February 2011

FASB—Fraud As a Standard Board[1]

One of my biggest regrets I have as an investor was failing to realize how the rumors of FASB's suspension of mark to market accounting in March of 2009 would send bankrupt financial stocks up hundreds of percentage points over the next two years. An investment of as little as $100,000 in these failed banks would have produced a small fortune for investors. I failed to invest in the banks back then because I didn't think that sophisticated investors would be so quick to play make-believe with their capital. I believed the market would follow the logic of Abraham Lincoln when he said, "How many legs does a dog have if you call the tail a leg? Four. Calling a tail a leg doesn't make it a leg."

I also recalled what happened to some gutsy speculators who were massively burned in the late 1980s by buying shares of the Savings and Loans when they were trading at only a few cents. "Cheap" stocks that have already fallen 90% can still lose another 100% after you buy them. Back then, hundreds of Savings and Loans were allowed to go bankrupt and the fraudsters were rightfully locked up in jail. To date, I am not aware of a single bankster from the Too Big To Fails (TBTF) that has gone to jail. Wasn't the extremely cumbersome Sarbanes Oxley bill supposed to hold CEOs accountable? Our country now has two sets of rules: Big Brother police state for the masses and whatever you can get away with for the ruling elite. Look at what our paramilitary SWAT team police force has become. I encourage everyone to watch the horrifying film, Waco: The Rules of Engagement, read up on Ruby Ridge, or to look into the SWAT team killing of seven-year-old, Aiyana Jones last year.[2] Contrast these episodes with when TBTF banksters steal billions of dollars and knowingly commit fraud and perjury. Nobody goes to jail to discourage the next crime; they get to settle with the SEC "without admitting any wrongdoing." Where are the handcuffs? How much longer will we submit to this?

If the United States is to prosper in our global economy, we need to restore the rule of law and have it apply to everyone equally. Did you know that CONgress is allowed to trade on insider information? We also need transparency in our reporting and financial markets to instill confidence in our markets to the globe.

Investing overseas used to appear riskier because of strange currencies, foreign regulators and lawmakers, and foreign accounting standards. The SEC has done an excellent job over the last decade of showing investors that it can't get much worse than Enron, Bear Stearns, Lehman, Madoff, and Stamford. Whistleblower, Harry Markopolos is famous for warning the SEC about Madoff ten years ago. In 2009, he testified, "The SEC had enough to get Madoff. I drew them pictures. I gave

[1] I would like to thank Karl Denninger of market-ticker.org for giving me permission to use his acronym for FASB.

[2] http://www.clickondetroit.com/news/23592538/detail.html

them a road map. I told them what questions to ask and who to phone." He also added, "they [SEC] roar like a mouse and fight like a flea."[3]

I believe investors would be better off without an SEC. A "powerful" regulator gives investors a false sense of security and makes them lazier when it comes to doing their own due diligence. All we really need is to enforce the rule of law and prosecute fraud and respect the rights of private property. The public has become too lax and reliant on the SEC to protect them. Last year we found out that many of the regulators were too busy downloading pornography at work to look into the books of the big investment banks before the financial crisis.[4] A recent web search found zero cases of an SEC employee being fired from the porn investigations.[5] What would happen to an employee at your firm who spent hours each workday on naughty.com?

It is not just the financial regulators that have been co-opted by their corporate handlers. In May of 2010, we found out that employees of the Mineral Management Service (MMS) were accepting gifts, being entertained, and having sexual relations with the oilmen they were supposed to be regulating! Some MMS employees were even allowing oilmen to fill out their inspection forms. Between the crystal meth hangovers, sex-toy parties, and emailing porn, I don't see how the MMS had time to protect the important gulf coast.[6]

Since the Corporatocracy has taken over DC, the regulators, and the media, I was hoping that the accounting profession would stand in the gap and provide much needed adult supervision. Alas, they have succumbed to the same greed and political pressure that is rotting our nation.

When we think of accountants, we typically think of brainy, conservative bald guys with glasses. We see them as careful and diligent number crunchers that will not rest until the assets of a company balance with the equity and liabilities to the penny. They are supposed to be the enforcers of rules and keep companies in check. Unfortunately, today's Financial Accounting Standards Board (FASB), the official arbiter of U.S. accounting rules, has succumbed to the influence of the financial lobby. Famed investor, Dr. John Hussman, recently had this to say:

> As for the U.S. financial system - particularly major banks - I am continually perplexed by the juxtaposition of tens of millions of underwater mortgages and millions of delinquent and unforeclosed homes, coupled with a set of FASB accounting rules (revised at the height of the recent crisis) that allows these debts to be carried at face value upon the discretion of the banks that report the data. I'll say one thing - it should take less than two seconds of thought to recognize that allowing dividends, bonuses, and other withdrawals of capital - without the requirement that banks mark their assets to market - is quite literally how Ponzi schemes function. We've laid a lovely turf lawn over a toxic waste dump, and are all too willing to assume that the underlying issues have been solved. The FASB and the Fed have turned the U.S. banking system into the Love Canal.[7]

