Mark-to-Market Accounting Essential, According to Nobel Prize Economists

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Yesterday, Nobel laureate Robert Merton and 2 other economists wrote in the Financial Times:

"Banks and other financial institutions are lobbying against fair-value accounting for their asset holdings. They claim many of their assets are not impaired, that they intend to hold them to maturity anyway and that recent transaction prices reflect distressed sales into an illiquid market, not what the assets are actually worth. Legislatures and regulators support these arguments, preferring to conceal depressed asset prices rather than deal with the consequences of insolvent banks.

This is not the way forward. While regulators and legislators are keen to find simple solutions to complex problems, allowing financial institutions to ignore market transactions is a bad idea."

Nobel economist Myron Scholes agrees:

"Financial institutions should use mark-to-market accounting or list the hard-to-value securities on public exchanges whenever possible, Scholes said in a Bloomberg Radio interview yesterday. Scholes … said investors need better data on prices to accurately value the debt and equity securities of banks.

"I'd like to see us encourage many more securities held on the books of the banks be migrated to exchanges if possible," he said. Doing so would "allow for market discovery and market pricing as much as possible," Scholes added…"

(Scholes is the economist who said in March that regulators need to "blow up or burn" the private over-the-counter derivative markets to help solve the financial crisis.)

Mark-to-market accounting is an accounting rule which forces banks to value their assets at today's fair market prices. Because the biggest banks hold many hundreds of billions of dollars worth of derivatives and securitized assets which have plummeted in value as the markets for these exotic investments has crashed, mark-to-market accounting would force the banks to declare large losses for these assets.

The banks holding the largest portfolios of securitized assets and derivatives, and the heads of Obama's economics team (National Economic Council director Larry Summers, Treasury Secretary Tim Geithner and Federal Reserve Chairman Ben Bernanke) believe that when the economy recovers, the prices for such exotic investments will recover. In other words, they believe that the banks and the banks' portfolios will recover when the economy turns around. They believe that a suspension of mark-to-market is essential to "ride out the storm". They also believe that mark-to-market, which was reinstated in 2007 after being suspended in 1938 by FDR, helped precipitate the crash. See this.

However, in March, another Nobel prize-winning economist, Paul Krugman, wrote:

"Top officials in the Obama administration and at the Federal Reserve have convinced themselves that troubled assets, often referred to these days as "toxic waste," are really worth much more than anyone is actually willing to pay for them — and that if these assets were properly priced, all our troubles would go away.

Thus, in a recent interview Tim Geithner, the Treasury secretary, tried to make a distinction between the "basic inherent economic value" of troubled assets and the "artificially depressed value" that those assets command right now. In recent transactions, even AAA-rated mortgage-backed securities have sold for less than 40 cents on the dollar, but Mr. Geithner seems to think they're worth much, much more.

And the government's job, he declared, is to "provide the financing to help get those markets working," pushing the price of toxic waste up to where it ought to be.

What's more, officials seem to believe that getting toxic waste properly priced would cure the ills of all our major financial institutions …

The truth is that the Bernanke-Geithner plan — the plan the administration keeps floating, in slightly different versions — isn't going to fly …"

And as I have previously noted, many top economists – including 2 other Nobel prize-winning economists – believe that the economy will not recover unless and until the real state of the banks and their assets are acknowledged and insolvent banks broken up in an orderly fashion.

The Financial Accounting Standards Board (FASB) is, in fact, considering a reversal from its April change in policy which suspended mark-to-market accounting. Specifically, FASB is considering vastly tightening mark-to-market requirements to include virtually all securities on a bank's balance sheet.

Most financial analysts had considered FASB's reinstatement of mark-to-market unlikely. But Merton and Scholes' very public advocacy for mark-to-market may have just changed the odds.

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