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First Trust

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Monday Morning Outlook

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Suspend Mark-to-Market, Before It Does More Harm

Apparently, public policy hath no fury like a CPA scorned.

In late 2007, the Financial Accounting Standards Board (FASB) changed the definition of mark-to-market accounting rules as they applied to the U.S. financial industry. They forced financial firms and auditors to use "observable," market prices to value securities rather than models or cash flow. Within a year, the U.S. was in the middle of the worst pure financial panic in a hundred years. Coincidence? We think not.

On its surface, market-to-market or "fair value" accounting makes some superficial sense. Markets usually provide transparent and verifiable prices, so companies can't just contrive numbers to make their earnings look good.

The problem with mark-to-market (MTM) is that it makes no accommodation for the fact that market prices for securities often deviate – sometimes substantially, but always ultimately temporarily – from the underlying fundamental value of the assets. Since markets are forward looking, MTM forces financial firms to take hits to capital over something that "might" happen in the future, but has not happened yet. It's like forcing homeowners to come up with more capital when a hurricane approaches because their house *might* be destroyed.

This, in turn, creates a vicious downward cycle as capital constraints hurt banks, undermine the economy and drive prices lower, and then destroy more capital. In 2008, when markets for mortgage-backed securities became extremely illiquid, the financial crisis intensified. This drove away private capital and enticed government to flood the system with liquidity. This government activity helped cause panic and a recession. But all of these government programs were just a way to work around the accounting rules.

As former FDIC chairman William Isaac has repeatedly said, if mark-to-market rules had been in place in the early 1980s, the Latin America debt crisis would have destroyed every money center bank in the US. Thank goodness that did not happen. Instead, the system was given time to heal. That's what should have happened in 2008. Instead, FASB stubbornly stuck to its guns over MTM accounting.

Finally, in mid-March 2009, with stocks at new lows, Congress started to twist arms on the issue. FASB was forced to loosen up its rules and allow cash flow to be used when markets were illiquid. Just this small change did the trick. Banks were finally able to raise new capital, $100 billion or so, and the stock market surged. In fact, things have improved so much that the Federal Reserve and Treasury are finding less and less interest in the programs they designed to "save" the financial system.

But now, like a horror flick monster that just won't stay dead, FASB's accountants are proposing to expand the application of mark-to-market accounting rules across the board, to include all financial assets, including regular loans. The outcome of this debate is extremely important.

MTM accounting, because it ties the balance sheet of an institution to its income statement, and then its capital accounts, creates unnecessary volatility. There is no real market for bank loans and the value of any loan is always in the eye of the beholder. As a result, "who" is doing the beholding determines the viability of an institution and maybe even the health of the economy.

If that power is given to accountants, who have no actual responsibility for running financial institutions, but can be tarred with some of the liability (think Arthur Andersen), the result will be a more tentative banking system that takes less risk. That may sound good these days, but imagine watching a football game played by accountants who stop running because they *might* get a broken leg when tackled. Fair value accounting needs to be fully suspended – now.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-27 / 9:00 am	New Home Sales - Jun	0.352 Mil	**0.352 Mil**	0.384 Mil	0.342 Mil
7-28 / 9:00 am	Consumer Confidence - Jul	49.0	**49.0**		49.3
7-29 / 7:30 am	Durable Goods - Jun	-0.6%	**+0.6%**		+1.1%
7:30 am	Durable Goods (Ex-Trans) - Jun	0.0%	**+1.2%**		+1.8%
7-30 / 7:30 am	Initial Claims - Jul 25	580K	**565K**		554K
7-31 / 7:30 am	Q2 GDP Advance	-1.5%	**-1.6%**		-5.5%
7:30 am	Q2 GDP Chain Price Index	+1.0%	**+0.9%**		+2.8%
9:00 am	Chicago PMI - Jul	43.0	**44.5**		39.9