

Mark to Market and the Eurozone Crisis

e21 Staff Editorial | June 7, 2010

The deepening financial crisis in Europe reflects investors' concerns with European banks' exposure to sovereign credit risk. If Greece, Ireland, and other ailing European countries are forced to restructure their debt by trading, for example, \$75 of new debt for every \$100 of outstanding principal, the biggest losers will be European banks that hold most of these governments' debt obligations. The European Central Bank has already made € 800 billion of loans to European banks, and it recently said that continued reliance on its funding among some mid-sized banks is "a cause for concern."

Meanwhile, Deutsche Bank estimates that European banks' losses on sovereign debt could be €75 billion. While this number may seem manageable, it is quite large given existing uncertainty about European banks' capital adequacy. European banks were not forced to write down the value of their assets from 2007-2008 to the same extent as U.S. banks. As a result, potential losses on sovereign debt are layered on top of questionable valuations of existing assets. According to the International Monetary Fund (IMF), as of April 2009 European banks had written down only 25% of the value of their bad assets. Last July, the European Central Bank (ECB) optimistically estimated that the total European write downs would be roughly \$300 billion (over 30%) less than the IMF estimate.

After the first quarter of 2009, the prices of risk assets began to increase as the economy again began to grow. This led banks to stop writing down the value of assets and, in some cases, inflating the value of their portfolios. However, because the Eurozone banks failed to mark down the assets sufficiently in

2007-2008, they remained undercapitalized even after the improvement in market conditions. The table below is adapted from the IMF's 2010 Global Financial Stability Report. Through the end of 2009, U.S. banks had taken \$680 billion in write downs or 77% of their total estimated credit losses of \$885 billion. By contrast, Eurozone banks had taken \$415 billion in write downs, or 62% of their estimated losses. Relative to October 2009 estimates, U.S. bank write downs equal 66.3% of expected losses while Eurozone bank write downs equal only 50.9% of probable losses.

Why did the U.S. banks write down their portfolios by 25% to 33% more than their European counterparts during 2007-2009? Primarily because of the reviled

	United States (ex-GSEs)	Euro Area
Total reported writedowns (to end-2009: Q4)²	680	415
Total capital raised (to end-2009: Q4)	329	256
Tier 1/RWA capital ratios (at end-2009), in percent	11.3 (+1.5)	9.1 (+1.1)
Estimated Writedowns April 2010 GFSR (billions of U.S. dollars)	885	665
Estimated Writedowns October 2009 GFSR (billions of U.S. dollars)	1,025	814

Financial Accounting Standards Board (FASB) requirement that banks record the value of certain assets at fair value, or “mark to market.” Of course, many observers argued that fair value accounting was the cause of the crisis.

In a classic case of blaming the messenger, many analysts contended that the problem was not so much the dodgy assets on bank balance sheets, but rather the way the banks were required to account for them: As liquidity in markets for securitized assets “dried up,” the few transactions that occurred tended to take place at distressed prices. The banks holding these assets were then forced to “mark down” the value of their portfolios to reflect these “unnaturally low” prices. This reduced banks’ capital and resulted in further forced selling, which pushed prices down further and intensified the vicious cycle.

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This narrative was appealing to lawmakers. Typical was the statement of Congressman Gary Ackerman, who argued that the market in 2008-2009 was “not a fair market.” If the market wasn’t fair, lawmakers reasoned, there was little sense in forcing banks to mark their assets to the prices that prevailed in it. In March 2009, Members of the House Financial Services Committee told the chairman of the Financial Accounting Standards Board (FASB) to suspend the fair value accounting rules or Congress would do it for them.

FASB did initiate changes, but loan performance since then suggests that the prices were right. According to the Federal Reserve Bank of New York (FRBNY), only 46.5% of all subprime mortgages are current. This means that 53.5% are either delinquent,

in foreclosure, or real estate owned. And this doesn’t include the foreclosed properties that have already been sold at auction. The figures for Alt-A loans are similar. According to the most recent Federal Deposit Insurance Corporation (FDIC) quarterly banking profile, the total volume of nonperforming loans is above 5% of total loans – an all-time record. It is those who argued that 2008 market prices implied “unrealistic” default rates that look foolish in retrospect, not the prices.

Moreover, recent academic research has bolstered the argument that fair value accounting had nothing to do with banks’ problems. Researchers at the Federal Reserve Bank of Boston found no linkage between fair value accounting and bank capital levels, largely because “fair value adjustments related to debt securities and unrealized gains on equity securities are excluded when computing Tier 1 regulatory capital.” Researchers from Notre Dame reach the same conclusion, emphasizing that only a small portion of bank assets were subjected to fair value accounting. This is an important point, as the assets banks intended to hold to maturity were not subject to fair value accounting and assets for which no market price was available (so-called Level 3 assets) were valued-based on a model.

The table below is taken from 10-Q reports filed by seven banks with the SEC during the 3rd quarter of 2008. With the exception of Goldman Sachs, only about one-third of the largest banks’ assets were carried at fair value. For larger regional banks, less than one-fifth of the assets were held at fair value. Given that such a large percentage of assets were allowed to be carried at historical cost, it is not surprising that a forthcoming paper in the *Journal of Economic Perspectives* concludes that existing accounting rules were more likely to result in bank assets being *overvalued* than undervalued.

Fair Value Holdings as of Q3 2008

Bank	Total Assets	Assets at Fair Value	Level 3 FV Assets ("mark to model")	Percentage of Assets Carried at Current Market Prices*
Goldman Sachs	1,088,145	676,123	78,088	55.0%
JP Morgan Chase	1,775,670	719,900	143,980	32.4%
Morgan Stanley	1,031,228	390,393	69,194	31.1%
Citigroup	2,195,861	820,924	154,656	30.3%
PNC**	142,771	38,997	3,453	24.9%
BB&T	136,465	25,877	792	18.4%
SunTrust Bank	177,232	29,456	2,733	15.1%
M&T Bank	65,893	8,900	74	13.4%

* (FV assets - Level 3 assets)/Total assets;
 ** PNC carries \$29.7 billion in level 2 assets

all numbers in millions \$

The political pendulum seems to have swung back on this issue. Lawmakers are now talking about holding hearings on transparency, rather than demanding rule changes to allow banks to hide losses. This is welcome. As the Eurozone crisis makes clear, transparency is the key to a well-functioning banking system. And nothing is more vital to transparency than ensuring that asset values are recorded at the same prices that prevail in the market. Whether or not it was reasonable for lawmakers to react to the crisis by suspending accounting rules, the lesson from the 2007-2008 period is that the U.S. banking system was better off for having written down the

value of the small portion of assets subject to fair value accounting rules.

When an investor is only willing to pay \$70 for an asset with a face value of \$100, that imparts important, forward-looking information about the value of the asset. Perhaps losses won't be precisely \$30, as implied by the discount, but given that the case for capitalism rests largely on a belief in the efficiency of the price system, it would be a mistake to suggest that prices should be ignored altogether.