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Mark-to-Market: Delivering the Financial Crisis to Your Front Door

JANA SHEARER*

I. INTRODUCTION

Given the current state of the economy, everyone is looking for someone to blame. Unfortunately, the brunt of the recent debate is focused on the wrong subject. Financial accounting rules, specifically fair value accounting or "mark-to-market," has generated considerable attention as a cause of the current crisis;[1] but, in reality, it has not *caused* anything. Instead, financial accounting rules have merely served as the messenger, delivering the effects of the current crisis to the front doors of many Americans.[2]

Mark-to-market is the practice of recording certain assets at fair value rather than at historical cost. It is primarily used to value financial instruments, such as mortgaged-backed securities held by financial institutions. In the midst of the subprime mortgage crisis and the resulting decline in the market for mortgaged-back securities, financial institutions have been forced to write down their assets to fair value, resulting in large losses. The size and severity of these losses and the consequences that these losses have on regulatory capital requirements has resulted in a public outcry to abandon mark-to-market.

Despite its strong position in 2008, the Financial Accounting Standards Board[3] ("FASB") has recently reevaluated its position on mark-to-market accounting and the application of mark-to-market to certain financial instruments. It has made some changes in application of mark-to-market accounting, but fortunately for the future of our economy, FASB has refused to abandon mark-to-market completely.

This comment takes the position that mark-to-market did not cause the current economic crisis; it simply delivered the errors of banks, mortgagors, and credit-rating agencies to the front door of many Americans. Part II will define

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1. *See* Robert H. Herz & Linda A. MacDonald, *Understanding the Issues: Some Facts about Fair Value*, FASB.ORG, May 2008, http://www.fasb.org/articles&reports/uti_fair_value_may_2008.pdf.

2. *See generally* Dane Mott & Sarah Deans, *Shooting the Messenger: TARP Contemplates SEC Suspension of Fair Value*, Sept. 29, 2008, *available at* http://schulzkelaw.com/wp-content/uploads/2008/09/fv-jpmorgan092908.pdf.

3. Although the Securities and Exchange Commission ("SEC") has the statutory authority to establish accounting standards, the SEC has looked to FASB for independent leadership in developing such standards. *See Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Exchange Act Release Nos. 33-8221, 34-47743, 2003 SEC LEXIS 993, at *1, 15 (April 25, 2003).

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mark-to-market accounting, including a history of the practice in the United States. Part III will provide a brief overview of the subprime mortgage crisis and its major causes. Part IV will discuss the role of mark-to-market in the current economic crisis. Part V will explain FASB's original position and discuss the recent changes to this position, in addition to proposing a recommendation to increase disclosure for investors.

II. MARK-TO-MARKET

A. *What is Mark-to-Market?*

Mark-to-market, often called fair value accounting, is the practice of recording certain assets at fair market value rather than at historical cost.[4] As the name implies, mark-to-market often results in an asset being valued based on its current market price, rather than the price paid for such asset.[5] It is primarily used for financial assets, specifically securities, but it is important to note that not all financial assets have to be reported at fair value.[6]

Under current accounting standards, securities are divided into three categories: held-to-maturity, trading, and available-for-sale.[7] The classification of a security depends on the intent of the investor and the type of security.[8] Debt securities that an investor purchased with the intent and ability to hold to maturity are classified as held-to-maturity.[9] Debt or equity securities that are purchased and held primarily for the purpose of sale in the near future are trading securities.[10] Investments that are not classified as either held-to-maturity or trading securities are deemed available-for-sale.[11] Trading and available-for-sale securities must be reported at fair value, or marked-to-market, while held-to-maturity securities, the category into which most loans fall, are reported at amortized cost (an adjusted historical cost value).[12]

In addition to determining the carrying value of a security, the classification also determines how periodic changes in value affect income.[13] If

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4. *See* Elizabeth Williamson & Kara Scannell, *The Financial Crisis: Momentum Gathers to Ease Mark-to-Market Accounting Rule*, WALL ST. J., October 2, 2008, at A6.
5. *Id.*
6. Herz & MacDonald, *supra* note 1.
7. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 115: ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES § 6 (1993) [hereinafter SFAS 115].
8. *Id.* §§ 6-12.
9. *Id.* § 7.
10. *Id.* § 12(a).
11. *Id.* § 12(b).
12. *See* SFAS 115, *supra* note 7, §§ 7, 12.
13. *See Mark-to-Market Accounting: Practices & Implications: Hearing before the Subcomm. On Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*,

a security is carried on the books at fair value, changes in the value of that security are either recognized through income on the income statement or are reported as "comprehensive income," an equity account on the balance sheet.[14] As discussed below, if the change in the value of a security is reflected in income, it will factor into the capital adequacy requirements.[15]

Even if a security is not required to be reported at fair value based on its classification, fair value concepts may still apply if the security is deemed to be "impaired."[16] At the end of each reporting period, all investments must be evaluated to "determine whether the fair value is lower than book value."[17] If a financial institution does not expect to collect all of the amounts due on the security, it is deemed to be "other than temporarily impaired" ("OTTI").[18] Once a security is OTTI, it must be written down to its current fair value.[19]

If an investment must be reported at fair value, the reporting entity (i.e., the investor) has to determine the fair value of that security.[20] *Statement of Financial Accounting Standards No. 157: Fair Value Measurements* ("SFAS 157"), issued in 2006, defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[21] An orderly transaction is one that is willingly undertaken by market participants after having been exposed to the market before the measurement date.[22] Importantly, fair value is not the price that would be received in a forced liquidation or fire sale.[23]

In addition to defining fair value, SFAS 157 establishes a hierarchy for determining the inputs used in the fair value determination.[24] Quoted prices in active markets for identical assets or liabilities make up Level 1, which is given the highest priority.[25] In the absence of quoted prices in active markets for identical assets or liabilities, SFAS 157 permits the use of alternative valuation

111th Cong. 94, 96 (2009) [hereinafter *Hearings*] (statement of Kevin J. Bailey, Deputy Comptroller, Office of the Comptroller of Currency), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg11148865/pdf/CHRG-111hhrg11148865.pdf.

14. *See id.* at 97.

15. *See id.*

16. *Id.* at 100.

17. *Id.* at 112, 114 (statement of Thomas Bailey, President and CEO, Brentwood Bank, on behalf of the Pennsylvania Association of Community Bankers and the Independent Community Bankers of America).

