

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss and James Bruss  
**DATE:** August 28, 2009  
**SUBJECT:** Mark-to-Market Expansion: FASB Tries to Make "Bank" A Four-Letter Word—Again

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FASB is back at it again. Not satisfied with the damage caused by mark-to-market accounting in the current credit crisis, the Financial Accounting Standards Board is now proposing that banks be required to mark not just securities, but loans as well, to market.

Earlier this year common sense won a small, if somewhat muddled, victory when FASB modified its mark-to-market accounting (MTM) rules to allow companies to value financial assets according to model or cash flow in the absence of a properly functioning market. It appeared FASB was finally learning the folly of forcing banks to value certain assets at market prices even when they had no intention of selling those assets any time in the near future. Wrong.

Now FASB is proposing to force banks to mark even loans to market prices. Taking the rhetorical—if not logical—high road, FASB and its defenders invoke the magic word, *transparency*, as if to say: if you dispute the usefulness of MTM, you stand against transparency. MTM, according to FASB, is the only way to provide investors with accurate information about the assets on companies' balance sheets. This is faulty thinking for a few reasons.

First, with few exceptions, the only reason a bank holds an asset on its balance sheet is for the cash flows that provide income. This is how banks make money. Banks, like all of us, enjoy it when their assets appreciate in price, but the real point of investing in assets for banks is to provide regular income. To take an example, the investment in a fixed-income security may fluctuate in market value from day to day even though it produces regular, predictable income. The value of the asset is the income it produces. If the security continues to provide the income it was designed to provide, and the purpose for which it was purchased, what is the rationale for requiring a bank to mark it to a market price?

In the case of loans the issue comes into even sharper focus. It is true that banks often sell loans. For example, some banks devote substantial portions of their business to originating commoditized loans, such as real estate mortgages, that they sell to investors such as Fannie Mae or GMAC. Those loans, however, do not remain with the bank for long and, in any event, won't suffer mark downs in value in the short time they are on the bank's balance sheet. But banks also make commercial real estate loans they have no intention of selling to an investor. The asset may face stress because of economic conditions (as many now do), while the borrower continues to make its regular payments on the loan. A bank would be wise to make provisions to cover the potential loss on the loan, even if it has confidence the loan will ultimately be paid off. It makes no sense, however, to mark the loan down to market because the bank has no interest in selling the loan. Applying market prices to long term assets is a category mistake.

Second, forcing a bank to recognize market value fluctuations—even as income remains steady—unnecessarily introduces volatility into the business. According to a July report by the Financial Crisis Advisory Group, a defender of MTM, this is the cost of doing business:

Proponents of fair value accounting do not deny that indeed mark-to-market accounting shows the fluctuations of the market, but they maintain that these cycles are a fact of life and that the use of fair value accounting does not exacerbate these cycles.

This is a particularly bold statement that would make even many MTM defenders blush. Banking is a business of small margins and sacrosanct capital requirements. As assets decrease in value, a bank's capital decreases and with it, the ability to generate more assets. We were all witness to this phenomenon in 2008. As investors became skittish about certain assets, the market for trading those assets began to deteriorate and prices fell. Banks were then forced to write those assets down—i.e., mark them to market. Their capital levels dropped and, as a result, credit availability began to decline as

banks saw their lending capacity contract. Lacking the ability to generate earnings through asset growth, many banks suffered losses.

Third, the argument that MTM is the only way to provide investors with transparency is misleading, particularly as it relates to marking loans to market. (As a reminder, we are investors too and we like transparency.) Banks hold reserves on their balance sheet against potential loan losses, according to predetermined policy. In addition, when banks realize their losses (or forecast additional losses), they provide additional reserves. Both the loan loss reserve and the provision for loan losses are publicly available to investors in quarterly regulatory filings. This is obviously not the tell-all kind of transparency FASB wants, but it certainly provides investors with information about asset quality. More importantly, it doesn't destroy capital and cause panic in the process.

At the risk of committing the genetic fallacy, it is perhaps worth examining the source of some of the justifications for maintaining MTM. One such justification, again on the theme of transparency, comes from James Chanos:

Obfuscating sound accounting rules by gutting MTM rules will only further reduce investors' trust in the financial statements of all companies, causing private capital – desperately needed in securities markets – to become even scarcer. Worse, obfuscation will further erode confidence in the American economy, with dire consequences for the very financial institutions who are calling for MTM changes.

First of all, it's interesting to note the very confident direction of the market and increased availability of private capital since FASB provided some relief from MTM in March. But it's also noteworthy that the words come from James Chanos, renowned short seller, whose bread is buttered by bad news. Short sellers are supposed to provide advance warning of asset deterioration; but should MTM exist for the purpose of helping short sellers get rich?

This is not to say MTM is without any valid rationale; transparency is always preferable to its absence. But looking at the destruction MTM has fostered, the already existing sources of information about loan quality, and the incoherent relationship between market pricing and long term assets, we see no reason to expand the mistake to loans. Does anyone really want a repeat of 2008?

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