SVB Collapse Reinvigorates Bank Accounting Debate

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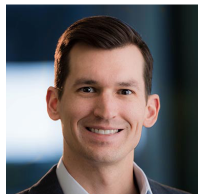
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In the aftermath of the run on Silicon Valley Bank that precipitated its collapse, the adequacy of current accounting guidelines for recording the value of securities has once again come into the spotlight.[1]

SVB's sudden collapse reinvigorated the debate over what measurement regime — fair value or amortized cost — is most appropriate for banks' financial reporting.

Far from being a dry academic argument over arcane accounting rules, this debate is crucial for understanding what information could have been provided to market participants to give them a better understanding of SVB's financial condition.

In a 2022 Form 10-K filed a few weeks before its collapse, SVB had designated 43% of its total assets as held-to-maturity, or HTM, securities — its largest asset line item. This designation meant that SVB was not required to report unrealized losses in fair value on its HTM portfolio in SVB's income statement or report those assets at fair value on its balance sheet.

SVB did, however, disclose fair value information about its HTM securities in the filing, which allowed market participants to discern that the fair value of SVB's HTM securities was $15 billion less than the amortized cost reported on SVB's balance sheet. Thus, both amortized cost and fair value were provided to market participants.

The decades-old debate over the appropriate application of fair value accounting rules was also at the forefront of ex post analyses of the 2008 financial crisis, but for exactly the opposite reasons they are being scrutinized in the wake of the SVB collapse. Unlike the arguments being made post-SVB, a widely held perspective was that reporting market values could cause further economic harm and would not fairly represent a company's financial position.

This article briefly describes the relevant principles that govern accounting for debt securities, including HTM securities, and the controversies that have followed this accounting since its inception.

Brief Overview of Guidance on Accounting for Debt Securities

The U.S. Securities and Exchange Commission has granted the Financial Accounting Standards Board the authority to establish financial accounting and reporting standards for public and private companies and not-for-profit organizations.

The basics of the current framework for accounting for debt securities, which was introduced by the FASB in 1993, requires companies to classify their debt securities into one of three categories: HTM, trading or available-for-sale securities. The classification of the debt securities governs the appropriate accounting treatment, i.e., fair value accounting is required for trading and available-for-sale securities, but amortized cost accounting is considered appropriate for HTM securities.

The reasoning behind the differing treatments is that HTM securities are those for which management has the positive intent to hold to maturity and, importantly, for which the company also has the ability to hold to maturity.

Thus, HTM securities are measured at amortized cost on a company's balance sheet net of an estimate for current expected credit losses, i.e., the newly effected CECL standard. Amortized cost represents the amount at which the security was acquired, adjusted for factors such as collection of cash or write-offs.

Unrealized gains and losses associated with changes in the fair value of HTM securities are not reported in the income statement, nor do they affect the measurement of the HTM securities on the balance sheet.

However, public business entities are required to disclose fair value and unrealized gains and losses, as SVB did in its year-end 2022 financial report.

In contrast to HTM securities, trading securities are generally those for which management has the intent of selling in the near term. Consequently, trading securities are measured at fair value on a company's balance sheet, and unrealized gains or losses are included in earnings.

Available-for-sale securities occupy the middle ground, as they are not classified as either HTM or trading securities.

Like trading securities, available-for-sale securities also are measured at fair value on a company's balance sheet, and unrealized gains or losses in fair value are generally

reported in a section below net income called "other comprehensive income" until realized.

Other comprehensive income represents accounting items that change the net assets of a company, and therefore are similar to revenue, expenses, gains and losses, but are excluded from net income.

The table below summarizes the relevant classification and measurement guidance for each category of debt securities.

Classification	Description of Classification	Measurement Principle	Reporting of Unrealized Gains/ Losses
Trading	Intent to sell in near term	Fair value	Earnings
Available-for-Sale (AFS)	Not trading or HTM	Fair value	Other comprehensive income
Held-to-Maturity (HTM)	Positive intent and ability to hold to maturity	Amortized cost	Not recognized but disclosed (if public business entity)

Entities are required to document their classification of debt securities upon acquisition and reassess the appropriateness of the classification at each reporting date. The FASB has explained that because amortized cost is only appropriate for HTM securities, meeting the requirements for that classification is the most restrictive.

The FASB has identified various circumstances that are inconsistent with HTM classification. For example, a company should not classify a debt security as HTM if it anticipates that the security would be sold in response to changes in market rates or for general liquidity needs.

On the flip side, the FASB has also identified circumstances that would not necessarily call into question HTM classification.

For example, the FASB noted that extremely remote disaster scenarios — such as a run on a bank — may cause an entity to sell HTM securities without necessarily calling into question its intent to hold other debt securities to maturity.

However, a pattern of selling HTM securities can call into question an entity's intent about all HTM securities, and companies are required to carefully consider whether the sale of HTM securities affects the classification of other HTM securities.

SVB's Balance Sheet Dominated by HTM Securities

Following the SVB collapse, some industry observers and participants have questioned whether recognizing HTM securities at fair value, instead of amortized cost, could have provided market participants more insight into the bank's true financial condition.

