

“Financial Decommodification: Risk and the Politics of Valuation in U.S. Banks.”

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During the global financial crisis of 2008, the American Bankers' Association (ABA) publicly pressured the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) to suspend and/or modify "fair value" accounting rules. The gist of the ABA's argument was that continuing to mark the accounting value of bank assets to current market values had introduced unhealthy volatility into the financial system, and severely undermined the already precarious stability of U.S. banks. Given the extraordinary economic conditions in 2007-2008, financial markets were said to be "illiquid," "thin" and "distressed." Under these circumstances, the bankers claimed, market prices had diverged far from "fundamental" or "intrinsic" asset values, even assuming there were enough transactions to generate a market price. Suspending or weakening "fair value" rules would enable bank valuations to reflect the true worth of assets rather than the "fire sale" prices that then prevailed in markets.¹ Modification would also, the banks claimed, forestall downward spirals where banks would have to raise money in order to comply with bank capital standards, and since this required asset dumping in distressed markets (at "fire sale" prices), asset prices would continue to drop and the problem of non-compliance would worsen rather than improve. These valuation difficulties were particularly acute for over-the-counter (OTC) financial derivatives and swaps (bespoke bilateral contracts between a dealer-banker and a particular client), which seldom had a benchmark market price and were generally enshrouded in opacity. Supposedly, OTC participants could privately manage risk through the appropriate use of measures like credit ratings, or the posting of collateral, but the events of 2008 showed that such measures were inadequate. The ABA's intervention was remarkable in that a fundamental mode of capitalist valuation was so publicly questioned by a group of prominent and powerful capitalists. Among other things, fair value accounting rules were seen as truly objective, realistic, and less prone to manipulation by interested parties (Power 2010).

In response to this political pressure, and in the context of the global financial crisis, regulators loosened bank accounting rules, and banks gained a greater measure of flexibility in how they valued their own assets. Researchers responded as well, and scholars have debated

¹ On the economics of "fire sales" see Shleifer and Vishny 2011.

whether fair value accounting standards indeed worsened the crisis, as the banks claimed at the time (Badertscher, Burks and Easton 2012, Bougen and Young 2012, Heaton, Lucas and McDonald 2010, Ryan 2008, Wallison 2008). But the more general issues raised by this episode stem from the interface between valuation and risk-assessment, and how it was expressed through emergent tensions over the application of “fair value” or “mark to market” accounting rules to financial institutions. The banks seemingly proposed a simple but radical solution to the problem of their exposure to excessive market risks: disengage the banks from the market. They suggested that there was a valuational alternative to market price, and that some kinds of valuation threatened to undermine financial stability. However, in an era in which neo-liberal ideas were ascendent, why wouldn’t market prices be regarded as the most accurate measure of economic value? Surely assets that are “underpriced” simply offer profitable arbitrage opportunities that when exploited will reduce the mis-pricing and make such discrepancies automatically disappear, as would assets that were “overpriced.” If such pricing mistakes are self-correcting, why the need to change accounting rules? Furthermore, do not accurate valuations enable market actors to make rational decisions and so increase overall market efficiency? And don’t market prices offer the best and truest indicators of asset value (or, as the efficient markets approach puts it, don’t they fully reflect all available information).

A number of conflicting imperatives operated at the interface between asset valuation and risk management. Accounting is primarily about valuation (what are a firm’s assets worth? Is a bank solvent or insolvent?), and the disclosure requirements mandated during the New Deal were intended to insure that investors could obtain credible, accurate and timely information about the financial status of publicly-traded firms. With accurate and complete information, investors can make rational decisions and a firm’s counterparties can take whatever measures they deem to be in their self-interest. In the case of banks, bank examiners assess a financial institution’s assets and liabilities to determine its solvency, and to take appropriate action if it is insolvent. The value of bank assets is sometimes hard to measure, especially for long-term illiquid items like loans. A traditional “originate and hold” bank will keep loans on its own balance sheet until maturity and may never seek a market valuation by trying to sell the loan. If the loan maintains its “performing” status, however, the bank can calculate the net present value of the payment stream and so determine the value of a particular asset. Those asset values can then be summed to calculate the total value of assets. Banks that securitize their assets (the “originate and

distribute” model) regularly obtain market valuations because they don’t keep loans on their balance sheets. Rather, they sell them off. But what happens when “accurate” valuations produce instability by allowing market risks to affect bank solvency? This could occur if accounting rules transmitted unstable market values into highly variable bank asset values (Plantin, Sapra and Shin 2008: 88).

