



THE SECRETARY OF THE TREASURY

WASHINGTON

March 24, 1992

Mr. Dennis R. Beresford
Chairman
Financial Accounting Standards Board
401 Merritt #7
Norwalk, CT 06856-5116

Dear Mr. Beresford:

I understand that the Financial Accounting Standards Board (FASB) is currently working on a proposal that would require all companies -- including banks and other depository institutions -- to record marketable debt and equity securities at market value in their financial statements, even if held only for investment. This proposal could have serious, unintended effects on the availability of credit as well as on the stability of the financial system, and I strongly urge the FASB not to adopt it at this time.

It is not yet clear that market value accounting (MVA) is an appropriate primary accounting measurement of banks' investment portfolios. Since changes in asset values would be reported as current income or loss, even if a bank had no intention of selling the asset, MVA could result in extremely volatile earnings and capital. This volatility would not be indicative of a bank's operating results and would therefore be misleading to shareholders and other users of financial statements.

Banks would naturally seek to avoid this artificial volatility, creating significant measurement and behavioral distortions. For example, banks would likely reduce their holdings of mortgage-backed and municipal securities, to reduce swings in reported earnings and capital. Given that banks currently purchase sizable amounts of these securities, such reductions could significantly disrupt these markets, draining liquidity and decreasing the overall amount of both mortgage and municipal financing.

It has been argued that reducing the attractiveness of securities holdings through measures such as MVA will cause banks to make more commercial and industrial loans. I disagree. I recognize that bank securities portfolios have risen, and commercial lending correspondingly declined, during the recent economic slowdown. While part of this balance sheet change appears to be due to slackened demand for loans, there have also been instances where regulators -- overreacting to problems of the past -- have employed overly stringent examination standards to sound bank loans. We have taken several specific measures to address these problems.

Applying accounting penalties to securities holdings, however, might simply encourage banks to shed securities without significantly increasing bank lending. To accomplish this downsizing, banks could simply let deposit interest rates fall, and funds would gradually flow out of the banking system to alternative investments. The Administration is extremely concerned about the credit crunch, but we believe that measures designed to affect bank lending directly are the better means to address these issues. Moreover, MVA could even result in more intense and frequent credit crunches, since a temporary dip in asset prices would result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity.

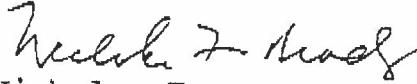
Finally, it is inappropriate to apply market value accounting to only a portion of a bank's balance sheet, as would the FASB proposal. This would fail to reflect positions that banks may have taken to minimize interest rate sensitivity, such as funding arrangements that match the maturities and repricing frequency of the investment portfolio. This, in turn, could exacerbate the public's perception of systemic financial instability even when the industry's underlying businesses are solid.

As you know, the question of market value information has already been addressed in the recently enacted Federal Deposit Insurance Corporation Improvement Act of 1991, as well as FAS 107, "Disclosures about Fair Values of Financial Institutions," issued in December 1991. These measures require supplemental disclosure of market value estimates in footnotes to a bank's financial statements, but retain historical cost as the primary valuation method for banks' investment assets in the financial statements themselves.

The Administration believes that -- until we have far more experience with the possible consequences of MVA for financial institutions -- the disclosure approach is the best approach. Disclosure of market values in supplemental information, rather than in the financial statements themselves, provides investors and other interested parties with sufficient market value information. It will also give policy makers the opportunity to examine in detail the advantages and disadvantages of such disclosures.

I trust the FASB will take these concerns into account as it analyzes and formulates a proposal on this issue. Thank you for your consideration in this important matter.

Sincerely,


Nicholas F. Brady