On Feb. 24, SVB filed its 2022 annual report with the SEC and reported $91.3 billion of HTM securities as of Dec. 31, 2022. HTM securities were SVB's largest asset line item on its balance sheet, comprising 43% of its total assets of $211.8 billion and consisting primarily of agency-issued residential and commercial mortgage-backed securities.

Consistent with accounting guidance, SVB also disclosed the fair value of its HTM securities of $76.2 billion. This fair value was over $15 billion lower than the reported amortized cost on the balance sheet of $91.3 billion. The reduction in value was largely a result of the rise in interest rates, as the value of SVB's long-term agency-issued mortgage-backed securities declined as interest rates rose.

The Long-Debated Use Of Fair Value Versus Amortized Cost

As early as the establishment of the SEC in 1934, the appropriateness of fair value versus cost measurement principles has been debated. In 1937, the commissioner of the SEC declared that "the purpose of accounting is to account — not to present opinions of value."

Similarly, the American Accounting Association proclaimed in 1936 that "[i]f values other than unamortized [historical] costs are to be quoted they should be expressed in financial statements only as collateral notations for informative purposes."

The debate regarding the appropriateness of amortized cost or fair value for financial institutions was part of the impetus behind the FASB's issuance of the current three-category classification and measurement scheme in 1993. However, the measurement debate remained unresolved.

The FASB passed the guidance on the three-category classification scheme on a 5-2 majority, with the two dissenting members advocating for fair value reporting for all securities, including those for which a company intends to hold to maturity. The dissenting board members noted, among other things, that fair value reflects the economic consequences of events in the period in which they occur.

The majority of the board ultimately decided to allow reporting HTM securities at amortized cost, reasoning that if the debt security is held to maturity, the cost will be realized and any interim unrealized gains and losses in fair value will reverse.[2]

Fair Value and The Financial Crisis Of 2008

In the fallout of the 2008 financial crisis, questions about the relevance and usefulness of fair value accounting returned to the spotlight. Comparing accounting questions raised today — whether fair value could have provided more insight into SVB's financial condition — to those raised in 2008 is illustrative of the debate about the trade-offs between fair value and amortized cost that arise during periods of economic disruption.

In 2008, a widely held perspective was that fair value accounting could result in negative economic consequences. Such accounting could exacerbate a crisis by creating a negative feedback loop between accounting practices and capital requirements.

These observers worried that writing assets on a balance sheet down to fair value could require a bank to sell additional assets to meet capital requirements. Such sales would then put more downward pressure on prices, which would require further write-downs of assets on the balance sheet, and so on, resulting in a spiraling effect.

A similar argument raised post-2008 held that fair value failed to give market participants a useful depiction of banks' balance sheets and income statements because temporary changes in market conditions could result in unrealized losses of fair value.

However, as long as the bank holds the security and the issuer continues to make principal and interest payments, the bank will not actually realize any loss due to the temporary change because the bank would receive all the cash flows promised by the security. Thus, the concern was raised that recognizing those unrealized losses could result in unnecessary volatility.

That is, a primary concern in 2008 was the negative impact of recognizing fair values — the opposite side of the same coin regarding the recent questions being raised in the fallout of SVB, where some have advocated for recognizing fair values because they believed it gives the most accurate depiction of banks' value.

Responses to the 2008 Crisis From Congress and the FASB

Following the 2008 crisis, Congress called for the SEC to conduct a study on mark-to-market accounting standards — a method for measuring accounts at fair value — which the SEC undertook following the passage of the Emergency Economic Stabilization Act.

In its final report to Congress, the SEC acknowledged the intense, then-current debate on the use of fair value both in the U.S. and internationally.

In 2010, the FASB proposed a requirement for most financial instruments to be presented on the balance sheet at both fair value and amortized cost, as well as for companies to consider both in determining net income and comprehensive income. In its proposal document, the FASB noted the controversies that surround questions of fair value measurement and how many knowledgeable people hold differing and strongly held views.

Ultimately, the FASB abandoned its proposal and noted feedback from most stakeholders advocating for retaining the use of amortized cost for financial instruments for instances including when an entity intends to hold them to maturity. The basics of the three-category classification and measurement scheme remain in effect today, and underly the current questions surrounding the scheme's pros and cons.

Conclusion

Strongly held and differing perspectives about the relevance of fair value accounting are nothing new. Interestingly, questions raised about the use of fair value in the fallout of SVB have been opposite to those raised following the 2008 financial crisis.

Given that fair value information about SVB's HTM securities was, in fact, disclosed, and in light of feedback the FASB received in 2008 about the usefulness of amortized cost information in certain instances, it remains to be seen if standard setters or regulators feel such disclosure was deficient and will decide to pursue changes to the relevant accounting rules.

The basic classification and measurement principles for accounting for debt securities was not changed as part of the 2008 crisis.

If the FASB decides to investigate changes to accounting for debt securities, they will likely face challenging questions about the use of fair value versus amortized cost. Moreover, standard setting usually takes time, with many projects at the FASB spanning years.

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Endnotes

1 Silicon Valley Bank is a wholly owned subsidiary of SVB Financial Group. This article refers to both as SVB.

2 Unrealized gains and losses associated with changes in the fair value of HTM securities will reverse at maturity given the amount an entity will receive is fixed — it will recover its investment when the issuer pays the amount owed at maturity and no gains or losses will be realized.

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