OTTI Update

by Steve Brown

Along with higher loan loss reserves, another trend in banking has been an increase in other-than-temporary impairment (OTTI) losses. As you recall, bankers must determine (according to GAAP) whether the decline in a securities value is other than temporary. If so, the bank must recognize the decline immediately in income, as opposed to carrying it on their balance sheets at book value. Management has wide latitude in determining when a security is considered for OTTI, but the negative value, ratings, reason for the decline, length of time the security is expected to be underwater, prospects for a value recovery and the intent to hold it until recovery must all be taken into account. In short, if the future book value of a security is not expected to be recognized, then OTTI turns an unrealized loss into a realized loss.

The recent credit crisis and real estate decline have led to a drop in the market value of many assets held by banks, including mortgage-backed securities and certain equities. Permanent impairment is notable for banks in 2Q who wrote down FNMA and FHLMC preferred stock holdings, trust preferred securities, lower tranched whole loan securities and some credit-leveraged securities. Even worse, banks that bought these securities as part of a leveraged program were hit doubly hard.

Banks taking OTTI should recognize a couple of items. Once a bank takes an OTTI charge, unlike an actual loss, it does not become a tax event until the security is sold. The ramification of this is that OTTI is carried as a deferred tax asset until sale, before the loss is realized. The other aspect of OTTI that creates confusion among non-accounting managers is the classification of the type of loss for tax purposes. In terms of tax impact, losses are either ordinary or capital. Notes and bonds are debt securities, which are ordinary assets for banks. Any realized losses on these instruments are considered ordinary for tax purposes and can be deducted without regard to whether the bank has ordinary gains or income. Assuming that valuation allowances are not required against some or all of a banks deferred tax assets, the bank should record the tax benefit expected at the time the OTTI is recorded for debt securities.

The problem becomes more difficult for equity-type securities (Fannie/Freddie preferreds), which made up the majority of OTTI for 2Q. These equity securities are capital assets for banks. Capital losses may be deducted only to the extent of capital gains. The capital loss from the sale of these assets can be carried back 3Y and forward 5Y (starting after sale). Of course, before recording any associated tax benefit (i.e. timing the sale) a bank must determine how a capital loss can be maximized. Since a bank does not readily have capital gains, management should look closely at recording capital gains (such as a branch sale and leaseback). In order to increase return, if the bank can demonstrate and support its ability to use the capital loss via capital gains, it can record the tax benefit at the time OTTI is recorded. If not, the bank needs to consider recording a valuation allowance against the related OTTI deferred tax asset that would offset the tax benefit.

Now that the markets are forcing OTTI education on bankers, some are starting to develop a more comprehensive policy around it (that takes some of the guesswork out and lays out strict tests). Stressed values, rating changes, volatility measures, cash flow changes and a host of other attributes are being formalized. Further, banks are better-documenting the reasons they believe the securities in question cannot be held to maturity (i.e. level of loss, economic outlook, spread reversions, etc.

Banks are also doing a better job at documenting the outcome of these tests (for both impaired and non-impaired securities) to create a more robust audit trail. Finally, bankers are spending more time increasing education with the audit committee. This gives banks a check and balance system to avoid timing issues associated with OTTI recognition.

OTTI is slightly complicated, but it has growing implications on how banks are run, by determining what securities banks will purchase in the future. Understanding OTTI is important because it foretells the future of banking - managers will have to manage their balance sheet market-to-market position on an on going basis. Please note, the above are examples only and we are not trying to give tax advice. Check with your accountants and tax professionals before taking any action.

BANK NEWS

Settlements

Following UBS and Citigroups announcements, JPMorgan and Morgan Stanley said they too had reached agreements with the NY Attorney General to buy back $7B in auction rate securities and pay a combined $60mm in fines.

Projections

On average, economists now expect economic growth to slow to 0.6% by the end of the 3Q. Meanwhile, overall growth for 2009 is projected at slightly below 2.0%.

Compromised Data

According to Wells Fargo, access codes connected to a reseller of consumer data may have compromised consumer social security numbers and other personal information for 7k people. These codes are internally used by employees to access consumer credit data. Most of those affected are no longer customers of Wells Fargo.