FAS 157 - RUNAWAY TRAIN COMING DOWN THE TRACKS

by Steve Brown

Early last year in this publication we told readers that FASB had released FAS 157 and 159. At that time, we also warned community bankers that both were going to be rolling down the tracks like a runaway freight train in 2008. Now that the year is here, it is time to revisit them. We know what you are thinking, but before tuning out for the morning and saying "let me dump this on the CFO and run," we suggest you might want to read further.

First, recall that FAS 157 is an accounting standard designed to provide consistent guidelines for how companies should come up with a "fair" or "market" value for their assets or liabilities. The underlying purpose of FAS 157 (Fair Value Measurements) is to create a consistent definition of what "fair value" is and how to calculate it. FAS 159 (The Fair Value Option for Financial Assets and Financial Liabilities), on the other hand, came out at the same time and it allows companies to mitigate income statement volatility by expanding on the use of "fair value." Bankers should know that while FAS 159 is optional, FAS 157 is not. As such, community bankers will have to deal with FAS 157 when they issue financial statements in 2008. At a minimum, FAS 157 items will have to appear in the footnotes.

To shed even more light on this issue and its impact on community bankers, recall that FAS 157 defines "fair value" as the price that would be received if an asset were sold (or the paid to transfer a liability) in an orderly fashion between market participants. Under FAS 157, companies must calculate fair value using one of three ways as follows: Level 1 = quoted prices in active markets for identical assets or liabilities. Level 2 = inputs other than quoted prices included in Level 1 that are observable for the asset or liability (either directly or indirectly). Level 3 = unobservable inputs.

Bankers wondering what the heck all of that means might consider some concrete examples.

To begin, a Level 1 price can be determined by an observable market price. For community bankers that could include prices on their stock (if traded on an exchange), a Treasury security, a callable agency security and many others. The key is that the price must be observable.

A Level 2 price is for assets or liabilities that do not have an observable price, but are based on inputs where prices are observable. Examples of this could be an interest-rate swap (based on inputs from the 10Y Treasury), or prices based on observable and regularly updated interest rates, yield curves, volatilities, prepayment speeds, loss severities or credit risks.

Finally, a Level 3 price is not observable, but rather is one for which market prices are scarce. Here, banks will have to use internal models to gauge their value, using their own assumptions about how market participants would price assets or liabilities using the best information available. Examples in this category could include goodwill, loans, CDOs, private equity, real estate and others.

In short, community bankers will need to beef up footnotes to segregate and capture the breakdown between measurements. In addition, gains or losses to earnings as a result of movement of "fair value" under each will also have to be reported. Finally, any other measurement that is the most painful possible for community banks must also be included in the footnotes (o.k., this one is just to see if you are paying attention).

The net result is that while community bankers are beginning to become aware of this, the impact is yet to be felt. It used to be that banks could argue that a given asset (or liability) was still holding up in price despite a given market downturn. Now, consider the disclosures that banks will have to make given that assets and liabilities will have to be priced as if they were going to be sold in the market. As such, expect writedowns (as we have already seen from the bigger banks) to begin to appear in the footnotes of community banks as early as the end of the 1Q. Get up to speed on FAS 157 and you will be the banker that catches the train instead of being run over by it.

BANK NEWS

FNMA

The GSE is rumored to have struck a deal with NY AG Andrew Cuomo that would require their in-house appraisal unit to be sold in order to maintain an arms-length distance in property valuations. This has consequences for larger banks that sell loans to FNMA, as they would need to use 3rd party companies for appraisals instead of the in-house unit.

Bank Satisfaction

The University of MI released their American Customer Satisfaction index rating 190 retail banks. Scores remained stable over last year, despite mortgage problems. Wachovia, JP Morgan Chase and Bank of America were the 3 highest rated banks. Citi and Wells tied for 4th.

BofA Countrywide

Despite higher than forecasted foreclosure rates, BofA is nearing the end of its due diligence for Countrywide and the deal is rumored to still be a "go."