~~The Mark-To-Market Change Will Kill~~ The PPIP Will Kill The Mark-To-Market Change

The Atlantic Online
July 9 2009
By Daniel Indiviglio

Despite news yesterday that the Treasury's Public-Private Investment Program (PPIP) is going forward, people are still talking about why it failed. That's because, despite the fact that the program still exists, if it works at all, it will likely be scaled way down in comparison to what was originally intended. The Wall Street Journal's Real Time Economics blog offers a theory today from guest contributor Lucian Bebchuk, professor of law, economics, and finance at Harvard Law School. He blames the PPIP's failure on the mark-to-market rule changes announced this past spring. I see things differently. I would contend that the PPIP, even if only marginally successful, could actually nullify those mark-to-market rule changes.

Before getting into any analysis, I wanted to provide readers some background and explain some jargon.

The PPIP is the program under which the Treasury hopes to entice banks to sell their toxic securities (like mortgage-backed securities) to a group of nine investors it announced yesterday.

Banks must "mark-to-market" securities that they hold periodically so that a market-based value for those securities is shown on their books.

One of the problems that banks had faced in regard to toxic securities was that, since the market was so bad for them, the prices banks sometimes would settle for in order to get rid of them were fire-sale prices, i.e. very low prices agreed to because of desperation to get rid of the junk. Some argue that the hold-to-maturity values of many of these toxic assets are much greater than the values the securities had been sold for over the past year. That led banks to complain that they shouldn't be forced to value those securities at the market value. In other words, they should not be forced to mark-to-market, because those prices did not accurately depict the securities' value.

Congress heard banks' complaining and pressured accounting regulators to make a change. In response, a few months ago, shortly after the PPIP was announced, Financial Accounting Standards Board (FASB) -- the body that sets accounting rules/standards -- announced that they were changing mark-to-market requirements. The change essentially gave into banks' complaint explained above, and suspended the requirement for marking the toxic securities to market. The new standard basically said, if the market is sufficiently inactive for a security (even if not wholly inactive), then you can ignore market value. Only when you sell it do you have you have to recognize any associated gain or loss. For those keeping score at home, that rule is called "FAS 157-e."

Got it? Good. Now I can actually do some analysis.

So Professor Bebchuk thinks that, since banks no longer need to mark toxic securities to market, they have no reason to participate in the PPIP. After all, perception is reality in finance. If the

values of toxic assets shown on banks' balance sheets don't get worse, banks' potential investors might no be as scared of them anymore. The whole problem with toxic securities in the first place was that investors couldn't tell just how ugly banks' balance sheets really were because nobody knew the value of the toxic securities. That's why the PPIP was developed -- so banks could get rid of those securities to comfort their investors.

My first critique of Bebchuk's point might already be clear: investors should be smart enough to call shenanigans. If banks suddenly look healthy, but nothing has changed except for their accounting requirements, then that's very suspect. Are investors dumb enough to trust health via accounting rule change? I certainly hope not. In reality, investors have become more comfortable due to banks' recent acquisition of new capital and adequate capital levels having been outlined through the government's stress tests.

But I think there's an even more interesting and very subtle point to be made. What if the PPIP makes the accounting rule change irrelevant? Even if mark-to-market requirements have been relaxed, there are still some banks that are likely to want to get rid of these assets. As I mentioned yesterday, the smaller banks will likely be most interested in the PPIP, since they aren't too big to fail according to the government and probably haven't scrounged up as much capital as the big guys. So maybe fewer securities will change hands through the PPIP than originally thought -- perhaps only something like $50 to $100 billion are traded, far less than the potentially $1 trillion envisioned. That should still be enough to declare an "active market" for most of those various types of toxic securities.

One of the original purposes of the PPIP was to create an active market for these toxic securities. And as long as there's an active market for those securities, then the accounting rule change is irrelevant. Those securities now must be marked-to-market, just like before. The new accounting rule only applies if there's a relatively inactive market. But even a marginally successful PPIP should create an active enough market to require those securities' market value be reflected on banks' balance sheets.

So what you could see here is the small banks turning the tables on the large ones. If enough of them choose to participate, they could force the big banks to mark-to-market their securities.