18. *See Hearings*, *supra* note 13, at 112, 114 (statement of Thomas Bailey).

19. *Id.*

20. *See id.* at 107 (statement of Kevin Bailey).

21. FINANCIAL ACCOUNTING STANDARDS BOARD, FAIR VALUE MEASUREMENTS, STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 157 § 5 (2006) [hereinafter SFAS 157].

22. *See* SFAS 157, *supra* note 21, § 7.

23. *See id.*

24. *See id.* § 22.

25. *Id.* §§ 22, 24.

techniques derived from other inputs.[26] Such other inputs include observable quoted prices for identical assets and liabilities in inactive markets,[27] observable quoted market prices for similar assets or liabilities in active markets (both Level 2 inputs),[28] and unobservable inputs, including an entity's own analysis of the available data that market participants would find important in pricing an asset or liability (Level 3 inputs).[29]

This hierarchy prioritizes observable inputs (Level 1 and 2) over unobservable inputs (Level 3).[30] By distinguishing between the more observable, an arguably more objective measurement, and the unobservable, a more subjective measurement, the hierarchy signifies the "relative reliability" of the fair value estimate.[31]

When a reporting entity makes a fair value determination, the entity must disclose the following: (1) the fair value measure of the security at the reporting date; (2) the level or levels of the hierarchy used in making the fair value determination; (3) a reconciliation of the beginning and ending values of the security if the valuations were made using Level 3 inputs; (4) the amount of total gains or losses for the period (segregating those included in earnings); and (5) the valuation techniques used to determine the fair value.[32] The purpose of these disclosure requirements is to permit financial statement users to assess the fair value measures and independently evaluate the valuations made and the effect of those valuations on earnings.[33]

B. History of Mark-to-Market

Traditionally, generally accepted accounting principles ("GAAP") in the United States preferred historical cost measurements rather than fair value accounting.[34] Historical cost is appealing because it provides an objective number, derived from an observable transaction, which can be independently verified.[35] However, as history has demonstrated, historical cost is not without its flaws.[36]

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26. *See id.* §§ 22-30; *see also Hearings*, *supra* note 13, at 139, 158-60 (statement of Robert H. Herz, Chairman, Financial Accounting Standards Board).

27. SFAS 157, *supra* note 21, § 28(b).

28. *Id.* § 28(a).

29. *Id.* § 30.

30. *See id.* § 22.

31. *See Hearings*, *supra* note 13, at 158-59 (statement of Robert H. Herz).

32. SFAS 157, *supra* note 21, § 32(a)-(e).

33. *See id.* § 32.

34. Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1, 50 (2008).

35. *See id.*

36. *See* Stanley Siegel, *The Coming Revolution in Accounting: The Emergence of Fair Value as the*

Recently, in response to the perceived deficiencies of the historical cost system and as part of a movement to globalize accounting standards, the United States has moved toward a dual-attribute model, incorporating fair value measurements.[37] This movement has been widely debated, a topic beyond the scope of this document.[38] Nevertheless, mark-to-market is a prime example of this movement and has taken center stage in the midst of the subprime mortgage crisis.

Contrary to popular belief, mark-to-market is not a new concept in financial accounting.[39] In fact, mark-to-market has been used to value certain financial instruments for decades.[40] Prior to the Great Depression, companies had considerable freedom to select their own accounting practices and policies.[41] Valuing assets at their current value was common practice.[42] Specifically, banking institutions were required to use current market values to value investment securities portfolios for "supervisory purposes."[43]

After the Great Depression, the accounting profession saw a general movement toward more "conservative" accounting practices such as historical cost.[44] This movement included an abandonment of the banking industry's use of fair value accounting for investment securities portfolios, which was sparked by concerns over how this practice affected the financial performance of banking institutions.[45]

Despite the concerns that caused fair value accounting to be abandoned after the Great Depression, later generations believed that mark-to-market accounting was "an important tool to communicate investment values to capital market participants."[46] After evaluating the causes of previous financial crises,

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Fundamental Principle of GAAP, 42 WAYNE L. REV. 1839, 1847 (1996).

37. *See id.* at 1846-49.

38. *See id.* Despite the opposition to this movement, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") have entered into an memorandum of understanding to converge, and globalize, accounting standards. *See A Roadmap for Convergence between IFRS and U.S. GAAP: 2006-2008 Memorandum of Understanding between the FASB and the IASB*, Feb. 27, 2006, *available at* http://www.iasb.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf. Fair value accounting is a barrier to global convergence. *See generally id.*

39. Herz & MacDonald, *supra* note 1.

40. *Id.*

41. Office of the Chief Accountant, Division of Corporation Finance of the United States Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* 34, Dec. 30, 2008, *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf [hereinafter SEC Report].

42. *Id.*

43. *See id.*

44. *Id.*

45. *Id.*

46. *Hearings*, *supra* note 13, at 211, 213 (statement of James Kroeker, Acting Chief Accountant, U.S. Securities and Exchange Commission).

mark-to-market accounting reemerged as the best tool to equip future generations for a future crisis, much like the one that the economy faces today.[47]

Mark-to-market did not make a full comeback overnight. From the 1940s until the mid-1970s, fair value accounting was essentially non-existent in U.S. financial reporting.[48] In 1975, the use of fair value accounting reemerged and expanded with the issuance of *Statement of Financial Accounting Standards No. 12, Accounting for Certain Marketable Securities*, which mandated that marketable securities be recorded at the "lower-of-cost-or-[market]."[49] In the 1980s, the practice gained even more attention with the onset of the Savings and Loan crisis, which exploited the deficiencies in the historical cost regime.[50]

As banking models changed during America's recovery from the Savings and Loan crisis, the need to establish disclosure and accounting requirements for financial instruments became apparent.[51] Banks were changing their financial strategies as a result of deregulation of interest rates and more active securities markets.[52] New, innovative financial instruments were created and GAAP, unable to keep up with the trends, had to develop accounting practices and procedures to deal with such instruments on a case-by-case basis.[53] Recognizing the deficiencies in the current case-by-case analysis, FASB finally responded by adding an expansive project to its agenda to "address financial reporting issues that were arising, or that were given a sense of urgency, as a result of financial innovation."[54] Between 1986 and 1997, FASB issued multiple pronouncements addressing fair value accounting and accounting for financial instruments, most of which required a fair value valuation.[55]

Since its reemergence in the wake of the Savings and Loan crisis, mark-to-

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47. *Id.*

48. *See* Stephen Zeff, *The SEC Rules Historic Cost Accounting: 1934 to the 1970s*, ACCT & BUS. RES. 49, 54-57 (2007) (Special Issue: International Accounting Policy Forum).