Hussman is referring to the April 9, 2009 FAS 157 (Financial Accounting Standards) update that suspended the use of mark to market accounting. Mark to market accounting is an accounting method where firms are required to regularly update their assets prices to reflect current market prices. During the panic of 2008, many of the TBTF banks did not like the discipline that mark to

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[3] http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5663759.ece
[4] http://abcnews.go.com/GMA/sec-pornography-employees-spent-hours-surfing-porn-sites/story?id=10452544
[5] http://www.cbsnews.com/stories/2010/04/28/politics/washingtonpost/main6440357.shtml
[6] http://motherjones.com/blue-marble/2010/05/ig-report-mms-regulators-accepted-gifts-jobs-oil-industry-drugs-porn
[7] http://www.hussmanfunds.com/wmc/wmc110124.htm

market accounting imposed on them. Many of the assets that they owned were trading at deep discounts to what they thought they were worth.

Below is a graph of one of the AAA ABX.HE subprime indexes. These indexes made a lot of news in 2007-08 as some of the savvier investors made fortunes shorting them. As you can see, this index

Courtesy of Bloomberg

collapsed in the fall of 2008 and bottomed out alongside the stock market in 2009. Under mark to market accounting, banks were forced to adjust their balance sheets to the market price of the subprime loans that they held on their books. I believe this to be the best system because it is transparent and leaves less grey area for banks to try and cover up reality.

Now that FASB has caved, we have mark-to-myth or mark-to-make-believe accounting. This allows banks to use a model to determine the "true worth" of a subprime second-lien against a heavily underwater home in Nevada. The bank may now carry this loan at close to face value, while the market may be correctly discounting that there is an extremely good chance that this home owner defaults and the second lien holder will recover zero. I think the big banks are using these models to exaggerate their assets by several billion dollars.

To be fair, the market is not always right either. It sometimes overvalues or undervalues particular assets. In discussing paper money versus gold, Georg Bernard Shaw said, "You have the choice between the natural stability of gold and the honesty and intelligence of the members of government. And with all due respect for those gentlemen, I advise you, as long as the capitalist system lasts, vote for gold." I would add that when given the choice of trusting creative bank accountants or the market, vote for the market.

I have written extensively about how using fiat paper money and fractional reserve banking already have made our financial system a house of cards. These banks are so large that their mistakes can literally bring poverty to millions of innocent people. Clearly the “leaders” of Bear Stearns, Lehman Brothers, Countrywide, AIG, Wachovia, Washington Mutual, and Merrill Lynch did not see a nationwide housing bust coming or they wouldn’t have invested so heavily in toxic mortgages. It makes me sick to think that we are now going to allow their accounting departments to be even less transparent and mark many of their assets to models that obviously aren’t good at predicting the “true value” of the financial assets that they hold on their books. Hopefully they will not be using the models that the rating agencies used to turn toxic waste subprime mortgages into AAA paper.

On January 28, we learned that part of the weakness in the gold market has been caused by SHK Asset Management’s liquidation of their futures positions in gold. The tiny $10 million fund controlled $850 million worth of gold. That is roughly equivalent to all of South Africa’s annual gold production. It is shocking that $10 million can be levered up to control $850 million.[8] We already allow too much leverage in our shaky system and it is insane that banks are allowed to keep as little as 10% of our deposits on reserves. Is loosening disclosure requirements and allowing creative accounting a step towards stability for the world’s economy?

On January 26, 2011 we learned that FASB Chairman, Leslie Seidman has decided to “bow to an intense lobbying campaing” from the bankers and continue with “mark to myth” accounting.[9] Leslie, if you are reading this, I want you to know that you are a coward and are helping perpetuate a ponzi banking system. The blood is already on your hands for the next financial crisis. I was hoping that the accounting profession would stand in the gap. I have been disappointed once again.

In addition to legitimizing “mark to myth” accounting, FASB rules allow companies to hide debt in off balance sheet special purpose entities (SPEs). As an outsider to the accounting profession, I don’t see how this could be OK as part of the official rules for accounting. According to David Trainer of New Constructs, there are over 2,900 companies with off balance sheet debt. He recently sited Kohl’s as an example of a company that kept over $8 billion of debt (61% of total assets and 50% of its market cap) off its balance sheet.[10]

Bank balance sheets are even more opaque. Hedge fund manager, Bill Fleckenstein, was one of the first to warn of the financial crisis brewing at the banks. In the fall of 2007 he wrote an incredibly prescient article called *Banks’ Dark Off-Balance Sheet World* where he questions banks use of complicated conduits and special-purpose investment vehicles. Fleckenstien states:

> As to why these infinitely leveraged black boxes (with extremely flexible accounting and disclosure rules) exist in the first place, I think we know the pat answer: so that financial institutions can employ them and utilize even more leverage than they are legally allowed

[8] http://www.ibtimes.com/articles/106288/20110128/huge-gold-position-liquidated-by-us-hedgefund-wsj.htm
[9] http://www.zerohedge.com/article/bankers-kill-mark-market-good-former-fdic-chairman-gloats
[10] http://seekingalpha.com/article/236687-off-balance-sheet-debt-fasb-proposes-a-new-standard-to-help-investors

to. Which makes one wonder: Since these entities are designed specifically to circumvent the rules, why have they been countenanced by the rule makers?

