

March 31, 2009

Mark-to-Market Update: Barney Frank on Regulatory Discretion and Pro-cyclicality

We think the application of strict mark-to-market accounting -- fair value under FAS 157 along with cautionary liability risks for auditors -- **to regulatory capital** has contributed to bank stock weakness, the banking crisis and the recession. It's been talked and written about for over a year, yet still hasn't been changed.

- Throughout the crisis, bank regulators have had the ability to vary from GAAP accounting, yet the debate still centers on accounting (are you for or against honest accounting?) rather than on regulatory capital, bond ratings and the CDS markets. Regulatory inaction has added to the market's volatility and anti-equity bias (which includes the July 2007 elimination of the uptick rule, lax enforcement of short-selling rules, marked preference for creditors and CDS beneficiaries over equity holders, perpetuation of the opaque CDS market including positions with no underlying economic interest, oligopoly status for bond raters despite both AAA bubble ratings and momentum-based bond downgrades, and asymmetric company information disclosure standards.)
- In March, Congress pressed the Financial Accounting Standards Board to hasten its review of the application of fair value accounting to illiquid or distressed markets and to other than temporary impairments. A FASB response is expected later this week. As discussed in our March 30 piece, 'March Rally: Reflation or Just a Bounce?', we think it may cause some minor reductions in other-than-temporary impairments. We do not think it will suspend or materially roll-back mark-to-market accounting, address the bigger problems in non-accounting areas, or change accounting rules enough to facilitate debt swaps or increase transaction volume.

Appearing on CNBC this morning, Arianna Huffington quizzed House Financial Services Chairman Barney Frank on mark-to-market. His answers generally made sense to us but didn't show a timeline or urgency in moving to repair the problems.

Asked whether FASB would relax mark-to-market, he said (per our notes):

- "My major point has been not that we should change mark-to-market (though there's some flexibility there). **We want regulators to show some discretion in how they react to it.** If a bank has to write down its capital because of a drop in the value of the assets it holds, nobody's trying to stop that. Regulators shouldn't have to react immediately because the consequence would be pro-cyclicality and banks would immediately have to stop their lending."

- Pressed by Huffington on transparency, Frank said: “Arianna, you came with an agenda.” Huffington: “You’re abandoning transparency.” Frank: We’re not abandoning anything. You do have an agenda. We’re talking about some adjustments.” (We sensed a distinct anti-equity bias in the choice of guests and the re-interpretation of Frank’s points.)
- Frank continued: “If you’re hold-to-maturity, we’ve discussed that with SEC and FASB. We’re not watering down mark-to-market. It is to give regulators discretion in how they react. Regulators should not automatically say you’ve got to cut your lending right away. There should be some discretion to the regulators.”
- Frank cited an example: “The Federal Home Loan Banks are holding mortgages to maturity, mortgages that are making payments. We don’t think they should have to have substantial markdowns as long as these mortgage are still paying because it makes no real difference in their economic position. If you force the FHLB banks to take these enormous writedowns that they’ve been forced to take by an overly rigid mark-to-market and no regulatory discretion, you cut back on mortgage lending. and we think that’s a mistake. “

Notes

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