

## Market Update – April 12, 2009

### Part 1: Introduction

Today, I am venturing into a topic that I have no right to discuss. Of course, many of you think that when I discuss finance. You may be right. But today, I'm going to discuss accounting. My goal is to give you a big picture view of something that has been big news for the past two weeks: the changes in fair value accounting (also known as "mark-to-market" accounting). In particular, I want to discuss this as it relates to banks. Obviously, there are people far more qualified to speak about this, so take my thoughts with a boulder of salt.

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### Part 2: Big Picture – Overview – Read this First as it will give you the big picture and will help you to understand Part 3.

Banks classify securities as either:

1. Held-to-Maturity
2. Trading Instruments
3. Available-for-Sale

Trading instruments and available-for-sale securities must be written down to fair value. **Fair value** is the price at which these securities would trade in a normal, orderly market. We determine fair value in different ways, depending on whether we classify the securities as Level 1, 2 or 3. Level 1 uses actual market prices; Level 2 uses inputs from similar transactions; and Level 3 uses the bank's own inputs and models.

Two important nuances:

1. While Held-to-Maturity securities are not normally written down, they are written down if their value is impaired and the impairment is "other than temporary." If written down, earnings and regulatory capital drop.
2. While "Available-for-Sale" securities are written down, the writedown does not impact earnings or regulatory capital. The writedown WILL affect earnings or regulatory capital if the impairment is "other than temporary."

Important Conclusions:

1. Values are greatly impacted by whether securities are classified as Level 1, 2 or 3. This classification will determine whether the bank uses actual market values or inputs or their own model.
2. The determination that an impairment is "other than temporary" has a big impact on earnings and regulatory capital. To the extent that banks are able

to avoid the classification (that an impairment is “other than temporary”), they can boost earnings and maintain regulatory capital.

### **Part 3: Background (Detail)**

Banks classify securities in one of three ways:

1. **Held-to-Maturity** – these are debt instruments that the bank intends to hold until maturity. They are put on the balance sheet at cost and amortized (i.e., they move systematically towards par value). Normally, changes in the value of this type of security do not affect the earnings or capital of the bank. A bank may, however, have to mark a “held to maturity” security down (lowering earnings and capital) – if it is impaired and the impairment does not appear to be temporary.
2. **Trading instruments** – debt or equity instruments that are owned in order to trade (hopefully at a profit). These instruments must be kept on the balance sheet at fair value (described below). Changes in fair value immediately impact the earnings and will affect the capital account.
3. **Available-for-sale** – these are debt or equity instruments that do not clearly fit into category one (held-to-maturity) or category two (trading instruments). These instruments are marked down to fair value, but the change is part of “Other Comprehensive Income” in the equity account. In other words, changes in value do not affect the earnings (until the security is sold). Importantly, by including the impairment in Other Comprehensive Income, the reduction to the Equity account does not affect regulatory capital. But, if the impairment is “other than temporary,” the loss is realized and it hits earnings (and capital).

With trading instruments and securities that are available-for-sale, they are marked to fair value. **Fair value** is the value that a buyer and seller would use to engage in a transaction in an orderly market.

In order to reach fair value, assets are classified in three ways:

1. **Level 1 Assets** – these assets trade in a liquid market. Prices are easily obtainable. A good example would be publicly traded stocks or Treasury bonds.
2. **Level 2 Assets** – assets that trade in inactive markets. We may not have an exact market price, but we can look at comparable securities and use those inputs to price our security. An example may be a corporate or municipal bond. This is sometimes referred to as “mark-to-model.”
3. **Level 3 Assets** – these assets trade in inactive markets and we don’t have comparable inputs to use to price them. We have to use our own

assumptions and models. People sometimes refer to this as “mark-to-make believe.”

#### **Part 4: The Changes**

FASB made the following changes:

1. **Made it easier for banks to ignore market transactions so that they can use their own inputs or models.** The FASB identified characteristics which evidence that a market is not active (or that a sale is distressed), including:
  - a. Few recent transactions
  - b. Quoted prices are not based on current information
  - c. Quotes vary substantially over time
  - d. Quotes vary substantially between different market participants
  - e. Large bid-ask spreads
2. **Made it easier to avoid classifying an impairment as “other than temporary.”** Securities that are held to maturity or available-for-sale must be written down if their drop in value is considered to be “other than temporary.” When it is written down, this hits the earnings and regulatory capital. In order to avoid this classification, it used to be that management had to assert that it had the ability and intent to hold the security until the price recovered. Going forward, management simply has to assert that it does not have the intent to sell the security and that it is “more likely than not” that they will not have to sell the security before its price recovers.
3. **Reduced the amount of loss that has to be recognized if a security is impaired and the impairment is “other than temporary.”** If a security fits the new standard of impairment that is not temporary, the only loss that has to be recognized is the credit loss, but not the decrease in value that has arisen from other sources (such as an illiquid market). The credit loss will hurt earnings and regulatory capital. BUT, the loss will not include the “non-credit” sources (such as illiquid markets) which will be housed in “Other Comprehensive Income” and will not affect earnings or regulatory capital. Obviously, this will all be impacted by management’s assumptions.
4. **The banks will need to have greater disclosure,** including:
  - a. The cost basis of available for sale and held-to-maturity debt securities by major security type
  - b. The methodology and key inputs, such as:
    - i. Performance indicators of the underlying assets in the security
    - ii. Loan to collateral value ratios
    - iii. Third party guarantees
    - iv. Levels of subordination
    - v. Vintage

## **Part 5: Arguments in Support of the FASB's Changes**

1. Marking-to-market forces banks to price securities well below their real valuation. The discount results from poor liquidity, not poor cash flows.
  - a. FHLB of Atlanta wrote down its MBS portfolio by \$87.4 million in Q3. Yet, their projected loss on the portfolio was \$44,000.
2. The old rules lead to a death spiral for the economy. Once one bank marks securities down, all others have to. Security prices drop and lending stops.
3. Lower valuations make it difficult to sell the securities at anything but fire price sales (and there's no incentive to do this).
4. These unrealistic losses have reduced banks' capital and therefore lending is reduced.
  - a. The incorrect reduction of equity destroys our system because banks are levered 10:1.
5. There's no reason to make a bank write down a security if the bank plans to hold it until it recovers or if we don't know what the actual losses will be.
6. The overstatement of losses has made it easier for short sellers to spread rumors and profit.
7. By forcing equity write-downs, we have increased the probability of insolvency and lowered the value of banks.
8. The old rules made it very easy for people to manipulate the market by entering into transactions to drive market values (of securities) down and hurt banks.
9. Accountants simply want to avoid liability and the old rules result in the accountants pointing to recent transactions in order to come up with values.
10. Bank stocks have surged since the change in rules. In addition, as confidence in banks has increased, we have more confidence in all companies.

## **Part 6: Arguments Against the Changes (Arguments are Grouped into Categories)**

### **There are Better Alternatives Than Lowering the Standards**

1. We know marking-to-market is not perfect, but leaving securities at cost certainly isn't better. Similarly, relying on management's assumptions is not attractive.
2. Do you like the idea of bank profits being higher because the banks are assuming that the securities are worth more than anyone is currently willing to pay for them? It's like me going in to get a loan and saying that my stock portfolio is worth more because we're not in normal times.
3. Investors need to know how much they could get if a security (or portfolio) was liquidated now. Investors do not need a rosy picture of what securities would be worth if we were in normal times.

4. We're seeing very large losses in CDOs and MBS. We shouldn't enable banks to hide these losses.
5. We have very limited evidence that these securities are being undervalued.
6. It's going to be particularly difficult to analyze credit losses if all banks are using different models.
7. It would be better to relax the regulatory capital rules, but allow people to trust the financial statements.

### **We've Increased Distrust in Many Ways**

1. We're going to further reduce investors' trust in the financial statements of all companies. This will make it more difficult to raise private capital.
2. We have eliminated the independence of standard-setters. In March, the FASB chairman was told by Congress to either make these changes or Congress would do it for them. Is this how we want our accounting rules created?
3. This change is problematic because it is so close in time to the Congressional grilling. In addition, there was a very short discussion period.
4. Apparently, FASB chairman Robert Herz disparaged "mark-to-management" accounting the day before his Congressional proctology exam.
5. The new accounting rules are the optimistic alternative. We tend to think of accounting rules as promoting conservatism.
6. One of the FASB members (Lawrence Smith) said that he was deciding which way to vote as late as the day of the vote. That doesn't give me much confidence that it was a clear decision.

### **If The Banks Like This Idea, It Must Be Bad**

1. We don't trust the banks (or Congress). The banks have a record of poor risk management, bad models, poor loans, etc. Why do we want to trust them to determine that a market is inactive or that a transaction is distressed?
2. Would banks be open to eliminating the mark-to-market accounting rules for clients who have these securities in margin accounts?