In 2009 Wells Fargo had $1.29 trillion in assets on balance sheet and an amazing $1.9 trillion off! How can an investor buy these stocks when they are complete black boxes? Wells CFO, Howard Atkins said, "virtually all of the mortgage business that we originate, we do not keep on the company's balance sheet." [11] They justify hiding these assets (including a lot of the toxic waste they bought from Wachovia) by noting that the assets are insured by the U.S. government. Don't forget, Fannie and Freddie can "put-back" these mortgages if they find that did not meet the standards that were specified (also known as fraud). Bank of America received another tax payer gift recently when it settled with Fannie and Freddie for only $2.8 billion for put-backs.[12] Clearly there is risk to these banks and it would be very reasonable for investors to be able to see what companies have off balance sheet. Investors in Enron found out the hard way and as I see it not much has changed since then.

The derivatives, SPVs, conduits, and models used to value assets are so complicated that I doubt that any CFO at a large bank truly understands everything that they own and can give you an accurate assessment of the true risks that they are taking. Grow a back-bone FASB. Our financial system needs transparency and forced discipline; not opaqueness and grey areas.

Markets

Update on Municipalities

January was a busy month for municipal bond news. The Ishares S&P National Municipal Bond Fund (MUB) hit a new low of $95.85 per share on January 14, Congress has begun working on legislation to allow states to file bankruptcy, and several cities came closer to facing the truth about debt.

On January 7, 2011 Chowchilla, California, a small city in Central California, failed to make a payment on bonds used to borrow money to refurbish its city hall. I don't see how their timing could have been any worse. They assumed home prices would always go to the moon and borrowed to expand the city hall close to the top of the housing market. They apparently needed more space for city workers, but have since had to cut their work force by 45% since mid-2009. Some houses are now selling for $200,000, down from $475,000 at their peak and the city has close to an 18% unemployment rate.[13]

It was also announced in Janaury that Vallejo, CA will only pay 5-20% to general unsecured creditors in their bankruptcy. "No city or county has used federal bankruptcy laws to force creditors to take less than they are owed," said Bruce Bennett, the lead lawyer in Orange County's 1994 bankruptcy.[14] The citizens of Vallejo will not have to pay a large portion of their debt, but unfortunately they did not take advantage of the opportunity to rewrite their union contracts.

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[11] http://www.thestreet.com/story/10552223/2/wells-fargos-balancing-act.html
[12] http://www.bloomberg.com/news/2011-01-03/banks-stocks-rise-after-bank-of-america-settles-mortgage-putback-claims.html
[13] http://www.latimes.com/news/local/la-me-chowchilla-20110107,0,4007963.story
[14] http://www.bloomberg.com/news/2011-01-19/bankrupt-vallejo-in-california-files-plan-to-end-court-control-of-finances.html

Without negotiating lower wages and benefits, they could end up back in bankruptcy court in the future.

Camden, New Jersey, "The Most Dangerous Town in America," is about to become even more dangerous. One fourth of the local government work force is expected to lose their jobs. That is about half of the police force and one third of the firemen. According to the FBI, the city had 2,380 violent crimes per 100,000 residents in 2009.[15] The public unions were not willing to negotiate reasonable concessions and many have chosen to sacrifice their co-workers' jobs in an effort to keep their higher pay. This news cannot help property values in Camden and its nearby neighbors.

Lastly, on January 20, the New York Times reported that congressmen are "working behind the scenes" and are "going about their work on tiptoe" with this issue.[16] It may be difficult to pass this legislation, but once you get to unsustainable debt levels, there is no other alternative but to negotiate your debt with creditors. In the long run, bankruptcy is the best decision for many municipalities. It may mean some pay cuts and lost pension benefits, but bankruptcy is simply reality for many cities and states. We can no longer kick the can down the road. The longer you try to postpone pain, the worse the pain will be when things begin to unravel.

Below is a chart of the iShares MSCI Emerging Markets Index fund. As you can see it peaked in November and has failed to follow the S&P 500 to a new high in February. The Russell 2000 Small Cap Index and the NASDAQ have also failed to confirm new highs from their recent peak. These divergences along with many overbought momentum indicators tell me to be cautious here. Don't forget that the Chinese stock market peaked in November of 2009 before the April 2010 peak on the S&P 500. The S&P then bled 17% in less than two months.

Courtesy of StockCharts.com

[15] http://www.nj.com/news/index.ssf/2011/01/mass_police_layoffs_being_in_c.html
[16] http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?_r=3&src=busln

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