In making sense of why the banks sought to modify accounting rules in 2008, I use the concept of “decommodification,” borrowed from Karl Polanyi (1944). Polanyi recognized that pure *laissez-faire* capitalism was an historical rarity that arose only under particular conditions. And even when those conditions were met, the situation wasn’t a stable one. According to Polanyi, completely free and competitive markets threaten to undermine their own social and political foundations: “To allow the market mechanism to be sole director of the fate of human beings and their natural environment, indeed, even of the amount and use of purchasing power, would result in the demolition of society” (Polanyi 1944: 73). As a result, 19th-century industrial societies witnessed a “double movement” in which the market was simultaneously extended and restricted. In order to expand markets, in other words, certain of their effects had to be tempered. The basic elements of Polanyi’s argument have been very influential in the literature on the welfare state (e.g., Esping-Anderson 1990, Brady, Seeleib-Kaiser and Beckfield 2005, Bolzendahl 2010, Martin 2004), and the concept specifically refers to the necessity of mitigating the effects of free labor markets if they are to remain politically sustainable. In particular, capitalist democracies (where wage-earners have the right to vote) have developed a number of policies to ensure that labor markets are not entirely free or perfectly competitive. These include minimum wage laws, unemployment insurance, workplace safety rules, employment protections, old-age pensions, and so forth. In some measure, therefore, labor is “decommodified,” and household earnings are stabilized in the face of labor market instabilities with policy that puts a “floor” underneath. Overall, Polanyi explained, “Society protected itself against the perils inherent in a self-regulating market system (Polanyi 1944: 76).

The concept of decommodification is more general than its current application in welfare state research suggests, and indeed Polanyi himself emphasized its relevance to the markets for the three general factors of production: land, labor and capital. In the latter case, he claimed that: “... the market administration of purchasing power would periodically liquidate business

enterprise, for shortages and surfeits of money would prove as disastrous to business as floods and droughts in primitive society” (Polanyi 1944: 73). In other words, Polanyi’s claims about the necessity of decommodification to stabilize financial markets directly contradict arguments made by the advocates of vigorous financial deregulation. Policy-makers like Alan Greenspan, who were so influential during the 1990s and early 2000s, clearly thought that the imperatives of rational self-interest and profit maximization ensured that self-regulating financial markets would efficiently and stably allocate society’s savings. Consequently, many New Deal regulations, established in the wake of the financial collapse of the early 1930s, were repealed or weakened at the end of the 20th-century. Here, I will use Polanyi’s concept to make sense of what banks were seeking during 2008: a way to insulate their assets from the vagaries of the market. In effect, they wanted to “decommodify” bank assets so as to put a “floor” under their valuation.

In extending the usage of the concept of “decommodification,” I point to some telling parallels between the events of 2008 and an earlier historical episode involving a similar political imperative. The push to decommodify was not just a crazy impulse of 2008 but rather reflected a deeper pattern. During the Great Depression, as more recently, the political incentive to stabilize financial and housing markets necessitated the suspension of strict market valuation. Specifically, during the 1930s federal bank examiners and policy makers began to differentiate between the market value of assets and their “intrinsic” or “fundamental” value, and deliberately used the latter measure (which was higher in dollar value) when assessing the worth of bank assets and home mortgages (Stuart 2003: 45-6). They did so in order to help stabilize the banking system. In similar fashion, the Home Owners’ Loan Corporation (HOLC) was established to bolster housing and mortgage markets by refinancing homeowners whose homes has collapsed in value. HOLC’s key intervention assumed that market prices did not reflect the fundamental value of a home, and in making a new mortgage it would use the latter rather than the former in determining the size of the loan it would make.

Among other things, the market is a valuational device, and through “price discovery” it gauges the worth of objects. In detaching asset valuation from market price, advocates of decommodification were forced to turn to valuational alternatives: other credible (or at least plausible) ways to determine what something was worth. Credit ratings, quantitative risk models, valuation techniques, and collateral all functioned as cognitive and operational devices to help

measure value and manage risk. Edwin Hutchins' (1995) study of navigation underscored that human cognition does not happen within the confines of a single human brain. Rather, cognition is distributed across and between people and a set of cognitive devices (like maps, charts, timepieces, compasses, rangefinders, GPS systems, or a rendering of the night sky). Similarly, risk assessment did not occur solely within the brains of bankers, risk officers, CEOs or CFOs, but rather in a distributed fashion that involved key models, assumptions, and pieces of information. By the early 2000s, the machinery of risk assessment was highly elaborate, quantitatively sophisticated, and enjoyed the endorsement of figures like Alan Greenspan and other top policymakers. But in 2008 it became apparent that risks had in fact been misrecognized, and that the consequences were not only born privately, but publicly. Extending Hutchins, I refer to this as "distributed misrecognition". Asset valuation formed one simple but foundational piece of this risk assessment machinery: what was an asset worth? How can one manage risk if one doesn't know what is at risk?

Fair Value Accounting Today

Purchased assets can be valued at their historic cost (what a firm paid to acquire them in the first place) or at their current market price. Only in rare circumstances will these two numbers be exactly equal. Using current market price means applying a "fair value" or "mark to market" standard. In 2006, FASB issued FAS No. 157 to clarify the definition and application of "fair value" measurement, specifying that "fair value" meant the price at which the reporting entity could sell an asset (i.e., an exit price) in an orderly market (see <http://www.fasb.org/summary/stsum157.shtml>).² When such exit prices are unavailable, FAS 157 stipulated a "fair value hierarchy" that gave reporting entities a menu of alternative inputs for valuation, and the order in which they were to proceed through the alternatives (FASB 2006: FAS157-12).³ The issuance of FAS 157 culminated a shift toward fair-value accounting that had

² The exact wording is: "Fair value is 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" (FASB 2006: FAS157-8).

