Statement of

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on

MARK-TO-MARKET ACCOUNTING:

Practices and Implications

Financial Services Subcommittee on Capital Markets, Insurance, and

Government Sponsored Enterprises

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Mr. Chairman and members of the committee, thank you for the opportunity to testify.

When I moved to Texas in 1991, someone gave me a little book of Texas wisdom titled, "Don't Squat with Your Spurs On." Among its nuggets of wisdom was this one: "No matter who says what, if it don't make sense, don't believe it." What's been going on with mark-to-market accounting doesn't make sense to me.

Much of our recent wealth destruction has resulted from slavish adherence to an accounting dogma that never should have applied to banks and other regulated financial intermediaries in the first place.

Thousands of banks, thrifts, insurance companies and credit unions who had absolutely nothing to do with making or securitizing subprime loans are victims, not villains. They purchased mortgage-backed securities because they thought they were safe and liquid, as indicated by their AAA rating.

When sub-prime mortgages in the pools began defaulting at a higher rate, the market for the bonds dried up. Yet, the rigid application of mark-to-market rules enforced by regulators and gun-shy internal and external auditors, forced drastic write-downs even when their owners were both willing and able to hold them until the market improved or hold them to maturity if necessary. Even though the bonds weren't trading, most of the underlying mortgages were still generating income, and most still are.

The tragedy comes not from the write-downs per se, but from the resulting decline—dollar for dollar— in regulatory capital. Hypothetical or potential losses in securities resulted in actual or real losses of capital if the securities were in an account labeled securities for sale rather than securities held to maturity. It would be a simple matter to change the labels, but the accounting rules don't allow it. Fixing that would be an easy interim step.

A closely related question is whether the impairment in individual mortgages is classified as "temporary" or "other than temporary," in which case they must be written off. Logic would suggest, at least, that any excess of capital written off that way could be added back to capital, or "accreted," if the original judgment is proven too pessimistic.

It's my understanding that most of the regulators concur with this, but are hesitant to allow it because of uncertainty over Congressional intent and reaction, and possibly the reaction of the SEC and FASB. Reassurance on that score from you would be helpful. They have the authority; they just need the nudge, or encouragement.

I've heard it said that mark-to-market was considered fine for banks until the market turned against them. This is not entirely true. Chairman Greenspan wrote a 4-page, single-spaced letter to the SEC 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. His letter is dated November 1, 1990.[1]

A little later Treasury Secretary Brady wrote a similar letter to the SEC.

Now fast-forward to 2009, when Paul Volcker, speaking as Chairman of The Group of 30 Experts, released the results of their study of the financial crisis.

His recommendation #12 on Fair Value Accounting says:[2]

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.

b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business models of these institutions…

If a mortgage in a pool collateralizing a security becomes impaired, the negative impact is multiplied. For example, if a bank buys a bond with 1000 underlying mortgages, and a few of these mortgages become "other than temporarily impaired," the bank has to write down and lose regulatory capital on the whole bond— not just on the impaired mortgages.

You can't unscramble an egg, but, if the bank had the same 1000 mortgages on its books individually, the write-downs would be much more modest.

While the original markdowns may not be justified, they can be self-fulfilling. The resulting loss of capital may attract increased supervisory attention, which, perversely, may lead to higher capital requirements just as capital is becoming scarcer.

The bank's worsened condition may bring higher FDIC deposit insurance as well. Restrictions on growth may then follow so the "weakened" bank can't try to grow out of its problems. The motive here is to preserve the insurance fund. As this process is multiplied across the banking system deposit insurance premiums may be raised across the board.

The banks after being restricted in their accumulation of capital reserves during the good times have their requirements increased when they can afford it least. The FDIC, after having to keep its premiums low during the good times has to raise them during the bad times. In the present case, an alternative needs to be found.

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[1] Alan Greenspan, "Letter to Hon. Richard C. Breeden," Federal Reserve, November 1, 1990. Available at http://www.bob-mcteer-blog.com/wp-content/plugins/uploads/Greenspan%20letter%20to%20SEC%20November%201990.pdf.
[2] Group of 30, "Financial Reform: A Framework for Financial Stability," Working Group on Financial Reform, January 15, 2009, page 14. Available at: http://www.group30.org/pubs/recommendations.pdf.

This whole perverse pro-cyclical sequence of events started in my example with unnecessarily rigid application of mark-to-market accounting.

I heard Chairman Frank acknowledge the pro-cyclical nature of mark-to-market accounting on television. I hope this committee will be able to do something about it.

One more point about pro-cyclicality. The uptick rule needs to be restored and the ban on naked shorts should be enforced.

It makes me sound naïve, I know, but it’s never seemed quite right to me that people are allowed to sell things they don’t own. When they can sell stocks they don’t even have to borrow, they can sell more than the total number of stocks outstanding. How fair is that?

Thank you.