49. *See* SEC Report, *supra* note 41, at 35.

50. *Id.*

51. *Id.* at 37.

52. *Id.* at 36.

53. *Id.*

54. FINANCE ACCOUNTING STANDARDS BOARD, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, STATEMENT OF FINANCE ACCOUNTING STANDARDS NO. 133 § 207 (1998).

55. *See* SEC Report, *supra* note 41, at 37; *see, e.g.,* Finance Accounting Standards Board, DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK, STATEMENT OF FINANCE ACCOUNTING STANDARDS NO. 105 (1990); FINANCE ACCOUNTING STANDARDS BOARD, DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 107 (1991); FINANCE ACCOUNTING STANDARDS BOARD, ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, STATEMENT OF FINANCE ACCOUNTING STANDARDS NO. 115 (1993); FINANCE ACCOUNTING STANDARDS BOARD, REPORTING COMPREHENSIVE INCOME, STATEMENT OF FINANCE ACCOUNTING STANDARDS NO. 130 (1997).

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market has not gone unnoticed. As the Enron debacle unfolded, mark-to-market sparked a heated debate, one which has never completely ceased. One of Enron's fatal schemes involved aggressively accounting for future revenue from its energy contracts in the current period.[56] Under the guise of mark-to-market, Enron estimated the future stream of income from each energy contract and recognized the entire amount as revenue in the current period even though the company had not yet performed on the contract.[57] This practice resulted in a substantial overstatement of income and the masking of losses.[58] Subsequent to the demise of Enron, FASB issued SFAS 157 in 2006 to clarify fair value measurements and avoid future abuses of mark-to-market.[59]

Since Enron, the mark-to-market debate has generated much attention from proponents, critics, and the accounting profession. The subprime mortgage crisis and mark-to-market's role in this situation has fueled the debate and once again brought mark-to-market into the spotlight.

III. THE SUB-PRIME MORTGAGE CRISIS

A. *Causes of the Subprime Mortgage Crisis*

To understand mark-to-market's role in the subprime crisis, an overview of the current crisis is necessary. There are many factors that have contributed to the current economic crisis, including changes in the regulation of financial institutions,[60] securitization of subprime mortgages,[61] and the failure of the credit rating agencies.[62]

1. Changes in the Regulation of Financial Institutions

In the 1970s and 1980s, the government recognized that owning a home was the "American dream."[63] But, it also recognized that increased home prices put this dream out of reach for many people, particularly those with

56. ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 101 (Nancy B. Rapoport & Bala G. Dharan, eds. 2004).

57. *Id.*

58. *Id.* at 103.

59. *See generally* SFAS 157, *supra* note 21.

60. *See* Rayth T. Myers, *Foreclosing on the Subprime Loan Crisis: Why Current Regulations are Flawed and What is Needed to Stop Another Crisis from Occurring*, 87 OR. L. REV. 311, 317-18 (2008).

61. Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 7 (2009).

62. *Hearings*, *supra* note 13, at 153 (statement of Robert Herz).

63. Board of Governors of the Federal Reserve System, *Interest-Only Mortgage Payments and Payment-Option ARMs – Are They for You?*, FEDERALRESERVE.GOV, Nov. 2006, http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf.

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lower income or poor credit.[64] To facilitate home ownership, many lenders began offering more loans in greater amounts to high-risk borrowers who may have otherwise been unable to obtain financing.[65] These "subprime" loans allowed high-risk "borrowers to purchase homes or refinance existing loans" and provided favorable terms to lenders by requiring "higher fees and interest rates" to compensate lenders for the added risk.[66]

Prior to this time, lenders were limited in adopting risk-based pricing standards.[67] State laws capped the interest rates that banks could charge, resulting in banks restricting lending only to those with good credit history, in effect freezing riskier borrowers out of the market.[68] Additionally, banks were limited to fixed-rate mortgages, which offered lower returns, causing banks to carefully evaluate the risks before lending money to even the safest borrowers.[69] Without adjustable rate mortgages, lenders could not justify taking on the risk of default with so little upside potential.[70]

In the early 1980s, two federal laws were enacted to encourage banks to lend money to higher-risk borrowers.[71] First, the Depository Institutions Deregulation and Monetary Control Act of 1980 permitted lenders to charge higher interest rates by preempting state interest rate caps.[72] Then, two years later, the Alternative Mortgage Transaction Parity Act of 1982 was enacted, permitting adjustable-rate mortgages and balloon payments.[73] The combination of the deregulation of lending terms and the availability of more accurate risk-based pricing promoted "subprime" lending, permitting higher-risk borrowers to obtain financing to purchase homes or refinance.[74] This was the beginning

64. Myers, *supra* note 60, at 311.
65. *Id.*
66. *Id.*
67. Zywicki & Adamson, *supra* note 61, at 6.
68. *Id.* at 6-7.
69. *Id.* at 6.
70. *See id.* at 6-7.
71. *Id.* at 6.
72. *See* Pub. L. No. 96-221, 94 Stat. 132 (1996) (codified in scattered sections of Title 12 of the United States Code).
73. *See* 12 U.S.C. §§ 3801-3806 (2009).
74. Zywicki & Adamson, *supra* note 61, at 6; *see also* Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve System, Fed. Deposit Ins. Corp. and the Office of Thrift Supervision, *Expanded Guidance for Subprime Lending Programs* 2 (Jan. 31, 2001), *available at* http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf ("The term 'subprime' refers to the credit characteristics of the individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.").

of the subprime mortgage market.[75]

Since this deregulation, the subprime mortgage market has become a big business, representing a large growth segment of the mortgage market.[76] From 1994 to 2005, the subprime mortgage market increased "from $35 billion to $665 billion."[77] Unfortunately, this increase has come at a great cost to families who, just a few years ago, were living the "American dream" in their own new home.[78] These families have had their homes taken away as a result of the increasing number of foreclosures, which are often the consequence of their own default.[79] Most of these defaults and foreclosures are not due to changes in income or unforeseen circumstances.[80] Instead, they are the result of unfavorable lending terms and unmanageable increases in payments on an interest-only or adjustable rate mortgage.[81]

2. Securitization

Mortgage securitization also played a role in the growth of the subprime mortgage market.[82] In its most basic form, securitization is "the aggregation and pooling of assets with similar characteristics in such a way that investors may purchase interests or securities backed by those assets."[83] First, the originator – here the bank that holds the subprime loans – pools the loans and sells them to an issuer.[84] The issuer then "issu[es] tradable, interest-bearing securities" to finance the purchase of the pooled assets.[85] These securities are sold to investors, who receive payments funded by the cash flows generated by the underlying loans (hence the reference to mortgage-backed securities).[86]

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75. *See* Myers, *supra* note 60, at 311-12.