³ FASB states (FASB 2006: FAS157-12, FAS157-13) that level 1 inputs involve: "... quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date." Absent level 1 inputs, reporting entities can then look to level 2 inputs, which are: "... inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or

occurred over several decades (Tweedie and Whittington 1984: chapter 7, Kemp 2005, Heaton, Lucas and McDonald 2010, Georgiou and Jack 2011). Other statements of the fair value standard included FAS No. 115, issued in 1993 (which accounted for investments in debt and equity securities), FAS No. 133, issued in 1998 (on derivatives and hedging activities), and FAS No. 159, issued in 2007 (concerning financial assets and liabilities).

One proximate motivation to adopt “fair value” standards for financial reporting in the U.S. stemmed from the experience of the Savings-and-Loan crisis of the 1980s. Reliance on historical cost accounting allowed S&L’s and their regulators to overlook the extent of the problem with S&L balance sheets and postpone the moment of reckoning (Georgiou and Jack 2011: 317, Plantin, Sapra and Shin 2008: 86). A “fair value” standard would have revealed the financial losses earlier, prompted more timely remedial action, and allowed for a less costly resolution. But the reliance on historical cost was itself the product of an even earlier set of problems. Shortly after its establishment in the 1930s, the SEC cracked down on the widespread practice among public utility companies to revalue their fixed assets upward in order to manipulate their reported profits (Walker 1992, Georgiou and Jack 2011: 316). From the 1940s until the 1970s (when inflation became a real problem), the SEC strongly encouraged firms to use historical cost as the basis for asset valuation (Heaton, Lucas and McDonald 2010: 66-67).

To be sure, even today fair value standards are not applied to all assets. Financial institutions begin by classifying their assets into three overall categories: those that are held-to-maturity, those which are traded, and those which are available for sale. The first group consists of assets that the bank intends to keep on its balance sheet, and they are valued at their historical cost. This value is adjusted only if the assets become permanently impaired (as, for example, when a debtor defaults on a loan or bond issue). The other two categories are marked to market,

indirectly.” This would include quoted prices for similar (but not identical) assets. Without level 1 or level 2 inputs, the entity may turn to level 3 inputs, which are: “... unobservable inputs for the asset or liability.” These unobservables will reflect: “... the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk)” (FASB 2006: FAS157-15). Some have termed level 3 valuation as “mark to model.” It does grant to the reporting entity considerable discretion in valuation (Laux and Leuz 2010: 97).

and so their value is adjusted as market prices change. But, depending on the availability of market prices, firms may resort to some other level of the fair value hierarchy.

FAS 157, which became effective in November of 2007, arrived just in time for the financial crisis and was soon put to the test. In the fall of 2008, U.S. banks expressed their unhappiness about fair value accounting rules, claiming that their application was endangering the stability of banks. In a letter to the SEC, the ABA flatly stated that: “One key factor that is recognized as having exacerbated these [financial] problems is fair value accounting” (ABA 2008c: 1). The ABA pointed out how difficult it was to find market prices when markets were illiquid: “As financial markets thin out or even seize up, as trades become fewer and more volatile, and in general as trading values become increasingly unreliable, it is daily more apparent that for many assets, especially under current conditions, there is not a true ‘fair value’” (ABA 2008c: 2). This kind of mispricing wasn’t a minor problem that solved itself, for in fact, the ABA claimed, it worsened the already bad conditions in financial markets: “Mark to market based on exit-price in an illiquid market results in an unrealistic downward bias, which reduces transparency and can have serious public policy implications” (ABA 2008c: 2). In various communications, the ABA acknowledged the worth of fair value standards during normal market operations, but asserted that financial markets in 2008 were “dislocated,” “seized,” “illiquid,” “frozen,” and “distressed.” Under these problematic circumstances, market prices would not reflect an asset’s “true value” and as a “pro-cyclical” policy, fair value standards were counterproductive (see, e.g., ABA 2008a, 2008b, 2008d).

Banks weren’t the only ones to worry about the effects of fair value accounting. Numerous scholars, policy analysts and commentators weighed in on the issue (IMF 2008, Plantin, Sapra and Shin 2008, Ryan 2008, Haldane 2009, Pozen 2009, Wallison 2009, FCIC 2011: 226-7, Bougen and Young 2012). A number of politicians called for the outright suspension of fair value accounting (Cheng 2009: 7). Although the bankers pushed hard to weaken fair value accounting, others pushed back. And it was some time before detailed academic studies of the role of fair value accounting in the crisis were completed (e.g., Bhat, Frankel and Martin 2011, Heaton, Lucas and McDonald 2010, Laux and Leuz 2010). In the meantime, however, the crisis dictated that something be done quickly. To begin, the Emergency Economic Stabilization Act of 2008 (the so-called TARP “bailout”) included a provision

requiring the SEC to study mark-to-market accounting standards and make recommendations. The study was quickly completed and issued December 30, 2008 (SEC 2008a). It concluded that fair value standards did not have a significant impact on bank failures, that they enabled investors to obtain accurate financial information, and that there were no really good alternatives to fair value. The report recommended that FAS No. 157 be “improved” rather than “suspended,” with a particular focus on the valuation of assets for which markets are illiquid or inactive (SEC 2008a: 7-9).

