MARK-TO-MARKET TO *WHAT* MARKET?

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The United States' economy has been struggling as it attempts to avoid plummeting into a crisis mode. Many believe that the financial industry is one of the major contributors to the stress factors in which the economy is struggling to overcome. The regulating agencies have been under fire to tighten regulations to prevent misleading financial reporting. The FASB just recently released an exposure draft: Amendments for Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs (ED). One of the main concerns with this draft is the requirement to use fair value accounting for all financial assets and liabilities. If the ED is put into effect as drafted, over half of the assets of the typical commercial bank, which for many represents over 60% of the their assets, will be subject to new disclosure requirements. The issue with the proposed disclosure requirements is one of valuation. The majority of the assets that will be affected are ones for which an active secondary market does not exist. Without this, financial statements will be prepared with an array of assumptions that will include a wide spectrum of speculations as bankers struggle to formulate an exit price for these assets, that by nature, contain significant and wide bid/ask spreads relating to each aspect of the price. We propose to examine the issues surrounding the implementation of this proposed valuation policy. The parties we will be focusing on are the financial institutions, the government, and the economy. In sum, we will be conducting interviews with financial institutions and regulatory agencies in an attempt to better understand the impact of the proposed legislation.

FASB, the Financial Accounting Standards Board, is an independent body that establishes and improves the United States' accounting standards. Since 1973, FASB has been creating financial standards for nongovernmental entities (Dash, 2010). These standards are officially recognized by the SEC, Securities and Exchange Commission and the AICPA, American Institute of Certified Public Accountants, in order to achieve accounting purity and transparency across industries (Isaac, 2010).

FASB has recently proposed mark-to-market accounting, also known as fair value measurement, for the banking industry. Currently, banks hold loans at original costs and create reserves based on a percentage of potential losses. Mark-to-market would "show loans on the balance sheets at historical costs, then adjust them for both loan-loss reserves and market values" (Reilly, 2010). FASB believes that this will allow investors to see the difference between management's planned losses and what the loan is actually worth. The value of the loan should include an adjustment for risk and should be determined based on market pricing of the asset or liability. Due to the fluctuation in the market, banks' holdings will be divided into two categories: those they trade, and those they hold for investment (Financial Accounting

Standards Board, 2010). The traded assets will be valued at the market price; the assets they hold will be marked-to-market. If the mark-to-market proposal by FASB is passed it could take effect as early as 2013 for banks with more than $1 billion in assets, and 2017 for banks with fewer assets (Dash, 2010).

Mark-to-market became a major concern for senior management of the banking industry in 2008. The proposal will significantly revise accounting methods for banking and will radically change how investors view the industry. FASB's proposal requires all financial instruments to be marked-to-market on the balance sheet, including the banking industry's number one asset: loans. This approach is so drastic that there has been global disagreement regarding the mark-to-market proposal (American Bankers Association, 2010b). The International Accounting Standards Board (IASB), the Basel Committee, G20 nations (a group of 20 finance ministers and central bank governors from 20 different economies: 19 countries and the European Union), United States bank regulators, and many financial investors have spoken against FASB's decision to attempt to implement it (Isaac, 2010).

In March 2010, mark-to-market accounting for the banking industry became a major concern, yet again. FASB released their exposure draft, with a six month period available for comment letters to be submitted in response. Over 2,800 letters were written to FASB - the most responses FASB has ever received due to the publication of an exposure draft.

The IASB found that investors did not want mark-to-market for long-term assets, such as loans, and rejected it in their final ruling of IFRS 9 in 2010. The United States is currently evaluating proposed legislation with respect to the implementation of International Financial Reporting Standards (IFRS), which would replace Generally Accepted Accounting Principles (GAAP). If the mark-to-market proposal is executed by FASB, it will create major difficulties in the adaptation of IFRS, causing competitive disadvantages for banks in the United States (Isaac, 2010).

This will not be the first time that our economy has experienced mark-to-market accounting in the financial industry. In 1938, bank regulators implemented mark-to-market on banks. Shortly after implementation, President Roosevelt and Treasury Secretary Henry Morganthau concluded that "mark-to-market was inhibiting bank lending and prolonging the Great Depression" (Isaac, 2010, pp. 1). Our current economy is now being referred to as the Great Recession. Implementing mark-to-market in the banking industry now versus seventy years ago may have the same affects (Isaac, 2010).