76. *Id*.

77. Ellen Schloemer et al., *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* 7 (2006), http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf. This number decreased "to $650 billion in 2007." Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 407 (2007).

78. *See* Schloemer et al., *supra* note 77, at 7.

79. *See id*.; *see also* Myers, *supra* note 62, at 312.

80. Schloemer et al., *supra* note 77, at 8.

81. *Id.* The specific terms of interest-only and adjustable rate mortgages are outside the scope of this document. For a basic discussion, see Board of Governors of the Federal Reserve System, *Interest-Only Mortgage Payments and Payment-Option ARMs – Are They for You?*, FEDERALRESERVE.GOV, Nov. 2006, *http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf* (generally describing Interest-Only and Adjustable Rate mortgages).

82. Zywicki & Adamson, *supra* note 61, at 7.

83. SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES 1-3 (Ronald S. Borod, ed. 1994) (1991).

84. Andreas Jobst, *What is Securitization*, FIN. & DEV. 48 (2008).

85. *Id.*

86. *Id.*

Once the subprime mortgages are securitized, they are often split into tranches through a process called "subordination."[87] These tranches represent different levels of risk and are sold separately.[88] Each tranch is given a credit rating, rather than an overall credit rating for the entire group.[89] Investment returns and losses are allocated among the tranches by seniority, with the least risky tranch having the first claim on the income from the underlying assets.[90]

Securitization allows banks to generate additional sources of funding by moving assets off of their balance sheet (and on to the balance sheet of another financial institution) or by borrowing against the assets.[91] This risk-sharing and creative capital generation has changed the nature of the lender/borrower relationship.[92] Traditionally, the lender was risk averse, closely scrutinizing its loan books and making cautious lending decisions with the knowledge that the lender alone assumed all responsibility for each and every loan.[93] Additionally, the loan would remain on the books of the lender, providing the investors with a clear picture of the lender's leverage.[94] Securitization changed the traditional lender/borrower relationship, delegating the traditional responsibilities of the lender among many separate stakeholders.[95] Because they could spread the risk and remove the subprime loans from their books, lenders became imprudent, relaxing their lending standards as a result of their decreasing risk exposure.[96]

3. Failure of Credit-Rating Agencies

Credit-rating agencies have also been blamed for their part in the subprime mortgage crisis.[97] After subprime mortgages are securitized and divided into tranches, each tranch is given a credit rating, rather than an overall credit rating for the entire group.[98] Unfortunately, due to other causes of the subprime

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87. Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* 29 (Wharton Financial Institutions Center Working Paper No. 07-43, March 2008), *available at* http://www.newyorkfed.org/research/staff_reports/sr318.pdf.

88. Jobst, *supra* note 84, at 49.

89. *Id.*

90. *Id.*

91. *Id.*

92. *See* Mott & Deans, *supra* note 2, at 5.

93. *Id.*

94. *Id.*

95. *Id.* at 6.

96. *See id.* ("[a]t the loan origination point, inadequate and sometimes fraudulent information was often collected about borrowers which ultimately undermine the ability of all other portions of the securitization structure to operate effectively. To put it bluntly, without detailed and accurate information about the borrower and the property, it's garbage in, garbage out.").

97. Erin M Wessendorf, Note, *Regulating the Credit Rating Agencies*, 3 ENTREPREN. BUS. L.J. 155, 166 (2008).

98. Jobst, *supra* note 84, at 49.

mortgage crisis, particularly adjustable rate mortgages, the default rate of the underlying mortgages were higher than the credit rating agencies predicted.[99] The failure of the credit rating agencies to properly account for the subprime mortgages resulted in a severe downgrading of the securitized investments, ultimately leading to a decrease in investor confidence and drying up the market for these mortgage-backed securities.[100]

IV. MARK-TO-MARKET'S ROLE IN THE CURRENT ECONOMIC CRISIS

It is difficult to imagine how accounting policies and procedures are being blamed for causing the current economic crisis considering they do not apply until long after subprime loans are made. In fact, mark-to-market does not come into play until after the investments are securitized and sold to investors. Even still, until the underlying loans began to noticeably default, mark-to-market posed no problems to financial institutions.

Mark-to-market did not cause the current crisis, but it has played some role in the current affairs of our economy. Its role has been to deliver the stories of the misdeeds of financial institutions, securitization, and credit rating agencies to the front door of every American. Rather than a cause of the crisis, mark-to-market is merely the messenger; and, as the old adage goes, don't shoot the messenger.[101]

The argument of mark-to-market's critics is as follows: Over the past few decades, banks have been making risky loans in the ordinary course of business. Banks then securitized these loans into bundles and sold them to the public to generate more capital and increase their lending capacity.[102] Banks leveraged themselves with these bundles, and, under GAAP, they were required to report these securities at fair value, rather than historical cost, in accordance with SFAS 157.[103] Because SFAS 157 requires the fair value of securities to be determined by the market if it is "observable," reporting entities had to write down the value of their securities to the market price, which substantially overstated losses because the market for these securities was illiquid or non-existent.[104] The exaggerated losses drove the values of the securities down further, affecting capital adequacy ratios, and tightening the availability of

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99. Wessendorf, *supra* note 97, at 166.

100. *Id.*

101. *See generally* Mott & Deans, *supra* note 2.

102. Jobst, *supra* note 84, at 49.

103. *See* Steve Forbes, *Obama Repeats Bush's Worst Mistakes*, WALL ST. J., Mar. 6, 2009, at A13; *see also* John M. Berry, *Mark-to-Market Rule Gives More Clarity: Not Less*, BLOOMBERG.COM, Apr. 3, 2009, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_berry&sid=ajc25z7IOrTk.