At the same time that the SEC was conducting its study, the FASB proposed a FASB Staff Position (FSP) to amend FAS No. 157 by clarifying how it would apply to assets in inactive markets (FSP FAS 157-d). The FASB proposal received many comments, including from the ABA. The ABA underscored again what it believed to be a: “... bias toward observable market data when the quality or usefulness of that data is questionable” (ABA 2008b: 1). One telling comment from a financial firm, forwarded by then Congressman Mark Kirk (R-IL), criticized the proposed FSP on the grounds that it really didn’t offer any relief to troubled financial institutions (Wehmer and Dykstra 2008). The letter went on to make specific reference to the valuation practices of HOLC during the financial crisis of the 1930s, commending HOLC for recognizing that: “... a more realistic concept of fair value was necessary and more meaningful than the highly distressed prices at a point in time during a market crisis (Wehmer and Dykstra 2008: 1). The letter suggested that FASB follow HOLC’s example and develop its own “intrinsic value concept.” In April of 2009 the FASB issued three final Staff Positions on the matter of fair value accounting, and although it did not reject fair value methods, in the circumstances of distressed sales or inactive markets, it did offer some flexibility to reporting entities (Heaton, Lucas and McDonald 2010: 68).

Subsequent research offered mixed results on the actual effects of fair value standards during the financial crisis. Both Laux and Leuz (2010) and Badertscher, Burks and Easton (2012) concluded that fair value rules did not force banks to dump assets and so did not play a substantial role in worsening the crisis. However, Bhat, Frankel and Martin (2011) studied bank holdings of mortgage-backed securities (MBS) and found that price drops prompted asset sales by banks, and furthermore that the effect was weaker once mark-to-market rules were eased in April of 2009. Merrill et al. (2012) show that capital-constrained insurance companies were more

likely to sell off residential mortgage-backed securities (RMBS), and at lower prices, than their less capital constrained counterparts. They conclude that fair value accounting rules led to asset fire sales.

Separate from their actual effects, fair value accounting rules were claimed by some powerful interest groups to be destabilizing. Transmitting problematic market prices instantly and directly into bank balance sheets would hurt banks, the claim went, particularly when those prices emerged out from “distressed,” “illiquid,” or “frozen” markets. And although fair value wasn’t abolished, it was modified in ways that gave banks some welcome flexibility. But the larger significance of this episode stems from the way in which political resources were mobilized to alter regulatory and accounting rules so as to insulate financial institutions from market instability. Even though the logic of market valuation had deliberately been inscribed within financial accounting rules (via FAS No. 157 and other measures) the effects were troublesome enough to motivate corresponding mitigation. And these compensatory actions were justified on the grounds that when markets were behaving in a disorderly and dysfunctional manner, banks had to be protected from them. Using the terminology of Polanyi, financial assets were partly “decommodified.”

New Deal Bank Standards

The crisis of 2008 is not the first episode to provoke attempts to decommodify the financial system. As Wehmer and Dykstra (2008) suggested in their letter to FASB, similar problems arose during the 1930s. During the Great Depression, corporate bonds constituted a substantial proportion of the total assets of U.S. banks. As the economy crashed, the solvency of banks depended on the value of the assets on their balance sheets, and as the value of these assets decreased, greater and greater numbers of banks failed. Following the emergency bank holiday of March 1933, 3460 banks were suspended in the third quarter of 1933. Consequently, the total number of banks within the Federal Reserve System declined from 8,929 in 1928 to 5,606 in 1933. Over the same period, the number of non-member banks declined from 16,869 to 8,601. The collapse of the worth of bank assets, and the subsequent collapse of many banks, put tremendous pressure both on the U.S. financial system and on the regulators and politicians who oversaw it.

One response to these problems involved a change in bank examination rules. Traditionally (and before the era of federal deposit insurance), it was the task of federal or state bank examiners to assess the actual financial status of a bank, to appraise bank assets and liabilities, and to close down banks that were insolvent (Jones 1940: 183). But by relaxing the financial standards they applied, bank regulators could introduce a measure of forbearance that would make it easier for marginal banks to survive. Before 1930, the Office of the Comptroller of the Currency (which regulated federally-chartered banks) valued bank-owned securities like bonds at their market value when calculating the overall worth of bank assets during a bank examination. As market prices plummeted, the value of total bank assets declined and more banks had negative worth (liabilities greater than assets). And with the collapse of the stock market, it was clear that bank balance sheets could not be repaired by having banks simply raise more capital from investors. But starting in 1931, as the bond market collapsed, the Comptroller initiated a new policy that made use of the ratings produced by agencies like Moody's, Poor's Publishing, and Standard Statistics (which later formed Standard and Poor's).⁴ This change built on a new valuation method devised by the Federal Reserve Bank of New York to use bond ratings as a way to estimate the overall quality of a bank's bond portfolio (Harold 1938: 160-161).⁵ Gustav Osterhus, the bank official who invented the new method, styled it as a "mechanical method designed to disclose true quality of a bank's investment account" (Osterhus 1931: 67).⁶ After the Comptroller's new policy, bonds rated "BBB" and higher could be valued at their *historical cost* (i.e., what the bank originally paid for them) rather than at their current

⁴ See the [New York Herald Tribune](#), December 30 1931, p.22.

