time, the BCBS acknowledged that mixed measurement models were far from perfect, also due to the necessity of complex hedge accounting provisions, which later turned out to be the Achilles heel of the whole mixed model (see below). Hence, a move towards FFVA in the long term should not *a priori* be discarded, even if in the short run the mixed model was deemed to be more appropriate. In a nutshell, the BCBS found itself in a dilemma, acknowledging both the potentially deleterious consequences of FFVA and the weaknesses of the mixed model. Without any idea in which overall direction to develop accounting standards, it simply urged standard setters to address problems in the mixed model as they arose without, however, abandoning it altogether.

The IASB, in its summary of the comment letters on the draft standard that were received, concluded that most of the preparers strongly opposed FFVA and the immediate recognition of the resulting gains and losses. Opposition to the JWGSS proposal proved to be so fierce that the project was temporarily abandoned by the IASB – a move that dovetailed with the BCBS’ skepticism about FFVA without, however, addressing its doubts about the mixed model. IAS 39, which the IASB had originally intended to replace by a much more coherent standard, hence became the point of departure for all subsequent debates. Unsurprisingly, the latter emerged before long, given that the impossibility to agree on a replacement for IAS 39 did not mean that its own inconsistencies had vanished.


On the face of it, the shelving of FFVA was a victory for the banking community. Banking supervisors had been equally uneasy with the approach, however, given its potential implications for bank and hence financial system stability. That said, both banks and supervisors leveled strong criticism against the mixed-measurement IAS 39, which had now become the default standard. The matter gained urgency in 2000 when the European Commission announced its intention to require companies listed in the EU to use international accounting standards. 77 This requirement was formalized in a regulation in 2002 that prescribed the use of IAS by 2005. Suddenly,
IAS 39 was no longer simply an object of theoretical debates but became of utmost importance to European listed banks, their regulators and national and EU political agencies.

The main point of conflict between standard setters, banks and public regulators was accounting for derivatives. The principles underlying 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. 

\[(\ldots)\text{In accordance with this principle, almost all derivatives falling within the scope of IAS 39 are measured at fair value.}\]

Previous accounting practices in Europe did not require all derivatives to be on the balance sheet, let alone to be measured at fair value. As derivatives’ value can fluctuate significantly in a short period of time, the resulting volatility in banks’ financial positions was again a major concern. Banks hitherto dealt with this volatility by a special practice called hedge accounting, in which income fluctuations due to changes in the value of derivatives could be removed by recognizing fluctuations in other, linked instruments that would otherwise be measured at historical cost. However, the IASB introduced strict rules for so-called ‘special

\[\text{hedge accounting.}\]

\[\text{Hague, 2004.}\]

\[\text{Some observers argue that in fact the mixed model introduces artificial volatility, especially when it concerns derivatives. As stated above, derivatives are instruments the value of which depends on some other underlying instrument. If an institution owns a derivative that is linked to another instrument on the balance sheet and if both instruments are measured at fair value, the shift in the value of one instrument would be offset by an equal shift in the value of the other, creating no volatility in the income statement. In a mixed model, it is possible that the derivative is measured at fair value and the other instrument at historic cost, meaning that shifts in value are not offset and hence create artificial volatility not corresponding to the underlying economic logic. See e.g. Whittington, 2005: 137.}\]

\[\text{A hedge is created when the shift in value of one instrument is offset by an equal shift in value by another instrument in the opposite direction. Hedging thus is a strategy to offset risk. Banks often use derivatives to create hedges, as these instruments by definition depend on the price of another instrument. Hedge accounting involves designating a derivative (measured at fair value) as a hedging instrument and other items as the hedged instruments (measured at historical cost). Changes in the value of the derivatives are allowed to be offset (in equity or in income) by recognizing an equal change in the value of the hedged instruments, thereby generating no volatility in either income or equity.}\]
accounting’, ensuring that such practices would be allowed only in clearly defined circumstances. Banks strongly opposed the strictness of the new hedge accounting provisions, arguing that they did not correspond to long-standing banking practices. Accounting techniques, so the basic idea, should adapt to banks’ risk management –challenging the whole notion that corporate accounts summarize the combined values of a company’s individual assets and liabilities. Especially French banks feared the consequences of the recognition of all derivatives and their measurement at fair value. Jacques Chirac, French president at the time, sent a letter to the European Commission in 2003 claiming that ‘IAS 39 could have nefarious consequences for Europe's economies’. Banks again received backing from the BCBS, as the committee feared that banks would abandon established risk management practices due to new hedge accounting rules. At the same time, the committee found it undesirable to have standards be so flexible as to open the door for the manipulation of the firms’ financial positions. According to the BCBS, hedging strategies should be clearly identifiable, measurable, effective and adequately documented in order for hedge accounting to be appropriate. At the same time, it remained concerned about the overly burdensome and stringent requirements imposed by IAS 39 that might deter banks and other companies from prudential risk management strategies. Banks might snub positions that would be adequate from a risk management perspective but uncertain to qualify for hedge accounting. In short, the supervisors wanted banks to have flexibility but also to make sure that that flexibility would not be abused – a circle that remained impossible to square.

