

The Mark-to-Market Rule

(The following document is three pages in length.)

Suspending mark-to-market rules would be much more effective than giving judges cram-down authority. In fact, if they wanted to, the Obama Administration could immediately suspend an accounting practice that is contributing to the ongoing financial crisis.

Because of a drastic reduction in home prices, many banks currently hold “toxic” mortgages whose face value is more than the actual value of the homes. Federal “mark-to-market” accounting rules compel banks to show this imbalance as a current loss, even when banks are willing and able to hold onto the mortgages to a future point when home prices might rise. Suspending the “mark-to-market” accounting rules would allow banks, homeowners, investors, and others to sort out “toxic” mortgages – without the threat of federal rules that require immediate losses. This simple action would inject needed investment into the economy, ease regulatory capital pressure on the banks, and allow time for home prices and mortgage balances to even out.

The most serious example of doing the right thing at the wrong time is overly strict adherence to “mark to market” accounting rules. Most of the write-downs of securities that are creating capital shortages in financial institutions don’t result from actual losses, or even expected losses. They result from having to mark down assets, some or even many of which could easily be held to maturity and redeemed at or closer to par. This includes securities issued or guaranteed by Fannie and Freddie and other investment-grade securities, especially those graded triple A.

Background on Mark-to-Market

According to Milton Friedman, mark-to-market accounting was responsible for many banks failing during the Great Depression. In fact, Franklin D. Roosevelt suspended it in 1938. [See “Why Mark-to-Market Accounting Rules Must Die” at Forbes.com, by Brian S. Wesbury and Robert Stein.](#)

In 2007, however, the Financial Accounting Standards Board issued [Statement No. 157](#), which clarified how to measure fair market value, and thus reinstated mark-to-market standards. This new directive became effective after November 15, 2007.

Problems with Mark-to-Market

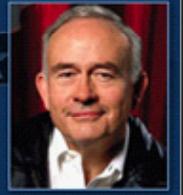
- Mark-to-market accounting forces firms to revalue their assets to current market values even when the market is frozen or dysfunctional and even when the assets could be held to maturity and redeemed at face value.

- On mortgage-backed securities, for example, even those containing mostly performing and cash-flowing underlying mortgages have to be treated as a virtual total loss because the market for them is not functioning.
- Holders of mortgage-backed securities point out that marking them to market is currently impossible because there is no market.
- “Prompt corrective action,” adopted as one the “reforms” of the early 1990s, makes the matter worse by allowing the authorities to pull the trigger before capital reaches zero.

Reforming Mark-to-Market

- Suspending mark-to-market is supported by William Isaac, former chairman of the Federal Deposit Insurance Corporation.
- Accounting purists would call suspending mark-to-market forbearance. But forbearance in shooting the sick and wounded with good recovery prospects is not inherently wrong. The greater evil would be to let a “rules is rules” mentality continue to make a bad situation worse.
- Identifying those securities that can easily be held to maturity, and classifying them as such, makes more sense than marking them down to levels that never need to be realized. Book losses if and when they are realized - not before.
- This does not mean hiding temporarily impaired assets. They can remain on the balance sheet with a footnote explaining the intent to hold to maturity.
- One approach that has been suggested by representatives of PricewaterhouseCoopers would involve continuing the markdowns, but have them count against current income (and capital) only the portion to be lasting and attributable to credit impairment. The portion of the markdown related to illiquidity could be counted in another account— one that would not immediately impact regulatory capital.
- Federal Reserve Chairman Ben Bernanke agrees that mark-to-market accounting rules need to be reformed to specify what to do when assets aren’t really traded, though he is against suspending them entirely. [See “Bernanke Says Mark-to-Market Accounting Should Be Improved” by Ian Katz at Bloomberg.com.](#)

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My Mark-to-Market Nightmare

I couldn't sleep at all last night. It started with a dream-nay, a nightmare-that I had taken a three-week vacation in a remote part of the world where cell phone reception was happily nonexistent. There were zero bars.

It was a good vacation. I came home refreshed, full of vim and vigor, and ready to re-join the rat race. All that changed when my accountant called with bad news. He said I was broke-flat broke. I thought he was kidding.

"How can that be?" I asked. "I have my portfolio of Treasury bills and notes and a few mortgage-backed securities to fall back on if necessary."

"Yes, but you've been gone three weeks, which is an eternity these days. During that time, your Treasuries declined in market value because interest rates increased, and your mortgage-backed securities became illiquid as trading in them virtually stopped. I had to mark them all down to market, which, in the case of the MBSs, was virtually zero. Sorry about that, but that's not the worst of it. Writing down the market value of your securities reduced their value by more than your net worth. So, you're now broke. You've gone from a high-net-worth individual to a no-net-worth individual."

"Wait a minute! I don't have to sell these securities now. I can wait until their prices recover. I can even hold them to maturity if I have to. There's no credit risk. The Treasuries were issued by the federal government, which could print money to pay them off if it had to, and the MBS's were issued by Fannie Mae and Freddie Mac, which are quasi-government. They are obviously too big and important for the government to let them fail."