⁵ Flandreau et al (2011) examine the poor performance of bond rating agencies during the 1930s and wonder how ratings could have been given regulatory standing in precisely the same decade. But this move was not unprecedented for the New York Federal Reserve Bank, perhaps because of its close ties to Wall Street and familiarity with current financial practices. Issued soon after the founding of the Federal Reserve System, a New York Fed circular on the topic of eligible paper (i.e., what member bank assets could be brought to the Fed discount window for rediscounting) shows that mercantile agency credit ratings factored into the determination of eligibility (Federal Reserve Bank of New York 1915). This was done without strong evidence of the predictive accuracy of credit ratings. Furthermore, rating agencies were increasingly a point of reference in US courts (Flandreau and Sławatyniec 2013).

⁶ He also criticized market prices as a way to value bonds on the grounds that prices simply reflect the overall judgments of investors, and most investors know little. In fact, they: "... do not investigate carefully" (Osterhus 1931: 110).

market value (Morton 1939: 277, Harold 1938: 26, Jones 1940: 187). The Federal Reserve Board granted additional official salience to bond ratings when it started in 1933 to publish tables that showed how current bond yields varied across different rating categories, using Moody's system of Aaa, Aa, A, and Baa for "investment grade" securities (see Federal Reserve Board 1933: 483). Many state bank regulators subsequently followed the Comptroller's new policy.⁷ Indeed, in 1938 the National Association of Supervisors of State Banks affirmed the use of bond ratings to group bank bond holdings into four different classes, with the highest rated bonds (i.e., given "AAA," "Aa," "A" or "Baa" ratings) being valued at their historic cost (Morton 1939: 280, Jones 1940: 194). Highly-rated bonds would no longer be marked to market.⁸

New Deal bank regulations also looked to the other end of the bond rating spectrum. The Banking Act of 1935 gave to the Comptroller of the Currency a new power to impose restrictions on the kinds of securities a national bank could purchase on its own account. In early 1936, the Comptroller applied this power when issuing a new rule that prohibited the purchase of securities that were "distinctly or predominantly speculative," or of an even lower standard (Atkins 1938, Palyi 1938: 70, Comptroller of the Currency 1937: 21-22). The real problem with U.S. banks, the Comptroller asserted in a speech to the California Bankers Association made in May 1936, lay chiefly on the asset side of the balance sheet, not on the liability side. During the 1920s, too many banks had invested in too many "speculative" bonds, and it was necessary to prevent them from doing so again (Federal Reserve Board 1936: 422-423). The rule also explicitly referred to the agency rating manuals when defining the meaning of terms like "speculative" or "predominantly speculative," (which, in the Moody's rating scale, meant ratings below the "Baa" level). Since bank examiners had little experience with the detailed assessment of financial securities, the application of ratings to bond portfolios was done quite mechanically (Atkins 1938: 14). Again, most state bank regulators followed the federal lead and adopted similar prohibitions (Palyi 1938: 73). Although bond ratings had been published and used by private investors since 1909, this direct incorporation of ratings into bank regulatory machinery

⁷ See, e.g., New York Times, June 22 1932, p.31.

⁸ In addition to protecting bank assets from the collapse of the bond market, this measure also put a premium on high ratings.

increased their significance many-fold. Low-rated bonds were sanctioned as much as high-rated bonds were encouraged. . Highly rated bonds could be protected from low market valuations.

An important additional step was taken in 1938, when the Uniform Agreement on Bank Supervisory Procedures tried to standardize bank examination procedures across multiple regulatory agencies, including the Federal Reserve, Comptroller of the Currency, and Federal Deposit Insurance Corporation (FDIC).⁹ The new common standard put bank assets into overall categories, depending on the bank examiner's judgment of the relevant level of risk or impairment. Assets in the top category were to be shown at book value, without adjustment for market depreciation (Simonson and Hempel 1993: 255). In appraising assets (both loans and securities), examiners were to consider them: "... in the light of inherent soundness rather than on a basis of day to day fluctuations" (Board of Governors 1938a: 564). More generally, regulators affirmed that the overall solvency of the banking system: "... should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth" (Board of Governors 1938a: 564). Instead of its normally dry bureaucratic language, here the Federal Reserve Bulletin utilized distinctive terminology to separate market prices from "intrinsic worth" or "inherent soundness," and to downplay the significance of market price. When these different measures didn't align, the agreement clearly signaled to regulators and examiners that they should overlook low asset prices and emphasize instead their "intrinsic worth."¹⁰ However, the Federal Reserve Board was emphatic that ignoring market price did not mean a "relaxation of standards" (Federal Reserve Board 1938b: 39). Many U.S. state banking authorities followed the lead of federal regulators and henceforth the distinction between "investment grade" and "below investment grade" became enormously consequential.¹¹

⁹ There were prior disagreements on this matter, pitting the Federal Reserve against the others. See Wall Street Journal May 6 1938, p.1, Wall Street Journal May 17 1938, p.1, Washington Post June 7 1938, p. x17, and Wall Street Journal July 16 1938, p.5.

¹⁰ Bach (1949: 275-6) also notes the regulatory difference between "intrinsic soundness" and "current market value," and the importance of recognizing the former during a recessionary period.

¹¹ See Wall Street Journal June 24 1938, p.1.

