Mark-to-Market Accounting: Practices and Implications

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Chairman Kanjorski, Ranking Member Garrett and other members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, I would like to thank you for the opportunity to testify at this hearing. Today I will discuss the implications, particularly to financial firms, in managing under mark-to-market accounting. My testimony is based upon 30 years of experience across both increasing and declining market environments of what works and what does not work. I also suggest ways that I believe regulators and standard-setters may address these issues.

At present, I am Chairman of SBCC Group Inc., an independent advisory firm that I founded in 1987. SBCC's work is both reactive and proactive. For example, we assess and contain existing risk problems that cause firms to bleed money as well as help firms to seize opportunities. I have worked on numerous projects borne from the financial distress of the stock market crashes of 1997, 2001 and 2008-9; the asset/liability and savings & loan crises of the late 1980s; the derivatives losses of the 1990s (Orange County, Bankers Trust, David Askin's Granite Funds, CMOs, inverse floaters, kitchen sink bonds); the LTCM and currency crises in 1998; the bursting of the credit bubble and meltdown that began in 2007. In this current crisis I have advised on multi-billion dollar liquidity runs, valuations and losses in the credit space (default swaps, CDOs, CLOs, CBOs, CDSs, ABCP and derivatives), on how to retool risk oversight and risk management, liquidity issues and new business matters driven by the current risk/return landscape.

We are in a period of significant global recession and prolonged mayhem in the financial markets. The United States faces an "economic Pearl Harbor" and has seen its economy "fall off a cliff," according to Warren Buffett earlier this week. "We are in a very vicious feedback cycle. It will end…but how fast we get there depends not only on the wisdom of government policy, but the degree to which it's communicated properly."[2] The debate on fair value and mark-to-market accounting standards deserves to be in the spotlight. Their application has been a

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[1] This draft dated March 9, 2009. The views in this testimony are my own and should not be taken to represent the views of SBCC, Yale University, Columbia University, the International Association of Financial Engineers, the National Board of Mathematics and their Applications, the LongChamp Group, OpHedge, or any principal or other individual or entity associated or affiliated with any of the foregoing. The author makes no representations or warranty, either expressed or implied, as to the accuracy or completeness of the information contained herein, nor is she recommending that this testimony serve as the basis for any investment decision – this testimony is for information purposes only. I am grateful to Charles Lucas, Dr. Toncred Styblo, Leon Metzger, Barbara Matthews Todd Groome and my colleagues at SBCC for helpful comments and discussion.

[2] CNBC interview of Warren Buffet, March 9, 2009.

primary consideration to market participants during times both good and bad. The over-arching goals must be to rebuild confidence, maintain integrity, promote safety and soundness, and encourage the right kind and amount of capital flows.

My testimony is summarized by the following: Mark to market accounting should not be thrown out. In normal markets mark to market represents fair value well; However, in distressed markets where only fire sales are taking place, marking to independent, third-party models may better approximate fair value. I offer four recommendations for the Subcommittee's consideration:

1. On Suspending Mark-to-Market Accounting

I do not support a suspension of fair value accounting that uses Mark to Market as its proxy. In the current environment I believe such a change would promote a further crisis of confidence. If Mark to Market were suspended -- even temporarily -- in favor of some version of discounted present value with conservative but not extreme default probability assumptions, I believe experts and laymen alike would be outraged. I agree with Chairman Barney Frank, "…if you were to abolish mark-to-market … you would get a negative reaction again on the investor side.[3]" I do support permitting the use of Mark to Model from an independent source in addition to Mark to Market as I believe it improves fair value determination.

Recently, tens of trillions of credit-risky assets – some considered plain vanilla a mere three years ago – have changed from valuation available from one or more dealers to valuation only by the user or by the user's independent valuation agent. As the credit markets collapsed beginning with the subprime crisis, dealers stopped providing valuations for many securitized instruments. An example of a securitized instrument is a collateralized debt obligation (CDO) which is based on the performance of a pool of underlying credit-risky instruments. These may be bank debt loans, commercial real estate loans, high quality residential mortgage loans, manufactured housing loans, subprime or Alt-A loans, auto loans, student loans, consumer credit card loans or just about any other type of loan that exists. As the crisis deepened, dealers also stopped providing, or held constant at deeply reduced levels, valuations for many of the underlying loans to the securitized instruments.

