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Mark-to-Market Accounting: Shooting Ourselves in the Foot

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One of the main causes of the 2008 financial crisis and current recession was subprime mortgages, which are home loans to borrowers with low credit scores, little or no down payment and high levels of debt. These borrowers have a higher risk of defaulting on their loans and are usually charged higher interest rates.

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Investment banks and financial firms converted many of these subprime mortgages into mortgage-backed securities (MBSs) that allow investors to collect the underlying mortgage payments and interest. Unfortunately, thousands of banks, thrifts, insurance companies and credit unions who were not involved in making loans invested in these MBSs, thinking their AAA rating indicated that they were safe investments.

In 2008, when the subprime mortgages in these pools began defaulting at a higher rate, the market for MBSs dried up. Yet, rigid mark-to-market accounting rules, enforced by regulators, forced the drastic write-down in the value of MBSs, even when investors were both willing and able to hold them until the market improved or to maturity, when the loans would be paid off, if necessary.

However, even though the MBSs have hardly been trading, most of the underlying mortgages are still generating income, making them worth more than their marked down prices. Thus, a cheap way of addressing the financial crisis and saving banks is to suspend these mark-to-market rules.

The History of Mark-to-Market. Mark-to-market accounting forces firms to revalue their assets to current market prices, such as a stock's price at the close of business. According to Milton Friedman, mark-to-market accounting was responsible for many banks failing during the Great Depression. In fact, President Roosevelt suspended it in 1938. The practice reappeared in the mid-1970s and was formally reintroduced in the early 1990s.

In 1994, the Financial Accounting Standards Board (FASB), the independent institution responsible for writing accounting rules for the Securities and Exchange Commission (SEC), issued the Statement of Financial Accounting Standards (FAS) 115, which applied to all financial firms. It split financial assets into three categories: those "held to maturity," those "held for sale" and those "held for trading." FAS 115 allowed firms to value assets "held to maturity" based on discounted cash flow, and it required them to value assets in the latter two categories using mark-to-market.

Although FAS 115 reinstated mark-to-market accounting principles, "how to mark these assets to market became a highly complex and controversial matter," says former White House counsel Peter J. Wallison. Therefore, in 2006, FASB issued Statement No. 157, which clarified how to measure fair market value and took effect on November 15, 2007. The statement requires firms

to mark to market assets at the price quoted in a functioning market or at the price of other, comparable assets with a working market. Assets that are not traded in an active market can be valued by discounted cash flow.

A Downward Spiral. The tragedy in marking to market comes not from the write-downs per se, but from the resulting decline — dollar for dollar — in regulatory capital.

As a general accounting rule, investments drop in value when their market price drops below their original purchase price, a situation called impairment. Impairments can be classified as "temporary" or "other than temporary," in which case they must be written off as worthless.

For example, if a bank buys an MBS with 1,000 underlying mortgages and a few of these mortgages become "other than temporarily impaired," the bank must write down the whole bond — not just the impaired mortgages. The write-downs would be much more modest if the same 1,000 mortgages were separated. For example, the Federal Home Loan Bank of Seattle has a portfolio of MBSs that are predicted to only lose $12 million in the long run. However, the MBSs were marked to market because they were classified as "other than temporarily impaired," causing the bank to report a $304 million loss.

Although the original mark down may not be justified, it can lead to a real loss of capital. This loss of capital may lead to higher capital requirements at a time when capital is becoming scarcer. A bank's worsened condition may also require it to pay higher Federal Deposit Insurance Corporation (FDIC) deposit insurance premiums in order to preserve the deposit insurance fund. As this process is multiplied across the banking system, these premiums may be raised across the board.

Consequently, the banks have their capital requirements increased when they can least afford it. The FDIC, after keeping its premiums low during good times, has to raise them during bad times. This is procyclical because it makes an economic downturn worse, and can artificially reinforce an economic boom.

"Mark-to-market accounting rules forced banks to drastically mark down the value of mortgage-backed securities."

If the securities are labeled "securities for sale" rather than "securities held to maturity," it can cause hypothetical or potential losses to result in actual or real losses of capital. These labels could be changed easily, but current accounting rules don't allow it. Fixing that would be an easy interim step.

Suspending Mark-to-Market. Mark-to-market had its critics early on. Federal Reserve Board Chairman Alan Greenspan wrote a 4-page, single-spaced letter to the SEC in November 1990, urging them not to apply mark-to-market to commercial banks because their business model is not that of a trader, but involves holding assets on their balance sheet. In 2002, Treasury Secretary Nicolas Brady wrote a similar letter to the SEC.

Earlier this year, Paul Volcker, speaking as chairman of the "Group of 30," a private nonprofit composed of senior representatives from the private and public sectors and academia, released their study of the financial crisis. Recommendation No. 12 on Fair Value Accounting says:

> a. Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments in distressed markets.

Even the International Accounting Standards Board, the international equivalent of the FASB, allowed European banks to relabel their MBSs as "held to maturity" in 2008 to avoid marking them to market. As a result of this change, says Wallison, Deutsche Bank went from a projected loss to a profit, and its stock price increased by 18 percent.

Conclusion. The most serious example of doing the right thing at the wrong time is overly strict adherence to mark-to-market accounting rules. Fortunately, there is historical and international precedent for suspending and reworking these rules. Congress and the SEC should consider doing so until the economy recovers.

Robert McTeer is a distinguished fellow with the National Center for Policy Analysis. This brief analysis is adapted from his March 12, 2009, testimony before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

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