The effects of the crisis are evident. Less evident are the causes of this crisis. To know them is very important for two reasons:

- to find remedies to the crisis
- to avoid, at least partially, that a crisis so deep and wide recurs in the future.

If we consider the causes, in common opinion, the factors chiefly responsible for the present crisis are two:

- the financial instruments, above all derivatives which tainted the financial market;
- the fair value, that is the accounting criterion used to recognize and measure financial instruments in the companies’ financial statements.

For example, this is the opinion that the influential American Bankers Association (ABA) stated in a letter to the SEC in September 2008.

In respect of Italy, I want to remind you of the fact that, very soon, the full adoption of European Directive 51/2003 will introduce FVA in our Civil Code.

As a consequence, not only Italian listed companies’ financial statements, but all Italian stock companies’ financial statements will have to deal with FVA.

This means that we all will have to cope with FV. This is a difficult challenge, because FV is a construct which is only apparently simple.

This is a typical definition of FV.
Looking at this definition, FV is a market value.

Determining this value is quite easy when markets are, using the accounting jargon, “active”.

Considering a financial instrument, a market is active if quoted prices are readily and regularly available from an exchange and those prices represent actual and regularly occurring market transactions on an arm’s length basis.

But what happens when markets are not active?

In this occurrence, an entity establishes fair value by using a valuation technique.

We have several valuation techniques at our disposal.

We can use recent arm’s length market transactions between knowledgeable and willing parties.
Or if available, we can use the current fair value of another instrument that is substantially the same.

If there are no market references, we can resort to discounted cash flow analysis and even to option pricing models.

It’s evident that there are different measurement levels for FV. We move from a mark-to-market logic to arrive, when the market is not active, to a mark-to-model logic. In this way the values we determine don’t reflect real current market conditions.

In this respect, I remind you of the incredible amount of financial instruments measured with the mark-to-model logic in the American banks’ portfolio in 2008.

I think this brief summary points out that there can be tight relationships between FVA and the present crisis of financial markets.

The crisis, in fact, made the financial markets not active. Very often, prices quoted in the market don’t mirror the real fundamental value of the company that the financial instruments refer to. For example, if we look at the Italian stock exchange, there are many companies which get along well but the shares of which are traded below par.
So, FVA has spurred many companies, above all banks and insurance companies, to impair the financial instruments they held, and to record heavy losses in their income statements which, in many cases, caused the companies’ bankruptcy.

In this respect, Citigroup is a poster child for impairment. It has written down more than $50 billion in assets.

Other companies, to lessen the magnitude of probable future impairment losses, decided to sell their financial assets. But, in this way, they increased the pricing downturn in the market.

Against this background, it’s easy to understand why many people accused FVA of being a procyclical catalyst that can stress the market trend. A catalyst which is welcomed during the upturn phases of the market, but which is cursed when the market goes down.

Many CFOs share this opinion and think that FVA: “has been extremely destructive of bank capital in the past year, and is a major cause of current credit crisis and economic downturn.”

Governments have been sensitive to claims like this, coming from the companies.

On April 2nd, after a bruising encounter with Congress, America’s Financial Accounting Standards Board (FASB) rushed through rule changes.

As a consequence, now, banks can use models to value illiquid assets more freely and have more flexibility in recognizing losses on long-term assets in their income statements.

In Europe also the governments of the EU put pressure on the International Accounting Standards Board about FVA. As a consequence, IASB modified IAS 39 and IFRS 7, the accounting principles which are the most concerned with measurement and disclosure of financial instruments.

Long story short, companies are allowed to reclassify their financial instruments in a way that free them from FVA rules.

At first sight, all these steps seem to disavow FVA.

But if we look closer into the question, may be things are different.

The influential SEC, in a report prepared for the American Congress, found that fair value accounting did not play a relevant role in the numerous bank failures of 2008.

The SEC staff also found that the suspension of fair value in favour of historical cost-based measures would likely increase investor uncertainty and could adversely impact market liquidity and the values of debt and equity securities.

SEC’s opinion is backed by the academic literature.

Many scholars underline that there is no empirical evidence that investors would be calmer under historical cost accounting (HCA).

Moreover, in time of market instability, it is also possible that market reactions are even more extreme if current market prices or fair-value estimates are not disclosed to the market.

May be, it’s worth while reminding you that, owing to the above-mentioned IAS 39 amendment, European banks reclassified, low and behold, over half a trillion dollars of assets, boosting their 2008 profit by $29 billion in the process! And this happened in the depths of the crisis.

For this reason, even in the bank and insurance world there are many people who recognize that companies might temper their risks if they know that the financial assets they are taking on have to be marked to market value every day.

Even the associations that represent the accountant and investor interests warned against a suspension of FVA.

For example, in a joint letter to the SEC in November 2008, the Consumer Federation of America, Center for Audit Quality, Council of Institutional Investors, Investment Management Association, and Chartered Financial Analyst Institute took a position in favour of FVA.

Looking at the picture we have drawn, it’s evident that the fair value matter has to be handled in a systematic way. For this reason the IASB has engaged in rewriting IAS 39.
Crisis or no crisis, this revision was absolutely necessary all the more that Sir David Tweedie, the IASB’s chairman, before the crisis broke out, publicly stated what you read in the slide.

So, last July the IASB issued an Exposure Draft of the new version of the IAS 39.

The new version proposes to put all financial assets into two buckets.

Loans and securities which share the characteristics of loans - in other words, assets that derive their value only from interest and repayment of principal - will be held at cost, provided banks can show they will hold them for the long term.

Everything else, including equities, derivatives and more complicated securities, will be held at fair value.

I personally believe that, to be really effective, the IASB’s activity will have to be developed in accordance with the FASB. Both the standard setters should work on the fair value construct by the light of the objective and the users of financial statements.

In particular, this reflection should consider the concept of market which fair value definition is based on.

In the opinion of many scholars standard-setters have not empirically investigated the characteristics of markets. For example, this is the opinion of an influential scholar as Michael Bromwich of the London School of Economics.

This statement shows that the fair value topic is strictly embedded in the concept of market efficiency.

This concept has been formalized by many financial economists during the last thirty years. It has fuelled the notion that markets regulate themselves, and financial innovation is always beneficial. The most esoteric financial instruments were built and traded on these ideas.

Today many people say: “No, this is not true”.

Even Paul Krugman, winner of the Nobel prize in economics in 2008, in a recent lecture was very critical towards the past 30 years of macroeconomic theory.

So, it’s time to discuss the market efficiency myth.

I’ve spoken too much. For sure FVA raises many and interesting questions.

So, let me conclude my introductory speech by asking a few summary questions. Four questions in particular:

- Who tipped the first domino of the present crisis?
- Can GAAPs really influence the economic and financial systems?
- Has FVA been unsuccessful to such a degree that we have to come back to HCA?
- Will the market efficiency concept still hold water?

I believe that our key note speakers will help us find sound answers.