MARK-TO-MARKET ACCOUNTING FOR LOANS

by Steve Brown

Who knew accounting could get so emotional? This is potentially a 3rd rail topic for us, but since we have had many requests to tackle it - please be kind.

We will open by stating our historic position that we are generally fans of mark-to-market accounting for all balance sheet

items (assuming it can be done reasonably accurately), because we believe it boost the quality of risk management. Had we had market-to-market in place back in mid-2007, community banks would have seen spreads for construction and CRE widen that our Loan Pricing Model and other systems underscored and moved to mitigate that risk. Further, banks would be a whole lot more sensitive in creating long term value; as both loans and deposits would be netted (in terms of risk) and potential mismatches could be better seen. Force anyone to mark the balance sheet to a "fair value" and we contend that destructive behavior in terms of pricing, structuring and allocation would change overnight. For those that say banks will not be able to get accurate pricing on loans, in some cases that is very true, but as of 2010, we now have better data points because of all the FDIC sales and improvement in loan pricing and valuation models. While no two loans are the same and models or pricing comps aren't perfect, they add value and offer a consistent and unemotional way to improve risk management. More to the point, if forced to be utilized, valuation models and methodologies will get even more accurate over time.

Before you send an angry e-mail about the discussion above, we also want to quickly state we are not supportive of FASB's current standard for mark-to-market. It is not only unfair since it would change the rules of the game in the middle of the game, but it would also have disastrous effect on capital at a time bankers can ill afford to take yet another capital hit.

Currently, banks treat loans on their books in 1 of 3 ways: held for sale (HFS), at fair value (FV), or and held for investment (HFI). HFS loans are held at the lower of amortized cost or market value. FV loans give the lender the option, but not the obligation, to mark each loan to market each quarter and have changes flow through the income statement. HFI are currently held at amortized cost, with an allowance for losses. HFI loans are by far the most common accounting by banks.

Last May, FASB released the long threatened loan mark-to-market proposal, putting forth a revised accounting standard for loans. The new standard (which is open for comment until Sept) would cause all financial assets, including loans, to be marked to fair value. Any resulting losses/gains would then be taken into comprehensive income. If passed, the proclamation would go into effect by 2013 and drop bank capital levels like a rock. We estimate the average community bank loan portfolio value could be hit by 5% to as much as 30%. In rough figures, we estimate that this single FASB ruling could deplete bank capital another $210B for the industry. In addition to the capital hit, the change in valuation could also cause a downward spiral in commercial real estate prices. This could be ugly, as credit would be constrained at a time when the largest amount of refinancing in history will be taking place (between 2011 and 2013).

While we are generally in favor of the idea of mark-to-market because of its positive risk management implications, the ends do not justify the means on this proposal. FASB is promoting this as a way to protect the investor, but we are unclear of the benefits. We have repeatedly looked at bank valuations and find the markets have roughly approximated the value of banks, given the perceived credit exposure. That is to say, from an equity standpoint, our current structure of amortized cost, loan loss and charge-offs could actually be as accurate as fair value. Until we know, why take the chance in this market?

BANK NEWS

FinReg

President Obama will sign the Dodd-Frank Wall Street Reform and Consumer Protection Act into law today, rewriting the rules governing financial service providers and products. The law is expected to result in some 5,000 pages of new regulations that will need to be followed by banks and could take as long as 3Ys to become fully understood. Unfortunately, we doubt the law does anything to protect the banking system.

Earnings

Wells Fargo announced a net income was up 12% over last year to $3.1B.The driver was a drop in loan provisions by 25% as credit concern eased. State Street brought in $432mm in profits despite a net investment loss of $50mm and a $10mm loan loss provision. M&I posted a $174mm net loss, as non-interest revenue fell 24% from 1Q.

M&A

California General Bank ($58.6mm, CA) will purchase Professional Business Bank ($305mm, CA) for an undisclosed sum. California General will operate 6 branches, $321mm in deposits and $265mm in loans.

Rating Problem

Moody's, S&P and Fitch will no longer allow their ratings to be used in documents for bond sales due to the legal liability created by the Dodd-Frank law. The rating agencies say that because of potential legal exposure, they will not allow bond issuers use their ratings. As a result, this has basically shut down all issuance including securitizations of mortgages, autos, credit cards and student loans.