

FASB Fanatics At It Again

We are not making this up: The Financial Accounting Standards Board (FASB) wants to broaden the “fair value” or “mark-to-market” rules that helped create the Panic of 2008. Now, they want to force banks to use those same rules not only for the securities they own, but also the loans they make.

By way of background, FASB changed accounting rules in late 2007, forcing financial firms and auditors to use “observable,” market prices to value many securities rather than models or cash flow. According to Milton Friedman, rules of this type helped cause the Great Depression. So, it is no surprise to us that within a year of their return, by late-2008, the U.S. experienced its first financial panic in a hundred years.

We have written extensively on this subject, but the number one problem with fair value accounting is that market prices for assets are forward-looking. In good times, prices reflect a positive outlook. In bad times, they reflect a negative outlook. And when markets freeze up, financial institutions must use prices that do not reflect actual cash flow. This forces losses on the system that are not yet real. The FASB rules create a vicious downward cycle of losses, bank failures, more fear and lower “observable” prices, more losses and more bank failures.

All the TARP and money, interest rate cuts, government stimulus, stress tests, and Fed balance sheet expansion in the world, cannot stop this downward spiral. That’s why the markets kept falling until March 9, 2009, when Congress started to twist arms on the issue. FASB was forced to correct its rules and allow cash flow to be used when markets were illiquid. Just this small change did the trick. Banks were finally able to raise new capital, the stock market surged, and the economy quickly headed for recovery.

Despite this unmistakable evidence that accounting rules were the culprit, FASB is not admitting a mistake. Instead, it is doubling-down on this rigid and ideological accounting fundamentalism. FASB wants to mark bank loans to market.

But there is no real market for bank loans. The value of any loan is always in the eye of the beholder. As a result, “who” is doing the beholding determines the viability of an institution and maybe even the health of the economy. How does a trader in New York, know what price to bid for a loan to a dry-cleaner in Burlington, Iowa? In fact, the minute a bank makes a loan to a local small business it will be forced to write down the value because no one else will pay 100 cents on the dollar for that loan, especially in times of economic stress.

To be clear, the financial system and economy are much healthier now than they were in 2008, when home prices were over-valued. This rule is pro-cyclical and right now the cycle is pointing up, not down. But when problems do come again (as they always do), this new rule, if implemented, could turn a brushfire into an inferno, causing capital to fall and banks to stop lending (and even sell assets) at just the wrong time.

Fair value accounting ties the balance sheet of the economy (the value of assets) to the income statement and capital accounts. Because the balance sheet is bigger, a small ripple in asset values creates a tsunami when applied to the income statement. Instead of reducing risk, fair value accounting has an unintended consequence of increasing the cyclical nature of the economy – which, by definition, increases risk.

And without risk-taking, growth suffers. FASB must cease and desist in this endeavor. They have asked for public comment, we suggest you comply.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-1 / 9:00 am	ISM Index - May	59.0	61.0	59.7	60.4
9:00 am	Construction Spending - May	+0.1%	-0.1%	+2.7%	0.2%
6-2 / <i>sometime</i>	Domestic Auto Sales - May	4.1 Mil	4.0 Mil		3.9 Mil
<i>during the day</i>	Domestic Truck Sales - May	4.8 Mil	4.9 Mil		4.8 Mil
6-3 / 7:30 am	Q1 Non-Farm Productivity	+3.4%	+3.5%		+3.6%
7:30 am	Q1 Unit Labor Costs	-1.4%	-1.6%		-1.6%
7:30 am	Initial Claims - May 29	450K	448K		460K
9:00 am	Factory Orders -Apr	1.7%	+2.0%		+1.6%
9:00 am	ISM Non-Man. - May	55.5	55.2		55.4
6-4 / 7:30 am	Non-Farm Payrolls - May	+508K	+615K		+290K
7:30 am	Manufacturing Payrolls - May	+33K	+45K		+44K
7:30 am	Unemployment Rate - May	9.8%	9.8%		9.9%
7:30 am	Average Hourly Earnings - May	+0.1%	+0.2%		0.0%
7:30 am	Average Weekly Hours - May	34.1	34.2		34.1