The main point of controversy turned out to be restrictions on hedge accounting for derivatives that banks used to hedge interest rate risks in their banking book: so-called macro-hedges. Banks were used to hedging risks using derivatives meant to cover net risk exposures, rather than hedging (potentially offsetting) exposures one-

83 Basel Committee on Banking Supervision, 2002: 5.
84 Ibid.
by-one. Leaving technical details aside, having the macro-hedge qualify for hedge accounting would make it easier for banks to defer recognizing changed derivatives values as profits or losses, thereby reducing volatility.\footnote{Parker, 2003.} The IASB was of the opinion that there should exist a clear link between the hedging instrument and the hedged instrument before hedge accounting could be permitted; otherwise management would have too much freedom to manage income and to hide losses and gains.

These conflicting positions led to a series of meetings between the IASB and representatives of banks from Germany, France and the UK in the course of 2003. These meetings resulted in a narrowing of the distance between the opposing parties. However, on key issues, such as on effectiveness testing, no agreement could be found, which meant that using hedge accounting would still be very difficult for banks under IAS 39 rules. In 2004 efforts were therefore made from all sides to have the IASB relax its rules on hedge accounting. Big banks intensely lobbied the IASB – both individually and through the European Banking Federation – but to no avail.

The European Financial Services Round Table (EFR), a trade association of mostly continental European banks and insurers, shifted its focus on the European Commission, hoping that the latter might have enough leverage to enforce an agreement. In a letter the EFR sent in February, it stated that ‘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’.\footnote{European Financial Services Roundtable, 2004.} The Commission had already threatened that it would not endorse the IASB’s derivative standards unaltered, and set a deadline for a solution in June.

The controversy remained unsolved, and by mid-June four countries (France, Italy, Spain and Belgium) expressed their opposition to a complete endorsement of IAS 39, with six others (including Germany) undecided.\footnote{Dombey, 2004.} EFRAG, an advisory body to the Commission on issues concerning accounting standards, also said it could not recommend full endorsement.\footnote{Walton, 2004: 6.} The Commission resolved that it would only partially endorse IAS 39, with controversial sections in the standard concerning hedge
accounting ‘carved out’ by the EU’s Accounting Regulatory Committee (ARC).\(^9\) The carved-out version was finally endorsed in the EU at the end of 2004. The EC stressed that this was only a temporary solution to a temporary standard and expressed its hope that the underlying problem be solved by the end of 2005.\(^9\) The ECB claimed that the carve out clearly did not represent an optimal long term solution.\(^9\) The ‘solution’ was suboptimal both from the perspective of standard setters as well as the prudential regulators; still, the fear that banks might abandon ‘sensible’ risk-management practices and that ‘ineffective hedges’ might lead to income volatility led public regulators to side with banks eventually. This alliance was not an incidence of ‘traditional’ regulatory capture, however. On hedge accounting supervisors sided with banks because their own interest in financial stability might be compromised if any one accounting methodology would be applied too stringently. On the other key issue, the so-called Fair Value Option (FVO), the supervisors were ready to face off bank lobbying because competitiveness issues could be effectively disentangled from concerns about financial stability.