104. *See* Berry, *supra* note 103; *Hearings*, *supra* note 13, at 114 (statement of Thomas Bailey).

credit to consumers.[105] In reality, critics argue, most of the underlying loans are substantially performing and mark-to-market has caused a severe overstatement of losses.[106] Critics claim that, despite the minimal actual losses, mark-to-market forces banks to overstate losses to the point where they appear to be insolvent, resulting in bank failures and causing a meltdown of our financial system.[107] According to critics, abandoning mark-to-market would have prevented the economic crisis.[108]

Notwithstanding the flaws in their argument, the critics are right about one thing: without mark-to-market accounting, we would not be in the midst of an economic and financial crisis *right now*. What they fail to recognize, however, is that the crisis undoubtedly would have presented itself sometime in the future and its effects may have been considerably more devastating than they are today.[109] Of course there is the chance that the value of mortgaged-backed securities would rise to pre-crisis levels in the future, but with $1.2 trillion in subprime loans outstanding[110] and more subprime loans being made every day, the probability that we would escape *all* of the consequences of this ticking time bomb is virtually non-existent. Mark-to-market accounting may have temporarily tightened credit for the average American, but it has warned this country of the current problems early enough to fix them before more damage is done.

Notably, the critics' basic argument is flawed for three reasons: (1) the argument is based on a misconception regarding SFAS 157; (2) SFAS 157's application in illiquid markets is not as rigid and strict as critics allege; and (3) mark-to-market's affect on capital adequacy requirements is overstated. Furthermore, mark-to-market has fulfilled its intended role by detecting a problem at the point where it can be remedied.

A. Misconceptions Regarding SFAS 157

Much of the recent debate over mark-to-market accounting has centered around SFAS 157.[111] Many scholars blame SFAS 157 for implementing fair value accounting.[112] This argument is fundamentally flawed because SFAS

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105. *Hearings*, *supra* note 13, at 152 (statement of Robert Herz).

106. Berry, *supra* note 103.

107. *See* Forbes, *supra* note 103, at A13.

108. *Hearings*, *supra* note 13, at 198, 201 (statement of William M. Isaac, Chairman, The Secura Group of LECG, Former Chairman, Federal Deposit Insurance Corporation).

109. *See id.* at 204. ("[t]he dark cloud on the horizon was about $1.2 trillion of subprime mortgages[.]").

110. *Id.*

111. *Hearings*, *supra* note 13, at 157 (statement of Robert Herz).

112. *See Mark-to-Market Accounting: Practices & Implications: Hearing before the Subcomm. On Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*,

157 did not resurrect mark-to-market accounting.[113] In fact, SFAS 157 does not even expand the use of the mark-to-market valuation.[114] As previously mentioned, fair value accounting has been used for decades.[115]

When FASB adopted SFAS 157, its purpose was to "[improve] the consistency and comparability" of mark-to-market measures by providing a uniform definition of fair value, establishing the hierarchy to arrive at a fair value estimate, and expanding disclosures regarding fair value measurements.[116] SFAS 157 does not change the assets and liabilities that entities are required to report at fair value.[117] There is no language in SFAS 157 indicating which assets or liabilities should be marked-to-market.[118] Instead, SFAS 157 only applies to clarify other accounting pronouncements that have required or permitted a fair value measurement for years.[119]

The fact that SFAS 157 did not implement mark-to-market undercuts the argument that mark-to-market accounting is "the principle reason why our financial system is in a meltdown."[120] This argument is based on the presumption that mark-to-market is new, when in fact it has been around, and used, for decades.[121] Critics say that resurrecting mark-to-market in 2006 (effective in 2007) caused the financial crisis,[122] but if mark-to-market is the *principal* cause, it seems that this crisis would have occurred earlier; sometime in the past twenty years during which mark-to-market has been used. A practice that is as flawed and destructive as critics allege would not have been able to withstand the test of time. If mark-to-market, is the *principal* reason for the current crisis, would not it have caused an impact earlier?

B. Illiquid Markets Cause Substantial Write-Downs

GAAP currently defines fair value based on an exit price, from the point

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111th Cong. 2 (2009) [hereinafter "CMSA Testimony"] (statement of the Commercial Mortgage Securities Association), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/cotton0312 09.pdf ("[Fair value accounting] is implemented in the United States through Statement of Financial Accounting Standards ("SFAS") 157."); *see also* Forbes, *supra* note 103 ("Mark-to-market was resurrected by the Financial Accounting Standards Board and became effective in the fall of 2007[.]").

113. *Hearings*, *supra* note 13, at 157 (statement of Robert Herz).

114. *Id.*

115. *See supra* note 40 and accompanying text.

116. *Hearings*, *supra* note 13, at 157 (statement of Robert Herz); *see also* SFAS 157, *supra* note 21, § 1.

117. *Hearings*, *supra* note 13, at 157 (statement of Robert Herz); *see also* SFAS 157, *supra* note 21, § 2(c).

118. *See generally* SFAS 157, *supra* note 21.

119. *Id.* § 2

120. Forbes, *supra* note 103.

121. *See supra* note 40 and accompanying text.

122. Forbes, *supra* note 103.

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of view of a market participant.[123] SFAS 157 specifically points out that fair value is not based on a "forced transaction."[124] In a market like today's, one that is characterized by a lack of trading volume, observable inputs, and willing buyers, critics of mark-to-market argue that the fair value measurements are severely overstated because they are forced to use observable inputs from any observable market, values that they argue are equivalent to a fire sale or a forced liquidation.[125]

Critics say that the fair value hierarchy established in SFAS 157 is problematic in illiquid markets.[126] In theory, they admit that the three level hierarchy should provide sufficient flexibility, allowing a reporting entity to use the most appropriate level while taking into account the current market conditions.[127] This system would allow entities to use Level 3 inputs to derive realistic fair value valuations in an illiquid market.[128] But in practice, critics claim that this flexibility is lacking.[129] The language of SFAS 157 does not require a liquid or efficient market, but requires only an "observable" market.[130] As a result, critics say, entities must report their securities at overly depressed values, which are the result of a current illiquid market, rather than at a more realistic valuation based on other factors.[131] These depressed values generate real losses, most of which, it is argued, are the result of book write-downs and not actual losses.[132]

Even assuming the critics are correct in their assessment of the current mark-to-market standards in illiquid markets, their problem is not with mark-to-market accounting; rather, it is with the application of the current fair value rules. It may be true that a large amount of banks' recent losses may be overstated by the use of mark-to-market. It also may be true that mark-to-market, as it is currently implemented by reporting entities, may be exacerbating these losses. However, this exacerbation has more to do with reporting entities' interpretation and application of the rule than the rule itself.[133]

Contrary to the critics' belief, FASB previously addressed the application

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123. SFAS 157, *supra* note 21, § 7.
124. *Id.*
125. *See Hearings*, *supra* note 13, at 114 (statement of Thomas Bailey).
126. *See id.* at 99, 110 (statement of Kevin Bailey).
127. CMSA Testimony, *supra* note 112, at 3.
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *See* Forbes, *supra* note 103.
133. Sarah Johnson & Marie Leone, *Congress Members Fume at Fair Value*, CFO.COM, March 12, 2009, http://www.cfo.com/printable/article.cfm/13306816.

