

## U.S. Institutional Investors Strongly Oppose FASB Proposal on Fair Value for Bank Loans

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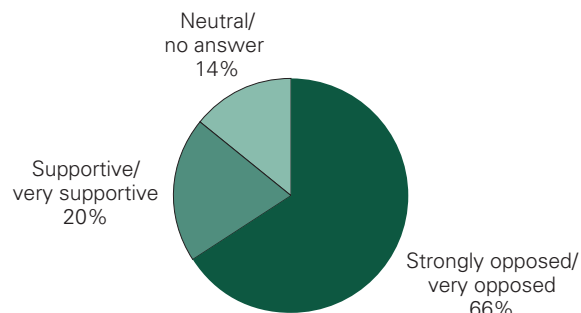
More than two-thirds of large institutional investors in the United States oppose a proposal by the Financial Accounting Standards Board (FASB) that would mandate fair value accounting treatment for most bank loans. Between 40% and 45% of institutions say the expansion of “mark-to-market” rules for bank loans would cause them to reduce their level of investment in U.S. banks.

In September 2010, Greenwich Associates teamed with Keefe, Bruyette & Woods (KBW) to interview large U.S. institutions about their level of understanding of and support for a series of proposals contained in an exposure draft on bank accounting for financial instruments issued by the Financial Accounting Standards Board in May. Among the key changes proposed in that draft is an expansion of fair value accounting rules that would require banks to report the value of most loans on their books at “market value” alongside current cost accounting valuations. The comment period on the draft exposure closed on September 30, 2010, with a vote on the proposals expected later this year.

From September 8 to September 20, Greenwich Associates and KBW surveyed 62 U.S. institutions about the FASB proposals. More than 40% of these institutions have assets under management of \$30 billion or more, and institutions participating in the study manage more than \$1 trillion in aggregate.

Approximately 20% of the institutions favor FASB’s proposal to require fair value accounting for most bank loans. Meanwhile, almost 55% of the institutions say they are “strongly opposed” to the proposal, with another 10–15% describing themselves as “opposed.”

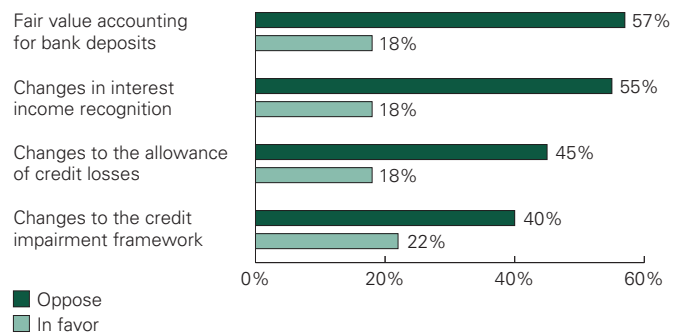
### FASB Finds Little Support Among U.S. Institutions



Note: Based on responses from 56 institutions.  
 Source: 2010 Greenwich Market Pulse — FASB Regulation

The study results reveal significant institutional opposition to several specific provisions contained in the FASB exposure draft:

### Significant Institutional Opposition to Specific Provisions in FASB Proposal



Note: Based on responses from 56 institutions.  
 Source: 2010 Greenwich Market Pulse — FASB Regulation

“FASB’s mission is to provide useful information to investors, and the current proposal to expand fair value reporting on bank balance sheets is intended to improve the quality of information available to investors,” says Thomas Michaud, Vice Chairman and President of Keefe, Bruyette & Woods. “But the results of this study demonstrate that a large majority of U.S. institutional investors think FASB is taking the wrong approach.”

### Objections to FASB Proposal

Many of the institutions participating in the Greenwich Associates/KBW study believe current accounting standards are inadequate and need to be revised.

However, the study results demonstrate that institutional investors do not see an extension of fair value accounting as a step in the right direction. Institutions’ primary objections to fair value accounting appear two-fold.

*Determining Fair Value:* First, institutions believe mark-to-market valuations would not be helpful in making investment decisions because fair market values for loans held on banks’ books and other infrequently traded financial instruments would not be reliable — particularly in difficult market conditions.

In part, institutions distrust estimates of fair value. Because the process of determining fair market value would have to include countless variables, many institutions doubt that accurate and consistent fair market valuations can be determined for these instruments. “Fair value for the vast

## Institutions Keeping Close Tabs on FASB Proposal

Two-thirds of the institutions say they are familiar with the broad accounting model proposed by the FASB for financial instruments, including one-third of study participants describing themselves as “very familiar” with the model. Only about one-in-10 institutions say they are not familiar with the new accounting model suggested in the FASB exposure draft.

