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BUSINESS WORLD

By **HOLMAN W. JENKINS, JR.**



Mark to Meltdown?

March 5, 2008; Page A16

No task is more thankless than to write about accounting for a family newspaper, yet it must be shared with the public that "mark to market," an accounting and regulatory innovation of the early 1990s, has proved another of Washington's fabulous failures -- that is, if the goal were curing market uncertainty through "improved" accounting practices. The atmospherics around the big subprime write-downs currently roiling Wall Street tell the story.

Start with Merrill Lynch's giant \$15 billion write-down of mortgage-related securities in January, which CEO John Thain introduced with a curiously contradictory "I think we're being conservative, but I don't think that we're likely to get much back on these things." Mmm. Either Merrill's write-downs are conservative, in which case many of the assets will come back, or they aren't. Is it any wonder Wall Streeters kibitzing about possible spectacular "write-ups" once the credit crisis passes point to Merrill as a top candidate?

Or take AIG's unexpectedly large write-down of subprime paper on Friday, blamed for the market's sell-off. Its chief told the world that its mortgages on paper had lost \$11 billion in value, but *sotto voce* predicted these "unrealized" losses would eventually correct themselves.

Or take Sam Zell, a real-estate investor whose pronouncements are given great weight in the markets. He pooh-poohed the red ink being liberally spilled on Wall Street, saying, "It's not a cash crisis, it's a 'mark' crisis," and predicted that write-ups would undo much

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of the damage once the "panic" subsides.

None of this should be surprising. Overstating the importance of accounting rules is, indeed, the essential error that leads to excessive twiddling with accounting rules.

Whether a company values its assets at historic cost or market value or a value derived by some other formula, investors still have to make their own forecasts and judgments. A thermometer is equally useful whether it says water freezes at 0 degrees or 32 degrees -- though it still doesn't tell what the temperature will be next week.

But loose as well is a fear that exaggerated writedowns in the current credit crunch are rapidly chewing through the banking system's capital cushion. Banks will be forced to dump assets at fire-sale prices, leading to yet more writedowns and more fire sales. At best, banks will have to keep shopping cheap equity to foreign potentates to keep themselves afloat. At worst, massive regulatory insolvency lies ahead.

This horror show, we hasten to add, has proven more theoretical than actual, but it plays a key role in the meltdown scenarios of NYU economist Nouriel Roubini, which he recently retailed for a congressional hearing. And it's hard to doubt that fears of accounting-prompted distress sales are partly behind the melodramatic yields now available in the corporate and municipal bond markets.

Then again, investors are hardly being misled, or else they wouldn't be engaged in a lively debate about what bank-held loans are really worth. And the Fed is helping to smooth over insolvency fears by lending against dodgy assets, and, to all appearances, by trying to inflate away mortgage debt. Ben Bernanke yesterday sounded like a man two aspirins away from calling for a federal housing bailout. With all this compromising of principles going on, it's hard to believe regulators aren't prepared to compromise their capital adequacy standards too, if that's what it takes to see Citigroup through the danger.

Still, accounting rules should not be doctored up as way to prejudice various business decision-making, though punishing practices they don't like is often (always?) the agenda of accounting-change advocates. Mark to market was a gift to the world from SEC Chief Richard Breeden in the early '90s. With the help of accounting mavens, he argued that requiring banks and other companies to account for financial assets at current market prices, as if the institutions were being sized up for liquidation, would provide a rough-tough discipline for the edification of investors, regulators and managers.

A rose would smell as sweet if it were called skunk cabbage -- so we always maintain when somebody predicts either dire or utopian results from a mere accounting change. Still, many questioned Mr. Breeden's initiative at the time, among them Fed Chairman Alan Greenspan and Bank of America's Richard M. Rosenberg. Particularly notable were their warnings that the new rule, when combined with risk-based capital standards, might lead banks to hold fewer loans on their own books, packaging more of them as complex securities for sale to investors.

Overlooked, too, was a phenomenon we perhaps understand better today -- the propensity of the speculators who provide much of the market's day-to-day liquidity to go on strike during moments when their services are most needed. "Mark to market" then becomes something else,

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because markets no longer exist for many of these abstruse securities. Banks are left oxymoronically trying to estimate what market prices would be if markets existed.

But the best argument was articulated by the late Citibanker Walter Wriston, and it applies equally to most of the accounting innovations with which the world has been oversupplied in recent decades: "Consistency of accounting treatment is always more useful to managers and investors than the latest fad of accounting aficionados."

Amen.

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