

[Online Forex Practice Account](#)

Mark-To-Model, Into The Twilight Zone

By STEVE H. HANKE AND JOHN A. TATOM | Posted Thursday, October 23, 2008 4:20 PM PT

On Sept. 30, the Securities and Exchange Commission challenged the primacy of using market prices as a measure of value.

The SEC's new accounting clarifications assert that whenever assets are temporarily impaired or their values are distressed — whatever that means — market prices might be unrepresentative estimates of value.

In such cases, the new clarifications allow for nonmarket, "mark-to-model" methods — the very methods employed by Enron — to be used for fair value accounting. With its embrace of nonmarket valuation methods, the SEC has entered the twilight zone.

And the SEC is not alone. Under heavy lobbying from major banks and European politicians — notably French President Nicolas Sarkozy — the Expert Advisory Panel of the International Accounting Standards Board made its recommendations on Oct. 10, and they were endorsed by the IASB.

Under the new IASB rules, it will become easier for companies to throw current market prices to the winds and replace them with values based on amortized costs.

The recent failures of some financial firms have given new life to arguments against the use of market prices, or mark-to-market accounting (MTM). Critics claim that firms with assets under price pressure face losses that deplete their capital and increase their risk of insolvency.

Such firms are forced to shrink by selling assets, but these sales can spark further asset price declines and capital losses, requiring further sales. At every stage, critics argue, firms are pushed toward insolvency by MTM. According to the critics of MTM, the bogeymen of the current crisis are market prices.

MTM rests on two principles: the social value of market prices and the role of accounting information. First, an asset is only worth its price in the marketplace, which is the only objective measure of value. Second, accounting statements must provide accurate and meaningful information. Investors have a right to accurate and actionable information on the value of their corporate assets.

The transparency of MTM is most critical when a firm is likely to have to sell assets or when it nears bankruptcy. This is precisely the situation in which some firms find themselves. But never mind. Major bank trade groups and some banks argue that these firms should mark asset values to models or to other arbitrary measures.

Most responsible authorities, however, including until recently Treasury Secretary Paulson and Chairman Bernanke, have had to defend MTM over the past year, something unimaginable after the accounting scandals of less than a decade ago.

In the recent turmoil, Bernanke softened, proposing that the government buy bad assets at a "hold-to-maturity" price, based on estimates of what securities would eventually be worth in a normal market or when payments come in over time. But the market price is the correct hold-to-maturity price.

Besides, if such appreciation could reasonably be expected, private firms would bid up the value of toxic securities today. We do not believe that the government should be in the business of promoting erroneous information.

There is no question that a decline in market liquidity reduces asset prices, especially for assets that are long-term or relatively illiquid. Those who hold such assets are worse off, and that is precisely what market prices indicate. Managers who ignore prices hoping for a better day are ignoring the best interests of their stockholders and other stakeholders.

MTM does not force asset sales. If MTM leads to a write-down, nothing is gained by a new sale, except in two cases. If an owner expects prices to fall further, then it could be beneficial to sell in advance. Or if an asset price decline reduces equity below a required regulatory level, the owner may have to sell assets in order to restore a required capital ratio.

Prices may still fall further, but not because of MTM. Shrinking assets and prices are exactly what the market requires when asset supply has expanded too much, pushing value below the sustainable replacement cost of assets.

If one had gone to sleep at the end of 2001 when Enron failed and just awoke, one might conclude that nothing had been learned. Besides finding that some banks had rushed headlong into the disastrous off-balance-sheet creations that had allowed Enron to destroy itself, they would also find that the appeal of Enron's practice of "marking to model" or to other fictional "fair" prices is strong.

Today's "frozen markets" simply reflect an unwillingness to sell at low prices or a hope that some institution (government) will step in to put an artificial floor under prices. Calls for valuing assets at inflated fictional values and forbearance are reminiscent of similar industry pleas during the S&L crisis, which also featured frozen markets, funny accounting and fears of price volatility due to MTM.

The great lesson of the S&L mess was to cut the cost of the crisis by relying on the marketplace to set prices, to trade on them to get bad assets off the books and to use market prices to spot and close failed institutions. MTM is part of the cure, not the disease; it will help accelerate the end of the current crisis and reduce its cost.

Hanke is a professor of applied economics at Johns Hopkins University and a senior fellow at the Cato Institute. Tatom is director of research at the Networks Financial Institute and an associate professor of finance at Indiana State University.

© Copyright 2008 Investor's Business Daily. All Rights Reserved.