The section dealing with the FVO was a second central part of IAS 39 that was ‘carved out’. This option had been proposed by the IASB in 2002 and introduced into an amended version of IAS 39 in December 2003. The FVO allowed the measurement of any financial asset or liability at fair value, with changes in value recognized as profits or losses, provided that the instrument was designated in the FVO category on initial recognition.\(^9\) As IAS 39 was a mixed standard and certain ‘natural hedges’ would not be recognized as such because of different accounting treatments, the FVO allowed for recognizing offsetting fluctuations without having to resort to complex and burdensome hedge accounting.\(^9\)

Interestingly enough, whereas the debate on hedge accounting provisions of IAS 39 showed the IASB’s worries over giving banks too much accounting freedom, the

---

\(^9\) Individual EU countries were in principle free to demand full application of the standard.
\(^9\) Whittington, 2005: 139.
\(^9\) Whittington, 2005: 139.
\(^9\) If hedge accounting rules did not allow the recognition of offsetting fluctuations of instruments that were valued on a different basis, then the FVO might still allow a bank to value the hedged instrument at fair value, meaning that treatment of the hedge and the hedged items would match once more.
initial FVO proposal would have provided banks with just that, even though the option was irrevocable, meaning that no reclassification would be allowed. Apparently, the IASB’s wish to move to a fair value system was so strong that it accepted the possible consequences that the same instruments would be measured differently by different institutions and that accounts would become less comparable.

Banking regulators and the European Central bank, however, remained doubtful about the FVO.\(^{94}\) The BCBS acknowledged that it might resolve some problems of the mixed measurement attributes of IAS 39, but it claimed that the FVO might generate similar problems to FFVA by allowing institutions to record a profit when its own creditworthiness deteriorated through fair-valuing liabilities, as discussed above.\(^{95}\) Moreover, for financial instruments that lack reliable fair values, for example due to the absence of market prices, ‘this option may permit companies to manage earnings in ways that would not easily be detected by financial statement users.’\(^{96}\) From a financial stability perspective the regulators feared that outside parties such as institutional investors would pressure banks gradually to extend the area of instruments to be fair valued, which *de facto* would mean a move towards FFVA, which would reintroduce the concerns about volatility in the banks’ income statement and in the financial system at large.\(^{97}\)

The IASB was responsive to this concern and issued a new exposure draft in March 2004 in which a more restrictive version of the FVO was proposed, much to the chagrin of banks. The European Banking Federation argued that the FVO would allow entities to overcome the basic flaws of IAS 39 and reduce income volatility as natural hedges could be recognized as such.\(^{98}\) The London Investment Banking Association (LIBA) called the unrestricted FVO a ‘key cornerstone’ and expressed its ‘disappointment that the Board is now proposing to amend this accounting

---

95 Basel Committee on Banking Supervision, 2002.
96 Ibid.: 2.
The industry responses to the proposed limitations were overwhelmingly negative. At the time of IAS 39 endorsement – at the end of 2004 – an adequate new version of the FVO had not been finalized. Hence the original, very permissive FVO provisions were also ‘carved out’, causing despair among banks who coveted the FVO freedom. In the first half of 2005, the issue was finally resolved in line with banking supervisors’ demands. In the new version, the option could only be used to eliminate or reduce significantly an ‘accounting mismatch’. Alternatively, entities would have to document clearly that instruments were managed with a specific risk or investment strategy and support FVO application by adequate disclosure.

Taken together, the controversies about hedge accounting and the FVO show how regulators and supervisors were not simply doing the banks’ bidding – even when the latter largely agreed with the line set out by the IASB, as in the case of the FVO. Rather, the supervisors’ position tried to balance banks’ accounting flexibility as a precondition for financial stability (in hedge accounting) with sufficiently strict rules lest banks could misrepresent their financial situation, and hence hide mounting problems from supervisors and investors. The deal that was struck represented an uneasy truce between stakeholders and competing arguments as discussions reached an impasse rather than any durable solution.


The ‘messy’ solution that had been found through the IAS 39 modification managed to calm nerves over derivatives accounting temporarily, largely because propitious financial condition until mid-2007 prevented any real problems from emerging. As the credit crisis started unfolding after the summer of 2007, accounting for financial instruments once again climbed on the political agenda. The crisis triggered two moves by the IASB: it modified IAS 39 once more, and it started to develop a new standard (IFRS 9) to replace IAS 39 eventually. Both moves again exposed the fundamental dilemmas faced by the stakeholders involved.

100 EFRAG, 2004.
As the credit crunch developed into a full blown financial crisis, fair value accounting came under fierce attack. Banks complained that FVA forced them to treat falling asset prices as losses even when they had no intention of selling the assets in question. They also expressed concern that in an environment of illiquid markets, the fair value of assets was impossible to ascertain, thereby heightening market uncertainty. Finally, banks as well as regulators argued that FVA induced pro-cyclical behavior, with falling asset prices triggering sales and curbs on lending, which themselves induced further falls in assets’ market values.