For example, for the multi-trillion dollar mortgage backed securities market (MBS), one major dealer stopped providing spreads and has only provided a constant dollar price ranging from distressed levels of $3 for B-rated MBS to $30 for AA-rated MBS for the last 4 months. Other dealers stopped providing spreads or prices altogether.

The dilemma is clear. The dealer quote implies that the true value of the best housing stock is 30% of its previous highs or that dealers are risk averse and are interested in purchasing such assets only at distressed prices. Yet many actual housing sales are currently occurring at prices over twice that level (75% of their previous highs). The contrast between actual trading prices in the housing market, and the values of the housing stock as implied by transaction prices in the financial markets are vastly different. I support Chairman Bernanke's statement that "we need to do a lot more to provide guidance to the financial institutions and to the investors about what are

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[3] Transcript of Chairman Frank's March 5, 2009 Press Conference

reasonable ways to address valuation of assets that are being traded or if traded at all in highly illiquid, fire-sale type markets."

A widespread reaction of the Enron and related scandals was to push hard to reduce flexibility in the application of accounting rules and the potential for similar deeply misleading if not fraudulent disclosures. But the present circumstances demonstrate the drawbacks of going too far in the direction of rigid application of inflexible rules, especially if misleading market valuations or gaping inconsistencies of valuation result.

Recommendation: The Subcommittee should encourage standard setters and regulators alike to provide users with urgent help to distinguish between going concern and liquidation valuation in an illiquid market. Do not abandon mark to market. Additional measures such as mark to model from independent sources should be added. Additional disclosure should be made so that it is clear when different approaches are employed.

2. On “Fair" Value

At certain times, a Mark to Market price is fair value. At other times a Mark to Model price is fair value. In my opinion, a fire sale price is rarely a fair value.

Paul Krugman reported in a recent column[4] in *The New York Times*, “market value is the only true measure of value”. But what happens when there is no market? There is little doubt that when markets function, they are competitive and effective in evaluating, combining, analyzing and disseminating information. But when markets do not function, participants must operate without mission critical information. In this case, as we observe in the current crisis, the market becomes prone to fear, rumor, wishful thinking or even denial. Many banks, insurance companies, and other intermediaries taking credit risk had capital at roughly 10% of total assets as the crisis started. In a world of credit-risky assets that are marked to “market” at half of face value, all such intermediaries cease to be viable as losses exceed capital by multiples. The intermediaries become bankrupt squared or cubed. If substantial assets should be marked down 25% rather than 60%, there still is severe damage, but it is a more manageable situation. Thus, getting to the right number – or surrounding the right number via multiple measures – is critical.

Given the uncertainty over the health of many traditional financial intermediaries, new shadow bankers are filling the gap. In increasing numbers, residential housing sales that first fell through due to a lack of financing are being closed with loans being made by the sellers. Institutional investors and corporate treasurers forced to set up securities operations when money managers closed or busted special purpose vehicles distributed securities in kind are setting up direct investment operations[5]. Vulture investors are circling to invest – if they can -- at fire sale prices. Ultimately the markets will unlock. Will it be more within shadow banking than traditional intermediaries, or the other way around? No matter which way, we need better supervision, more flexible standard setting (for example across normal and distressed markets) and more effective regulation.

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[4] Paul Krugman, “The Big Dither”, *The New York Times*, March 5, 2009
[5] For example, tri-party repo, receivables factoring and other short-term investment activities

Recommendation: The Subcommittee should promote a more flexible approach to defining "fair" value. None of the single measures are the best choice across super-heated, normal and distressed market conditions. The Subcommittee should promote more supervisory activity, and provide the necessary tools to the supervisors (both analytic and monetary) to keep up with the firms they supervise

3. We Should Not Rely on Single Measures

I am unable to join those who call for a ***single*** approach whether it be Mark to Market, Mark to Value, Mark to Model or "Mark to Moosh[6]." In reading much of the past year's writings and testimony on this topic I was struck by how often the word "single" appeared as a qualifier in taking the position for or against the Mark to Market approach. Imagine if a doctor were to make a critical diagnosis based on a single test result. Often, multiple measures are required, for example to distinguish between an acute infection and a terminal illness. Each measure reveals valuable – yet different -- information to aid in the collective diagnosis. Relying on a single measure may lead to the wrong conclusion. This also is true in today's complex financial markets. Measures such as Mark to Market, Mark to Value and Mark to Model typically produce different numbers. Taken collectively the measures have the greatest value. Each measure – and how far apart the measures are at different points in time -- reveals important information about an asset or a liability or about a firm or a market. Add to these risk management accounting – which affords a look at future values in addition to backward-looking values – and an even better picture evolves.

