BEAUTY, VALUE AND FAS 157

by Steve Brown

As we usher in the New Year, we also ring in FAS 157 which will be effective for reporting entities as of 01/01/08. FAS 157 provides a consistent definition to value balance sheet items and, different from the past, looks at not what you paid for an item, but a best estimation of what you could sell a position for. While disclosure of the market value of loans is not new, FAS 157 changes the way institutions have to document and determine market value.

Basically, FAS 157 establishes a 3 level framework to derive fair value. Level 3, are those instruments, like loans, that have no observable inputs. As you can imagine, the calculation of a Level 3 instrument requires significant judgment on the part of management. This is exactly what is happening in terms of the subprime market and credit crisis. In order to assist banks help price and value their loans, as of January 2008, we began publishing a matrix of loan pricing (sent out in the monthly ALCO report) based on the following factors: 1) Where we have seen actual loans trade (we keep a log of loan types and where they have priced); and, 2) To the extent we do not observe actual trades, we are using our Loan Pricing model to create a risk-based pricing level, using observed trades as a basis for price.

As a caveat, since no two loans are alike, we have established a benchmark cost of funds, borrower quality, fees and loan size. Banks will have to make adjustments, either by using their own loan pricing model or estimating using the matrix price for their own particular differences in credit, cost of funds, fees, etc. This loan pricing matrix will be published monthly as part of our normal End-of-Month Report that is sent out via e-mail after the close of each month (we just sent one out last Thursday). This matrix gives banks yet another frame of reference, which may be incorporated into mark-to-market methodology documentation.

If you are not already a subscriber to the month-end report, contact us via e-mail and we will enroll you (and send you the latest version). Given the ongoing market volatility in all areas of lending, many bankers wish FASB would revert back to the old fashioned cost accounting methodology of yore (since the price would be quantifiable and indisputable). However, since risk changes, FASB these days is more interested not in what a bank paid for an asset, but what it can be valued at today. Put another way, while many may argue that pricing is difficult since "beauty is in the eye of the beholder," for accounting purposes, beauty really only pertains to the bid side of the equation.

SECURED FED FUNDS

We have a limited amount of availability left in our seasonal 2008 Secured Fed Funds Program. Priced at Fed Funds + 20bp, this is a simple way to pick up earnings. This program allows your bank to invest on an overnight basis in Fed Funds backed by an investment-grade bank and secured by conditional U.S. government receivables (tax refunds). This is an uncommitted line, so you only have to invest on the day of borrowing, if you have the money. No commitment is required to participate. The Program will kick off in the next 2 weeks, so we are making a final push. If you have not signed up yet, let us know via e-mail and we will send out all the information you need to get started.

BANK NEWS

Soft Holiday Spending

New research finds online spending this holiday season came in at its slowest pace on record, as higher oil prices and rising mortgage defaults led to a cut back in consumer spending. Experts predict this will be the worst holiday shopping season in 5Ys.

Housing Sector Pain

KB Home, the nation's No. 5 builder by revenue, said it is currently in talks with lenders. KB said large write downs in the value of its inventory and abandoned land option contracts had forced it to no longer be in compliance with some terms of its lines of credit.

Recession Prediction

Harvard economist Marty Feldstein said he now expects the economy to slip into a recession unless the FOMC cuts rates further and the Administration can push through tax cuts.

Rough Seas Ahead

Treasury Secretary Paulson said in a speech yesterday that the 1.8mm subprime mortgages that will reset over the next 2Ys, raises "the potential of a market failure."

Credit Situation

A new report from Moody's indicates banks may have to set aside even more reserves/capital in order to handle fluctuations in the value of collateralized debt obligations ("CDOs") and other structured credit products. While no exact number was provided, it is interesting to note that banks sold $469B of CDOs in 2007 and $769B in 2006.

Bankruptcies Jump

The American Bankruptcy Institute reported that the number of Americans filing for consumer bankruptcy rose by nearly 40% in 2007 to 801k, up from 573k in 2006.

Defaults Coming

Although the default rate for US high-yield companies fell to just 0.34% in December, a group of analysts are predicting that number will rise to 4-5% by the end of 2009.