Mr Herz:

I read in today’s Wall Street Journal that the FASB has approved an accounting change for banks, which would require them to show the market value of their loans on their balance sheets. Your comments stating that the current method of accounting “is kind of out-of-date” and in support of this change you are quoted as saying that “From a balance sheet perspective, a lot of people want to see what things are actually worth now.” I strongly disagree with this change.

The credit/liquidity crisis on 2008-2009 demonstrated the inadequacies of the market to fairly and accurately value assets. In fact is demonstrated how arbitrary and functionally flawed the market can be. The market value approach is, in part, what contributed to the banking crisis. When the market, in affect, ceased to exist the value of the loans were priced at unreasonably low levels. The market value was not related to the security itself, but rather external factors (ie. lack of credit based on a declining balance sheet, due to declining prices). As credit was no longer available, due to what amounted to margin calls, prices declined. As prices declined, there became panic pricing as there ceased to be buyers readily available to purchase those securitized loans at a fair value, or what seemed to be any value at all. The market spiraled downward and out of control, which led to the worst banking crisis since the Great Depression, if not in history.

There is a persistent ideology amongst academics, politicians and many people in general, that markets are rational and efficient. While the argument may be made that the market value of securitized loans during the banking crisis was an aberration, whereas the market is otherwise efficient, these “aberrations” can effectively destroy financial systems, which it did. This does not only apply to pricing of loans but of the equity markets, bond market and commodity markets as well. In fact anytime that there is a market for any asset, the value of the asset is determined, not by its inherent value, but rather by the markets perception of its inherent value. When a disconnect exists between the inherent and perceived value of an asset, either asset bubbles or asset collapses occur. This becomes very dangerous when a critical item, like the banking systems, is solely dependant on the market to continuously value assets correctly.

Further, as so much of the trading of all asset classes are done via computer program trading models that can execute trades instantaneously based on algorithms designed to quantify data and buy or sell when certain criteria are met or violated, the gyrations in any and every market increase. The events in the U.S. equity markets of May 6, 2010 are a prime example of the inherent flaws of the market, while certainly not the only example. Chances are that if this proposal becomes the rule, than banks will need an index to value their portfolio of loans against, or a standardization of loans that will allow their trading to be easily facilitated. In any event, this will subject them to the same trading mechanisms that exist in other markets, subjecting them to the potential for greater gyrations or market “aberrations”. The outcome would be detrimental for banks. Instead of having a major banking crisis once every 80 years, the number of crisis will increase to the number of times there are market aberrations. This will create a need for more frequent bank bailouts.

Please reconsider your opinion on this rule.

Trennon Waters