

A VETERAN LENDER'S TAKE ON FAIR-VALUE ACCOUNTING PROPOSAL

Ed calls it a "step backwards," and a move away from transparency and credibility

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On more than one occasion recently, I've suggested that the quality of our decision-making processes might be materially improved if we were guided more by principles than the application of rules. While originally I was thinking about the sorts of ethical choices the each of us makes most every day, the issue of fair value for accounting of bank loan assets seems to belong in the category of the trumping of rules over principles.

Crux of the lender's argument against fair-value

The Financial Accounting Standards Board, the five-member group that is the custodian of the body of rules governing "generally accepted accounting principles," seems intent on proceeding with the objective of expanding the application of fair-value accounting for bank assets. The proposal is to modify GAAP to require the application of fair-value accounting methodology for bank loans. This means that loans will be subject to accounting adjustments to reflect the value of loans, giving effect to prevailing market rates of interest. (FASB is accepting comments on this through Sept. 30, 2010. For assistance in commenting, from ABA, members can click [here](#). A public page is available for interested investors can be found [here](#).)

What is very different in the case of loans, versus investment securities intended for sale or trading, is that most banks do not ordinarily "trade" loans with any frequency or regularity. (This excepts loans typically originated and ultimately sold, such as home mortgages, through a securitization process.) Instead, banks typically fund loans and hold them to maturity or ultimate collection of principal. Should the loans ultimately be subject to actual or anticipated credit losses, such adjustments to valuation are handled through the Allowance for Loan and Lease Losses. Credit-related assets are normally subject to a valuation type of methodology.

There are several principles enshrined in financial accounting that are currently-and have for a very long time been-generally accepted accounting principles.

Historical cost. A key principle is that assets are recorded on the books of the acquirer at historical cost. Using the example of a bank loan, subsequent changes to value of the loan, to account for the possible non-collection of principal in full, are accomplished by a formal valuation reserve (such as the loan loss allowance). Other assets can be subject to a similar valuation reserve or by direct charge down to reflect economic impairment of the asset.

Lending versus "useful life" perspective. Another key principle is that the consumption or use of a capital asset is governed by the concept of "useful life," and the allocation of a portion of the useful life by month, quarter, or year. This is called "accrual accounting." Periodic accruals are the means for adjusting carrying value of the asset to account for its use or consumption. Although loans are not subject to "consumption-type" accruals, bankers typically set an amortization schedule that is less than the useful life of the underlying capital asset or purpose of the loan. This roots accounting for loans firmly within GAAP as it has been taught, understood, and practiced for a great many years.

Where values should appear. A third key principle is that all adjustments to the assets or liabilities on an entity's balance sheet are run through the equity accounts. In my early days, as a trainee, at The Bank of New York, credit analysts always reconciled surplus. In my early days as a trainee, I thought it was just a "fussy" rule. But I came to appreciate that it was an excellent way to check for consistency of presentation of financial statements. If surplus didn't reconcile, something was wrong. In the new mark-to-market methodology, there would actually be a second bottom line that highlights the difference between fair value of loans and GAAP as applied to all the other bank assets.

60/40 is "generally accepted"? One final point about GAAP. FASB is composed of five individuals, each highly qualified accounting professionals from both industry and academia. At the present time, the present board is reportedly split three to two in favor of applying fair value accounting to bank loans. (FASB's Chairman recently announced his impending retirement, and an expansion of the board is coming.) With this sort of split-60/40-it undermines the notion that such a rule would become "generally accepted." This is simply wrong headed.

So...why are things headed this way?

The proponents of fair value say that the process will improve transparency of bank financial statements and improve the methodology of valuing assets to give effect to the income stream adjusted for current levels of market rates. Opponents of fair-value accounting for loans cite the added complexity in the financial statement presentation, interpretation, and comprehension.

It's possible that both sides are correct in the views they hold, in some sense.

But I'm troubled by another thought.

Can one imagine an advocate of a position such as fair-value accounting as being so right that he or she is wrong? Said another way, "Does too sharp a pencil rip the paper?"

After all, banks learned decades ago how to better manage interest rate gap by shortening the stated maturities of loans and synching loan rates with the maturities of interest-bearing liabilities. Long ago we as an industry also began to loan money for longer-term uses while adjusting the maturities of our loan assets to provide opportunities to reevaluate creditworthiness of the borrower as well as resetting rates of interest.

The additional process of marking loan assets to fair value and producing a "second bottom line" of income statement results seems to take us and the users of our financial statements in the opposite direction from the stated intent of enhancing transparency and credibility.

To me, this is a step backwards and designed to satisfy mainly those who feel that a sure sign of progress is to be found in increasing complexity rather than simplification.

It's another possible triumph of those who find it more satisfactory to follow rules than apply principles. Lenders will want to pay close attention to the results of FASB's deliberations in the wake of the comments on this controversial proposal.

For another perspective on fair-value accounting, also in opposition, see ALCO BEAT's guest columnist George Darling in his article, "Fair-value accounting as new 'GAAP'? That's unacceptable!" [Click here](#)

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