The IASB wall is coming down

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Earlier this week I had an article on Forbes about the absurdity of bad debt less provisioning for banks under the rules of International Financial Reporting Standards established by the International Accounting Standards Board. I summarised all the arguments there: I won't repeat them.

Yesterday Adair Tuner — Lord Turner, chair of the Financial services Authority — joined in the attack in a speech at the Institute of Chartered Accountants in England and Wales. The speech is here. It is, I admit, pretty technical. It's also (rather refreshingly) highly competent. he asked the question:

So are banks different in ways relevant to accounting standards? In what ways, and what should we do about it?

His answer was they are, of course. As he noted:

Two aspects of bank accounting in particular could be relevant to the macro-prudential and macroeconomic concerns which make banks different.

* *First, the treatment of loan losses within the banking book, the way in which we capture, or fail to capture, present or future potential loan losses arising from credit default.*

* *Second, the valuation approach in the trading book (and other items which are marked to market), the recognition of unrealised gains or losses in general, but in particular in more illiquid securities.*

In both these areas, there is a strong case that the present accounting treatment contributes to the problem of procyclicality.

To out it another way, mark to market accounting rules when used by banks helped create the current crisis for the reasons I noted in Forbes. Or as he puts it:

On the banking book side, the current IASB accounting treatment requires banks to *recognise the implications for potential loan losses of events which have already occurred, such as failures to make interest or principal payments; but also requires them only to recognise such known events, not to anticipate possible or probable future events. This necessarily implies that loan loss provisions will vary dramatically through the economic cycle, and means that in good years income will be declared which does not reflect the average future loan losses likely to arise from loans being put on the books.*

As a result, this accounting treatment can contribute to a cycle of self-reinforcing responses which tends to exacerbate the volatility of credit extension and of the economic cycle, both on the way up and the way down.

At long last! Someone has said it. Actually, he said more than that. As he pointed out:

For the fundamental problem we face is that there are no definitive â€šÃ„Ã²facts' about value — but that value in financial markets is contingent on specific circumstances and on the action of all other participants. For an individual bank selling slices of its individual portfolio in conditions where the actions of other banks can be considered as independent, mark-to-market accounting provides meaningful facts and a useful management discipline. But if all banks simultaneously try to sell all or a significant proportion of their assets, the facts become quite different.

Or to put it another way — those who built accounting rules on the basis of the efficient market hypothesis get those rules very, very wrong.

So he argues for a new form of accounting for bank losses:

Faced with that trade off between divergent aims, the FSA's ideal preference would be to provide not one but two separate lines of account information on loan loss provisions.

* *The existing line, based as now, on the facts of already incurred credit impairment events.*

* *And a separate line, based either on a formula, as in Spain, or on the judgements of management, challenged by regulators, and with the details, basis and rationale for that judgement extensively disclosed.*

Which is am pretty damning indictment of what has gone before.

It's also a damning indictment of the International Accounting Standards Board's claim that the only people with interest in accounts are providers of capital. he is saying there is reason to provide data for many more reasons than that, and if that is all that is done disaster can follow — as it has.

Not a good day for the IASB. Or banks

But a good day for accountancy, maybe.