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of mark-to-market in illiquid markets in October 2008.[134] According to FASB's statement of guidance, in determining the fair value of a security in a dislocated market, it cannot be presumed that all market activity represents a forced sale based on the illiquid or inactive market alone.[135] However, it is equally as inappropriate to conclude that *any* transaction price is determinative of fair value.[136] Instead, the fair value determination is dependent on "the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales."[137]

Given FASB's recommendation that entities use judgment in determining the fair value of a security in an illiquid market, the argument that the mark-to-market hierarchy causes extreme undervaluation loses force. Mark-to-market is not meant to be a rigid standard, despite the allegations of its critics. Rather than requiring strict adherence to a black-letter rule to determine fair value, mark-to-market is a flexible, principle-based approach, requiring some level of judgment on the part of the reporting entity.[138]

C. Effect of Mark-to-Market on Capital Adequacy Requirements

The interplay between mark-to-market and capital adequacy requirements, often called capital reserve requirements, has been blamed for the bank failures during the subprime mortgage crisis. Capital adequacy requirements were established to prevent banks from taking on excessive risk.[139] These requirements mandate that financial institutions maintain a certain level of capital – excess of assets over liabilities – as a "cushion against insolvency."[140] To comply with these rules, a bank must maintain an amount of capital equal to a determined percentage of its assets.[141] The requisite percentage is determined in accordance with the Basel I Framework.[142]

Critics argue that mark-to-market has caused financial institutions to overstate trillions of dollars in losses.[143] When these losses are reported, critics

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134. *See* FASB Staff Position, FAS No. 157-3, § 1 (Oct. 10, 2008).

135. *Id.* at § 9(a).

136. *Id.*

137. *Id.*

138. *Hearings, supra* note 13, at 159 (statement of Robert Herz).

139. JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 284 (1992).

140. *Id.*

141. *Id.*

142. *Hearings, supra* note 13, at 101 (statement of Kevin Bailey). A complete discussion of the Basel I Framework is beyond the scope of this document. It should also be noted that federal banking agencies adopted the Basel II Framework in 2007, which is expected to be implemented in 2011. *Id.* at 102; *see generally* Robert F. Hugi et al., *U.S. Adoption of Basel II and the Basel II Securitization Framework*, 12 N.C. BANKING INST. 45 (2008).

143. Berry, *supra* note 103.

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say, banks fall below their regulatory capital requirements, rendering them insolvent. If banks do not fail as a result of their insolvency, critics argue that the extreme losses decrease their capital so low that it becomes impossible for them to lend money.[144] As a result, the ripple effect is that the average American is unable to obtain a loan.

While mark-to-market may have contributed to the unavailability of credit by calling attention to the thin capitalization of banks, it has not caused banks to fail. In response to the allegation that mark-to-market is to blame for the recent bank failures, the SEC conducted a study of the twenty-two banks that failed between 2006 and 2008.[145] After individually evaluating the failed banks, the SEC determined that fair value accounting was not the primary cause of *any* of these bank failures.[146] The most significant factor, according to the SEC, was the underlying lending activities of the failed banks.[147] In fact, for most of the failed banks, mark-to-market was applied only in "limited circumstances."[148] Credit losses (actual losses on extended credit) were the cause of the decrease in capital adequacy, not the recognition of fair value declines.[149]

Mark-to-market has undoubtedly resulted in some level of decline in regulatory capital, which has, in turn, decreased the availability of loans to the average American. However, the effects of fair value accounting on regulatory capital are often overstated. In general, only changes in fair value that flow through earnings are included in the regulatory capital requirements.[150] In contrast, if the losses do not flow through income, they are generally not included in the regulatory capital requirements.[151] As a result, only write-downs of trading securities and OTTI securities are included in determining whether capital adequacy requirements are met.[152] Considering that banks only use fair value accounting in "limited circumstances," and some of these "limited circumstances" have no effect on capital adequacy requirements, mark-to-market's impact on the availability of credit is limited, at best.

Furthermore, the use of mark-to-market accounting in those "limited circumstances" is an appropriate reflection of the banks' current financial and

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144. Paul Gigot, *Future of Finance (A Special Report) –No Easy Answer: Three Finance Experts on Mark-to-Market Accounting, Foreclosure Protection, and China's Economic Warning*, WALL ST. J., Mar. 31, 2009, at R11.

145. *See* SEC Report, *supra* note 41, at 98.

146. *Id.* at 125.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Hearings*, *supra* note 13, at 103 (statement of Kevin Bailey).

151. *Id.*

152. *See id. at* 103-04.

economic position.[153] Capital adequacy requirements are meant to protect depositors and investors.[154] By maintaining sufficient levels of capital, banks make investment less risky for the investors by attempting to ensure that they will be able to recoup their deposit or investment at some time in the future.[155] Because many of the assets valued at fair value are held with the intent to trade or sell in the near future, reporting them at fair value gives an investor the real picture of what a bank would recover if the assets were sold in the current period. In making the decision to invest, the current solvency and viability of the investment is an important factor. Only mark-to-market can provide such a current depiction of the financial situation.

