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December 23, 2008

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Commission Request for Comment on Mark-to-Market Accounting
File No. 4-573

Dear Chairman Cox:

I appreciate the opportunity to comment on this important issue.

I urge the Securities and Exchange Commission (SEC) to maintain and even to expand the orientation of Generally Accepted Accounting Principles (GAAP) toward market-oriented accounting. This approach, where feasible, is far superior to an historical amortized cost approach or to a discounted cash flows approach, since it makes use of the information that the collective actions and beliefs of the participants in markets can provide. The alternatives provide too much discretion to incumbent managements to adjust information in ways that provide them with a valuable option that benefits them (and, often, their shareholders) at the expense of creditors and (in the case of depository institutions) the deposit insurance agencies.[1]

The market-oriented accounting approach works best when markets are thick and liquid. At the other extreme, where there are no markets for an asset, then per force a modeling approach is necessary (with, of course, oversight and review by a company's auditor). The difficulties and ambiguities arise when markets are thin and illiquid. This has been arguably the case for the mortgage-related securities that have bedeviled the financial sector for the past 18 months.

In such instances of thin and illiquid markets, I urge the SEC to maintain an orientation toward market information but also to recognize that some modeling is necessary, so as not to rely on unrealistic and unrepresentative "fire sale" prices. But this modeling should not be used as an excuse to rely excessively on historical costs or on discounted cash flows.

[1] I advance this opinion as a former regulator of the savings and loan (S&L) industry. From November 1986 until August 1989 I was one of the Board Members of the Federal Home Loan Bank Board, which had responsibilities for regulating the S&L industry and for providing deposit insurance to the S&L industry through the Federal Savings and Loan Insurance Corporation (FSLIC).

Let me offer as an illustration the following example: If a bank were to consider a personal loan to an individual, it would want to know that individual's net worth. Included in that net worth would be the net asset value of the individual's house (if owned). Houses are generally considered to be in thin and illiquid markets. So, what is the value of a house?

There is clearly a range of possible answers to this question. The bank, as a potential creditor to the individual, would generally not be interested in historical cost – what the individual paid for the house (unless it was very recently purchased, in which case the purchase price could be close to current market value). Similarly, the bank would not be interested in the claim by the individual that she intended to reside in the house for the next 10 years and so only the discounted value (perhaps determined through a cash-flow model) from 10 years in the future should be relevant.

Instead, the bank would be interested in what the house is worth "now" – but the "now" surely would not be represented by "what could the house be sold for within the next 24 hours?" As one alternative, the bank might ask, "what could the house be sold for if the seller had, say, 2-3 months of opportunity to sell it, using a real estate broker, etc.?" This need not involve speculation on trends in house prices in the next 2-3 months but simply a recognition that a reasonable selling effort is necessary to overcome the effects of thin markets. As another alternative, the bank might ask a third-party appraiser to offer an opinion as to the value of the house. The appraiser would likely look at the sales prices of other houses that were recently sold in the same neighborhood and then try to adjust that information for any trends that those other transactions indicated as well as adjusting for the special features of the house in question as compared with those that are the basis for comparison.

Note that both approaches start with an orientation toward market-based information and then uses some modeling (What would 2-3 months of selling effort yield, as compared to 24 hours? How should the sales prices of the comparable houses be adjusted to achieve an estimate of the value of the house in question?) to adjust that market information to something that would be more relevant to the bank as creditor.

I urge the SEC to adopt a similar approach – an orientation toward market information, but the limited use of some necessary modeling, when markets are thin and illiquid – as it considers the structure of GAAP accounting.

As a final comment: I find it truly ironic that the same financial institutions that have reportedly been reluctant to lend to each other over these past few months – because they have distrusted the values on each other's balance sheets and thus have been unsure as to who is really solvent and who is not – are also the financial institutions that argue against market-oriented accounting measures that would make balance sheets more transparent and more reflective of the reality of market-oriented information.

Sincerely,
Lawrence J. White