COUNTING THE BEANS OF OTTI, FV, FASB AND BANKING

by Steve Brown

Late last week, following an extensive outcry and aggressive write-in campaign by bankers, the Financial Accounting Standards Board (FASB) finally modified its rules on "other than temporary impairment" (OTTI). All hail the bean counters.

There are two key aspects to the modifications worthy of discussion at this point related to OTTI and "fair value." The first, OTTI, states that securities need to be marked to market and that continues under the modified rule. In addition, if the bank has the intent to sell a security, then the bank should record the full market loss in earnings. If, however, the bank has no intent (or requirement) to sell the security, then it should record the estimated credit loss portion in earnings and the noncredit portion in "other comprehensive income" (OCI). This change allows banks to split credit losses from non-credit losses (such as a decline in value due to interest rates or low liquidity). By booking the difference between credit losses and mark to market losses in OCI, the income statement only includes the amount of impairment that is likely to be realized. In short, changes were designed to better reflect the difference between the fair value and the carrying value of impaired assets.

The change to OTTI is a mostly a good one for bankers, since it should serve to stabilize earnings and boost capital. The rules will have the most significant positive impact on larger banks (because they have a plethora of toxic assets) who will now be able to revalue the carrying amount of their toxic securities. The changes essentially eliminate the need for banks to write down assets they intend to hold to maturity, so that in turn, should help stabilize regulatory capital (since it is also supported by earnings). Experts predict the all-in impact of the change on large banks could be as much as a 10% increase in capital. In addition, banks that made purchase-accounting acquisitions and marked assets/liabilities very conservatively could also benefit.

The second key aspect to the rule change relates to "fair value." As part of the change, banks can use judgment in estimating market values when markets are illiquid or inactive. This allows banks to use modeled cashflows (such as present value of future cash flows) to estimate value, instead of relying solely on market price quotes during a stressed period. This change should also help banks since it eliminates the impact of being forced to use "fire sale" values when the market is under strain. Bankers should be sure they incorporate additional procedures, document evaluation processes, conduct model testing and improve disclosures as may be needed, to ensure compliance is adequate.

A few other important things bankers should know as a result of these modifications are: the rules are effective in the 2Q, but can be adopted in the 1Q if the bank so chooses; market losses are still required to be calculated and reported as they always have been for Held to Maturity securities (i.e. the new rule does not apply to HTM securities); fair value disclosures under SFAS 107 (disclosures about fair value of financial instruments) that were required on an annual basis must now be reported quarterly.

We consider this a "win" and it should raise the prestige of bean counters everywhere.

BANK NEWS

M&A

First Capital Bancorp ($460mm, VA) and Eastern Virginia Bank ($1.09Bmm, VA) agreed to a merger deal valued at an estimated $27mm. Combined, the banks will have $1.2B in deposits over 32 branches.

Threat

Secretary Geithner said the administration would move to replace top bank executives or board members if additional "exceptional assistance" is required.

Earning Season

Corporate earnings announcements start tomorrow and run through May 14th. Analysts predict earnings will be lower by an average 37% over last year.

Floors

The Financial Stability Forum is in discussions over an international leverage ratio which is counter to the Basel II capital rule (paring capital with risk). Also on the table is a reduction in reliance on VAR models and a larger emphasis on stress testing.

Small Business

According to a JD Power and Associates study, small business owners are more satisfied with bank services compared to last year. A key factor for business customers is having a dedicated representative on their account. A simple visit from the account manager at the customer's place of business not only increases satisfaction but may also translate to earnings. By the numbers, if 5% of less satisfied business customers became loyal customers, revenue from increased account balances could jump by 4% (that's $180K/customer in additional revenue).

Checking Value

Research finds an estimated 25% of checking account customers will overdraw their account at least once each year. Unfortunately for banks, studies also find that punitive fees on overdrafts drive 25% of annual customer attrition. Community banks that have not already done so may want to revisit fee structures to waive the first time offense or adjust pricing to hang onto hard-earned customers.