Bond market prices dropped at the outset of the Depression, and so these new valuation policies in effect allowed federal and state bank regulators to overlook the substantial decline in the value of bank bond assets, and to treat a particular bank as if it were in better financial condition than it actually was. Market valuation of bank bonds was partly suspended, contingent on the private evaluations produced by the bond rating agencies. In addition, new prudential standards for banks constrained their own bond portfolios to exclude assets that were, again relying on the judgment of the rating agencies, “below investment grade” (Fons 2004). For the first time, bond ratings were given regulatory standing in a manner that deliberately protected banks from the vagaries of the bond market and forestalled insolvency. Such regulatory forbearance kept a bank open until a future time when, it was hoped, its assets would have recovered their “true” value. Yet this change was not simply an ad hoc life-line thrown to banks, for as Jones (1940: 186) explained: “... bank assets have a particularly indeterminate value in periods of crisis. Current market prices cannot be accepted because markets are demoralized, and many classes of bank assets, e.g., most bank loans and real estate, cannot be sold at any price.” In other words, during a crisis, previously trustworthy market signals became inaccurate and unreliable as measures of value, reflecting a “demoralized” collective sentiment rather than economic fundamentals. Since market price is the default measure of value, departure from this standard would presumably be justified only under special circumstances. When the Federal Reserve Board reconsidered the Uniform Agreement in 1949, during the postwar boom, the insulation of highly rated bonds from valuation by market price was simply continued (Clayton 1949).¹²

New Deal Mortgage Standards

The prospect of a total collapse of the banking system during the Great Depression prompted “decommodification” of bank bond portfolios. Other markets closely linked to the financial system also teetered on the edge, and were similarly insulated from pure market forces. Some financial institutions invested in home mortgages, and so were adversely affected by the

¹² There were some minor modifications of the labels of different groups of bonds, and group 2 (“substandard” quality) securities were to be valued at market prices rather than at an 18-month moving average of market prices (Federal Reserve Board 1949: 776-777). Most importantly, however, highly rated bonds were not to be valued at their market prices.

decline in housing prices. Real estate market prices dropped, homeowners failed to make their mortgage payments and even defaulted, loans shifted from “performing” to “non-performing” status, and so the financial institutions which made home mortgage loans moved toward insolvency. In fact, the entire housing market collapsed as residential property construction fell 95% between 1928 and 1933 (Jackson 1980: 424).

The Home Owners’ Loan Corporation (HOLC) was established as a short-term measure in 1933 to bolster the housing and home mortgage markets by helping to refinance homeowners on easier terms (longer-term loans worth up to 80% of the value of the home). HOLC was explicit in not taking current market value as the measure of what a house was worth (and therefore, how large of a new loan could be made to the homeowner): “The Corporation will not depend upon the technical market value. On the other hand, it will give equal weight to (1) present market value; (2) cost of reproduction of the property, less depreciation; and (3) a capitalization of the reasonable monthly rental value of the property over a period of the past 10 years.” (HOLC 1933: 2). In effect, this more complicated method of appraisal allowed HOLC to derive estimates that were significantly higher than current market values (Wickens 1937: 76-77, Fishback, Rose and Snowden 2013: 74-75). But this higher value was considered the “normal” value of a home, in contrast to its current market value (Fishback, Rose and Snowden 2013: 59). With a higher appraisal, HOLC could extend larger loans secured by real estate and provide more support to the mortgage and housing markets. Similarly, the Emergency Farm Mortgage Act of 1933 supported additional loans to aid farmers. As with any type of mortgage, the size of the loan was conditional on the value of the underlying property that secured the loan, so the appraised value of a farm dictated the magnitude of financial assistance. As Gaddis (1935: 469) notes, the Act of 1933 changed appraisal methods, shifting away from current values to “normal values,” where the latter did not reflect the collapse in prices that afflicted rural real estate markets during the early 1930s.

The Federal Housing Administration (FHA) was established in 1934 and it also was intended to support housing and mortgage markets (Weimer 1937). One of its primary activities involved the provision of mortgage insurance for home mortgages that conformed to new and more affordable mortgage standards (longer-term, higher loan-to-value ratios, and self-amortizing). The new standards significantly reduced the required monthly payments and

allowed buyers to finance a greater proportion of the value of their new home. In short, homeownership became easier. Despite reducing a borrower's monthly financial burden, however, the appraised value of a home remained a key variable. Here the FHA made a telling accommodation. Its 1936 Underwriting Manual explicitly laid out some "axioms of valuation": "Valuation endeavors to estimate prices which are fair and warranted, that is, prices which represent the worth at the time of appraisal of the future benefits which will arise from ownership, rather than prices which can be obtained in the market" (quoted in Stuart 2003: 47). Clearly, official policy at the FHA was that market price need not be the best estimate of value, and appraisers would retain a meaningful level of discretion in making their estimates.¹³ In a manner that paralleled the bank regulators, the FHA also included credit agencies in the mortgage-application evaluation procedure (Stuart 2003: 91). When evaluating an applicant, a lender could turn to one of three credit reporting agencies (which evaluated individual borrowers rather than corporate bond issues).