### **We're Hurting the Chance of PIPP Success**

1. Banks may now say that they are not going to sell these securities, so they don't need to mark them down. It may stop participation in PIPP.
2. These rule changes may make it easier for banks to ignore the PIPP auction results. Banks can decide that bids are too low and that they are not going to

write their assets down. Or, if another bank sells the same security, it may be easier to say that this is a distressed sale.

3. This plan is similar to PIPP. It's an attempt to increase the equity value of banks. PIPP does it through bids that are too high. This does it through accounting.
4. The rule changes will stop banks from doing what the PIPP wants them to do – get rid of the assets. They can keep the assets on their books and maintain their value.

### **Helping Short Sellers**

1. We may actually be creating more opportunities for short sellers. The reduction in markdowns will allow short sellers to convince the market that there are problems which the market has not recognized.

### **Other Arguments**

1. Do you really believe that all of the problems have been based on accounting issues?
2. The SEC recently studied the “mark-to-market” rules and concluded that they did not cause the bank failures in 2008. The SEC found that stocks dropped before any writedowns. I have not read the SEC report, but this sounds like flawed logic. Stocks can drop because they know that the writedowns will eventually happen and will lower the bank's regulatory capital.
3. Giving flexibility to banks will result in greater variance of estimates. This makes analysis harder for investors.
4. While stock prices have increased, so have prices on credit default swaps. In other words, we have seen greater potential upside for shareholders and greater possibility of loss for bondholders. In other words, we've increased risk and the result is a wealth transfer (from bondholders to shareholders).
5. Doesn't this smell just like “options aren't an expense” or “we don't have a way to value the option expense” arguments of the 1990s?

### **Part 7: You're Supposed to Fill in Form Letters**

Many different opinions were expressed to the FASB as they considered these issues. Many groups asked members to use form letters (APPROPRIATELY FILLED IN) to lobby the FASB. The Georgia Affordable Housing Coalition submitted a comment letter to the FASB. Apparently, their letter specifically said, “This letter sets forth the comments of [insert name of organization here] regarding these proposals.” Nice work Georgia. Interestingly, one time I was having breakfast in Georgia and I sat at a table next to these guys. I heard one of them place his order when he said, “I'll have three eggs any style with the meat of your choice.” Lets be honest here...Georgians are descendants of people who wanted to go on the Oklahoma land rush, but got lost.

## Part 8: Conclusion

Typically, when I research and write these Market Updates, I know my opinion and I struggle to maintain some fairness to the other side. This week, researching this issue helped to change my opinion. I'm officially in the middle on this one.

I started with the view that these changes were a total sham. The value of these securities has not changed, but we want to measure them differently. I still feel that way. Yet, I'm sympathetic to the view that these securities may be trading in distressed markets and this causes a tremendous number of problems. Simply put, I could imagine a situation in which one of my neighbors has to sell their home in this market and it could lower the "market value" of my house. Yet, the neighbor's sale might be somewhat distressed and if I had to report my lower net worth to my bank and post more capital, I'd be very unhappy.

We have inconsistencies in a lot of this accounting. If a bank makes a mortgage loan, they will maintain the loan at cost. If a bank buys a liquid mortgage backed security, the bank will use fair value (likely they will use recent transactions). If a bank buys a CDO that is backed by mortgages, the bank will probably use their own model to value this. I'm not sure that this makes sense.

A few conclusions:

1. Banks are going to have to disclose their changes in valuation techniques. We'll see more emphasis on analyzing level 3 assets. We'll want to examine changes in unrealized gains / losses in Level 3 assets. If a bank reduces those losses to increase capital, are you going to be suspicious?
2. I like the additional disclosures that banks will have to make.
3. Some analysts have said that this change in rules could increase bank profits by 20%.
4. Tangible common equity will continue to be the more important guide to bank capitalization because it factors in unrealized losses.
5. Maybe none of this matters – it's all guidance.
6. The reason that we're still fighting about this is that we still don't know the value of these securities. The investment bankers who put these together really did us wrong.

In sum, I don't agree with every argument (in support of or against the changes) that I listed. But, I think most of them make sense. There are a lot of smart people who feel very strongly on each side of this issue. Much of this comes down to whether you believe that current transactions are true market values or whether you think these are being done at misleadingly low prices. Regardless of which side you come down on, hopefully this paper helps you to see a little bit more of the issues.

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