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MARK-TO-MARKET ACCOUNTING CHANGE – What Does It Mean?

by Ellen R. Marshall

This morning the Financial Accounting Standards Board announced that it is changing certain of the mark-to-market rules for assets that are held for sale, but are hard to value in today's illiquid marketplace. The change will permit the banks to revalue these assets to a value that is based on what the assets would sell for in a normalized market, rather than using fire-sale prices. This is expected to enable those banks that wrote down values in the past, based on an approach that used fire-sale prices, to write up those assets, if the long-term cash flow modeling, credit and interest rate characteristics justify doing so.

Commentators are already trading speculations as to whether this change will tend to increase or decrease the amount of mortgage loan and other assets that banks wish to sell. The answer is: both. Some banks are likely to be motivated to sell more assets, and other banks are likely to be motivated to sell fewer assets. What the accounting change does is free up the banks to decide whether to hold or sell on the basis of real economic considerations, rather than the accounting treatment. For some portfolios, this will mean that the bank will now decide to retain a portfolio that it otherwise would have sold. For others it will mean that the bank will newly consider selling a portfolio.

Today's change is mainly about the portfolios that were already designated as "held for sale." If the assets were written down to fire-sale prices, they might actually be revalued (with a recognition of gain) to reflect the new assessment of value. For these assets, the holder might have sought to sell in the past, notwithstanding low offers, because the asset was already being carried at a low price. With the opportunity to write the asset up, a sale becomes unattractive until the market returns to normal, when presumably

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prevailing prices will rise to the new carrying level.

On the other hand, the change has the potential to free up assets that were previously characterized as "held for investment." Banks that might otherwise have considered selling asset portfolios simply to reduce their overall balance sheet size, have in the past been reluctant to test the market for specific assets, lest those assets be recharacterized as being "held for sale," and thereupon become subject to steep write-downs, even if the assets do not end up being sold. If the effect of today's accounting change is to permit the bank to retain the asset at its current carrying value after "testing the waters" for a sale, that could encourage banks to start offering up portfolios of either performing or nonperforming loans, according to their economic needs and abilities to absorb some level of loss.

For this process to commence, the banks would need to see that the valuation model that their accountants will find acceptable for "held for sale" assets is identical to, or reasonably close to, the valuation model that applies to "held for investment" assets. The new FASB approach does not quite say that this is the case, but there is reason to think that its effects may be close to that result.

The new FASB announcement may also have a ripple effect by signaling an attitude toward the valuation process. To the extent that individual audit firms may have been reluctant in the past to countenance valuation approaches other than on a fire-sale basis, they now seem to be getting encouragement to accept more holistic valuation processes.

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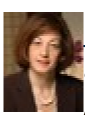

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