THE BIG PICTURE OF 159

by Steve Brown

While many banks are rationalizing 159 away before the April 30th early adoption deadline, rest assured it will be back. In fact, the rules say all banks will need to adopt the proclamation's principals and substantiate their fair value methodology promoted in FAS 159 and further outlined in FAS 157 by Jan 1, 2008. We think FAS 159 does not go far enough. Yes, the move will create more volatility on the balance sheet and the income statement, but that is the point. Banks that don't want the balance sheet swings will need to more effectively manage risk. Banks that run a 6.00%, 3-month CD promotion for example, will instantly see the loss of franchise value to their bottom line. Conversely, those that book a 7.25%, 10Y office loan will see value materialize. Given this change, successful banks will need to adopt an attitude of asset management over traditional banking. Once banks start marking to market, total return (stated interest rate, plus market value change, plus reinvestment) will step to the forefront. The long-run implications for banks are positive, but there will be some growing pains along the way. Take the mere fact that FAS 159 eliminates loan losses and accrued interest as balance sheet items. Loans will be marked-to-market, so both are already part of the market value. That means there is no need to handle them as separate accounting items. For example, assume a bank's loan was originated at a par dollar price ($100.00) and they booked a 1% loan loss allowance. That loan would be carried under FAS 159 at a $99.00 dollar price or a 1% discount. This also forces banks to deal with credit risk on an ongoing basis. At present, loans are valued using a discounted cash flow methodology without regard to the risk associated with that set of cash flows. In addition, many banks will struggle with their loan systems, since fair market value is used to calculate interest accruals going forward. Systems will either have to be modified or manually adjusted. Credit underwriting will also soon change, as a bank's borrowers will also start to implement FAS 159 and its related guidance. All this trouble pales in comparison to the actual system required to value underlying instruments. Here at BIG, it has taken us more than 3 months to adjust our models to be able to apply fair value to our client's balance sheets. Deposits, fee income streams, stock for PCBB (think of that gain) and loans will all need a quantifiable and accurate system to capture fair value. While banks currently calculate fair value on a discounted cash flow basis going forward, banks will have to learn how to also incorporate credit spreads and market prices for at least 30 types of instruments. We estimate the average $2B bank will need to do this on more than 140 instruments. While complexities are deep and early adoption timing is short, we sincerely feel this is what the industry needs to take risk management to its next level. We will soon provide clients with more information on policies, procedures, methodologies and assistance. If you have any thoughts on the above, or would like additional information as it becomes available, please let us know. We would like to get the word out to other bankers struggling with the same issues. We also expect to have a tactical position paper out shortly.

BANK NEWS

M&A

A consortium of banks and private equity funds have purchased student loan lender Sallie Mae for $25B. The buyers were JPMorgan Chase, Bank of America, JC Flowers and Friedman Fleischer & Lowe. Sallie Mae manages a $130B portfolio of 10mm student loans and is America's largest source of funding and servicing for education loans.

M&A

Late Friday, Royal Bank of Scotland PLC, Banco Santander Central Hispano SA and Dutch bank Fortis NV sent a letter to ABN AMRO "inviting" the company to enter talks with them. The move is a counter to efforts already underway by Barclay's PLC to acquire ABN AMRO.

Industry

John W. "Jack" Henry, the founder of technology firm Jack Henry & Associates, has died at the age of 71. He founded Jack Henry & Associates in 1976. Jack Henry's company has grown to employ 3,500 people and has 8,700 financial institution clients.

Competition

Wachovia, the 4th largest bank, said 1Q profit climbed 33%. The bank indicated that commercial lending growth and the acquisition of Golden West Financial offset lower NIM and higher credit losses. Commercial lending surged 10% as NIM declined to 3.01%.

Expanding

Republic Bancorp ($3.1B, KY) said it will open 4 branches in KY and may open 2 in FL in the next 18 months.

CFO Study

A study of senior financial executives by Grant Thornton finds 34% said the economy will improve this year, while 71% said inflation will stay flat.

Countrywide

The largest mortgage underwriter in the nation said that its rate of pending foreclosures nearly doubled in March to 0.83% from 0.44%.