### Institutions Are Well-Informed About FASB Proposals

	Not Very Familiar	Very Familiar
Fair value loan accounting	16%	84%
Change in interest income recognition	24%	55%
Changes in reserve methodology	16%	73%
Changes to credit impairment framework	24%	57%
Fair value of deposits	31%	53%

Note: Based on responses from 56 institutions.  
Source: 2010 Greenwich Market Pulse — FASB Regulation

Institutions are even more confident in their own understanding of the FASB’s specific proposals to extend fair value accounting to most bank loans. Almost 85% of institutions say they are familiar with this proposal, including about half of institutions describing themselves as “very familiar.” Institutions’ level of familiarity falls off to some extent for other specific provisions in the exposure draft. However, the fact that more than half of institutions describe themselves as familiar with complicated proposals regarding changes in bank interest income recognition, the allowance of credit losses, the credit impairment framework, and the accounting treatment of bank deposits illustrates the importance the investment community attaches to these accounting issues.

Only about 30% of institutions say they are familiar with a related proposal issued by the International Accounting Standards Board (IASB). The IASB is a London-based organization charged with developing International Financial Reporting Standards (IFRS). In 2002, the IASB and FASB agreed to work toward convergence to a single set of global accounting standards. That “convergence” process is still underway and seems to have hit a snag in the form of competing proposals issued by the two bodies on fair value accounting. In general, the FASB proposal goes much farther than the IASB initiative in extending fair value accounting to banks’ loans and other financial instruments.

majority of loans is not available because there are simply too many inputs and business decisions surrounding them,” says one analyst. “To suggest that loan X can be ‘valued’ simply given an index value, some level of interest rates and an assumed LTV is grossly misunderstanding the business of banking. Banking does not fit into buckets of fair value as so many MBS and ABS portfolios do. I do not believe fair value can be gauged with any degree of accuracy, and any attempt will provide figures that only cloud reality. Fair value is simply not possible.”

Beyond the challenges inherent in the valuation process, institutions are concerned about the subjectivity that an extension of fair value will introduce into the reporting

process. “I’d be forced to look at an information set whose underlying construct would be very dubious,” explains an analyst. “The proposal wouldn’t improve my assessment of the economic returns of the businesses I would potentially be investing in.”

“It would seriously degrade the comparability of company financial statements by giving management significantly more discretion,” says a portfolio manager. “I have no doubt more management teams will cheat to enhance their current earnings picture, which will provide excellent shorting opportunities.”

*Introducing More Volatility:* The second major objection expressed by institutions about the fair value extension is a fear that variations in reported fair market values will magnify cyclicality in bank earnings and the economy as a whole. Many institutions commented on these concerns:

“I would imagine short-term traders would be delighted by the adoption of fair value accounting because of the volatility it would introduce,” says one analyst. “I try to look at the longer-term view of the business, and make my credit analysis serve that purpose. Quarter-to-quarter volatility of balance sheet item carrying values with inadequate disclosure of how they are calculated does not help me.”

“I don’t believe the fair value approach proposed will improve understanding of banks,” adds another analyst. “It will simply play into the hands of speculators who want short-term volatility.”

“It would make the banks more at risk for liquidity-induced runs due to the high variability of the equity base,” says an analyst at a \$30 billion+ investment management firm. “FASB is wrong to assume that you can separate accounting and regulatory capital.”

### Alternatives to Mark-to-Market

Although institutional investors acknowledge that current reporting standards for banks require reform, most do not see the fair value provisions of the FASB proposal as an improvement to existing accounting rules. As one analyst explains, “Contrary to FASB’s position that constructing a hypothetical fair value for nearly all balance sheet items provides ‘useful information’, the proposed changes would meaningfully degrade the usefulness of the reporting by most major financial services firms.”

Instead, institutions say they would prefer rule changes that increase transparency and provide enhanced disclosure of information on specific bank portfolio holdings. In fact, approximately 65% of the institutions participating in the study believe FASB’s recently issued accounting standards update requiring enhanced disclosures about the reporting of credit quality and allowance for loan

losses will provide more useful information to investors than the proposed fair value of loan receivables.

As one analyst explained: “It would be more helpful to have consistent LTV, interest coverage, maturity, geographic breakdown by type of loan and origination than an arbitrary fair value account. This helps investors make their own assessment of valuation — not some management-judged fair value.”

“FASB should drop its fair value proposals for the loans and deposits and focus on greater disclosure of actually helpful information like LTV, interest coverage, geographic information,” continues the analyst.

“I don’t think fair value would improve the usefulness of the information if it’s not readily determinable from independent sources,” adds another analyst. “More disclosure about credit quality and exposures would be helpful in periods when they are not causing material losses.”

