Competitive Enterprise Institute

Suspend Mark-to-Market Rules and Make Accounting Regulators Accountable

In CEI's last Agenda for Congress, we noted that "mark-to-market accounting—which requires financial instruments such as loans to be valued at the price of an ill-defined "market"—has been blamed by both Democrats and Republicans for spreading the credit contagion from bad banks to good." We recommended, "Congress should require regulatory agencies to suspend mark-to-market accounting mandates such as Financial Accounting Standard 157 until better guidance is developed for illiquid markets."

In the spring of 2009, Congress came pretty close to doing just that. The Financial Accounting Standards Board (FASB) was hauled before Congressional hearings and members of both parties expressed concern that FAS 157 was exacerbating the crisis by causing banks to take huge paper losses and tighten lending unnecessarily. Sensing the threat of legislation, FASB announced a relaxation of the rule, an action that sent the Dow Jones Industrial Average soaring that day to above 8,000 for the first time in months. This simple change to accounting rules led to a stabilization of the economy that billions in bailouts had failed to achieve.

But now that the legislative focus on accounting rules has faded, FASB is trying to push through an expanded mark-to-market rule that would cover virtually all bank loans. Mark-to-market mandates have generated questions about their accuracy and their economic impact. They exaggerate losses by forcing financial institutions to write down performing loans based on another institution's fire sale even if the market for such loans is highly illiquid and the financial institution in question has no plans to sell the loans.

Underlying all these problems is the fact that there are relatively few checks on the accounting standards body that makes these rules. FASB is a private body, yet Congress requires public companies to support it through a type of tax, known as an accounting support fee. Moreover, federal regulatory agencies like the Securities and Exchange Commission and the Federal Deposit Insurance Corporation almost always defer to FASB in setting standards for everything from investor reports to solvency rules.

Earlier this decade, FASB greatly limited the use of employee stock options—which are very effective at creating wealth and giving more people access to it—by requiring companies to "expense"—that is, subtract the estimated value of stock options—from current earnings, even though stock options never result in a cash outflow. This policy has had little effect on levels of executive compensation, but has caused companies to greatly reduce stock options for rank-and-file workers. It has also

resulted in misleading financial reports for investors of companies that utilize stock options, as companies are required to report phantom "losses" when there has been no money leaving the firm's coffers. Congress should:

- Require regulatory agencies to suspend FASB's mark-to-market accounting mandates until better guidance is developed for illiquid markets.
- Reverse the options expensing standard.
- Hold hearings to examine FASB's process of setting accounting standards and whether the agency should continue to have a de facto monopoly on setting those standards.

John Berlau