Home mortgages, and the residences that secured them, represented another important economic asset where regulators and government agencies, pressed by the realities of economic collapse, distinguished between market prices and "intrinsic values" and chose to favor the latter when market prices were too low. Economic value was no longer strictly dictated by the market because the latter was generating current market prices that were politically intolerable. Faced with catastrophe, policymakers and regulators instead embraced a variety of alternative valuation methods that in some manner captured what they deemed to be the "true" value of an asset. The beneficiaries of this decommodification included banks with non-performing mortgages on their books, but also homeowners, mortgagees, and others with an interest in the vitality of the real estate market.

Financial Decommodification

It is no coincidence that during the Great Depression and the Great Recession (the worst downturn since the Great Depression), regulators, examiners, agencies and policy makers

¹³ FHA guidelines also played an important role in encouraging residential segregation, by having underwriting standards that favored homogeneous neighborhoods over those that were mixed either by race or class (Jackson 1980: 430-1).

worked to disconnect the valuational machinery of the financial sector from a market that was variously characterized as “insolvent,” “illiquid,” “demoralized,” and “distressed.” Markets expand and contract, and severe contractions produce outcomes that are politically unpopular: widespread insolvencies, failures, foreclosures and defaults. Market instability per se was less important than instability that drove down prices and begat economic decline. Rather than simply submit to the harsh strictures of the market (as Treasury Secretary Andrew Mellon once recommended),¹⁴ however, various parties deployed alternative valuational rules that enabled them to act with some authority as if assets were worth significantly more than what current market prices indicated. The rejection of the market was only partial, however, because bond ratings themselves were “market based” in the sense that they were produced in and for private investors and financial markets. This shift valuation did not represent a wholesale rejection of the market, but rather a rearticulation of the relationship between financial institutions and markets.

In some instances, the new rules for the first time imported into public regulation the bond ratings produced by private rating agencies. This had the effect of dispersing valuation so that public oversight partnered with private evaluation to determine the effective worth of assets and the solvency of financial institutions. Such valuational fiat stemmed from attempts to stabilize the financial system and the housing market. And unlike many of the policies that “decommodified” labor (e.g., minimum wage laws, unemployment pensions, etc) the measures that decommodified the financial system were implemented bureaucratically via regulatory modification, mostly out of the spotlight of overt political contention.

The decision to incorporate credit ratings directly into financial regulations ultimately proved to be a fateful one. Indeed, according to Partnoy (2009) the decision to give regulatory standing to credit ratings in the 1930s inadvertently worsened the crisis of 2008. Distributing the valuation of assets between public and private organizations increased the significance of the judgments made by bond rating agencies, and magnified the effect of “mistaken” ratings. Following the lead of federal bank regulators, many other regulatory agencies in and outside of the U.S. adopted ratings to set prudential standards, protect investors, and govern market access

¹⁴ Mellon famously recommended to “... liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate ... it will purge the rottenness out of the system.”

(FCIC 2011: 119, Langohr and Langohr 2008: 430-439). During the 1990s, ratings were also transplanted into the private contractual machinery at the core of the burgeoning OTC derivatives markets: under an ISDA master agreement, swap transactions typically required each side to post collateral, contingent on their ratings, as a type of private risk management (Cunningham and Werlen 1996, Gregory 2010: 65-66, ISDA 1996: 11,20,49-50) . To receive a ratings downgrade from Moody's or S&P signaled greater risk and meant having to post more collateral (which, in fact, was the proximate cause of the collapse of AIG in 2008). By the end of the 20th-century, many parties in financial markets depended on ratings to calibrate and manage risk.

Coming from both public regulatory and private contractual sources, the imperative to achieve “AAA” rating helped to fuel the frenzy of financial engineering that investment banks undertook to turn pools of subprime mortgages into high-grade securities. Credit ratings played a central role in the securitization process in which assets were pooled, tranced, rated, and sold to investors around the world in form of ABSs, RMBSs, CDOs, CDO²s, and other exotic instruments (MacKenzie 2011). Rating agencies were paid directly by issuers to rate securities (the “issuer pays” model), and so it was clear that agency's real customers were the issuers of securities, not the buyers (FCIC 2011: 118-119). Nevertheless, buyers relied on ratings to determine the riskiness of an investment, with “AAA” signaling the very safest investments. And often buyers were constrained by prudential regulations to rely on ratings. In cooperation with rating agencies, securitizers worked to create new instruments that would have the highest possible ratings, and so be most attractive to investors (SEC 2008b).

Whether or not it makes use of credit ratings in an alternative valualational regime, decommodification need not be the only way to stabilize markets. Bank capital standards create financial “cushions” that can absorb losses and prevent a financial institution from collapsing. Deposit insurance protects banks from bank runs caused by panicky depositors. Other prudential regulations attempt can impose some measure of asset diversification among banks. Likewise, housing markets can be boosted in a variety of ways (e.g., via tax expenditures like the home mortgage interest deduction for federal income taxes). But in these two historical episodes, during the 1930s and the 2000s, U.S. regulators and policy makers were prompted to “decommodify” assets whose production, distribution, and evaluation had previously been

largely governed by market forces. Both times, the goal was not simply to smooth or stabilize asset values whether they went up or down, but to ensure that they didn't go down too far. Decommodification was, in other words, asymmetric.

