The US Congress has authorised the administration to buy US$700 billion ($51 trillion) worth of distressed assets. It has also asked the Securities and Exchange Commission (SEC) to consider the possibility of suspending the mark-to-market rule, and report back to the Congress within 90 days.

What is mark-to-market? Why is it controversial? What does it have to do with the current financial crisis?

Mark-to-market requires firms to report the fair value of their assets or liabilities according to the market price available at the measurement date. If financial institutions had bought investment products worth at least US$562 million, they must report their market value. If the market value rises to US$700 million, the financial institution would book a paper profit of US$8 million. If the products are worth only US$550 million, the financial institution would book an unrealised loss of US$12 million. The mark-to-market rule is designed to reflect the true value of assets.

There is a difference between assets held for trading purposes and those held until maturity. Changes in the market price of assets held for trading reflect potential gains or losses. But if the assets are held until maturity, price changes are irrelevant since it is the final price at maturity that matters. The mark-to-market rule allows for different accounting treatment according to the purpose of the investment.

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Mark-to-market: Dangers abound

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Where investment banks are concerned, there is a presumption that their investments are for trading purposes. Thus they are exposed to the mark-to-market rule. In a financial crisis, that means there can be tremendous downward pressure on their asset values.

The rule is one of the most significant departures in recent years from the cost accounting convention. Its application may result in significant fluctuations in reported earnings. Some argue that such volatilities merely reflect the true underlying value of assets or liabilities. Others argue that the rule introduces a subjective element to the financial reporting process and may cause extreme volatilities. That is the main concern in the current crisis as extreme volatilities can weaken confidence.

Complexities can also arise if the financial assets in question do not have quoted prices or they are not traded. Complex derivatives like collateralised debt obligations (CDOs) and credit default swaps (CDSs) are examples of such assets in the current crisis. Their true values are hard to come by. The SEC is considering the possibility of suspending the mark-to-market rule for these assets. The current transaction prices for CDOs and CDSs in the market do not represent fair value; they are, as sellers are under compulsion to sell. Firms should be allowed instead to use the so-called Level 3 fair value hierarchy.

This allows firms to use unobservable inputs to value their assets or liabilities. They can ignore market prices and use a valuation technique they deem relevant.

There is clearly a case for financial institutions to abandon the mark-to-market rule if they intend to hold the financial assets to maturity. In such cases, they should be shielded from capital sale prices and not be forced to book unrealised losses. The rule has drastic consequences for banks in particular exposed to a financial crisis: Their assets appear suddenly to decrease in value, thus making them look less solvent than they really are. The rule can result in a situation where the value of a bank’s liabilities far outweighs the value of its assets, thus causing a run on the bank.

The suspension of the mark-to-market rule can halt the downward spiral of asset prices. This would provide a break to the increasing unrealised losses of firms. If left unchecked, such unrealised losses can severely dampen confidence.

That said, the use of Level 3 fair value hierarchy may not help in shoring up market confidence because the assets’ value will be at the discretion of the reporting entity. Liquidity in the financial market may be dampened because market participants refuse to accept such valuations. The rating agencies too may have difficulties accepting the valuations and this too may damage the reputation of the firm. In addition, firms may be subjected to legal wrangles if the market prices continue to be inconsistent with the Level 3 valuation and shareholders or counter-parties suffer losses. And finally, there is the issue of moral hazard: How can firms be trusted to value their own assets in a crisis situation?

It is questionable whether suspending the mark-to-market rule will do more good than harm. In the worst-case scenario, the regulator may be accused of helping struggling firms conceal their true financial position by shifting the goalposts.

Desperate times require desperate measures but suspending mark-to-market may be too desperate a measure. Sunlight is the best disinfectant and suspending the rule would obscure the true financial health of financial institutions. And this, in turn, may slow down the recovery process as good money is poured into bad firms.

The writer is Vice-Dean and Associate Professor of Accounting at the NUS Business School. This is the sixth article in the Straits Times-NUS Business School series on the financial crisis.