September 19, 2008

To the Editor of The Wall Street Journal

In Thursday’s Journal, page A25, “Bad Accounting Rules Helped Sink AIG,” Zachary Karabell blames accounting for AIG’s demise. Based on what I can learn from the press, AIG wrote credit default swaps (CDSs) on home mortgage loans, which CDSs said that AIG would pay the holder of the mortgages if the homeowners did not pay. AIG accounted for those CDSs at estimated market prices—that is, the estimated prices that AIG would have had to pay to have another party step into AIG’s shoes in the swap. This is the accounting required by FASB Statements 133 and 157.

As homeowners began to fall behind in their payments on their mortgages and as the market prices of the homes underlying the mortgages also declined, the likelihood of AIG’s having to pay the holders of the CDSs increased as did the estimated amount that AIG would have to pay to the holder of the CDSs. The estimated market prices of the CDSs reflected those variables. This is what can happen when one writes a put option contract on mortgage loans.

I do not know how Karabell would do it or how he would measure it, but he somehow would have AIG not record a liability for the full amount of losses that AIG had suffered to date as a result of the put option contracts AIG had written. He says that amount of liability is not “real.” So, Karabell is not disputing AIG’s accounting for the CDSs; he is complaining about AIG’s having to record the full measure of a liability for a put option contract written by AIG. What would he do—record only a portion of it? The “real” portion? Guess what the SEC and Department of Justice would say to that!

Karabell does not say what he would have the holders of the CDSs do in their accounting for their assets, which is the flip side of AIG’s accounting. Suppose a bank or mutual fund held the CDSs; would Karabell say that the bank or mutual fund may not or should not record as an asset the full market price of the CDSs issued by AIG? That that full market price is not “real”? What would the
shareholders of the bank or mutual fund say to that? Guess what the SEC and the Department of Justice would say to that!

Lots of commentators are questioning the merits of mark-to-market accounting required by the FASB in Statements 133 and 157 for the likes of AIG. To fully understand and appreciate the results of the accounting, those commentators should put themselves in the shoes of investors, say the holders of mutual funds that own these kinds of assets. Look at the accounting by mutual funds where mark-to-market accounting has a long, successful history of communicating valuable information to investors, where that information forms the basis for trading of mutual fund shares on a daily basis. The marketplace says these prices indeed are real.

[Mr. Schuetze was a charter member of the Financial Accounting Standards Board in the 1970s and Chief Accountant at the SEC in the 1990s.]

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