Current accounting standards do not allow multiple measures, but insist on a single measure. While other valuations can be disclosed in footnotes, many users rely only on the accounting values. For five decades economists and accountants have debated the relative merits of historical-cost, fair-value and other accounting measures. Recent market events do not demonstrate that Mark to Market should be abandoned but rather that other measures should be used to a greater degree alongside. Widely-used single measures can and will be arbitraged, and certainly played a role along with too many simplifying assumptions and too much liquidity in the meltdown. In my experience the desire to simplify accounting, risk and return views – and to produce single "answers" played a significant role in numerous financial losses.

Recommendation: The Subcommittee should encourage standard setters and regulators alike to implement multiple measures and promote their collective value. Managers, boards, regulators and other overseers should be well-trained in the strengths and weaknesses of the various measures.

4. On pro-cyclicality

The use of Mark to Market for valuation tends to be pro-cyclical. Values are overstated in good times and understated in bad times, neither of which serves the interests of stakeholders or strengthens incentives for investors to take a long view.

[6] Transcript from "Roundtable on Mark-to-Market Accounting" before the Securities and Exchange Commission, October 29, 2008

The following story illustrates the point. It is drawn from numerous real projects and transactions over the past few years: In the early 2000s a collateralized debt obligation ("CDO") was purchased by an investor for $100 million. For several years, the dealer provided the sole valuation for the instrument at or close to par. These were recorded as the Mark to Market value by the investor for accounting purposes. Note that it is common for complex instruments such as CDOs that only one dealer is willing to provide ongoing Mark to Market values to the investor. Most often, these values are provided by the originating dealer who sold the instrument to the investor. In our story, after the market dislocation in 2007, the dealer reduced the valuation to $90 million and then stopped providing a valuation altogether. At this same time, droves of investors in the 50+ trillion credit derivative space were left without their previous source for a Mark to Market value as dealers stopped providing quotes.

The Mark to Model value for the CDO was $ 75 million at the time of purchase, and $50 million at the time the dealer stopped providing valuations. There is no doubt that the Mark to Market treatment turbo-charged the valuation positively at the time of purchase and maintained a substantial premium to Mark to Model up to the time that the dealer stopped providing valuations. In my experience, Mark to Market and Mark to Model values converge when markets are normal and diverge when markets are over-heated or illiquid. The benefit of using the measures together is clear: with both pieces of information, the user may determine the premium paid by the investor to enter the trade ($25 million), perhaps indicating that the market was over-heated for CDO-type investments. Providing such information to regulators and other stakeholders may be useful in the assessment of future bubbles.

Also important to consider is whether a "one size fits all" approach to accounting standards reduces the diversity of market participants approach to investment and trading styles in the markets. In any given market environment differences exist among and between global banks, broker dealers, regional banks, insurance companies, pension funds and asset management firms, among others. They have varying business considerations and time frames to hold assets and different abilities to do so (due to liquidity pressures or the absence thereof) in order to realize the intended value.

Diversity supports market stability, and reduces the potential for pro-cyclical and thus financially unstable behavior. The current Mark to Market financial reporting promotes common market and risk management approaches and therefore pro-cyclical behavior. A "one size fits all" approach may lead to a "crowded response" by risk managers when markets become extremely volatile or disrupted. The negative impact of this was exemplified during the LTCM crisis in 1998.

Recommendation: The Subcommittee should make it a priority to reduce the pro-cyclical impact of the current approach. This includes promoting multiple measures and reducing the likelihood that market participants will act in concert due to "one size fits all" approaches. Disclosure should be increased regarding the use of single mark to market prices for complex instruments and whenever measures diverge under different methodologies.

Thank you. I welcome any questions you may have.