This paper does not aspire to offer an exhaustive list of instances where people have attempted to decommodify financial institutions (I imagine a careful survey of previous financial crises would likely reveal other cases). Nor is it the only situation where people have challenged the economic value bestowed by the operations of the market. Consider, for example, the moral economy standard of a "fair price" invoked in early modern bread riots and by subsistence peasant farmers (Thompson 1971, Scott 1976). In this case, there was little appeal to a popular notion of "fair price" for financial assets or homes. Rather, the current market price was rejected as an appropriate or accurate measure of "true value" because of the unusually disturbed status of the market, not because of any moral implications or qualms about fairness. Presumably, the return to market "normality" would restore market price to its favored position as the standard for valuation.

Conclusion

In an era where markets were ascendant, and where some version of *laissez-faire* economic doctrine (known as "neo-liberalism" in the 2000s) was dominant, important economic interests worked to suspend market valuation. This intervention wasn't motivated by a deep critique of capitalism, nor by a sense that the rules of some moral economy had been transgressed, nor even by a narrow conviction that the efficient markets hypothesis was wrong. Rather, market valuation was suspended or weakened because markets were deemed to be (temporarily) dysfunctional, and therefore market prices no longer measured the actual, underlying worth of assets. Instability was the consequence of market prices unhinged from true value, and during a financial crisis, such instability became politically intolerable, not just to the bankers but to all others with an interest in functioning financial systems. Over the 20th-century, as more and more American households became engaged with the financial system, either by using financial services or possessing financial assets, those with an interest in functioning finance grew in numbers. By applying a different valualational standard, *illiquid but solvent* banks could "ride out" the crisis. Of course, *illiquid and insolvent* banks might postpone the inevitable, but their day of reckoning would eventually come. Unfortunately, however, by allowing

insolvent banks to continue to operate, the eventual cost of failure (to creditors, taxpayers, insurers) often increases.¹⁵

Advocates argued that default valuation rules (“fair value accounting” or its equivalent) had to be suspended, and they recognized that the onus was on them to make the case for change. Using distinctive and resonant terminology (“illiquid,” “distressed,” “dislocated,” “seized up”), they discounted current market prices and proposed alternatives. But as with Justice Potter Stewart’s recognition of pornography (“I know it when I see it”), there was no precise *ex ante* definition of market distress. Market distress, the *sine qua non* of this valuational intervention, was in the eye of the beholder, and not everyone saw eye-to-eye on this issue. Hence political action to frame the issue and mobilize support had to precede valuational modification, if the latter were to succeed. And as a practical matter, valuational alternatives relied on available cognitive devices like bond ratings and quantitative financial models. Unfortunately, these had their own limitations which during the 2008 crisis contributed to a collective “misrecognition” of value and risk.

To view this particular intervention as a form of “decommodification” links it to public policies that normally are not associated with financial regulation, particularly those that concern wages, pensions, and labor protections. Such a linkage holds out the possibility of a comparative analysis of decommodification, across issue areas. Decommodification provides a way for market societies to tolerate the risks and instabilities that markets generate. Some of these risks are more problematic than others, and so many countries have developed programs to decommodify labor markets. Many countries have also developed ways to stabilize their financial systems, although many of the policy measures taken during the 1930s were repealed during deregulation at the end of the 20th-century.

As conceived by Polanyi, decommodification was part of a “double movement” with respect to the expansion and contraction of markets, clearly the politics vary dramatically. Popular demonstrations by workers in support of higher wages, at one end of the spectrum, contrast sharply as a mode of collective action from highly technical memos on accounting

¹⁵ Witness regulatory forbearance and the costs of the S&L crisis in the 1980s.

methods submitted to regulatory agencies, at the other end. Furthermore, low-income wage-earners are a much bigger voting bloc than bank employees, and so more likely to have political voice in a capitalist democracy. So both the means and the outcome of decommodification will vary depending on what (or who) is being decommodified. Nevertheless, both types of decommodification aimed at tempering the instabilities of labor and financial markets by focusing on the bottom of the wage or price distribution. Policies tried to raise up the bottom rather than pull down the top. And although the proximate beneficiaries varied between traditional and financial decommodification (workers vs. banks), the financial crises of 1933 and 2008 showed that many have an interest in a stable financial system, not just the banks.

Financial decommodification via the weakening of “fair value” accounting standards offered a quick way to protect financial institutions from “distressed” markets. It can help impede the propagation of bank failures and slow down cascading insolvency, which benefits the financial sector but also those who depend on credit (e.g., homeowners). Modification of accounting rules possesses little political salience so such measures can be taken without much political debate or popular consideration. Furthermore it doesn’t provoke the same kind of political opposition as traditional decommodification. Employers often oppose minimum wage laws or higher minimum wages because they will face higher labor costs. They oppose workplace protections that impede the free operation of “employment at will” (e.g., the unconstrained right to terminate employees). By contrast, new valuation standards don’t impose burdens that are obvious and immediate enough to mobilize widespread political opposition. Social movements do not spring up in defense of “technicalities” like mark-to-market accounting rules. This is not to say that financial decommodification is costless, of course, merely that the discussion of the relative costs and benefits of such a policy is likely to be a technocratic one dominated by experts.

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