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Economic Commentary

Mark-to-Market Mayhem

To a supporter of capitalism and free markets, the current debate over a Treasury Department proposal for a $700 billion fund to purchase illiquid assets, is troubling on many fronts.

First, a temporary and targeted change in mark-to-market accounting rules could help solve the current financial market problems at much lower cost. But this alternative has been dismissed with very little in the way of debate.

Second, when the public hears that the government must save the economy from capitalism run amok, it loses faith in our free market system. In other words, the huge Treasury proposal has accelerated the momentum toward political populism.

And, third, it seems clear that much of the current crisis has been exacerbated by mark-to-market accounting, which has created massive, and unnecessary, losses for financial firms. These losses, caused because the current price of many illiquid securities are well below the true hold-to-maturity value, could have been avoided. The current crisis is actually smaller than the 1980s and 1990s bank and savings and loan crisis, but is being made dramatically worse by the current accounting rules.

Some argue that if we change accounting rules in the midst of a crisis, then investors (especially foreign ones) would lose faith in the US as a safe haven. They add that changing the rules is like sweeping the problem under the rug, which could lead to a Japanese-style decade of lost growth.

However, these arguments do not hold water. Many foreign countries do not have mark-to-market accounting rules like the US. In fact, the lack of transparency in many other countries, especially those with less freedom (just think Chinese banks), is appalling.

Relaxing mark-to-market rules temporarily in the US, let's say 3 years, for troubled assets issued between 2003 and 2007, will not undermine our standing in the world. In addition, the proposal of a $700 billion bailout fund, combined with the government takeover of Fannie Mae, Freddie Mac and AIG, has already undermined foreign confidence. Just look at the dollar. It has plummeted in recent days. And listen to what foreigners are saying about capitalism, which is now under more fire than it has seen since the 1970s.

Finally, back in the 1990s, Japan took six years to get real overnight lending rates below zero, while the US did it in six months starting last September. Also, in 1989, Japan initiated one of its largest tax hikes in history when it lifted the Value Added Tax from 0% to 5% and the capital gains tax rate from 0% to 20%. The combination of tight money and tax hikes (which killed the Japanese economy) were the real catalyst behind Japan's lost decade, not just an unwillingness to accept losses. The US is nowhere near this kind of environment.

Another argument for the bailout is that financial market problems are so severe today that public money must be used to solve them, because private money can't or won't. This argument is interesting. Where do those who make this point think public money comes from? It doesn't grow on trees; it comes from the private sector.

In fact, if the Treasury makes a profit on its plan, which some say could reach into the trillions of dollars, then these profits will be made at the expense of the US financial sector. In other words, any profit made by the new government investment fund is just indirect taxes. They are profits that could have accrued to the private sector.

There are two reasons private money has been slow to buy the highly illiquid securities behind this problem.

First, mark-to-market accounting has continued to drive down prices. This means any buyer, unless they do not need to mark, faces risks that have nothing to do with underlying assets quality, but instead have to do with accounting rules. Second, short sellers and potential buyers are using capital requirements as a wedge to drive down the price of assets, put financial firms in difficulty and create a fire sale environment.

The vast majority of mortgages are still paying on time. In fact, roughly 75% of subprime mortgages are current. As a result, a 22 cent price in the open market (as in the case of Lone Star Funds purchase of distressed assets from Merrill Lynch) does not make any sense. To justify this price, the market was either pricing in absolute economic Armageddon (worse than the Great Depression), or it knew Merrill had no choice. Whether a bank sells or not, the 22 cent mark has the same impact on its balance sheet. Lone Star took advantage of this fact and used the illiquid market to bring in assets that will provide a handsome return.

We must remember that behind every mortgage is a house, and even if 100% of subprime mortgages were foreclosed on, these bonds would still be worth at least 40 cents on the dollar. As a result, everyone knows that mark-to-market prices of less than this are not realistic. Yet, the accounting rules we have today are forcing companies to price to these insanely low prices. It is true that the root of this crisis is bad mortgage loans, but probably 70% of the real crisis that we face today is caused by mark-to-market accounting in an illiquid market. What's most fascinating is that the Treasury is selling its plan as a way to put a bottom in mortgage pool prices, tipping its hat to the problem of mark-to-market accounting without acknowledging it. It is a real shame that there is so little discussion of this reality.

Instead, conventional wisdom is pushing through one of the largest interventions in the US financial system in history. To be sure, the $700 billion Treasury plan will probably be successful at putting the bottom in and ending the mark-to-market downward spiral. But this is done at a large cost, and in a centralized system, which is anathema to a free market.

Rather than this, a simple, decentralized system of forgiving mark-to-market accounting temporarily, and in a targeted fashion is a much better option. This would help restore market sanity with much less government intervention. At the least, it ought to be incorporated in the current legislation so that the companies facing a fire sale of their assets would get to play on a level playing field with the government and private equity funds. It provides a free market solution, rather than a socialist one.

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