The extent of recognized bank losses under IAS rules triggered intense bank lobbying of the IASB. EU member states, with France and Germany leading the way, urged the IASB to modify IAS 39 to create some breathing space for banks. The EU message to the IASB boiled down to a threat that ‘either you change the rules, or we will’. Already a new version of IAS 39 containing a draft carve out was circulating, following an initiative of French president Sarkozy. The pressure on the IASB was so intense that it decided to modify the standard in October 2008, allowing for the reclassification of assets into categories that did not require market-based valuations. The fact that the IASB gave in to EU pressures, and that it did not follow its normal stakeholder consultation practices, was criticized by investors and accountants, but the threat of an EU changing rules in defiance of the IASB was simply too great. Yet another carve-out would have been disastrous for the authority of the IASB, although giving in to the threats proved to be a severe blow as well. The IASB defended its move by claiming that the modification ensured at least some transparency on reclassifications, which would not have been required had the EU simply removed the provisions in the IAS 39 standard.

The necessity of a modification of IAS 39 shows the dire situation in which public actors found themselves. The sudden claim that particular assets were long-term investments, even though no complaints had been heard about irrational valuations

---

102 Casabona and Shoaib, 2010.
104 The EU regulation requiring the use of IAS stated that the standards should not disadvantage European companies as compared to those in other major markets. It was argued that as reclassification in ‘rare circumstances’ was allowed in the US, this should also be allowed in the EU. Ibid.
when market prices went up, was hard to stomach for many observers. The problem went deeper, however. Standard setters had an obvious point claiming that falling assets prices reflected poor investment decisions of banks. And allowing banks to defer recognition of losses is problematic from a prudential perspective, as the Savings and Loans crisis in the US in the 1980s and the ‘lost decade’ in Japan in the 1990s clearly showed. At the same time, the danger of credit intermediaries imploding was even more severe and triggered demands for rule modification, allowing banks more freedom to choose ‘appropriate’ valuation techniques for their assets.

The second key move of the IASB was to start development of a new standard to replace IAS 39. In March 2008, the IASB had issued a discussion paper to explore how accounting for financial instruments could be improved, referring to the perceived complexity of IAS 39 as a main motive for such a revision. The IASB argued that in the long term, a move towards a single measurement method would significantly reduce complexity, and that fair value was the most appropriate method in this respect. Hence, the IASB argued for a long-term move towards full fair value accounting, effectively going back to the position it had taken a decade earlier.

Not surprisingly, strong opposition from banks followed. The crisis had also changed the perspective of regulators, however. Now they clearly pointed to a mixed model as the most desirable option; any move to FFVA, even in the long run, was out of the question. These responses echo the positions that had been taken more than a decade earlier during the Joint Working Group controversy (Episode I). The International Banking Federation reiterated that a mixed system was more suitable for banks than FFVA. Most other banks, with a small number of investment banks as an exception, supported this line, as did the Committee of European Banking Supervisors, the EU’s banking watchdog, and the BCBS.

Under pressure of the G20 and countries such as Germany and France, who quickly wanted to see a new standard in which fewer financial instruments were measured at fair value, the IASB had pledged to speed up its revision process and to issue a new

105 International Banking Federation, 2008. The International Banking Federation is the representative body for a group of banking associations, which include the American, Australian, Canadian, Chinese, Indian, Japanese and European banking associations/federations.
standard (IFRS 9) by the end of 2009.\textsuperscript{106} When a draft version was issued in July 2009 the IASB made clear that as there were conflicting views and issues to be resolved, 

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.\textsuperscript{107}

Instead, the standard’s main difference compared to IAS 39 was that there were fewer accounting categories, the choice being between historical cost and fair value.\textsuperscript{108} In the IASB’s draft proposal, the characteristics of the instrument in question itself should be the main classification criterion and subsequent reclassification should not be permitted. In contrast, the European Banking Federation argued that the ‘business model’ (i.e. the way in which the instruments are managed) should be primary in classification decisions, with the characteristic of the instruments being secondary.\textsuperscript{109} Going further, reclassification should be mandatory if the circumstances required that. The BCBS came to broadly the same conclusions, but it also emphasized that the ‘business model’ should be supported by clearly documented risk management strategies and that reclassification should only be allowed in case of ‘events having clearly led to a change in business model’.\textsuperscript{110} Out of a shared concern for financial institutions’ viability, banks and their regulators argued in the same direction; at the same time, regulators remained steadfast not to grant banks too much freedom in asset (re)classification.