D. Mark-to-Market has Served its Intended Purpose

Arguably, mark-to-market has been successful in serving the purpose for which it was established. As previously stated, after a period of extinction, mark-to-market was reinvigorated in response to the Savings and Loan crisis of the 1980s.[156] It has been argued that the mark-to-market approach would have helped to reveal the problems with savings and loan institutions earlier, which could have prompted change and reversed the problem at a lower cost.[157]

The Savings and Loan crisis exploited the deficiencies in the traditional accounting system used subsequent to the Great Depression. During the 1980s, savings and loan institutions carried their assets at historical cost.[158] As interest rates were driven up by high inflation, savings and loans were in the position that, if they were to sell their mortgaged assets, they would have to severely discount them because they were no longer worth the book value, which was recorded at historical cost.[159] Instead, because they could continue to carry these mortgaged assets at historical cost, banks could avoid the reality of their desperate financial situations.[160] In fact, that is exactly what they did: banks held the depressed assets to avoid recognizing losses, but they continued to lend.[161] Had they had to revalue these assets at fair market value, liabilities would have exceeded assets, rendering many institutions economically insolvent.[162]

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153. *Id.* at 103.

154. *See* MACEY & MILLER, *supra* note 139, at 284.

155. *See id.*; *see also Hearings*, *supra* note 13, at 101-02 (statement of Kevin Bailey).

156. *See* Williamson & Scannell, *supra* note 4.

157. Franklin Allen & Elena Carletti, *Mark-to-Market Accounting and Liquidity Pricing*, 45 J. OF ACCT. & ECON. 358, 376 (2008).

158. SEC Report, *supra* note 41, at 35.

159. *Id.*

160. *Id.* at 36.

161. *Id.*

162. *Id.*

In response to the deficiencies of the historical cost system exploited during the Savings and Loan crisis, previous generations reinstituted a mark-to-market system to provide a more accurate picture of the *current* financial status of the banks.[163] Investors want to know what they would lose if a bank failed today. As the Savings and Loan crisis demonstrated, a bank's ability to keep extending credit when it is effectively insolvent can have a disastrous outcome.

Mark-to-market has accomplished its goal by effectively preventing another exploitation of the historical cost system, like this country saw in the 1980s. Banks, now required to report the fair value of certain assets, specifically mortgage-backed securities, cannot continue to lend carelessly, unscathed by the consequences of their actions. Mark-to-market accounting has drawn attention to the problems of subprime mortgages and securitization before these problems had a chance to grow to the level of the Savings and Loan crisis. Thanks to mark-to-market accounting, we have been warned that something is wrong in our financial system.

Mark-to-market is the vehicle that saved this country from further destruction; it is not the cause of the current crisis. Had mark-to-market not brought the current situation to our attention, the risky lending practices, securitization of subprime mortgages, and optimistic credit rating would have continued for years. America may not have felt the urgency of the situation like it does today; but at some point, the effects of subprime lending would have been felt, potentially on a much larger scale. Instead of shooting the messenger and abandoning mark-to-market, we should find the real culprits and fix the problem before the economic situation worsens, hopefully at a lower cost to banks and citizens alike.

V. FASB'S ORIGINAL STANCE, CHANGES, AND RECOMMENDATIONS

A. FASB's Original Stance on Mark-to-Market

In response to the public outcries to abandon mark-to-market accounting, FASB has remained strong in its position that mark-to-market is here to stay.[164] Despite its opposition, many investors, financial analysts, and others have indicated that fair value accounting is "instrumental in providing financial statement users with important information about the current values of a company's financial assets and with better and more timely information about the risks faced by financial institutions in the current environment."[165] In fact,

163. *See* Arthur Levitt, *Weakening a Market Watchdog: An Accounting Rule Change's Real Costs*, WASH. POST, Mar. 26, 2009, at A21.

164. *See generally Hearings*, *supra* note 13 (statement of Robery Herz) (explaining FASB's current position on mark-to-market accounting).

165. *Id.* at 166.

the CFA Institute recently conducted an online survey of more than 2000 investors and, of those surveyed, seventy-nine percent indicated that for financial institutions, fair value accounting "improves transparency and contributes to investor understanding about risk."[166] In making an investment decision, investors want to know what banks would stand to lose if their investments were sold immediately.[167] Only mark-to-market accounting can provide this current, ever-changing information.

1. Recent Changes

On April 9, 2009, FASB slightly backed down from its staunch position, issuing final guidance on mark-to-market accounting and accounting for impaired securities.[168] Included in this guidance is further instruction on how to determine fair value in an inactive or illiquid market.[169] By providing a list of factors, FASB has instructed reporting entities to determine whether the market for an asset, although active, has suffered a significant decrease compared to normal market activity.[170] After this determination is made, the reporting entity must further analyze the transaction and inputs to determine fair value.[171] Consistent with the principles-based nature of mark-to-market accounting, the fair value determination must be consistent with the overall objective of estimating the orderly sale price under current market conditions.[172]

Some financial institutions do not expect the guidance on mark-to-market to meaningfully impact their earnings.[173] But, FASB's guidance on accounting for impaired securities marks an obvious deviation from their once strong position.[174] Prior to the issuance of this guidance, an entity had to assert that it had the intent and ability to hold the asset until the value recovers to avoid being classified as OTTI.[175] Under the new rule, an entity only must assert that it is "more likely than not" that they will hold onto the security and not be required to sell it before recovering the amortized cost basis.[176] The effect of

166. Herz & MacDonald, *supra* note 1, at 1.

167. Levitt, supra note 163.

168. *FASB Issues Final Staff Positions on Mark-to-Market, Impairments*, 77 U.S.L.W. 2611, Apr. 14, 2009 [hereinafter FASB Positions].

169. *See* FASB Staff Position, FAS No. 157-4 (Apr. 9, 2009).

170. *Id.* § 12.

171. *Id.* § 13.

172. *Id.* § 14.

173. FASB Positions, *supra* note 168.

174. *See* FASB Staff Position, FAS No. 115-2 and FAS No. 124-2 §§ 19, 21 (Apr. 9, 2009) [hereinafter FAS 115-2 and FAS 124-2].

175. Kara Scannell, *FASB Eases Mark-to-Market Rules*, WALL ST. J., April 3, 2009, at C1.

176. FAS 115-2 and FAS 124-2, *supra* note 174, § 7.

this rule is that management has more discretion in determining whether an asset is impaired.[177]

Since changes in the fair value of OTTI securities flow through income and affect capital adequacy, this change has weakened mark-to-market's role as a market "watchdog" that will alert investors when something is amiss.[178] The rule cannot serve its purpose without reliable information.[179] If management is able to distort the financial statements using its judgment, mark-to-market is less effective as a warning device.