FASB proposed mark-to-market in the 1990s for certain financial investments in the financial industry. At the time, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the U.S. Department of Treasury strongly opposed the proposal. All three entities believed mark-to-market "would not accurately reflect the bank business model" (Isaac, 2010, pp. 1). They believed it would create unwanted and unnecessary volatility in bank earnings and capital, as well as create severe credit contractions. These are some of the same arguments the Federal Reserve, FDIC, U.S. Department of Treasury, and the bankers of America have today (Isaac, 2010). If these arguments were valid in the 1990s, why wouldn't they be valid today? There have been no significant changes in regulation that would make it easier to implement mark-to-market in our economy at the moment.

Still, FASB has reasons they believe are legitimate to propose mark-to-market, all of which were triggered by the financial crisis. First, and foremost, they believe banking regulations need to be tightened. Mark-to-market will not only increase regulation, but will also improve financial transparency of banks and financial firms. Part of financial transparency is requiring banks to recognize their losses more quickly than they are currently (Dash, 2010). This will force companies to “disclose their true financial health” (Corporate Compliance Insights, 2009, pp.1). In response to investor complaints that the current rules of GAAP do not accurately represent the underlying economic condition of the United States, FASB’s mark-to-market proposal should give investors a clearer picture of a company’s actual net worth and will be “easier to compare financial statements across the industry” (Landy, 2010, pp. 1). FASB is convinced mark-to-market will “fix” all of these problems; all they need is to get every other financial organization and firm on board (Landy, 2010).

Interviews were conducted with upper management of a privately-held bank, Beacon Bank, and a publically held bank, who wishes not to be named due to legal reasons. Each bank had opinions about FASB’s mark-to-market proposal and reasons they do not want it implemented specific to the size or business plan of the bank, as well as reasons that applied to both banks.

Beacon Bank is a privately held bank in Minnesota with approximately $300,000,000 in assets as of January 1, 2010. Mr. Robert Weiss, President and CEO of Beacon Bank, discussed how important community banks are to our economy. The problem with mark-to-market in respect to these smaller banks is cost. Fear of going out of business or steep declines in the overall book value of banks is a concern nationwide, especially in the community banking sector. The most important factor to a community bank is its relationship with customers on a daily basis. Mark-to-market threatens the current business model in ways that would impede confidence. Banks will have to put an “inordinate amount of time and resources on market value pricing” which has yet to be determined how that will happen (R. Weiss, personal communication, 11/09/2010). But community bankers are not just worried about themselves; they are worried about their investors, as well. With the possible failure of banks, investors (shareholders and depositors) will potentially have fewer investing options. Since costs will increase across the banking industry, but in the community banking sector specifically, some percentage of this increased cost will be transferred to the customer, causing product cuts and loans to be priced at variable rates (R. Weiss, personal communication, 11/09/2010).

The publically held bank that was interviewed is an international bank with approximately $280,000,000,000 in assets as of January 1, 2010. A vice-president argued that mark-to-market implementation could cause publically traded banks to lose capital, therefore dropping their stock price. Large commercial banks are also concerned with all of the unknowns in the proposal. Some of the major questions that have yet to be answered by FASB are (personal communication, 11/19/2010):

- How often will banks mark-to-market? Monthly? Quarterly? Annually?
- Who will set the parameters and value each loan?
- How do you value loan policies?
- Will this increase costs for FDIC insurance?
- By what means will mark-to-market make financial statements more comparable?

Most of the key concerns are shared by community banks and large, publically held banks. Bankers are worried that mark-to-market will implement a regulation that is not relevant to the commercial banking business model and may force banks to change it, therefore forcing some banks out of business. Since every bank will not have the same standard of valuation there will be a lack of consistency. This will undermine the reliability in bank capital levels and will decrease the comparability among banks. Mark-to-market will also affect a bank's willingness to lend and their ability to lend. With loans needing to be marked-to-market (whether defaulted or not), values will fluctuate outrageously, causing banks to no longer take on the long-term commitments. With regulators and the Federal Reserve wanting banks to increase lending, mark-to-market seems to be proposed at the wrong time (personal communication, 11/19/2010).