In the final standard, issued in November 2009, banks have increased freedom to classify particular assets in the historical cost category, and reclassification is required

\textsuperscript{106} Actually, the revision would take place in three steps. The new standard, IFRS 9, would be introduced at the end of 2009 and then further developed, and would have to be adopted by January 2013 at the latest, with early adoption being permitted starting in 2009. The first stage would deal with classification and measurement of financial instruments (finished by the end of 2009), the second stage with the ongoing measurement and impairment methodology and the third stage with hedge accounting (both to be finished by the end of 2010).

\textsuperscript{107} International Accounting Standards Board, 2009: BC13.

\textsuperscript{108} In IAS39 there were four accounting categories for financial assets: (1) for trading instruments (fair value through income statement); (2) instruments available for sale (fair value through equity); (3) held to maturity (historical cost); and (4) loans and receivables (historical cost).

\textsuperscript{109} European Banking Federation, 2009.

\textsuperscript{110} Basel Committee on Banking Supervision, 2009: 1f.
when the ‘business model’ changes. Nevertheless, the EU refused to adopt the standard, triggering shock reactions from around the world. Numerous Continental banks were sitting on piles of losses that had yet to be recognized in the income statement. According to Tait and Sanderson, ‘French, German and Italian banks with large investment banking activities would be hit disproportionately by the changes, forcing them to book losses on large holdings of derivatives’. After more than a decade of going back and forth on accounting for derivatives, still no satisfactory solution had been found. The tension between banks’ need for flexibility in the name of financial stability on the one hand, and the potential for abuse of that flexibility on the other, remains unresolved. If banks and their regulators have repeatedly found themselves on the same side of debates over accounting reforms, then it has been the impossibility to resolve this tension more than anything else that has brought them together.

CONCLUSION
This paper has tried to unpack the convoluted politics of accounting standard setting over the past two decades and in particular the struggle over FVA. In contrast to traditional political economy accounts of such politics, which emphasize conflicts between actors with identifiable power resources and clear interests, our account has highlighted the contingency of stakeholders’ policy preferences and the shifting alliances concerning accounting standards.

The ultimate driver of this dynamic lies in the indeterminacy of values of financial assets itself. The application of any given valuation technique not only measures the economic present but also shapes the economic future. Such techniques are necessarily faulty, and as we argued, none of the available ones can provide the financial stability that public authorities covet. Hence, public actors find themselves endorsing temporary solutions that turn into permanent ones and half-baked

---

111 The change in business model is quite restrictive, however: it should be the ‘result of external or internal changes and must be significant to the entity’s operations and demonstrable to external parties’ Moreover, ‘a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)’ or ‘a temporary disappearance of a particular market for financial assets’ do not qualify for a ‘changed business model’. International Accounting Standards Board, 2009: §§ B 5.9-5.11.
112 Tait and Sanderson, 2009: 19.
measures for want to convincing solutions. More importantly for our account, just as the specific preferences of banks themselves (when they want to apply FVA and when they do not) change over time, so do the preferences of those in charge of their stability. The politics of accounting are contingent on overall market and economic conditions – which themselves, as the credit crisis has demonstrated, can be driven by the regulations and accounting techniques that shape financial markets.

Beyond the domain of accounting itself, this paper has demonstrated how theories from heterodox economics can inform modeling the policy preferences of actors in financial governance. Even though this paper has concentrated on accounting, this argument should in principle be applicable to other domains of financial regulation in which the contingencies of valuation generate policy challenges. The regulation of credit rating agencies is an example: post-crisis reform proposals on both sides of the Atlantic have dodged the question of how ratings as assessments of credit worthiness could be detached from their own impact on market functioning.

With its emphasis on contingency and the importance of human cognition to financial market functioning and hence policy preference formation, this paper clearly links to constructivist scholarship in IPE. At the same time it shows that that need not put it out of touch with the strengths of open economy politics, which uses economic scholarship to theorize the preferences of actors in the political economy. We hope that this paper will be read as one example of how the two traditions can be fruitfully integrated.

113 Abdelal, Blyth, and Parsons, 2010.


