Did Accounting Regulations Make Community Banking a Riskier Business?
A View of Mark-to-Market Accounting in Georgia Banking

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The Financial Accounting and Standards Board (FASB) sets the tone for accounting practices across a wide array of businesses, including the banking sector. Prior to the 2007-2009 Recession, the FASB adopted rule modifications, known as FAS157 that changed the way business were supposed to value assets. The intent of the rule change, from an accounting standpoint, was to make business operations more transparent. During the US housing market collapse and subsequent financial turmoil, Georgia became home to a disproportionately large number of both housing foreclosures and bank failures. The changes adopted by the FASB that took effect in November 2007 likely made community-based banks, especially those located in high-growth areas like Georgia, riskier, not safer.

The Vicious Cycle
The new standard expanded mark-to-market valuation to more assets held by banks. A major issue with mark-to-market prices that has been identified in research is the potential for “negative feedback loops.” In a stable market, the impact of the accounting rule change may have been beneficial to the investor and for banks; however, the timing was unfortunate. The rule changes were made just prior to the onset of the US housing market collapse. The result was a vicious cycle of negative re-valuation, forced fire sales of bank assets, followed by more negative asset re-valuations with the (then current) market prices based on the new fire-sale prices. Mortgage-backed securities were an extreme example of this cycle. Even when many of the mortgages contained in mortgage-backed securities were being paid, the mark-to-market value of these “asset” fell to essentially zero, driving a wedge between the value based on its cash flow and the current market price.

This cycle was especially vicious for smaller banks that, because of their ties to the local housing market and commercial real estate sector, were less able to diversify their asset portfolio. As assets held by community banks lost value, so did the stock price of many of even the strongest publically-traded community-based banks. While federal officials struggled to comprehend the enormity of the problem and formulate a strategy to deal with it for the nation’s largest (too big to fail) banks, community-based banks were already starting to fail. Banks in fast growing states were especially vulnerable. Having contained some of the nation’s fastest growing counties at that time, Georgia became an epicenter of foreclosures and of bank failures.

The graph below depicts an index of 134 publicly-traded community-based banks along with delinquency rates for all loans (in red) and residential properties (in green). In the 3rd quarter of 2006, the US started experiencing a rise in the rate of foreclosure in residential property. In January 2007, the average value of stock in these 134 banks began to decline rapidly. The decline in these banks’ average stock price is likely the result of investors pricing in the risk associated with these banks’ exposure to the housing market and assets backed by real estate. The decline in these banking stocks continued for more than two full years, extending from January 2007 to March 2009, falling from a peak of 1.19 to a minimum of 0.36 (a decline in value of 69.8%).

In March 2009, the FASB initiated a discussion period about the potential of relaxing the mark-to-market rules implemented in late 2007 to help lessen the severity of the cycle of devaluation (denoted in the graph by the light blue vertical bar). Less than two weeks later, the FASB issued the official amendment to FAS157, which provides more guidance on how to fairly value assets and securities that are in illiquid markets. The amendment states that if the market for a security is illiquid, and/or a sale, hypothetical or not, was not orderly (i.e., forced) then management is allowed to use different "techniques" to value those securities, such as discounting cash flows. Early adopters were allowed to apply the ruling as of March 15, 2009, and the rest as of June 15, 2009.

1 The sample of community banks were selected based on the publication American Registry’s Top 200 Publicly Traded Community Banks of 2005. Not all banks’ stock was traded during the period. The sample consists of banks with reported daily stock prices. (see http://www.americanregistry.com/recognition/top-200-publicly-traded-community-banks/22454 for a listing of banks). Delinquency rates are obtained the Federal Reserve Bank (see http://www.federalreserve.gov/releases/chargeoff/delallnsa.htm).
According to a Bloomberg article (March, 30, 2009), it was anticipated that the new amendments could significantly affect banks' statements of earnings and allow them to defer reporting losses. Interestingly, the period surrounding the March-April 2009 discussion period and rule change marks the end of the rapid decline in these 134 community bank stocks. One might argue that these banking stocks stabilized as the mortgage delinquency rates began to subside; however, delinquency rates continued to rise for another year beyond the rule change.