Additionally, FASB made another significant change to accounting for impaired securities.[180] Once an investment is deemed to be OTTI, only credit losses (losses related to the underlying creditworthiness) will be recognized in income and, in turn, affect regulatory capital.[181] A decline in fair value of the security due to the market condition will be recognized in other comprehensive income, having no effect on regulatory capital.[182]

For OTTI assets, banks have generally indicated their intent (at least their likely intent) to hold onto the asset until it recovers.[183] Since losses on OTTI assets will most likely be postponed for a period of time, perhaps only credit losses (or *actual* losses resulting from the underlying obligation) should be counted in calculating regulatory capital. Even conceding this position, altering the financial information reporting requirements is not the most effective way to accomplish this goal.[184] The same result is more appropriately achieved by amending the regulatory mechanisms for determining capital adequacy.[185]

B. *Recommendations*

1. FASB Should Maintain its Original Stance on Mark-to-Market

After every federal election, there is a push to change accounting rules in the process of broad regulatory renovation.[186] Mark-to-market should not be abandoned as part of this initiative. Recognizing that fair value accounting is far from perfect, it has served its purpose in detecting the current crisis quickly and delivering the message to American stakeholders. Previous generations, in

177. Scannell, *supra* note 175.
178. *See* Levitt, *supra* note 163.
179. *Id.*
180. *See* FAS 115-2 and FAS 124-2, *supra* note 174, § 19, 21.
181. *Id.* § 4.
182. *Id.*
183. *See supra* notes 175-76 and accompanying text.
184. *See Hearings*, *supra* note 13, at 152 (statement of Robert Herz).
185. *See id.*
186. *See* Williamson & Scannell, *supra* note 4.

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response to first-hand experience, equipped us with the tools to uncover an emergency in the making.[187]

FASB should not back down in its support of mark-to-market. As an independent organization,[188] FASB should not give in to political or economic pressures. Its primary role is to promulgate accounting standards to increase the transparency of financial reporting, providing investors with clear and accurate information on which to base investment decisions.[189] By implementing and clarifying mark-to-market, FASB has accomplished its objective and should maintain its position, despite biased opposition.

Blaming mark-to-market for causing the recent economic crisis is counterproductive. Mark-to-market did not cause the subprime mortgage crisis, nor can it end it.[190] Although abandoning mark-to-market would put money back into the lending pool, it would not fix the underlying problems that caused the subprime mortgage crisis. The defaulting loans would still exist and mortgage-backed securities are not likely to recover. In effect, abandoning mark-to-market would simply be covering up the problem and hoping it disappears. We need to identify the true culprits and fix the problem before it gets worse. Simply ignoring the issue and blaming the messenger will not bring the economy out of this recession. FASB should maintain its original stance on mark-to-market and remain strong in the face of political and economic pressure to provide a "quick fix" for the problems plaguing the financial industry.

2. Use of Pro Forma Financial Statements

Although mark-to-market can't end the crisis, it should not make it worse.[191] Without eliminating such an important tool in crisis prevention, the accounting profession already has an additional tool to deal with unusual or non-recurring losses, such as those caused by mark-to-market accounting: pro forma financial statements.

Pro forma statements provide a financial picture of a reporting entity without factoring in unusual or non-recurring transactions.[192] It is plausible to characterize this recession and the resulting decreases in the market prices of securities as unusual. FASB should allow reporting entities to utilize pro forma statements in connection with large write-downs in assets in an attempt to

187. *See Hearings*, *supra* note 13, at 213 (statement of James Kroeker).

188. *Hearings*, *supra* note 13, at 146-47 (statement of Robert Herz).

189. *Id.* at 4.

190. *See* Johnson & Leone, *supra* note 133.

191. *See id.*

192. *See* John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 68 n.379 (2003).

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restore investor confidence.

Using pro forma statements, stakeholders could still benefit from the messenger function that mark-to-market serves, while getting a more realistic picture of actual losses incurred. Instead of valuing losses by marking-to-market, reporting entities could use a "mark-to-model" theory to report the fair value of securities on pro forma statements, using more subjective inputs (Level 3) such as expected cash flows from the underlying assets.[193] Of course, the valuation used would have to be disclosed, in detail, in the footnotes of financial statements in accordance with the requirements of SFAS 157.

Using pro formas, investors would be provided with two sets of financial statements: the financial statements derived by using GAAP and pro forma financial statements offering a more subjective, realistic value based on actual losses or cash flows. After reading and analyzing the "mark-to-model" theory used to determine the fair value of a security, investors could compare the pro forma financial picture with the mark-to-market financial picture. From there, investors could make their own determination as to whether the reporting entity is viable, solvent, or a good investment.

"Mark-to-model" may provide a more realistic financial picture over the long term, but mark-to-market serves an independent purpose. Since we have seen our current system work to uncover a potential disaster, we should not abandon it at the demand of political and economic opposition.

VI. CONCLUSION

Mark-to-market did not initiate the financial crisis, but it delivered the stories of the misdeeds of financial institutions, securitization, and credit rating agencies to the front door of every American. Since the 1970s, banks have been making risky lending decisions, securitizing these loans to generate more capital, and selling them to investors using overly optimistic credit ratings. Yet, despite all of these culprits that *should* be blamed for the subprime mortgage crisis, mark-to-market accounting is taking the heat for its role in the current state of the economy: the role of the messenger.

The role of mark-to-market as the bearer of bad news is important to recognizing and preventing a crisis like the Savings and Loan crisis of the 1980s. After realizing the deficiencies of the historical cost system, previous generations recognized the importance of current information regarding the values of a reporting entity's financial assets. Investors want to know what banks would stand to lose if their investments were sold immediately. Mark-to-market provides this timely, ever-changing information, permitting investors to

193. *See generally* SFAS 157, *supra* note 21 (defining standards for calculation of fair value measurements).

better evaluate the risks associated with their investments.

Despite its opposition, mark-to-market should not be abandoned. It has served an important role in detecting and reporting the problems created by subprime lending. Although FASB has made some minor changes to fair value accounting in general, it appears that mark-to-market is here to stay.

To turn this economy around, we need to identify the true culprits of the subprime mortgage crisis and fix the problem before it gets worse. Simply ignoring the issue and blaming mark-to-market accounting will not bring the economy out of this recession. FASB should maintain its original stance on the issue and remain strong in the face of political and economic pressure. After all, there is no reason to shoot the messenger!