Prepublication Draft

Is "Mark to Funding" the Answer? Fair Value Definition Also Needs Examination

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If you want to start a fight in the financial world, try to pin the blame somewhere for the current financial crisis. With debt markets locked up tight and equity bashed to very low levels, everyone is understandably trying to duck any blame. One place where a lot of blame is being placed is on the "mark to market" style of accounting currently required by Financial Accounting Standards Board (FASB). Mark-to-market accounting means valuing an asset at its current price, regardless of other quantifying and qualifying elements. Mark-to-market accounting is FAS 157, defining Fair Value Measurements. This new rule became effective in November of 2007, right about the same time things started going south in the banking world.

Former FDIC chairman William Isaac puts the blame for the credit crisis squarely on the use of mark to market accounting during a downturn as one of the major reasons why markets have blown up. So does Steve Forbes, and any of a number of others in the financial world. The American Bankers Association wrote to Secretary Henry Paulson urging reform to the mark to market approach. An article in Forbes magazine points out:

> *What many people do not realize is that mark-to-market accounting existed in the Great Depression and, according to Milton Friedman, was an important reason behind many bank failures. In 1938, Franklin Delano Roosevelt called on a commission to study the problem and the rule was finally suspended.*[1]

The European-based International Accounting Standards Board (IASB) states that bottom-feeding prices should not be relied on as market prices for the intent of valuing assets. On the flip side of the coin, FASB and many others believe that mark to market accounting is just fine. Mary Schapiro, President Obama's nominee to head the Security and Exchange Commission (the agency who oversees FASB) after Christopher Cox steps down, noted in a Congressional forum that "while there are a lot of different views on whether mark-to-market accounting contributed to this crisis, my personal view is that it was not a significant factor. As Chair, I will read the recent SEC report on this matter fully, talk with other regulators, and get their view as we move forward." The IASB's caution on looking at market prices at bottom-feeding prices is somewhat echoed by the SEC and FASB, but they take no firm stand on granting companies real freedom to take a solid step away from the current mark-to-market sinkhole.

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An Alternative?

Who is right on the mark-to-market issue? Those calling for its demise? Or the regulators who think it is just fine? Perhaps there is an alternative to both, a real viable third path? It turns out there is an excellent alternative. This is the potential direction that is arising in Europe, the concept of "mark-to-funding." This innovative approach, presented by Avinash Persaud at a lecture to London's Gresham College in late 2008, allows a company to choose between marking assets to market or to value them according to their prospective value if held for a longer time frame. (reference) The opportunity to do this is not a fantasy—under the International Accounting Standards Board, it is available in some circumstances when a company declares its intention to hold an asset for a significant time period. (reference)

Persuad points out why the mark-to-funding alternative has become necessary:

> *In the Liquidity Black Hole of 2007/8 credit risk instruments were priced, not in terms of the probabilities of default, but in terms of they would fetch if they had to be sold tomorrow in a massive clearance sale, to the diminishing number of buyers who do not require credit to purchase assets and do not care about mark-to-market volatility. Consequently, prices have plummeted far below any measure determined by the risk of default. These prices represent liquidity-risk, not credit-risk.*[2]

How did we get here?

Alfred King, Vice Chairman of Marshall & Stevens, points out that a major issue here is one fostered by a new definition of fair value that has had unintended consequences. For over a century the business community singularly used the fair market value definition. The change to fair value, which is basically a non-going concern, exit price is vastly different. The result now is that the rule FASB has come out with, SFAS 157, is fundamentally flawed. The problem is one that appraisers have long bumped into—the definition of value. King notes that the definition of Fair Value "currently enshrined in GAAP, underlines the Board's lack of understanding of how appraisers actually do their work. The problems now facing the government, investors and financial intuitions have been wildly exacerbated by SFAS 157." (reference) King's bottom line is that to assert financial reporting should be based on a bankruptcy model that everything is for sale (coming from the Fair Value approach instead of the Fair Market Approach) surely would destroy the real underlying value of any going concern. King believes that a change in the definition of Fair Value needs to occur, and that auditors need to be willing to accept the professional judgment of appraisers as soon as possible.

Where do we go next?

As nasty as these events have been, Persuad does not think it necessary to totally abandon the mark-to-market approach. His idea of mark-to-funding is more of an alternative than a wholesale replacement. How does this play out? He notes "the valuation 'window' and the duration of risk management should be linked directly to the maturity of funding. . . 'mark-to-funding' would provide scope for banks and other institutions to create (risk absorbing) pools of capital – funded by long-term liabilities – that could buy assets that are at a distressed price today, without being held back by short-term price volatility." If there is sold funding behind an asset, and the owner is planning on holding the asset for awhile, there is no reason that the owner should be penalized for a short-term drop in the current market.

The mark-to-funding makes a lot of sense as most assets are being sold with the idea of being held for considerable lengths of time. It smoothes out the ups and downs that come from incessantly (or at least quarterly) marking everything to market. The concept of mark-to-funding seems to be an excellent concept, particularly when an asset is going to be held for long term. Imagine how tough it would be to have to sell all of your stocks at their lowest point instead of being able to hold on to them until they reach their true potential down the road. The entire buy-and-hold concept for investing assumes some rough spots but looks out toward a longer time period for realizing eventual gains. The idea of the mark-to-funding approach to valuing assets takes a similar long-term view that helps aim beyond short term volatility. Persuad's concept of using mark-to-funding is one of the best out there and deserves significant consideration. Add to it a change back in the definition of value—from Fair Value to Fair Market Value, and some real answers may emerge. What do you think?

References

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