When Fed locks up funds, small businesses suffer

September 17 2015

When the Federal Reserve raises interest rates to slow down a speeding economy—effectively raising the price of money—banks often sell down their stockpile of securities to keep the financial assembly lines going. That's much like a widget-building company might rely on a warehouse of raw materials when prices rise.

But according to newly published research from Binghamton University, federal accounting rules can padlock those warehouses, particularly hurting small banks and their customers.

"They just don't have the funds to lend. They have less access to other funding resources—commercial paper, exotics," said Anthony Meder, an assistant professor of accounting at Binghamton University and author of the paper "Interaction Between Accounting Standards and Monetary Policy: The Effect of SFAS 115," published in the September 2015 issue of *The Accounting Review*.

Here's what's happening: The Statement of Financial Accounting Standard 115, set by the Financial Accounting Standards Board, keeps corporations on U.S. stock exchanges transparent by governing how they report finances. It requires banks to categorize the securities they buy in one of three ways: tradable in the everyday course of business, available for sale or hold to maturity.

Accounting regulations govern the hold-to-mature securities, or HTMs, in a different way. Rather than recording profit or loss as income on quarterly statements, they aren't recorded until sold at maturity, which can provide some accounting benefits over time.

However, they cannot be sold before maturity without facing significant accounting penalties. So when the Federal Reserve raises rates, and banks look to sell excess securities to maintain liquidity, those banks holding too much in HTMs—particularly those with less than $1 billion in assets—are stuck with a warehouse full of cash they can't use.

That, in turn, means the Federal Reserve can overshoot its mark in slowing down the economy, like hitting the brakes too hard on a speeding car.

It also means small businesses in particular—from a local pizza joint to a bio-pharma startup—have a tough time getting cash they need to grow, said Meder, a regional bank's credit analyst before he came to academia. "Regional banks are where the local businesses tend to go," he said.

And as small companies generally have greater growth potential than larger companies, that further limits economic development.

However, Meder, who spent six years in research and the peer review process, is reluctant to tell the federal government how to consider bank portfolios in their decisions. "Can they pull out the HTMs? I don't know," he said. It just wasn't part of his research.

The important part, says Meder, who describes himself as an empiricist always looking for fact, is that whatever the Federal Reserve decides to do with it, he has given them new information—new fact—that can make a difference.

More information: Interaction between Accounting Standards and Monetary Policy: The Effect of SFAS 115, Anthony A. Meder, DOI:

10.2308/accr-51029