"I'm afraid a lot happened during your vacation. Fannie and Freddie are government now; they, too, got marked to market and taken over by the government. So did AIG, the huge world-wide insurance company."

"Well, there you are. All my securities are now government securities, and, if necessary, I can hold them all to maturity. There's no need, no rationale, to mark them to market. Besides how low could they go anyway?"

"Your Treasuries are pretty short term, which is in your favor, but a flight into Treasuries still reduced their yield. Your Mortgage-backed securities took the biggest hit. Since the market for them has virtually dried up, I've had to mark them all the way down."

"All the way down?"

"Yes, all the way down."

"Well, I guess I could always sell my house."

"I've already taken the liberty of putting a for-sale sign out front."

"Thanks a lot. I'm glad I have a thoughtful accountant like you. I don't know what I would do without you."

"Thanks. I do my best. I'm actually trying to get appointed to FASB, which is the Financial Accounting Standards Board. That's the outfit that makes up these accounting rules. It would be quite an honor for me. It is the most powerful organization in the country. Even their bosses at the SEC and Treasury are afraid to mess with them."

"Do they have the power to change their rules or modify them a bit to help the country get through this housing crisis?"

"Yes, of course. Or, the SEC could direct them to do it. In its big bailout bill, Congress reaffirmed the SEC's authority to do that in order to remove any doubt. I don't know why they are defying Congress."

"Do you think it will get done eventually?"

"I doubt it. Accountants take pride in their professionalism, and it just wouldn't look right for them to modify an accounting rule just to save the financial sector and the economy."

"Speaking of that, I read on the plane that the Federal Reserve, probably the most conservative institution in America, if not the world, has been pulling out all the stops-taking unprecedented steps-to get the country through this national emergency. And I understand the Treasury has also taken extraordinary, unprecedented steps to save the economy. Am I right?"

"You are right."

"And I believe there is a provision in the Emergency Powers Act, or some such law, that gives the President the right to suspend even the Bill of Rights in a national emergency. Am I right about that too?"

"I believe so."

"So the Bill of Rights may be suspended in a national emergency, but not mark to market accounting?"

"It would appear so."

About that time I woke up in a cold sweat and said a little prayer:

"Lord, please don't ever mark me to market, especially on one of my down days."



Commentary
Why Mark To Market?
Bob McTeer

I was afraid of accounting in school; I still am. Back then, I feared it would wreck my grade point average; today, I fear it will wreck our financial system.

It has come uncoupled from common sense. It's ceased being a tool for business and has become its master—and not a benevolent master at that. It's causing unnecessary failures of basically healthy businesses and contributing to the downward spiral of our credit markets.

I refer primarily to mark to market accounting, which forces firms to revalue their assets to current market values even when the market is frozen or dysfunctional and even when the assets could be held to maturity and redeemed at face value.

If a bank loan goes into default, it makes sense to write it off the books. If a borrower has missed several payments, it makes sense to set aside a provision for the likely loss. But if a security trades lower because market interest rates have risen or because of problems in the market itself, requiring an immediate write-down is unduly harsh, because capital is reduced by the same amount.

Because capital is usually, and legitimately, a small percentage of assets, capital can easily go to zero and a perfectly sound institution can be declared insolvent and taken over by its insurer or some other government agencies.

“Prompt corrective action,” also adopted as one the “reforms” of the early 1990s, makes the matter worse by allowing the authorities to pull the trigger before capital reaches zero. Its purpose is to reduce the cost of “resolving” (read “taking over”) troubled institutions, but what it amounts to is shooting the sick and wounded to expedite the burial. Efficiency and cost effectiveness trumps fairness.

Were Fannie Mae and Freddie Mac insolvent when the government took them over? Did their capital reach zero? I don't know, but I doubt it. It all depends on how much capital was reduced by marking assets to market. People will say management had an incentive to write their assets down to little. Granted, but might the government have had an incentive to mark them down too much to justify a “conservatorship,” which was apparently its preferred solution?

As I write this, there is much discussion of private sector purchases of weakened financial institutions and the disincentive provided by the prospect of triggering mark-downs by doing so. The purchasee already has low marks, which will be inherited by the purchaser, in addition to which the ratings agencies are likely to downgrade the new entity and trigger other negative events.

Isn't it ironic, and galling, that the rating agencies helped create our current problems by looking through rose-colored glasses during the good times, and now they are exacerbating it by looking through their dark shades.

Mark to market rules and strict ratings may be appropriate (though unfair) in the good times as a means of preparing institutions for the bad times. That doesn't mean they should be rigidly applied or even tightened up during the bad times. Hard exercise may boost your immune system to help stave off disease. Hard exercise after the onset of the disease may not be such a good idea.

Critics of some mild regulatory forbearance during this most serious of crises since the Great Depression will no doubt cite transparency as essential, but the two can go together. I'm not advocating hiding temporarily impaired assets. They can remain on the balance sheet with a footnote explaining the intent to hold to maturity.

It is time for common sense to come before accounting purity and cut our losses. It's one thing to become a victim of a bad loan or a bad economy. It's quite another thing to become a victim of unnecessarily strict accounting rules.

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