The more likely explanation is that allowing banks (and other businesses) to use potentially more appropriate alternative valuation methods for illiquid assets (or assets for which the markets are frozen) has resulted in stabilization in investors’ risk assessment of the community banking sector. In short, investors, who keenly understand accounting rules, stopped bidding down community bank stock prices once these banks were allowed to be less aggressive in re-valuing their assets. Relaxing FAS157 made these banks less risky from the investor’s viewpoint.

The Consequences of Bank Failures in Georgia
The failure of a bank can stem from variety of different situations, but the risk facing many community banks during the housing market collapse was regulatory failure, or falling below the required capital ratio. Since 2000, Georgia has seen 86 of its banks fall into receivership, and as of January 2013, Georgia accounts for 17.4 percent of closed banks in the US. Although more than 9 in 10 banks that failed in Georgia since 2000 were merged into the operations of an acquiring bank, large numbers of jobs in the banking sector have been eliminated. From peak to trough employment (2006 to 2010), banking-related firms in Georgia lost a total of about 16,000 jobs. Though the recovery has brought some of those jobs back to the state, the loss in labor income (including benefits) associated with these banking jobs accounts for $1-$1.2 billion per year, and the subsequent reduction in banking activity cost the state a total $4.2 billion in directly generated output. The reduction in banking activity also affected other industries. Another $2.8 billion in indirect and induced economic activity was also lost over the period. In total, the reduction in banking activities in Georgia resulted in an estimated economic output loss of $7.0 billion from the employment high to its low. Furthermore, for every banking job lost in the state, another 1.26 jobs were eliminated in other industries.

Community-based banks accounted for the vast majority of bank failures, possibly because of their relatively small size. These community bank failures have had a substantial impact on small businesses’ access to credit. In 2006, banks with assets of less than $10 billion (small banks) made up 55.1 percent of Small Business Administration (SBA) loans, or about $349.4 billion. As the number of small banks declined, so has the share of SBA loans from those banks. In 2011, 52.5 percent of loans originated at small banks or about $318.9 billion. Despite the economic recovery that began in mid-2009, SBA lending has continued to weaken. Both smaller and larger banks are providing fewer dollars in loans to small businesses. From 2010 to 2011, SBA lending at smaller banks declined by 6.2 percent, and at larger banks (with greater than $10 billion in assets), SBA lending fell by 9.2 percent. Given these trend in credit availability, the relative slowness of the economic recovery should come as no surprise.

**Concluding Remarks**

Mark-to-market accounting is not to blame for the housing market problems or the financial crisis the US experienced over the last seven years. In fact, the rule provides investors information they need to make important decisions. However, under certain conditions, mark-to-market can make already existing problems worse. Furthermore, we might always think that more information is better; but, consider the case of publicizing a list of banks that are on the “FDIC Watch List.” Investors would probably like to know who the FDIC may be visiting in the near future. That information would be very helpful in making better investment decisions. However, publicizing a list of banks the FDIC is considering actions against would likely ensure a rapid loss of deposits, further erosion of confidence, and, in the end, an increase in the probability of bank failure. This is one of the primary reasons there was forced participation even among relatively healthy financial institutions in the Troubled Asset Relief Program (TARP). Treasury and Federal Reserve Bank policymakers were worried about the potential for creating panic among investors and depositors and/or further damaging the financial reputation of those banks that the program was targeting. Without wider participation in TARP, accepting TARP funds may have ensured bank failure.

The solution to the vicious cycle problem created by mark-to-market is flexibility in periods of emergency. The April 2009 relaxation of FAS157 allowed banks to slow down the process of writing down assets, preventing further sell-offs and additional write-downs. Circuit-breakers have been used on Wall Street to halt trading during massive panic sell-offs like those that occurred on Black Monday. The purpose of these automatic actions is to reduce massive panic-driven sell-offs and to reduce market volatility. In the 1980s, Latin American debt was allowed to stay on the balance sheets of banks without huge mark-downs. Under typical market conditions, mark-to-market is likely the appropriate way to estimate value for assets; however, during the period between late 2008 through 2009, markets for real estate-related bank assets were far from orderly. This period provides a strong indication that inflexible implementation of mark-to-market valuation standards is not an accounting panacea.

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3 Black Monday refers to October 19, 1987, when the Dow Jones Industrial Average lost more than 500 points, or 22.6 percent in a day.