



Make Fair Value Fair

Monday, December 15, 2008 | By Bob McTeer

The last time I looked I couldn't find mark-to-market accounting in the Constitution of the United States. It must be the eleventh commandment because it's obviously sacred. I understand the President has the authority under the Emergency Powers Act, or some such legislation, to suspend the Bill of Rights in case of a national emergency. Well, we have a national emergency, so mark to market must be more important than the Bill of Rights.

If a foreign power destroyed a fraction of the wealth that mark-to-market accounting has in the past year, we'd go to war. I'm no accountant, but, as I understand it, mark to market is part of what they call "fair-value" accounting; so it must be fair.

If so, I have a couple of questions. What's fair about a financial institution being put out of business because a small portion of its bundled assets become impaired and the whole bundle must be treated as a loss? How is it fair that an expected loss of a few thousand dollars a few years from now, in some cases, must be treated as a loss of millions in the here and now? If a small number of mortgages behind a mortgage-backed security become impaired, or potentially impaired, why must the whole bundle be written off? If I have a sack of apples with a couple of bad ones, I throw the bad ones away -- not the whole sack.

More questions: If the "impairment" results from lack of liquidity because markets aren't working, why can't banks simply hold on to their securities -- until maturity if necessary? Why must they assume a fire sale at fire-sale prices for something they don't have to sell? If some of the impairment results from actual losses on the underlying mortgages, why can't they write off only that portion of the impairment? Does it really make sense to force write-offs of the whole bundle of mortgages when only a few would have to be written off if the mortgages were held individually?

What makes the answers so crucial is that these write-offs we're talking about reduce the banks' regulatory capital dollar for dollar. That used to mean failure or a forced marriage when capital reaches zero. These days it only has to approach zero, to preserve insurance funds and stretch bail-out money.

The answers to my questions apparently have to do with transparency -- investors and creditors need to see exactly what you've got in your portfolio. Well, show them. Surely, you can show them what's in the sack without having to throw the sack away. Surely, transparency can be achieved without throwing common sense out the door.

In a recent blog posting, I described a variant, the PWC proposal, which would count only the markdowns attributable to credit impairment against regulatory capital and would treat those attributable to illiquidity in another manner. Show it all; let it all hang out; just don't crucify our financial system and economy on the cross of mark-to-market accounting.

Now is the time for all good accountants to come to the aid of their country, and put some fairness in fair value.