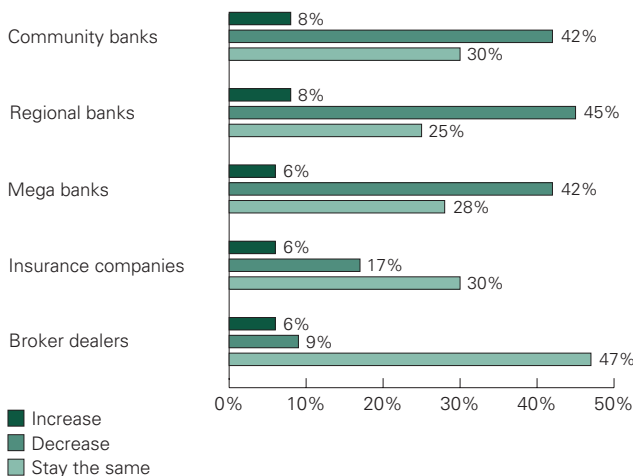
Finally, 70% of institutions would favor an alternative proposal that would require banks to include enhanced disclosures about fair value in 10Q/10K reporting, but not on the balance sheet. Only 15–20% of institutions would oppose such a requirement.

### Proposed Changes Would Reduce Institutional Investment in U.S. Banks

The study results suggest that implementation of the current FASB proposal would have a negative impact on the ability of small and large U.S. banks to raise capital.

Forty-three percent of institutions say they will reduce their investments in U.S. banks if the current FASB proposal is implemented. That share includes 11% of institutions

#### Proposed FASB Rules Would Reduce Investment in Banks



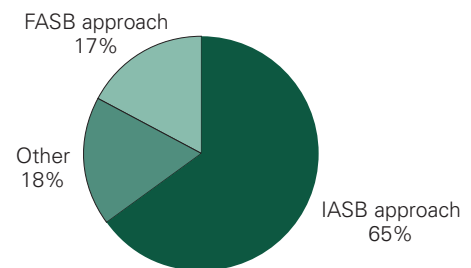
Note: Based on responses from 53 institutions.  
Source: 2010 Greenwich Market Pulse — FASB Regulation

saying they would “significantly decrease” their level of investment. At the opposite extreme, only one-in-10 institutions say they would increase its level of bank sector investing if the FASB proposal is approved.

Slightly more than 40% of institutions say they will reduce their level of investment in “mega-banks” if the proposal is approved in existing form, and a comparable share say they will decrease their investments in community banks. Forty-five percent of institutions say they will reduce their investments in regional banks if the proposal is approved. Only 5–10% of institutions say implementation of the current proposal would prompt them to increase their level of investment in any of the three categories of U.S. banks. Roughly one-third of institutions say implementation of the current FASB proposal would cause them to reduce their level of investment in non-bank financials.

An analyst explains why he believes implementation of the current FASB proposal would reduce the flow of investment capital into the U.S. banking sector: “For a financials specialist, FASB’s proposal would significantly increase the resources required to allocate capital to the financial services sector by requiring investors to work around, on a one-off basis, the impact of FASB’s counter-productive proposal for each prospective portfolio investment. For non-specialists, FASB’s proposal would push the marginal investor away from a sector that would be deemed too difficult to analyze.”

#### Institutions That Oppose FASB Proposal Welcome IASB Approach



Note: Based on responses from 43 institutions.  
Source: 2010 Greenwich Market Pulse — FASB Regulation

#### Conclusion

The fact that roughly two-thirds of U.S. institutions oppose the fair value proposals contained in the FASB exposure draft should give FASB board members cause to rethink their approach before voting on the final rule revisions later this year.

As Greenwich Associates consultant Don Raftery concludes, “Given the results of this study, the best way forward seems clear: The FASB should adjust its proposal to be more in line with the IASB approach while mandating enhanced disclosure of portfolio details related to loan type, geog-

raphy, loan-to-value, interest coverage and other type of information that help investors conduct their own analysis and valuation.”

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*Thomas Michaud is Vice Chairman and President of Keefe, Bruyette & Woods.*

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## **Methodology**

*Greenwich Associates surveyed 62 U.S. institutions about their level of understanding and support for a series of proposals contained in an exposure draft on bank accounting for financial instruments issued by the Financial Accounting Standards Board (FASB) in May 2010. Surveys were conducted via the internet from September 8 through September 20, 2010.*

*The findings reported in this document reflect solely the views reported to Greenwich Associates by the research participants. They do not represent opinions or endorsements by Greenwich Associates or its staff. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Greenwich Associates compiles the data received, conducts statistical analysis and review for presentation purposes in order to produce the final results.*

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