Many believe there will be "significant costs to banks, with little benefit to the users" (American Bankers Association, 2010c, pp. 5). Not only are these changes costly, they are also immensely time consuming. Banks will have to make changes to their loan processing system, and integrate the new regulatory changes into it. The problem with that is it may take several years before a generally accepted software solution is created. A dual general ledger system will need to be created to have books marked-to-market and have books at face-value. New methods will need to be formed to determine credit, interest rates and liquidity adjustments. A new procedure will need to be engineered for the closing process of interest income recognition as well. All of these tasks will need to be tested and comply with Sarbanes-Oxley before they can be put into effect. Finally, loan officers and upper management will need to be trained in the new procedures and will most likely be involved in a continuing education program (American Bankers Association, 2010c).

The American Bankers Association (ABA), an independent financial organization that bank executives can be a part of, has some concerns of their own regarding mark-to-market. The ABA believes that fair value accounting will not reflect how the banks are actually managed and will therefore provide less relevant information to the investors than current practices. They are also concerned about "how the new fair value model [will] be treated for capital purposes by bank regulators"(American Bankers Association, 2010a, pp. 1). Many of the uncertainties need to be worked out before FASB can even consider implementing mark-to-market (American Bankers Association, 2010a).

As previously mentioned, some government entities and the Federal Reserve have problems with the proposal. In fact, Congress has already taken action by attacking FASB to "relax rules in order to loosen credit and increase loans" (Dash, 2010, pp. 1). But what mark-to-market will be doing is tightening rules, constraining credit, and decreasing loans. The FDIC makes a strong argument against mark-to-market since there is not a liquid market for deposits and loans held to maturity. They believe that since there is no market it will cause banks to be less transparent, and will possibly cause another financial crisis or a double dip. The Chairman of the Federal Reserve, Ben Bernanke, stated that "commercial real-estate loans should not be marked down because the collateral value has declined" (Stein & Wesbury, 2010, pp. 1). Bernanke believes that mark-to-market will affect the ability of the Federal Reserve to exit its quantitative-easing policy, therefore stunting growth of the loan market in the years to come (Stein & Wesbury, 2010). A former Federal Reserve Chairman, Paul Volcker, also disagrees with FASB's proposal. Volcker stated that mark-to-market is "not appropriate for the basic portfolio of instruments that you have created with a customer and intend to hold" (American Bankers Association, 2010c, pp. 3). All

of these entities have expressed disfavor to FASB's mark-to-market proposal, yet the discussion continues.

The banking industry will not be the only one affected by the implementation of mark-to-market. Investors, referring to shareholders and depositors of a financial institution, auditors, and the economy will also be affected.

Shareholders will be introduced to a complex accounting system that most investors do not want or need in their portfolio. They will slowly realize that the reliability and comparability between financial institutions has drastically diminished, and may completely disappear. And finally, the volatility of the assets of a bank in the mark-to-market accounting system will be perceived as more risk than an investor may be willing to take (American Bankers Association, 2010a).

Depositors will never fully understand mark-to-market evaluation in the banking system and will therefore never understand the results. Because there will not be an understanding of the new accounting process, the depositors may perceive increased risk with respect to the security of their investments since the media will more than likely be reporting fair value losses or deficits, especially in the current economy we are in (American Bankers Association, 2010a).

Auditors may move more toward a subjective evaluation than an objective one that is currently in place. The mark-to-market proposal "seems open to interpretation," which auditors will need to construe for themselves (Reilly, 2010, pp. 1). They will need to make a greater effort to determine whether a loan is distressed or not, since there is not a market for the assets that banks will be marking-to-market (Orol, 2009). Most important though, is the fact that auditors will need to be trained on a new way to audit banks and financial institutions where there is not always the same technique of marking-to-market (Reilly, 2010).

Throughout our research, the government, financial institutions, and independent organizations have stated their concern for what effect mark-to-market will have on the economy. There are three major concerns that have been voiced to FASB. First, "implementing mark-to-market will have negative implications for employment and economic growth" possibly causing a double-dip recession (Isaac, 2010, pp. 2). Second, the high costs and additional volatility the financial institutions must take on will increase the cost of capital to U.S. companies. And finally, the "costs of implementation and administration, along with the increase in financial statement volatility, will put U.S. companies at a competitive disadvantage with IFRS-based competitors in pursuing capital world-wide" (American Bankers Association, 2010c, pp. 5). After listing all of these downfalls of mark-to-market implementation as proposed by FASB, one question arises: What is the upside?

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